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# **Inward Foreign Direct Investment and Constitutional Change in Scotland**

## **Introduction**

A referendum on Scottish independence from the United Kingdom takes place on 18 September 2014. A vote in favour of independence will lead to the break-up of a union which has existed since 1707, with a planned independence date, following negotiations, set for 24 March 2016. Between the referendum and the planned independence date, a UK General Election will be held, in which the issue of UK membership of the European Union will loom large (Appendix 1).

Independence will have far-reaching and irreversible implications for the economies of both Scotland and the rest of the UK (rUK) and their businesses and stakeholders. The original and ultimate “single market”, in which economies north and south of the border are totally integrated, will be dissolved. Businesses which operated freely across borders will overnight become exporters, importers and multinational enterprises (MNEs) (and movement of people becomes international migration). This paper focuses more narrowly on the implications of constitutional change for inward foreign direct investment (FDI) and overseas -owned MNEs in Scotland, although some observations are also made on the wider international business scene in Scotland and rUK because of the integrated nature of much business activity.

In the period after 1945, the attraction of inward FDI was a key policy instrument of the UK government to deal with deindustrialization and regional disparities in income, and Scotland was very successful in attracting overseas-owned enterprises (Dimitratos *et al.*, 2009). Inward FDI attraction, especially from the USA, has continued to be as an important policy instrument to the present day and makes a crucial contribution to the economy. Sustaining and enhancing the contribution of

inward investment will be essential in any independent Scotland. The key issue and focus of this paper is thus the potential implications of independence for inward FDI in Scotland.

MNEs operate within a variety of political regimes in their regional and global operations and hence are not unaccustomed to political and economic risks. Political risk is associated with host (usually) government interference with business operations (Kobrin, 1979) and may take many forms. But secessions present challenges and opportunities which are ubiquitous; and being relatively uncommon, MNEs and their subsidiaries are hence less experienced in their management.

Following this introduction, the paper provides a brief overview of the institutional environment for international business in Scotland and the Scottish Government's economic strategy. The next section reviews the background of inward foreign investment in Scotland, followed by an assessment of the current landscape and performance of inward FDI and the implications for the foreign-owned sector in an independent Scotland. The final sections consider the opportunities and challenges for the future of an independent Scotland; and the influences of political risks and uncertainties on investor strategies.

### **The Country and Institutional Background**

For several decades after 1945, Scotland continued to suffer from industrial decline, a legacy of its heavy engineering past, with per capita GDP growth and other measures of economic well-being remaining lower than the rest of the UK. It was this which led in 1979 to the so-called Barnett formula which (still today) provides a block grant to partially offset income differentials in the poorer regions of the UK (McCrone, 2013). This has meant that public expenditure in Scotland is around 10 percent higher than

the UK average. However Scotland's economic circumstances have changed substantially, due in significant part to the success of inward FDI. The performance of the Scottish economy has been similar to the UK average for more than a decade and on various measures of economic performance is nearer to the UK average than regions outside London and the South East of England, although this is in part due out-migration (McGregor and Swales, 2013). By the measure of labour productivity, both Scotland and the UK are close to the OECD average. (For an overview of recent developments in the Scottish economy, see Liddell *et al.*, 2014).

Constitutionally the Scottish Parliament was established in 1999, bringing with it a series of devolved decision-making powers (Appendix 1). However, Scotland has had a high level of independence for many years in areas of economic and industrial development. Since 2001 international business policy has been implemented through Scottish Development International (SDI): its formation was associated with a radical rethink in approach following the virtual demise of electronics, focusing upon "global connections" and designed to build a globally integrated economy (Scottish Executive, 2001a, b). This has led to stronger emphasis in favour of exporting, but also to a wider perspective on target sectors and countries for investment (Table 1) (Scottish Government, 2007; SDI, 2011).

Insert Table 1 near here

### **Inward Foreign Direct Investment into Scotland**

For four decades following 1945, Scotland was both a welcoming and attractive location for greenfield, market-seeking FDI in manufacturing industry, largely from the USA. The principal determinants were regional financial assistance, the

availability of low cost labour and the English language. Competition in this period was mainly from Ireland and to some extent Spain. Within a largely healthy scene, there was also significant volatility. In the late 1970s this was associated with technological restructuring as electronics replaced mechanical engineering, and pan-European strategies were evolving with integrated supply chains. More significant was the next stage of multinational integration from regional to global strategies which in the 1990s was associated with plant closures and relocations to Eastern Europe and East Asia and a devastating collapse in the electronics industry in “Silicon Glen” (Dimitratos *et al.*, 2009). Fundamentally Scotland was a “branch plant economy” where footloose foreign-owned firms were weakly embedded in the local milieu, representing “competence-exploiting” as opposed to “competence-creating” FDI (Cantwell and Mudambi, 2005). Still, the foreign-owned sector remained through this period as the most productive, best-paying, innovative and export-oriented group of manufacturing firms in Scotland (Dimitratos *et al.*, 2009).

#### *The inward FDI landscape today*

The estimates of overall trends of FDI into Scotland over the period 2003-2012 are shown in Appendix 2. In total 745 projects were attracted over the period, generating 76,000 new jobs and £24.6bn. in capital expenditure. While no direct comparisons are possible with earlier years, the data show a continuance of the long-term trend to smaller projects, especially in terms of employment creation: during this period, the average project generated 102 jobs with capital investment of \$33mn. The US was the main source country accounting for 40 percent of projects. There was also significant concentration by sector: for example, coal, oil & gas plus renewable energy represented over 50 percent of all capital investment (but only 13% of jobs); whereas

food, drink & tobacco was the top job creator (11,658 jobs, 15.2% of the total).

