IR – PERPUSTAKAAN UNIVERSITAS AIRLANGGA

THE INFLUENCE OF BREXIT ON FOREIGN DIRECT INVESTMENT IN THE UNITED KINGDOM

This research and advisory report is a bachelor thesis required in order to graduate with Bachelor of Science from Saxion University of Applied Science

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ABSTRACT

Brexit started as an idea of getting sovereignty from the European Union by the British. After long way of tricky relationship between the UK and EU, finally on 23rd June 2016 British had referendum to no longer be part of European Union. Up until this thesis is finished, there is no certain time and deal on how brexit should be. These uncertainty has made some major corporations to consider leaving UK as one of their part of supply chain, including Unilever as the biggest Anglo-Dutch corporation. This decision by corporations can affect British' foreign direct investment level, even though UK has been the largest FDI destination in Europe for years. Some precedent researches and journals have predicted that it will plummet in long term, some believed the plunge will only last for short term. This research aims to explain the impact of brexit on UK's FDI, as well as giving suggestions to companies which are facing the same problem as Unilever. The author used literature review method through various scientific journals and reliable new report, in order to finish this bachelor thesis. Findings and conclusions from this thesis is aimed to help students and researchers in economic field to understand better about brexit and its impact towards FDI in UK.

Keywords: Brexit, foreign direct investment, project inflow, supply chain management

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MILIK PERPUSTAKAAN UNIVERSITAS AIRLANGGA SURABAYA

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CHAPTER I

INTRODUCTION

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Chapter I

Introduction

1.1 Problem Description

In what Britons took to calling the Battle of the Thames, both sides sent flag-waving flotillas down the river to advertise their cause (The OCR, 2016). The "Leave" campaign blasted the theme song from "The Great Escape" from Westminster Bridge, and Bob Geldof, a prominent campaigner in the "Remain" campaign, bellowed facts about fishing from boat-mounted speakers (The OCR, 2016). The next day, a man fatally shot and stabbed a Member of Parliament, Jo Cox, who supported staying in the European Union. The man shouted, "My name is death to traitors! Freedom for Britain!" The killing has shocked the country and drawn attention to the increasingly heated national debate (The OCR, 2016). This is much more than a vote on membership in a 28-nation bloc. It is about national and social identity, Britain's place in the world and the future of the European project (The OCR, 2016).

A portmanteau of the words "Britain" and "exit,", "Brexit", has become the nickname for a British exit of the European Union after the June 23 (2016) referendum asking voters: "Should the United Kingdom remain a member of the European Union or leave the European Union?"(The OCR, 2016). A lot is implied in one of the campaign's slogans, "Take control." Britain's loss of full authority over its economic policies and regulations has so rankled many of the country's citizens (The OCR, 2016). "There are two things at play here," said Brian Klaas, a fellow in comparative politics at the London School of Economics (The OCR, 2016). "One is the cultural nostalgia for Britain's lost place in the world. This idea that Britain used to matter, Britain used to be able to do things without having to consult Brussels." Then there is immigration. "There's this feeling that we're losing our cultural identity and our national identity," Mr. Klaas said, "at the same time that there's this influx of people who are willing to work for low wages." (The OCR, 2016). Projections differ significantly over the precise economic effect, but there is a consensus that leaving would hurt Britain financially, at least in the short term. (The OCR, 2016). Without access to the union's open markets, Britain would probably lose trade and investment (The OCR, 2016).

Unilever, one of the UK's best known corporate giants, had announced on March 2018, it will be consolidating its legal headquarters in Rotterdam, dealing a sharp

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blow to Britain's status as a European business hub ahead of Brexit (Independent, 2018). Unilever took a bold action to propose on moving their headquarter (HQ) to Netherlands after almost a century resided in London. Unilever said that it also intends to simplify from its current structure of being two legal entities, transforming into one legal entity that will be incorporated in the Netherlands (Independent, 2018). This decision was caused by constant falling of their shares value during the end of 2017 and beginning 2018, after a disappointing Nielsen report indicating that the company has continued to lose market share. Part of its decision also revolved around a plan by the Dutch to scrap the withholding tax on dividends (Harry, J. (2018, September 19)). Unilever, as the third largest company in UK, will have a blow on UK's economy if it finalizes this proposal. Although the company did not specifically cite Brexit as a reason for its move, the decision is expected to bruise Theresa May's government with just a year to go until the UK is due to quit the trading bloc (Independent, 2018).

