

# Attracting Foreign Direct Investment To Your Community



*Attracting foreign direct investment (FDI) can be an integral part of a community's economic development strategy. This report describes the basics of FDI and provides a framework for creating a local strategy to attract investment by overseas firms.*

**January 2009**

As businesses expand into foreign markets, they often find it to their advantage to have operations within those markets. Building or acquiring business assets beyond a firm's home county borders is known as foreign direct investment (FDI). Under the right circumstances, FDI can provide significant advantages for both the investing firm and the host country or region.

FDI is, however, risky for the investing firm and often controversial for the host. So while some states and regions in the U.S. have enthusiastically embraced FDI as part of their economic development strategies, other states have not. Successes around the country have led to reconsideration of the previous views of FDI, and most states are now actively seeking investment from overseas, many with attractive financial incentive packages. While Washington State and the Puget Sound region have had active programs to promote international trade and logistics activity, efforts to attract FDI have been inconsistent.

While state and regional programs can work to attract FDI to the area, local economic development efforts can build on those programs to promote their specific advantages. As will be described below, FDI attraction quickly comes down to the level of individual firms and their strategic needs. Local communities will find that they have assets that meet the global strategic needs of international businesses and can compete for investment. This report will help communities understand how global businesses think about overseas investment and help identify their best selling points to those businesses.

We begin with an overview of FDI and Washington State's record in attracting it. We then look at the various factors that determine where investment goes in the U.S., and what those factors mean for communities in Washington. Finally we provide a framework for presenting the assets of local communities in ways that potential investing firms will find attractive.

## **Defining FDI**

Before discussing strategies it is imperative to have a clear understanding of what is meant by foreign investment. The broadest definition would encompass any assets that are acquired using foreign capital, ranging from real estate to factories to bank deposits. FDI, a subset of all foreign investment, usually means acquisition or construction of productive capital, such as factories, hotels or stores and the associated brands and technologies.

Although this tool kit focuses mostly on this more strict definition of FDI, local communities often have some particular interests, such as attracting portfolio investments (i.e. non-controlling stock

purchases) and investments in real estate development, especially from sovereign wealth funds. While explicitly promoting the acquisition of U.S. firms or existing real estate may be problematic, as will be discussed below, acquisition may be a useful form of FDI if it leads to strengthening and growth of the firm.

A helpful framework for understanding the business context of FDI is to examine a firm's entry strategy, which is the method by which they serve a foreign market. FDI is one of several possible entry strategies. Firms that wish to sell their products or services outside their home country can:

**Export.** This is the easiest and lowest risk way to enter a market and allows a firm to leverage its home-country assets and labor pool once its local markets are saturated. Exporting makes the most sense for products that are reasonably standardized across markets and are inexpensive to ship, relative to the cost of the product. Areas with low labor and/or materials costs will tend to export to areas with high costs.

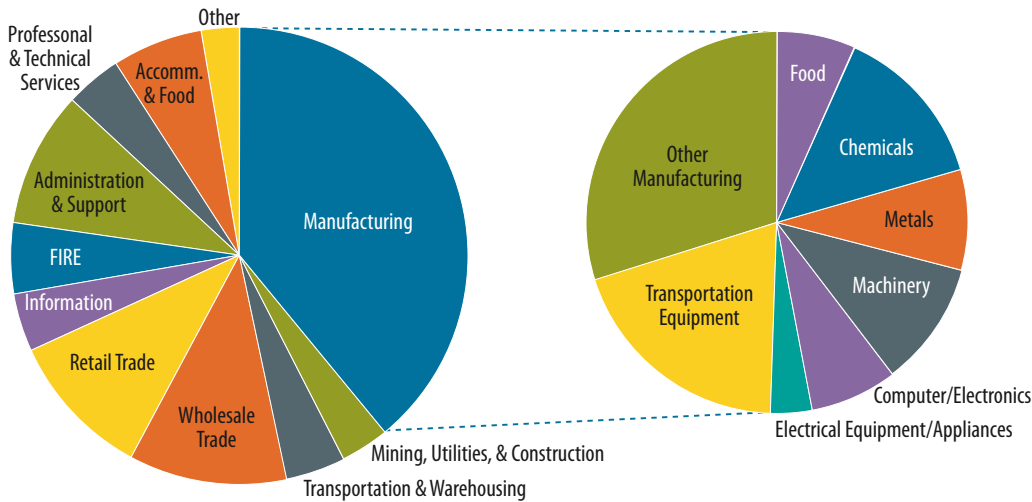
**License/contract/franchise/joint venture.** These techniques rely on the investment capital of a foreign partner. Licensing brands, technologies and design to overseas producers allows firms to avoid both the inconveniences of exporting and the risk of direct investment. Licensing and contract production is especially effective for low tech products with strong brands, such as food products or logo merchandise.