Despite this concentration, outside the top ten the category of “Other sectors” represented 38 percent of projects and 40 percent of jobs.

Using a different data source (Ernst & Young, 2012, 2013[1]), within a UK context Scottish performance regarding inward FDI attraction has been striking in the recent past. In 2012, the country was ranked 2<sup>nd</sup> among the twelve UK regions in terms of both number of *projects* (11% of total, with London #1) and *job creation* (16%, with the North West of England #1). In 2011, Scotland’s share of *projects* was a much smaller 7.5 percent (ranked #3), but it was leading location for *job creation* as it had been in 2010. Ernst & Young (2012: 17) suggest “this strong performance may reflect the committed approach of Scottish Development International over many years”.

It is significant that pre-referendum Scotland is already heading in a different sectoral direction to that of the UK as a whole, where business services and software were the most important sectors in 2012; machinery & equipment, electronics and automotive components were also represented in the UK top 10 by share of projects (Ernst & Young, 2013). While strong in FDI R&D projects, still the UK as a whole struggles in manufacturing (and Scotland may be facing a particularly acute challenge). Bell (2011) argues that Scottish manufacturing is retrenching to industries like food and drink where it had a comparative advantage but where innovation is weak.

Overall, the Scottish economy is highly dependent upon foreign-owned MNEs for employment, investment and research & development (R&D)[2]. One outcome, shown in Table 2, is that in the large firm category (>250 employees) foreign investors represented nearly 50 percent of jobs and 70 percent of turnover in

manufacturing, rising to 71 percent and 85 percent if rUK investors are included. (The significance of rUK investors is of course a measure of integration within the UK single market). Although the figures are less dramatic when all employee size bands are included, MNE subsidiaries are still a major presence in manufacturing especially by the measure of turnover. Other data (Leonard, 2013) have indicated that the level of overseas ownership (i.e. excluding rUK) in the largest enterprises (>250 employees) increased significantly between 2002 and 2012.

Insert Table 2 near here

Even more striking are the figures for R&D (Table 3): in manufacturing, overseas-owned MNEs accounted for 73 percent of R&D spend, with the US as the major contributor; considering all sectors the share was only slightly lower at 65 percent. Regrettably data are not available on the embeddedness of this R&D within the local milieu.

Insert Table 3 here

These inward FDI characteristics are positive and an indicator of Scotland's attractiveness and openness in the global economy. A central issue remains the performance of the indigenous private sector: maximizing the benefits from inward FDI requires a strong domestic industry possessing the capabilities and capacity to absorb technology and to generate positive linkage and spillover benefits. However, innovativeness in Scotland is weak on key innovation-related measures, including entrepreneurship, the business birth rate, R&D, and innovation activity:

### *Entrepreneurship*

- The proportion of people of working age intending to start a business (in the next three years) is well below the UK average; but English migrants and rest of world immigrants to Scotland are more entrepreneurial than their non-migrant peers (Levie, 2013).

### *Business birth rate*

- In 2012 Scotland represented 8.8% of the UK population with 6.3% of business births and 6.7% of business deaths; and ranked 8<sup>th</sup> equal among 12 UK regions and states in 2012 (ONS, 2011).

### *Research and Development*

- Business enterprise R&D in Scotland was 0.59% of Scottish GDP in 2012 compared with 1.09% for the UK (Scottish Government, 2013b). Given the dominance of R&D in Scotland by inward investors, the weakness of indigenous research and development is problematic.

### *Innovation activity*

- In 2011 Scotland had 33% innovation-active firms compared with 37% in UK. If Scotland is to match UK figure, 500 additional innovation-active firms would be required (Turnbull and Richmond, 2013).

## **Scotland's Natural Resources and Priority Sectors**

### *Natural resource FDI*

Unlike the market- and efficiency-seeking focus of FDI attraction in the past, current patterns indicate greater diversity, and especially a much stronger performance in natural resource-seeking FDI (see Table 4). Diversity is beneficial as the impact of volatility and decline in the dominant overseas-owned electronics industry in the

1980s and 1990s revealed (Young *et al.*, 1993). Natural resource-seeking FDI has shown significant expansion; this has been boosted by the growth of renewables where Scotland has strong natural and geographic advantages onshore and offshore for wind, wave and tidal power, with substantial expertise from oil and gas and power generation industries (CSAs).

Over the 2003-2012 period, the four sectoral groupings accounted for 33.9 percent of employment and 61.9 percent of capital spending within the FDI total in Scotland. Such investment is different, for example, from market- and footloose efficiency-seeking FDI in a number of ways: First, natural-resource-seeking investment is location-bound and immobile by definition, although there could be a “drifting-away” effect in the face of uncertainty; and second, it is not internationally contestable in the same way as market/efficiency-seeking FDI and, therefore, may not face the same scrutiny regarding investment competitiveness and contribution. Still, the sectors are very heterogeneous: for example, some (e.g. oil and gas) are highly capital intensive with limited job creation[3]; whereas others like food and tourism are generally labour-intensive with a predominance of small firms.