The proposal to move the HQ was not being warmly accepted by Unilever's shareholder, especially the British shareholder. The ninth-largest holder of Unilever, the asset management arm of insurer Aviva, doesn't want the company to move at all, apparently planning to vote against it (Harry, J. (2018, September 19)). American shareholder also prefers to stay in London rather than moving to Netherlands. This protest all revolved on Dutch's regulation regarding withholding tax, something that simply does not exist in UK until now. When The HQ resides in Rotterdam, British shareholder will have to reduce their dividend income on withholding tax to Dutch government. This impact also to American shareholder, as they do not have to do now, thanks to tax treaty between US and UK (Harry, J. (2018, September 19)).

Unilever had to convince at least 75% of its shareholder to execute the plan. In order to convince their shareholder, Unilever plans to utilize a "substitution payment mechanism" in which it distributes capital in a way that doesn't trigger the new tax. According to Reuters, a recent poll showed that only 11% of voters support scrapping the tax, indicating that getting rid of it could be an uphill battle, so it makes sense that Unilever is exploring different options (Harry, J. (2018, September 19)). Turned out, this plan was not sufficient enough to convince most of its shareholder. Most of Unilever's shareholders opposed the proposal, which caused Unilever to announce their change of plan on beginning of October 2018. Unilever directors have decided to

withdraw their proposal to move out of the UK HQ to a single Netherlands HQ (The Guardian, 2018).

Even though Unilever has decided not to move forward with their proposal move its headquarters to the Netherlands after Brexit, this does not mean other companies in similar positions might take the same approach. A different approach is possible, such as: moving out headquarter from UK to other country and moving supply chain from UK to EU. These different approaches will likely have impact on UK, especially on UK's Foreign Direct Investment (FDI). In general, foreign direct investment (FDI) represents investments made by companies from other countries in a host country for various purposes: expansion of current establishments, acquisition of local firms or creation of new subsidiaries (Simionescu, M. (2016)). It is an important measurement for a country's welfare. FDI can raises national productivity and therefore raises output and wages. FDI also stimulates domestic firms to improve – for example, through stronger supply chains and tougher competition. (Dhingra, S. ET. Al. (2016)). The positive effect of European Union (EU) membership on FDI for The United Kingdom (UK) is robust, ranging between 14% and 38% under different statistical assumption (Dhingra, S. et. Al. (2016)).

Brexit is likely to impact several elements of the economy after UK finalizes Brexit on March 2019. The question is whether these impact will be positive or negative, short-term or long-term, it is also depends on which scenario UK use for their Brexit, a soft Brexit or hard Brexit. UK needs to make new regulation regarding their trade policy that includes import and export, because they can no longer follow EU's regulation regarding this matter. These changes can affect UK's FDI level, therefore output and wages will also be affected and the whole nation's welfare (Dhingra, S. et. Al. (2016)).

This whole dilemma of Brexit and FDI, whether foreign companies disinvesting or stay investing in UK, will lead to a raise in uncertainty level of investment atmosphere for UK. The question is how Brexit will impact UK's investment, how severe the impact will be, and how long this impact will take a toll on UK's investment atmosphere. Therefore this research is conducted to observe and conclude the influence of Brexit on Foreign Direct Investment in the United Kingdom. It is important to know beforehand not only for government and policy makers, but also for companies,

management, and public in general. Companies need to adjust with Brexit scenario, whether they have operational, investment, exporting, and/or importing from UK. This also is applicable for Unilever, as they have their main HQ in UK. Unilever has to understand whether their decision to cancel their single HQ in Netherlands proposal is a good decision for term purpose or not.