**Acquisition.** Firms can purchase a business in a target market that has similar product lines. This has the advantage of instant branding while allowing the foreign subsidiary to gradually introduce new brands and products from the home country. Purchasing a firm has all the usual risks and struggles of a merger/acquisition, plus the added challenge of operating in a different culture.

**Build new capacity.** The most complex and risky way to operate in a foreign market is to build production and/or service capacity from the ground up. Unlike licensing or contracting, proprietary capacity ensures control over technology and quality, as well as additional margins from production. Unlike a takeover, new capacity comes without baggage and can be dedicated to the specific needs of the parent company's products and processes.

Both acquisitions and new capacity are generally considered FDI. A local FDI strategy should have as its aim gaining new capacity, but as we will see below, foreign acquisition of existing businesses can be a first step in a growing presence by a foreign firm. Similarly, although we are not considering real estate investment as part of an FDI strategy, such investments might be a precursor to other investments.

**FIGURE 1: Total FDI in U.S. by Industry, 2005**

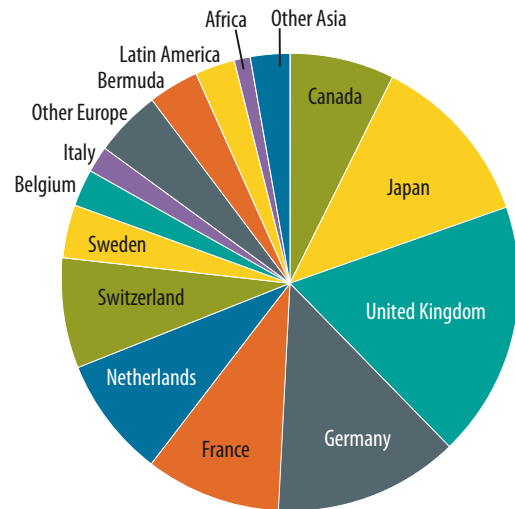


Source: BEA

Figure 1 shows FDI by sector and industry. Manufacturing is a much larger share of the FDI pie than the overall U.S. economic pie, which makes sense when considering the advantages in materials and transportation, and the ease of adapting certain types of products. Foreign firms have, however, made investments in most other sectors of the economy, so most communities with a substantial business base should have some sectors that might attract FDI.

Figure 2, show the origins of FDI as of 2005, indicates that FDI is dominated by a small number of countries. Local communities should examine this list to see if there are natural affinities between investing countries and the local population. One of the factors potential investors look for is the comfort of expatriate managers, and if a local community has a large population of immigrants from countries with a propensity to invest abroad, that can be a selling point.

**FIGURE 2: Sources of FDI in U.S., 2005**



Source: BEA

## Washington's Position as a Host to FDI

Compared to other states, Washington has not been very successful in attracting FDI. Measuring the jobs in foreign-owned firms as a percentage of total employment, Washington ranks 29th in the country. The top three states — Delaware, South Carolina and Connecticut — all have over seven percent of their private sector employees working in foreign-owned firms, while Washington has less than three percent.

In some specific industries Washington does rank among the top states for total jobs in foreign-owned subsidiaries. Washington ranks first in investment in electromedical instruments (2,300 jobs in 2005), eighth in electronic instruments (2,600 jobs), second in aerospace (700 jobs). In two sectors generally considered very strong in Washington, however, FDI is not impressive.

In transportation and warehousing, Washington ranks 17<sup>th</sup> (4,400 jobs) and in information, Washington ranks 14<sup>th</sup> (121 jobs).