Insert Table 4 near here

### *Growth sectors*

Recent government trade and investment strategy identified a number of “Growth” sectors (Table 1) which have the potential to make a significant contribution to development due to: i) distinctive capabilities and the potential for international success; ii) providing regional diversity; and iii) overcoming market failures through government intervention. Encompassing the natural-resource based industries, these

growth sectors have high levels of Scottish ownership overall, which may be desirable from a Scottish government perspective. Thus some have a dominance of very small firms (SMEs) and are clearly important for sustaining vulnerable and fragile rural economies, tourism being a particular case (Scottish Government, 2009a). Food & drink generally fits into this category too with low rates of R&D and levels of skills, and a productivity level only 40 percent of foreign-owned MNEs in the sector (Scottish Government, 2009b). Consolidation is required in these fragmented and small firm sectors. Life sciences has potential associated with the strong science base in Scottish universities but it too lacks critical mass (Scottish Government, 2009c[4]).

#### *Export performance*

Trade performance will become an increasingly significant imperative if Scotland votes for independence, but also challenging as the country is peripheral to international markets raising transaction costs. The possibility of border controls with rUK and the more generally negative ‘border effects’ (UK Treasury, 2013) are likely to damage (two-way) trade relations. Market-seeking MNE subsidiaries in Scotland serving EU and worldwide markets could suffer as the rUK will remain a major export destination. A drive for enhanced competitiveness will be critical in these circumstances. Estimated rUK data are provided by the Scottish Government and these are included in Tables 5 and 6 which follow (see also Dept of BIS, 2013).

Although export data are not available by ownership, it is possible to provide some interpretation linked to the inward FDI theme, given the size dominance of MNE subsidiaries and their sectoral patterns. For example, about 30 percent of international exports are derived from around 10 companies; and 50 percent from about 50 businesses). Furthermore, large companies (>250 employees) accounted for

57 percent of international exports in 2012 and 64 percent of exports to rUK (Scottish Government, 2014).

Insert Table 5 near here

Table 5 shows the top 10 export industries distinguishing exports to international and rUK markets. Food & beverages are ranked #1 and #4 respectively for the two areas. Whisky (substantially foreign-owned) is by far the largest constituent of food & beverage manufacturing at £3.9 billion. Financial and insurance services is ranked #1 in exports to rUK, where the large Scottish registered companies, RBS, Lloyds and Standard Chartered are major export players[5].

Insert Table 6 near here

The importance of rUK as an export destination is highlighted clearly in Table 6: rUK exports in 2012 were valued at £45.6 billion in comparison with sales to the #1 international destination – USA - of £3.6 billion and to all international destinations of £26 billion.

### *Synthesis*

This section of the paper has focused upon the role of inward FDI and MNEs in the economy. Coming into the independence referendum, the Scottish economy is performing generally well in a UK context, both in terms of overall economic performance and FDI attraction. There is more diversity than hitherto and country's strengths in immobile natural resources (CSAs) provide some protection from

uncertainty, although the “growth sectors” are a mixed bag. Weaknesses (weak FSAs) exist in technologically advanced manufacturing industry; and as has been the case for many years the overseas-owned sector needs stronger integration into the economy, through improved levels of innovation and absorptive capacity in the domestic private sector. There were thus big challenges ahead even before the proposals for Scottish independence.

### **Constitutional Change, International Business and Inward Foreign Direct Investment**

In this section, the focus is on the implications of potential independence, emphasizing the inward investment and international business dimensions. The determinants of inward FDI are well known from the literature, including: a) Market size and growth potential; b) Openness; c) Skilled workforce availability; d) Clustering / agglomeration potential; and e) Business climate, including political stability and good governance (Driffield et al, 2013; Rugman, 2009; Walsh and Yu, 2010; Wheeler and Mody, 1992). The evidence on these factors is mixed and strongly contextual in terms of country type, sector, firm and investment motivations (Ernst & Young, 2012, 2013). But the basic fact is that political instability and institutional change and uncertainty are problematic for foreign investors. The high sunk costs of capital intensive FDI projects (e.g. oil & gas, renewables), for example, makes investors highly sensitive to political risk.

The opportunities and challenges facing the economy and businesses and their stakeholders are ubiquitous and a summary is presented in Table 7. These are drawn *inter alia* from recent studies published by governments both sides of the border; consultants and think-tanks, and academic institutions.

Table 7 near here

### *Challenges of transition*

The most obvious challenges are those derived from the transitional arrangements required by a break-up of the UK. These negotiations will inevitably be problematic and costly for both Scotland and rUK, with considerable risks and uncertainties for international business (as well as for domestic business and the population at large). The big contentious issues include: monetary policy (particularly Scottish currency and potential currency union with rUK); fiscal policy (debt sharing, public expenditure, taxation and welfare payments); EU membership and associated questions (including adoption of the Euro, Treaty on Stability, Schengen Agreement and border controls, and UK budget rebate); there are also specific sectoral factors particularly in Energy, Defence (and the removal of UK military bases), and Banking & Financial services[6].

These transitional costs will take a number of forms (see also Young, 2014):

1. *Institutional*: It has been indicated that 200 UK public bodies will need to be re-created, and that there are 36 national regulators in UK that provide regulatory functions in Scotland which will need (Dept. of BIS, 2013); and other evidence is cited indicating costs of £15 million to establish or reorganize a single policy department. For SDI, operating internationally means building new export policy arrangements: the White Paper (Scottish Government, 2013a) proposes 70-90 diplomatic missions overseas, at a cost of £90-120 million assuming sharing takes place with rUK or other countries' offices. Applications will also be required to achieve membership of a range of international organizations

including EU, WTO, IMF, OECD and NATO. Although Scotland would be assumed to meet most of the membership criteria (EU membership is potentially more challenging), it remains the case that the process of accession could well be protracted. Interestingly there has been little comment on the World Trade Organization which will require commitments in significant areas such as rules on national treatment and expropriation[7].