In this research, it will therefore focus on the following management problem "factors that are influencing "Unilever" to stay in or move their headquarter from the United Kingdom after Brexit". It needs to be taken into account on why this factors are very important for Unilever, which have made them decide on this proposal in the first place. Knowing and Understanding these factors may have significant influence on companies, how to deal with political and economic issues surrounding broken trade bloc agreement. As the main objective of this research, at the end it will be known "the influence of Brexit on Foreign Direct Investment in the United Kingdom".

The intended use of this research results is for companies who are dealing with such problem, in order to analyze and advice which strategies work the most efficient and effective for companies in a long term purpose.

1.2 Research Questions

1.2.1 Main Question: *"What is the influence of Brexit on United Kingdom's Foreign Direct Investment?"*

1.2.2 Sub-Questions :

- How is the impact on foreign direct investment in UK post-brexit, based on academic literature?
- How is the impact on Project inflow in UK post-brexit?
- What is the long term effect on FDI in the UK of leaving EU?

1.3 Research Methodology

Based on the research questions stated above, to address this issues using a descriptive research via literature review methodology. This methodology is chosen because, this topic on Brexit is an evolving study, and so it is more relevant to conduct a "preliminary" search of existing study, while also to identify and collaborate information from in-progress research. Additionally, through literature review, it is possible to develop critical perspective in analyzing this study. This study is based on relevant literature which discuss and analyses Brexit and its relation to Foreign Direct

Investment. In this methodology, there will be 4 objectives that needs to be fulfilled, which are: (1). Surveys the literature that has been chosen for certain area of study, (2). Synthesize the information in that literature into a summary, (3) Critically analysis the information gathered by identifying gaps in current knowledge; by showing limitations of theories and points of view; and by formulating areas for further research and reviewing areas of controversy, (4) Presents the literature in an organized way. (Retrieved from rlf.org.uk). The search for relevant materials comprises the following range of media:

- Article from Journals (that have been approved) are the main source in this research and advisory report
- Professional articles related to management problem
- Newspaper and magazine article
- Other sources (such as reliable website, conference results)

1.3.1 Article search method

The following journals most of articles that are included in this research project:

- Journal of International Financial Markets, Institutions and Money
- Social Science Research Network
- Economic Modelling
- Finance Research Letters
- National Bureau of Economic Research
- Bulgarian Economic Papers
- GLO Discussion Paper
- International Journal of Financial Studies
- National Institute Economic Review
- CEP Policy Analysis
- Brexit 2016

1.3.2 Identification of key words

In order to retrieve the relevant articles, the following keywords used in various combinations: *Brexit, Foreign Direct Investment, FDI projects, project inflow, Market analysis, investor reactions, post-transition economies, emerging economies, trading, EU single Market, trading bloc, export and import, investment partnership, transatlantic trade, welfare effect, productivity.*

1.3.3 Selection of Engines

The following search engines have been used to identify abstract summaries of relevant articles:

- Elsevier
- EconStor
- Scopus
- MDPI
- Emerald Insight
- CEP/LSE
- Research Gate
- Science Direct
- Google Scholar

1.3.4 Selection and Number of Articles

Firstly, in order to find the relevant articles, the key words mentioned above were used. The articles were selected by titles and abstract. The first search resulted in hundreds of articles. Then the articles were narrowed down to the relation towards brexit and foreign direct investment. Finalized results were eliminated from time selection. The articles chosen were the ones written after 2010, the newest one among others.

1.3.5 Research method for other media

Next to articles from Journals, other media are used, such as Professional articles related to management problem, Newspaper and magazine article, and other sources (such as reliable website, conference results). Regarding to professional articles were selected from the relation to management problem, which is related to Unilever plan to move headquarter in correspondent to Brexit. These articles were found from reliable sources such as newspaper reuters and financial times, alongside investment analysis website seeking alpha. Newspaper and magazine were selected only from reliable source such as the telegraph and BBC. Other means are from websites like government websites, saxion bibliotheek, and statistical results published by Centre for economic and business research (Cebr).

