Vito Amendolagine Riccardo Crescenzi Roberta Rabellotti November 28th, 2024

How regions can manage foreign direct investment in a turbulent world

Amid a succession of global crises, governments are increasingly reluctant to allow foreign takeovers of their businesses. They prefer that foreign companies build new facilities from scratch, something known as greenfield investments. ***Vito Amendolagine*****,** ***Riccardo Crescenzi*** *and* ***Roberta Rabellotti*** *write that for governments, the trick lies in creating a welcoming environment for investment while safeguarding against potential risks to national and regional interests.*

With so much uncertainty in the world, governments are getting nervous about foreign companies buying up domestic businesses. Even though the number of these takeovers hasn't changed much in the last decade, there's a growing feeling that they aren't good for the economy. A general fear is that foreign ownership just means taking jobs away and closing factories without creating anything new, leading to less competition and giving foreign companies too much power.

But it's not just about the economy. There are also concerns about the social and political impact of foreign companies taking over key industries like transportation, communication or even infrastructure. Increased national security concerns over foreign activities have reinforced government scepticism of acquisitions, particularly those undertaken by multinationals from emerging countries (especially China). To address these concerns, many countries, including those in the European Union as well as the UK, are making it harder for foreign companies to buy up domestic businesses, particularly in strategic sectors like technology. Governments are acquiring more power to review these deals and make sure they don't pose a risk to national security.

A report released by the European Commission on 17 October 2024 reveals that "the number of notifications to the EU cooperation mechanism increased by 18 per cent since the EU framework was put in place in 2020," indicating heightened concerns over security risks associated with investments from non-EU countries. The document underscores "the increased levels of attention

being paid to the risks that certain investments from third countries may present to the security or public order in the EU and/or to EU projects and programmes of common interest."

On the flip side, governments around the world are on a mission to attract foreign companies to build new facilities, which is known as "greenfield investment". These projects are seen as powerful engines for economic growth, bringing new jobs, technology, and fresh ideas to fuel recovery, especially after economic slumps.

But now that the spotlight has shifted to greenfield projects, a key question is how to protect local/regional interests while attracting investments. A balancing act is needed to maximise benefits of foreign investment while minimising its potential downsides.

A recent study of how big international corporations in the Forbes Global 2000 list invest in Europe provides some new insights on this conundrum. The study analyses the choice of businesses between the acquisition of an existing local company and the establishment of an entirely new facility, and it zooms into sub-national local economies in order to gain a granular view of these investment choices.

When multinationals make the decision between buying an existing business and building a new one from scratch, they consider lots of factors, including the quality of local institutions and the innovative potential of the host local economy or sub-national region. Surprisingly, they often prefer to buy existing businesses in regions with weaker institutions and less innovation. They do this to reduce the risk associated with establishing a new business in these locations.

This might sound like bad news for regions that are already doing well, but it's not that simple. The study finds that the most innovative and efficient companies prefer to make greenfield investments in regions with strong institutions and high innovation capacity. This means that these regions might face some competition from less well-performing regions but can still attract the best investments. The key is that strong institutions and a supportive environment can attract more foreign investment, but they also make it more competitive for foreign companies to do business. Therefore, only the best companies will choose to invest in these regions, which is a good thing for their host economies in the long run.

What does this all mean for policymakers?

The study highlights the importance of understanding how different businesses operate and interact with the local environment. Instead of just focusing on national policies, policymakers must consider individual regions and the specific challenges they face. The study suggests that by building a strong local environment, with good infrastructure, skilled workers and a supportive regulatory and administrative framework, governments can attract higher-quality foreign investments. This can help break the cycle where less developed regions are stuck with low-quality (low productivity) investment that doesn't lead to long-term growth.

By improving the quality of local institutions, governments can attract businesses that are more likely to invest in new facilities and bring in new technologies. This can lead to higher productivity and economic growth, particularly in regions that are struggling to compete.

Even though the competition for foreign investments is fierce, every region can take steps to improve its attractiveness to businesses. Many countries have investment promotion agencies (IPAs) that work at both national and local levels to attract foreign investment. Research shows that local IPAs, those working directly with businesses in a region, are particularly effective in attracting greenfield investments, especially in less developed areas. They provide support and information to businesses, making it easier for them to invest and create new jobs. This is another piece of evidence that local conditions matter. By working to improve their local environment, regions can attract the right kind of investments and influence how companies operate. This can help shape the economic development of a region for the better.

While foreign investment is important, it's not a magic bullet for economic development, especially in less developed regions. A big multinational company's investments alone don't guarantee jobs or prosperity. There are many examples of companies setting up low-skill, low-paying factories in less developed areas without really contributing to the local economy.

Attracting the "right" kind of investment, the kind that creates good jobs and benefits the community, is a complex puzzle. It requires a deep understanding of what drives companies to invest in one way or another. We need to understand why some companies choose to build new factories while others prefer to buy existing businesses. This novel empirical evidence can help governments design better policies, both nationally and locally, to attract the type of investment that will truly benefit communities and drive sustainable development.

So, it's important to consider the bigger picture. While it's understandable for countries to want to protect their interests and limit foreign takeovers, especially when national security is at stake, it's important to be aware of the potential downsides. Policies aimed at stopping foreign acquisitions might hurt the most developed regions, which often rely on these deals for connections to global markets and for access to new ideas and technologies.

However, this could also be an opportunity for less developed regions with strong institutions and a solid foundation for growth. If it's harder for foreign companies to buy existing businesses, they may be more likely to build new ones in regions with a more favourable environment. Ultimately, finding the right balance between protecting national interests and attracting foreign investment requires careful consideration and a willingness to adapt policies to the unique needs of each region.

Sign up for our weekly newsletter here.

- *This blog post is based on "The geography of acquisitions and greenfield investments: firm heterogeneity and regional institutional conditions", in the Journal of Regional Science. It is co-*

published with the LSE GILD Blog.

- *The post represents the views of the author(s), not the position of LSE Business Review or the London School of Economics and Political Science.*
- *Featured image provided by Shutterstock*
- *When you leave a comment, you're agreeing to our Comment Policy.*

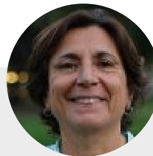
About the author

Vito Amendolagine

Vito Amendolagine is an Associate Professor of Economics at the Università degli studi di Foggia.

Riccardo Crescenzi

Riccardo Crescenzi is a Professor of Economic Geography at LSE's Department of Geography and Environment.



Roberta Rabellotti

Roberta Rabellotti is a Professor in the Department of Political and Social Sciences, University of Pavia.

Posted In: Economics and Finance | LSE Authors | Management

© LSE 2024