2. *Transactional*: These include the costs of transferring or developing new administrative systems which relate to the loss of scale economies and the need for duplication of activities now spread across the UK; negotiating costs; human resource capacity and capability constraints creating inefficiency costs; and political costs in respect of managing expectations.
3. *Fiscal, monetary and exchange rate policy*: These concern restructuring taxation and government spending; debt sharing and management; interest rates and currency relationships. The debate over a currency union is a critical one which would require Scotland ceding some sovereignty on budgetary matters: the UK Government and other political parties have to this point rejected the Scottish Government's proposals (see Saunders *et al.*, 2014). The currency issue has implications for EU membership which could be blocked if Scotland did not have a lender of last resort
4. *The Border*: Studies of Canada/USA and Czech Republic/Slovakia show significant 'border effects' in reducing trade (UK Treasury, 2013); and a major thrust of Irish Government policy after independence was to reduce the country's dependence on UK trade (Bradley, 2014). While the latter may be unlikely in the Scottish case, still Scotland and rUK will face "liabilities of foreignness" (Zaheer, 1995) with each other after independence. Scottish

businesses will be encouraged to look for new markets. There is recognition of the need to take advantage of higher growth emerging markets, in particular China, India and Middle East (Scottish Government, 2007), although the experience of the UK as a whole has been poor to date.

5. *Risks and uncertainties* These relate to: a) political risk or uncertainty about future public policies leading to a risk premium; b) default risk because of the creditworthiness of both the UK and Scotland; and c) currency risk arising from exchange risk uncertainties. Borrowing costs are likely to rise because of lenders' fears about these uncertainties. One example is the Scottish Government's threat to default on its share of UK national debt if a currency union is not agreed, which would lead to a default premium (Saunders *et al.*, 2014).

The period of "transition" is of unknown duration, and will vary by sector. Much depends on the negotiating stance taken by the UK and Scottish Governments and the balance between cooperation and division. Positively, in an analysis of peaceful secessions, it was found that: a) secession is irrevocable; b) policies in the two states diverge; c) the *settlement is made quickly*; d) the settlement is accomplished constitutionally; and e) the government is broadened and strengthened on both sides, and there is a premium on solidarity (Young 1994a,b). Even so the date set for independence of March 2016 does appear to be optimistic.

### *Opportunities*

The potential opportunities from independence are much softer than their cost and uncertainty counterparts; and, moreover, incorporate imperatives facing the economy

for a lengthy period from the past, and in some cases could have been progressed using existing devolved powers (See also *Oxford Economics*, 2014:80).

Yet there are opportunities such as the potential for better tailoring of policy measures to match the country's potential. Edinburgh will grow as the capital city of an independent country; and research by the *Centre for Cities* (2014) revealed that in the 2010-2012 years, Edinburgh was ranked #2 in the UK for private sector job creation after London. Aside from greater investment by business services firms, counterintuitively there may be some potential for attracting regional headquarters of MNEs (especially if corporate taxes are lowered). "Brand Scotland" should further be enhanced by independence, and includes the requirement for brand development in FDI attraction: in evidence to a UK Select Committee, SDI (2012) admitted that "potential investors are unaware of the benefits of locating in Scotland in terms of...skills, research base, infrastructure etc". The Scottish Government is placing great store on renewable technologies as a mechanism for reindustrialization, and Table 8 provides a brief case of this sector and initiatives being pursued.

Insert Table 8 near here

### **Managing Political Risk**

Political risk is usually associated with host government interference with business operations (Boddewyn and Brewer, 1994; Kobrin, 1979). Managing political risk requires i) protecting new and existing operations and investments domestically and internationally; and ii) exploiting the opportunities arising from constitutional change - in the interests of stakeholders (shareholders, customers, employees) (PwC, 2006) - during the hiatus of uncertainty of indeterminate duration if Scotland votes for

independence. Each company needs to consider its own situation and make contingency plans, first, for the short-term to protect the business for stakeholders and manage change; and, second, for the medium/long-term to take strategic decisions on international business operations.

Interpreting the patterns and evidence on inward FDI in Scotland, conceptually the impact of independence in terms of *Degree of political risks and uncertainties* may be presented as a 2x2 matrix where the horizontal axis is represented by the *Market scope* of the foreign MNE subsidiary (Scotland/rUK or Regional/Global) and the vertical axis by *Operations mode* (Exports or Value chain integration). There are thus four categories of inward investors:

- Cell 1 is characteristic of subsidiaries which primarily operate domestically and export to rUK. Uncertainty is high because of the “border effect”: aside from the likelihood of border controls, there are also emergent liabilities of foreignness. Hotels and tourism are good illustration given the high numbers of short-break visitors from rUK to Scotland. Renewable energy is in a similar position where substantial exports take place to rUK; and financial services too.
- Subsidiaries in Cell 2 are rUK focused but their business model is more complex than those in Cell 1, involving two-way flows of products and services / raw materials and semi-finished goods. There may be many companies operating as sellers and buyers or managing more complex value chains in the former single market. Data show that in terms of integration into supply chains, Scotland is much more integrated with rUK than the rest of the world. Across all industries, 60 percent of inputs are sourced in Scotland, 30 percent from rUK, and 10 percent from the rest of the world (Dept of BIS, 2013; UK Treasury, 2013).