Given the state's very strong trade position and sophisticated manufacturing and services base, this poor showing is somewhat surprising. We will now look at some possible explanations for Washington's low ranking to see if there is any fatal flaw in the state's economy or geography that would make an FDI attraction program futile.

To get a better idea of Washington's general attractiveness as a location for foreign investment, a number of macro factors were tested for all states to see if any of them might explain Washington's position.

### **Market Size**

Since FDI is a way to gain access to lucrative markets, it might be assumed that such investments would be concentrated in the largest states. When looked at in absolute numbers, this is true, with the highest number of FDI-related jobs in California, New York, Texas, Florida and Illinois. But when look at as a percentage of all employment, size of state ceases to matter. None of the leading FDI states is particularly large. Charting the FDI employment percentage against total state employment shows no meaningful relationship.

### **Industry Size and Agglomeration**

A second logical assumption would be that FDI in a given sector or industry would tend to be attracted to states that have a large concentration of such industries. This is often holds true at the industry level, but not at the sector level. There is no relationship between the intensity of manufacturing in a state and the percentage of that manufacturing that is foreign owned. The information sector shows a slight positive relationship between industry intensity and FDI, but Washington's status as the state with the highest percentage of its workforce in the information sector (which includes software) does not gain it much advantage in FDI. In the finance, insurance, real estate (FIRE) sector, there is a very strong relationship between industry intensity and FDI.

### **Business Costs**

A key component of any investment decision is the cost of doing business in the prospective location.

**Wages.** Manufacturing can be labor intensive, and because many manufacturers are competing with low-wages in developing countries, wage levels would seem to have an impact on FDI decisions. They appear not to. In fact, wages correlate positively with FDI, which is a counter-intuitive result.

**Unionization.** There is no meaningful relationship between the level of manufacturing FDI and the level of unionization in a state.

**Taxes.** States with a low business tax burden have slightly more success attracting FDI. The tax picture is somewhat cloudy, however, since many states offer tax incentives for investment.

**Overall cost of doing business.** The Milken Institute publishes a state-by-state cost of doing business index. There is no meaningful relationship between the Milken Institute's cost of doing business index and the level of manufacturing FDI in a state.

The seeming unimportance of these basic cost factors in manufacturing FDI is good news for Washington, since it is a high wage, high tax, high cost state. As will be discussed below, businesses looking for sites for investment tend to be more interested in key business inputs than they are in costs. At the state level costs can be a tie-breaker, but are rarely the first consideration.

At the local level, however, costs can be a key consideration. Once a firm has decided to invest in a state or region, it still must pick a specific site in a specific community. Individual jurisdictions in Washington have a wide array of business taxes, mitigation fees, development regulations, utility rates and fees and permitting processes, and the sum of these can produce major cost differences between sites within a few miles of each other.

### **Education**

States with a high level of college graduation tend to receive higher levels of foreign investment in both the information and FIRE sectors. Washington has a relatively high level of bachelors degrees — 31 percent of adults — but has low levels of FDI in the FIRE sector, and just average foreign investment in the information sector. Washington's highly educated workforce offers an untapped advantage in attracting FDI in knowledge-intensive industries.

### **Location**

Looking at the lists of the most successful FDI states, one thing stands out: they are all east of the Mississippi river. California has a large amount of FDI, but as a percentage of employment, FDI is low. There is, it turns out, a strong negative relationship between the percentage of the workforce in foreign-owned firms in a state and the distance of the state capital from New York City.

This brief review of macro factors does not turn up any obvious reason that Washington State should have such a low level of FDI. None of these standard factors predict FDI success in manufacturing, and on the one factor that does seem to predict FDI in both the FIRE and information sectors — college degrees — Washington scores fairly well. The problem of location — being far from the East Coast — is obviously not one that can be remedied, but should only be relevant for industries with high transportation costs.

The conclusion of this look at macro factors is that none of them stand in the way of Washington capturing a higher level of FDI. We can now turn to the question of just what does motivate foreign firms to invest in one location or another so we can understand how to construct a strategy to appeal to them.

## **Strategic Considerations**

The vast academic and popular literature on FDI points to some generally accepted principles that must be considered when developing a strategy to attract FDI.