- Cell 3 firms comprise regionally/globally focused exporters. Food and drink exporters (whisky by far the largest, but salmon farming too) provide good illustrations. And generally, assuming a supportive business environment, there would be opportunities for firms for which “UK markets are less important than international sales” such as “machinery & equipment and computers and electronics” (Oxford Economics, 2014; see also MacKay, 2014).
- Cell 4 firms comprise MNE subsidiaries operating within integrated regional/global (but primarily the former) value chains. In the past the electronics companies were in this category and were highly vulnerable to changing international cost competitiveness. At present there are fewer subsidiaries in this situation, but reorganization of Scotland/rUK activities within such value chains will be necessary.

Insert Figure 3 near here

To complete the model, specifically sectoral factors need to be included, especially in the high political risk industries of energy (particularly oil & gas but also renewables and utilities); banking & financial services; and defence. The energy sector is highly complex: oil & gas is immobile with high sunk costs and subject to continuing government intervention, beginning with negotiating Scotland’s oil share. Oil and gas revenues are volatile and declining but still of considerable importance. High capital intensity means that returns accrue primarily to shareholders, the bulk of whom are not Scottish residents, and hence uncertainty may lead to higher outflows of profits. In addition, there are problematic questions over tax relief guarantees on the decommissioning of oil & gas infrastructure to encourage continuing investment

activity (estimated at £30 billion) which could influence FDI decisions. There are also substantial flows of subsidized renewable energy-generated electricity flowing into the English market which will be a negotiating issue between the rUK and Scottish governments if independence occurs (*The Economist*, 2014).

Banking, insurance & financial services is a huge sector relative to the size of the economy. The Scottish registered behemoths RBS, Lloyds and Standard Life will become Scottish-owned MNEs; and are taking steps to protect their interests by registering new companies in rUK which could include headquarters functions. Similar behaviour is to be expected among overseas-owned subsidiaries. In defence, shipbuilding is currently dependent upon orders from the Ministry of Defence. Job cuts were announced across the UK in early 2014 and an independence vote could lead to the curtailment of Royal Navy contracts; and linked to this is the commitment to close the nuclear submarine base in Scotland (a long-term project).

For the parent MNEs (substantially US-based) of Scottish subsidiaries, concerns over an independence vote will be especially high where the latter represent one or more of the following: i) a high proportion of the group assets, operations or international revenues; ii) a central role within regional/global supply chains and the “global factory”; iii) an important location for innovation hubs and decision centres for the MNE group; and iv) expansion plans in Scotland are at an advanced stage as the independence referendum approaches (see also PwC, 2006).

### **Domestic firm behaviour and implications for inward FDI**

While the focus of this paper has been inward FDI, the behaviour of domestic firms in Scotland may also have wider implications for the absorptive capacity of the indigenous players to capture the spillover effects of FDI. This is particularly salient if

they seek to reduce their exposure to political uncertainty during the transition towards independence (or even in the event of a vote to remain part of the union).. Here, the experience of Quebec in Canada is instructive.

Between 1978 and 1981, 30 corporate headquarters moved from Montreal, in the province of Quebec, to Toronto in the neighbouring province of Ontario. According to the Fraser Institute, a Canadian think-tank, the top 500 companies located in Montreal, Quebec's largest city, dropped from 96 in 1990 to 75 by 2011. While the reasons for the decline of Montreal are complex and multi-causal, they also parallel the rise of nationalism and two referendums on independence in 1980 and 1995. The loss of corporate headquarters in Quebec also meant a decline in supporting business services, the concentration of which can result in both spillover and spinoff effects for other companies located, or locating in the region (Gainer, 2011).

While there are important differences (e.g. cultural and linguistic) between the Quebec experience and Scotland, the risk of large domestic firms relocating head office functions to the rUK, Europe or further abroad, may well have knock-on effects for both Scotland's attractiveness in the short to medium term for FDI, and also for the capabilities and capacity of domestic firms to capture the positive benefits of FDI spill-over effects. A qualitative sampling based on interviews of senior business leaders in Scotland, for instance, suggests that upwards of 10 percent of the 60 interviewed are putting in place contingency plans to migrate head office operations out of Scotland (MacKay, 2014; see also Botham and Clelland, 2005).

Research by international business scholars has emphasized two dimensions of the local context that influences FDI attractiveness. The first is how differences in institutional frameworks (formal and informal) influence business strategies of both foreign entrants (Meyer *et al.*, 2011) and local firms (Peng, 2003). With formal

institutions becoming increasingly mobile, and informal institutions relatively immobile, MNEs must weigh up the benefits and costs of adapting to local contexts when deciding on the international attractiveness of location (Meyer *et al.*, 2011).

The second dimension is the relative resource endowments of people, local firms and the wider economy (Dunning, 1998). Resources can be ‘natural’ or ‘competency’ based, but form the basis of a country’s location advantages (Meyer *et al.*, 2011). The relocation of head office functions by Scottish domestic firms to the rUK or beyond would, therefore, decrease the location advantages of competency-seeking FDI, with the prospect of also diminishing the absorptive capacity of domestic firms to take advantage of spillover benefits from foreign firms locating subsidiaries in Scotland. On the other hand, the countervailing ‘capital city’ effect noted above could enhance Scotland’s capacity, including for regional HQ attraction.

## **Conclusions**

The continued importance of overseas-owned MNEs for the Scottish economy is clear from this paper but the subsidiaries are generally weakly embedded, meaning in effect a dual economy. So in the trying conditions which seem likely to pertain in the early years of an independent Scotland, a much greater emphasis upon building an innovative domestic private sector is critical. The country’s comparative advantage in location-bound natural resource industries provides a degree of protection from closure or relocation which was absent among the footloose market-seeking MNEs of the past. Still, some at least of the natural resource “growth” sectors lack an innovation-orientation. Furthermore, while this paper has shown that much attention is now being paid to “reindustrializing through renewables”, independence-related

uncertainties loom large. It is also worth noting, however, that the Scottish government has a record of commitment to and leadership in this sector.

The MNE subsidiaries in Scotland have mostly been quiet over the forthcoming referendum. This is unlike the position of some of the Scottish-based MNEs, as the *Oxford Economics* (2014) report for the Scottish headquartered global engineering giant the Weir Group shows, and of course the Scottish headquartered banks and financial services companies; although not all are negative in their attitudes to independence. The caution of the foreign-owned sector likely reflects a view that independence is a decision for Scots and concerns about alienating the Scottish Government. Since secession is a relatively uncommon event, even the parents of these MNE subsidiaries are inexperienced in managing independence and its aftermath.

The business environment will be uncertain and risky in the early years after any independence vote in September 2014. This works through to political risk for MNE subsidiaries at both the operational level (decisions concerning business processes and operating systems associated with a plethora of re-created institutions) and the strategic level (dealing with market scope and operation modes and other major decisions). The independence-related issues may become embroiled with the wider politics of both the rUK and indeed potentially the EU. Given Scotland's relative stability, however, and the government's public commitment to policies that foster economic growth, it is possible that opportunities, as well as the more well-defined risks, exist for MNE investment.

Researchers in different fields, including international business and management and international political economy, have a major role to play in identifying these opportunities and risks. The study of international political economy has been on a

back-burner for some years (but see Eden and Lenway, 2001; Grosse, 2005) and may now begin to see a stronger revival. The material in this paper itself may be analyzed from a more formal international business perspective, applying, for example, the CSA-FSA (country-specific and firm-specific advantages) framework of Rugman and Verbeke (2009) - if Scotland votes for independence.

## Notes

1. As with the fDi Intelligence data, that of Ernst & Young is based on public announcements, intelligence and business surveys, and may not identify all projects. For both sources, employment data are based on estimates.
2. The statistics which follow mostly draw from Scottish Government sources. There are two sources: The Global Connections Survey, an annual survey of businesses collecting information on exports and international connections in Scotland (Scottish Government, 2014); and the Business, Enterprise and Energy Statistics (Scottish Government, 2013b). The two datasets are not directly comparable.
3. The oil industry has also been one of the favourite sectors in arguing the “obsolescing bargain view” (Eden et al, 2005; Grosse, 2005).
4. For sectoral reviews, see the Key Sector Reports listed in the References, plus Hood et al. (2002).
5. This accounts for the announcements in the financial companies’ Annual Reports 2013 that they would be setting up new companies in England to lower their risk profile.

6. Due to space constraints, readers should consult some of the references cited earlier and in the Addendum to the References. An excellent primer is McCrone (2013); see also Goudie (2013).
7. Presentation by Alan M. Rugman on *Scottish Independence, Quebec and MNEs* at the AIB UK&I Conference at the University of York, 11<sup>th</sup> April 2014.

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## **TABLES**

**Table 1.** Scotland's International Trade and Investment Strategy 2011-2105

### **Opportunity 1: Internationalization**

- a. More businesses trading internationally
- b. Greater support for growth companies
- c. International exploitation of Scotland's education sector

### **Opportunity 2: Inward Investment**

- a. Greater focus on strategic inward investment
- b. Embedding companies, encouraging expansion and supplier links
- c. Low carbon opportunities

**Growth Sectors:** Food & drink, Financial & business services, Life sciences, Energy (including Renewables), Sustainable tourism and Creative industries. Plus enabling technologies, and opportunities in Healthcare and Education.

**Priority Emerging markets:** China, India, Middle East

**Priority:** Wider promotion of Scotland

Source: Scottish Development International (2011); The Scottish Government (2007)

**Table 2.** Percentage of registered enterprises employment and turnover in Scotland, by country of ownership (Employee size band 250+) (March 2013)

<b>Employment</b>	<b>Scotland</b> (%)	<b>rUK</b> (%)	<b>Abroad*</b> (%)
Manufacturing	28.7	22.6	48.7
All sectors	36.5	34.9	28.6
<b>Turnover</b>	<b>Scotland</b> (%)	<b>rUK</b> (%)	<b>Abroad*</b> (%)
Manufacturing	15.3	15.8	68.9
All sectors	21.9	27.6	50.5

\*Not further analyzed in source.