### **Continuum of Entry Strategies**

The four market entry strategies mentioned above — export, licensing, acquisition, new capacity — do not exist in isolation from one another, but rather form a continuum along the risk-reward spectrum. Exporting and licensing are low risk activities, but both come with inherent limits on the level of sophistication with which a firm can operate in a foreign market. Acquisition and building new capacity carry much higher risks but offer the opportunity to build true global reach. As businesses grow and expand into overseas markets they will move along this continuum and use more than one entry strategy at a time, depending on the country and the maturity of the business.

As will be discussed next, the focus of an FDI strategy should be on becoming a platform for the global operations of outstanding companies, understanding that early entry strategies may not provide the initial investment most desired.

## FDI in the Context of a Firm's Global Strategy

Because building new capacity in a foreign country is the riskiest way to operate internationally, firms need to have good reason to venture from the safer paths of exporting or licensing. The FDI literature all points to the need to identify the strategic gains that a company hopes to achieve through FDI and how those gains fit within the firm's long-term global strategy. For any community to attract direct investment it must offer foreign firms something they cannot get operating at home or elsewhere in the U.S.

In his book *Redefining Global Strategies*, Harvard Business School professor Pankaj Ghemawat provides a useful framework for understanding the value that firms seek when investing overseas. Under the acronym ADDING, he discusses:

**Adding volume or growth.** Businesses discover that building a global presence provides economies of scale and the ability to serve large global customers.

**Decreasing costs.** Overseas operations offer access to lower cost labor and materials.

**Differentiating products.** Operating within overseas markets allows better product modification and country-specific marketing.

**Improving bargaining power.** Size counts when dealing with suppliers and competition, and a larger global presence gives a firm more leverage over rivals.

**Normalizing risk.** Operating in multiple countries diversifies markets, as well as sources of labor and materials, allowing a firm to weather disruptions in any one place.

**Generating knowledge.** Operating within a country, using local employees, provides access to new technologies and ways of doing business that can be applicable in other markets.

From a more functional perspective, these strategic goals can be pursued by looking for advantages in workforce, access to technology and access to local marketing knowledge. In selecting specific locations, investing firms will look for access to infrastructure, a favorable business climate and an attractive location for relocating executives.

## Clusters and Firms

FDI exhibits a strong cluster effect, with foreign firms tending to locate their acquisitions and new capacity near the predominant centers of their U.S. counterparts. The forces that give rise to clustering of domestic industries — workforce, suppliers, services — can be even more important to foreign firms who do not have the range of national contacts that a domestic firm could call on outside of the cluster area.

In the end, however, FDI is a function of the global strategies of individual firms. Within a given cluster some firms will be more mature and/or globally-oriented than others, and the globally-oriented firms will all have different approaches to and timing of market entry. Thus, an FDI attraction strategy drives to the level of the individual firm.

## National Business History and Culture

While the most useful way to approach FDI is through clusters and firms, home countries do matter. Approaches to globalization are influenced by national cultures and prevailing business practices. Businesses in Britain and Northern Europe have been operating globally for centuries, and the prevailing culture of business in those countries lends itself to multinational operations.

Thus, when looking for prospective firms within a target cluster, the most promising prospects will likely come from countries that have a history of globalized business. This will, of course, change over time as businesses in all countries realize they must globalize to survive.

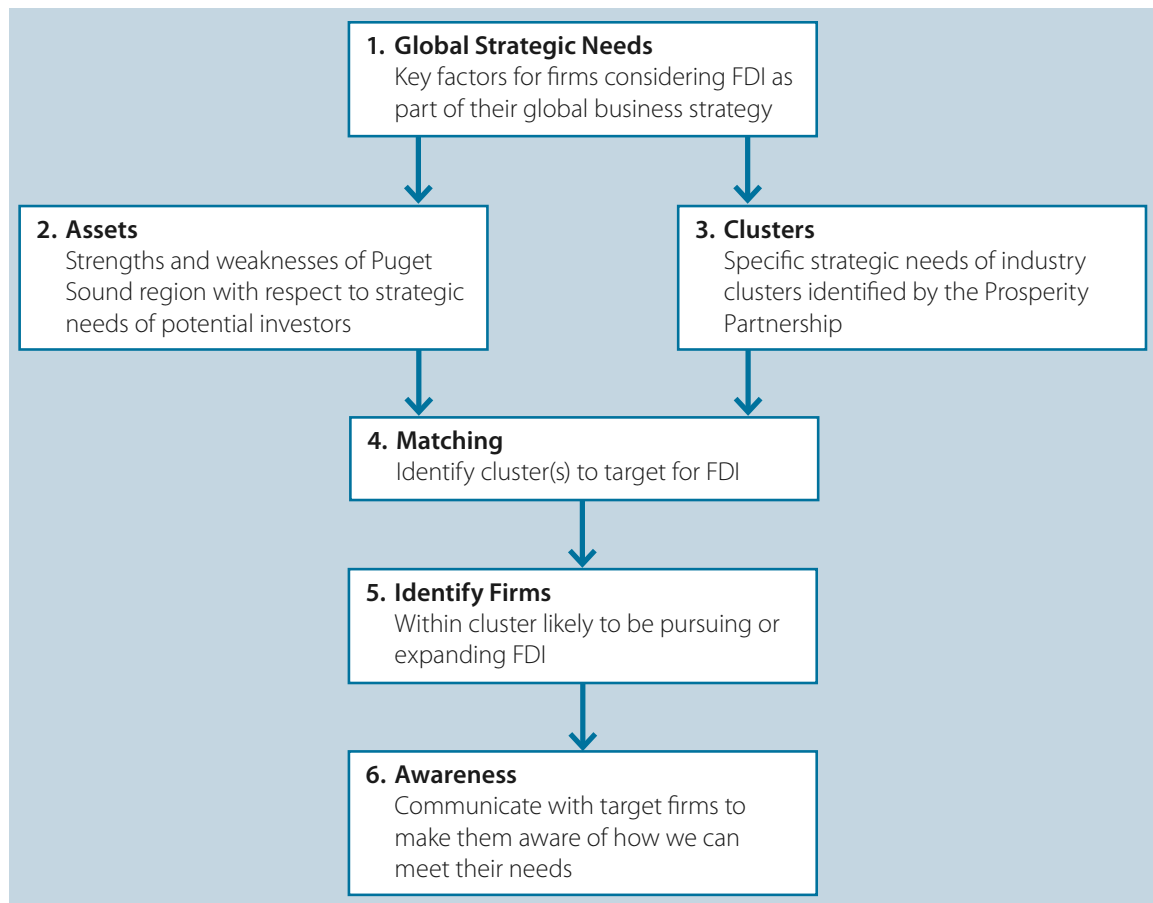
## Building on a State and Regional Strategy to Attract FDI

A local FDI attraction strategy builds on the broader state and regional strategy, executing components of that strategy at the local level. The larger strategy is based on the idea that direct investment is part of a continuum of entry methods that a firm will use to pursue its globalization goals. The state and regional FDI strategy might best be summed up in the question:

*How can we **match our assets** with the **global strategic needs of potential investing firms in promising clusters**, and how do we build **awareness** among those firm about our ability to meet their needs?*

Figure 3 shows the basic steps in answering this question at the state and regional level.

**FIGURE 3: Strategy for Attracting Foreign Direct Investment**



At the local level, the strategy works mostly in steps 2, 3, 4 and 6. Most local FDI attraction efforts will not have the resources to undertake steps 1 and 5. Step one involves global research that is complex and broadly applicable, so there is no reason to duplicate it at the local level. For Step 5, if the local strategy is targeting a cluster identified by the regional or state strategy, this work can be done at the broader level.

## Local Strategy: identify Assets

For the local component of Step 2, a community provides a finer grained analysis of the degree to which that area has specific assets that meet a firm's global strategic needs. These assets might fall under:

### Workforce

Workforce needs of a firm run the entire range from upper management to highly trained scientists and engineers to savvy marketers to production personnel. Since the U.S. is a relatively high-cost area, the workforce must have knowledge and skills not available in the home country or in low-cost developing countries.

**Local strategic action:** inventory the workforce assets of the community. This includes the existing workforce in relevant clusters that is large enough to have unemployed or underemployed workers at any given time. It also includes an estimate of future high school and college graduates and training programs that would be available through local community colleges. Outlying communities may have a workforce that is employed at distant worksites that would be attracted to local jobs with shorter commutes.