Source: Scottish Government, Businesses in Scotland 2013

**Table 3.** Percentage of expenditure and employment on R&D in Scotland, by country of ownership (2012)

<b>R&amp;D Expenditure</b>	<b>Scotland (%)</b>	<b>rUK (%)</b>	<b>Other EU (%)</b>	<b>USA</b>	<b>Rest of world (%)</b>
Manufacturing	24.7	2.0	19.6	47.2	6.4
All sectors	32.0	2.7	19.9	38.0	7.3
<b>R&amp;D Employment</b>	<b>Scotland (%)</b>	<b>rUK (%)</b>	<b>Other EU</b>	<b>USA</b>	<b>Rest of world (%)</b>
Manufacturing	n.a.	n.a.	n.a.	n.a	n.a.
All sectors	44.2	2.4	13.4	32.4	7.5

Source: The Scottish Government, Business Enterprise Research and Development Data for Scotland (2013b); Office for National Statistics

**Table 4.** Natural Resource-Based FDI Projects in Scotland (2003-Oct. 2012)

Sector	No. of projects	Jobs created	% of total jobs - all sectors	Av. jobs created per project	Capital invest. US\$m	% of all capital invest. - all sectors	Av. capital invest. per project US\$m
Coal, oil & natural gas	47	7,453	9.7	158	7,399	30.0	157
Food, drink & tobacco	45	11,658	15.2	259	999	4.1	22
Renewable energy	39	2,555	3.4	65	5,012	20.4	129
Hotels & tourism	28	4,258	5.6	152	1,828	7.4	65
<b>Totals</b>	159	25,924	33.9%	163	15,238	61.9	95.8

Note: All of these industries are included within the Scottish Government Growth Sectors. Excluded are Life Sciences, Creative industries and Financial & Business Services which are not Natural resource-based.

Source: Calculated from Department for Business, Innovation and Skills (2013, Table A1) citing fDI Intelligence from Financial Times.

**Table 5.** Scotland's top 10 international export Industries, by value, 2012 (and rUK comparisons)

Industry Sector	Exports to International Markets £m	Rank:Top 10 Exports to International Markets	Exports to rUK £m	Rank: Top 10 Exports to rUK
Manufacture of food, beverages and tobacco products	4665	1	4080	4
<i>Of which Distilling, rectifying and blending of spirits</i>	<i>3930</i>	<i>nr</i>	<i>685</i>	<i>nr</i>
Manufacture of coke, refined petroleum and chemical products	4135	2	2600	6
Business services*, engineering, technical testing and analysis	1720	3	2930	5
Wholesale, retail trade; repair of motor vehicles and motorcycles	1650	4	4660	3
Financial and insurance activities	1415	5	9815	1
Manufacture of machinery and equipment NEC	1275	6	495	nr
Mining and quarrying	1145	7	2535	7
Manufacture of computer, electronic and optical products	1080	8	750	nr
Manufacture of transport equipment	990	9	1430	10

Admin. and support services	990	10	2095	8
Utilities	365	nr	4920	2
Transportation and storage	710	nr	2045	9

\*Business services are: Legal, accounting, management, architecture activities  
Note: Only top 10 are ranked. nr = Not ranked.

Source: Scottish Government, Global Connections Survey (2014)

**Table 6.** Scotland's top 10 destinations for international exports  
(and exports to rUK) (2012)

Rank	Destination	Total Exports (£m)
1	USA	3555
2	Netherlands	2665
3	France	2165
4	Germany	1525
5	Norway	920
6	Switzerland	870
7	Spain	830
8	Eire	815
9	Belgium	735
10	Denmark	645
<b>Total</b>	<b>10 countries</b>	<b>19295</b>
<b>Total All International Exports</b>	<b>All destinations</b>	<b>25995</b>
<b>rUK Exports</b>	<b>rUK</b>	<b>45570</b>

Source: Scottish Government, Global Connections Survey (2014)

**Table 7.** Opportunities and Challenges for the Future of FDI and International Business in an Independent Scotland

### **Challenges and Costs of Transition**

- *Institutional*: re-creation of UK public bodies; legal and regulatory; formal and informal institutional factors. Membership of international organizations, including EU (membership and terms), WTO, IMF.
- *Transactional*: negotiating costs; administrative systems; human resource constraints; political costs.
- *Fiscal, monetary & exchange rate policy*: currency; restructuring taxation and public spending; debt management.
- *The Border*: trade barriers; immigration controls; liabilities of foreignness.
- *Risks and uncertainties* for businesses and all stakeholders: political risk; default risk; currency risk.

Note:

1. Costs may be: i) short-term & long-term; ii) fixed & variable; iii) national, regional and global; iv) economic & political.
2. Many of the transitional challenges have sectoral dimensions e.g. energy; defence; banking & financial services.

### **Opportunities**

- New policy opportunities, where more tailored policy measures can be promoted e.g. airport policy; competition policy; patents; R&D support.
- Reindustrialization through strategic coupling in renewable technologies.

- Creative use of fiscal policy levers e.g. corporation tax (although benefits contested e.g. 'race to the bottom').
- Increased drive for connectedness within the global knowledge economy.
- Requirement to exploit new market opportunities, as businesses in Scotland redirect operations away from the rUK (and vice versa).
- A further enhanced role for Edinburgh as the capital of an independent Scotland.
- An expanded role for Scottish universities, in building an advanced manufacturing sector through collaborative R&D with inward investors. But also various negatives e.g. loss of research council funding; need to concentrate of narrower range of research areas.
- Requirement and opportunities for improved branding of Scotland as a business location for FDI; plus in sectors like food and tourism.
- Enhanced entrepreneurialism - psychological urge to action following independence despite risk and uncertainty ('animal spirits', Keynes 1936).