### Access to Technology

Scientific knowledge is generally available globally, but the people who turn that knowledge into products are often concentrated in certain areas. Technology access is often a function of workforce access.

**Local strategic action:** inventory technology assets. This includes colleges and universities, firms in related clusters, consultancies and suppliers.

### Marketing Knowledge

Few products are totally universal, and a presence in a market provides knowledge of how to adapt products and marketing approaches. Like technology, this too is often a function of workforce.

**Local strategic action:** inventory product design, advertising and distribution assets. Identify related products that have been launched from the area and provide case studies.

### Land and Infrastructure

Major operations must have access to appropriate sites and/or facilities, and to key transportation and communications infrastructure to connect it to customers and headquarters.

**Local strategic action:** identify sites and commercial real estate that would be appropriate for target clusters and firms. Describe transportation, utility and communication infrastructure services and how they would meet the needs of cluster firms.

### Business Climate

Although the analysis of macro factors such as wage levels and taxation did not yield a significant connection to FDI, these factors can be a tiebreaker among competing sites.

**Local strategic action:** identify business climate factors that distinguish the local area from other parts of the region and state. This would include taxes, utility rates, impact fees, permitting times and mitigation requirements.

## Quality of Life

Overseas operations are usually integrated into the management structure of the parent firm, so executives will often rotate through various locations. It is helpful if these postings are viewed not just as professionally rewarding, but also personally rewarding.

**Local strategic action:** describe ways in which the local community is friendly to expatriate residents from various parts of the world. Identify housing opportunities, school choices and community features and activities that enhance the quality of life.

## Local strategy: Identify Clusters

The regional strategy, in Step 3, will have identified industry clusters that are promising candidates for FDI. Promising clusters are ones (a) whose firms have a tendency to invest in foreign capacity and for which it makes sense to have capacity in the U.S.; and (b) in which the state and/or region have a competitive advantage.

From this larger set of clusters a local community may identify a cluster that has a strong presence in the local area. The local presence of this cluster provides the workforce, technology and supporting suppliers and services that a foreign-owned firm in that cluster would be attracted to.

A local community that has a strong niche presence of a cluster which the larger state and regional strategies have not identified as a top priority may wish to pursue FDI in that cluster independently. This will, however, require resources that the larger strategic process may not be willing to provide, especially in identifying and contacting specific firms.

## Local strategy: Awareness

Having identified the relevant assets to promote, and clusters and firms to promote them to, the local FDI effort needs to produce a communications program to build awareness of those assets. For communities with limited resources this program may be executed in conjunction with a broader regional program. Communities with sufficient resources may be able to execute an awareness program independently, perhaps working through local individuals and firms with overseas contacts.

However it is executed, this communications/awareness program should operate at three levels:

**Global.** Although the strategy is built around targeting clusters and firms, it never hurts to make others aware of a community's advantages.

**Cluster.** The advantages of the community for the cluster are outlined, and communicated through industry channels.

**Firm.** Target firms are contacted directly with custom information.

An awareness/communications program would include print, audio/visual and web-based materials in a variety of languages and formats. While some high-production value materials will be necessary, the emphasis should be on customizable information products that can be tailored to individual firms.

## An FDI Strategy: From Global to Local

Every investment in new capacity by a firm in a foreign country represents a curious mix of global and local. The investing firms, from whatever country, are by definition among the most sophisticated businesses in the world, having taken their global strategy to the far end of the risk-reward spectrum. At the same time, each foreign operation is placed within a specific community for specific reasons that have a lot to do with the assets of that local area.

A large part of this report has focused on the nature of FDI so that local communities can launch their recruitment efforts with a basic understanding of what motivates firms to build capacity in foreign countries. Without such an understanding it would be easy for a community to waste considerable resources chasing after firms that might seem like logical fits, but whose global strategies are not mature or are at odds with what that community can offer.

The essence of an FDI attraction strategy is to fit local assets to the needs of global businesses. But global business is a very big space and local governments and economic development organizations have limited resources to operate within it. An ideal strategy would use state or regional resources to identify firms that might find the state or region a good fit for their global businesses, and then use local efforts to attract those firms to the most advantageous community. As state and regional strategies unfold, local communities can, in parallel, begin to gather information about their own assets so that when the larger strategy launches, the local component is ready.