**Table 8.** Reindustrialization through renewable technologies

The Scottish government's commitment to the development of renewable energy has attracted substantial inward investment from companies such as Doosan, Mitsubishi and Gamesa. The explicit government strategy has been to encourage diversification and use of the skills and technologies developed in the oil and gas of industries in this new renewables sector. McDonald and Jennings (2013) have discussed the value of the government's general commitment to innovation hubs and partnering of university R&D activity with MNEs. In the renewable energy sector, support for initiatives such as the European Offshore Wind Deployment Centre in Aberdeen (a joint venture with Vattenfall of Sweden), the European Marine Energy Centre, with its many overseas-based partners, based in Orkney and the announcement of the Saltire Prize, a £10m incentive for the development of wave or tidal energy has established Scotland in the vanguard of these technologies. Cowell et.al. (2013) noted how the political commitment and leadership in this sector had encouraged the development of a close policy community that was able to work effectively with businesses and provide the infrastructure, labour-market and planning support that sustains long-run investment and growth. Although not without its risks, the relationship between the Scottish government and the renewable energy sector is an example of the type of deliberate and strategic coupling that attracts inward investment and facilitates ongoing research, development and innovation of new technologies that are central to global production networks. (Coe et al., 2004; MacKinnon, 2012). It is encapsulated in the First Minister's commitment to renewables as "the source of Scotland's reindustrialization" (Salmond, 2012).

## Appendix 1. Scottish parliament powers pre-independence referendum

*Key dates:* 18 September 2014 Referendum on Independence; 7 May 2015; UK Government Elections; 24 March 2016 planned Independence Day; 5 May 2016 Scottish Government Elections ((The Scottish Government, White Paper 2013a). The Conservative Government has also proposed 2017 as the year for an in/out referendum on UK membership of the EU.

<i>Devolved powers to Scottish Parliament (established 1999)</i>	<i>Reserved powers to UK Parliament</i>
<ul style="list-style-type: none"> <li>• Agriculture, forestry &amp; fisheries</li> <li>• Education &amp; training</li> <li>• Environment</li> <li>• Health &amp; social services</li> <li>• Housing</li> <li>• Law &amp; order</li> <li>• Sport &amp; the arts</li> <li>• Tourism &amp; economic development</li> <li>• Transport (largely)</li> </ul> <p>Additional powers from Scotland Act 2012. Some (e.g. income tax) will not come into effect for several years:</p>	<ul style="list-style-type: none"> <li>• Benefits &amp; social security</li> <li>• Immigration</li> <li>• Defence</li> <li>• Employment</li> <li>• Broadcasting</li> <li>• Trade &amp; energy</li> <li>• Energy: nuclear; coal, gas, electricity</li> <li>• Consumer rights &amp; data protection</li> <li>• The Constitution</li> </ul>

- |  |  |
|--|--|
| <ul style="list-style-type: none"><li>• New Scottish rate of income tax</li><li>• New borrowing powers</li><li>• Control of stamp duty, land tax &amp; landfill tax</li><li>• Powers over misuse of drugs; drink-driving limit; national speed limit; administration of elections.</li></ul> |  |
|--|--|

**Note: devolved powers in Economic and Industrial Development matters**

As is evident from above, Scotland has had high level of independence for many years in areas of economic development: human capital formation (education, skills, health); transport and industrial development, including financial assistance to industry (e.g. Regional Selective Assistance).

**Appendix 2.** Inward FDI trends in Scotland by sector (2003-Oct. 2012)

Sector	No. of projects	Jobs created	% of total jobs - all sectors	Av. jobs created per project	Capital invest. US\$m	% of all capital invest. - all sectors	Av. capital invest. per project US\$m
Software & IT services	69	3,658	4.8	53	635	2.6	9
Indust. Machinery, Equip. & Tools	68	2,957	3.9	43	281	1.1	4
Business services	61	4,663	6.1	76	287	1.2	5
Financial services	50	4,857	6.3	97	1,175	4.8	24
Coal, oil & natural gas	47	7,453	9.7	158	7,399	30.0	157
Food, drink & tobacco	45	11,658	15.2	259	999	4.0	22
Renewable energy	39	2,555	3.3	65	5,012	20.4	129
Textiles	30	2,082	2.7	69	560	2.3	19
Hotels & tourism	28	4,258	5.6	152	1,828	7.4	65
Pharmaceuticals	28	1,649	2.2	58	289	1.2	10

Other sectors	280	30,778	40.2	109	6,161	25.0	22
<b>Totals</b>	745	76,568	100.0%	102	24, 626	100.0%	33

Notes:

1. Project and capital investment data derived from public announcements, intelligence and business surveys; employment data based on estimates. No stock data were available.

2. Based on 81 projects into Scotland, key investment determinants were i) skilled workforce availability (37%); ii) domestic market growth potential (24.7%); iii) proximity to markets or customers. Access to resources is an underlying determinant in the resource-based sectors (Coal, oil and natural gas; Food, drink & tobacco; Renewable energy; and Hotels & tourism).

Source: Calculated from Department for Business, Innovation and Skills (2013, Table A1) citing fDI Intelligence from Financial Times

## FIGURES

**Figure 1.** Degree of risk and uncertainty for foreign-owned MNE subsidiaries in Scotland - by market scope and operations mode

<b>OPERATIONS MODE</b>	<b>MARKET SCOPE</b>	
	<i>Degree of risk and uncertainty</i>	
	<b>Scotland/rUK</b>	<b>Regional/Global</b>
<b>Exports</b>	1. Moderate/High	3. Low
<b>Value Chain integration</b>	2. High	4. Low/Moderate

Source: Authors