1.4 Research Objective

The intended use of this research results is for companies who are dealing with problem such as Unilever in bracing for Brexit and everything that follows, in order to

analyze and advice which strategies work the most efficient and effective for companies in a long term purpose. Other than that, this research can be useful specifically for company coach as representative of clients in business sectors and public in general as insight for the influence of Brexit on Foreign Direct Investment in the United Kingdom.

The goal of this research is to present theoretical framework regarding the issue relating FDI and Brexit. From this theoretical framework, conclusion can be formed and answer the research questions that have been mentioned previously. The conclusion will be the foundation in formulating the advice policy for business sector (company, manager, business consultant) as concerned parties who have to deal with this issue in practice.

1.5 Thesis Structure

I. Introduction

This chapter contains materials which will be discussed in the thesis. Such as background of research, research question, research objectives, research methodology, and systematic writing.

II. Theoretical Framework

The theoretical basis of this research is the foundation of theory which will become the supporting element of the formulation of hypotheses and basic research discussion.

III. Conclusion

This part covers the conclusions that can be drawn based on the results of literature review and suggestions related to similar studies in the past.

IV. Policy

This category consists of recommendations for external users, such as companies and public in general.

V. References List

This section contains a list of a literature review that made this research possible.

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CHAPTER II

THEORETICAL FRAMEWORK

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Chapter II

Theoretical Framework

2.1. Insight of British Exit (Brexit)

In this section, the insight into brexit, its surrounding events and scenarios will be explained thoroughly into 4 different sub-sections, which are: definition of Brexit, history leading to Brexit referendum, after referendum situation of Brexit deal, possible different scenarios of Brexit deal and current situation.

2.1.1. Definition of Brexit

Lately, a phrase called brexit is often mentioned everywhere from news report, to books and scientific journals even in daily conversation. Brexit is an abbreviation derived from two words, "British" and "Exit". It is referred to the event of United Kingdom's proposal to leave European Union and become independent from the European's economic and trade block. Brexit was first mention by Peter Wilding, founder and director of British influence, back in 2012 (BBC, 2016). It gained popularity immediately due to the similarity with another term refereeing of Greece potential withdrawal from Euro zone back in 2012, or widely known as "Grexit". Brexit became "unofficially official" term after British Prime Minister, David Cameroon, announced he would be holding a referendum of possible UK's withdrawal from European Union in 2012 (BBC, 2016).

2.1.2. History Leading to Brexit Referendum

After looking at the strong post-war recovery and alliance of France and Germany in the early 60s, Britain applied to join European Economic Community (EEC) in 1961 to save its economic turmoil after the 2nd world war. This attempt was vetoed twice by French president's Charles de Gaulle due to his dislike towards Britain's alliance with the US. After de Gaulle had left office in 1969, United Kingdom successfully became a member of EEC in 1973 led by its then Prime Minister, Edward Heath (Troitiño, D. R., et.al, 2018). When membership was put to a referendum in 1975, it had the support of Britain's three main parties and all its national newspapers. The result was resounding - with more than 67% voting in favor. But that did not end the debate. There was no immediate economic fillip - in fact strikes and power cuts continued, and rising oil prices caused double-digit inflation (Troitiño, D. R., et.al, 2018). This

has become the reason of long time debate and British questioning whether there are any real benefit for UK to join EEC later become European Union.

Despite unstable situation at the beginning of EEC membership, it cannot be denied that United Kingdom has thrived for the better because of its membership. Since joining in 1973, the UK has continued to be an influential voice in global affairs. It has retained its special relationship with the USA, which receives 17% of UK exports. The UK remains one of the most competitive economies in the world. It is true that by being in the Customs Union, the UK's trade is governed by the rules of the Union, but those rules have given the UK easier access to one third of the world's markets by value, and access to more markets than countries like Canada and Switzerland. EU mutual recognition agreements facilitate trade with China and the USA, among others. EU membership does not appear to hinder German's trade with China, which is three times bigger than the UK's. More important trade deals are in the pipeline (Troitiño, D. R., et.al, 2018).

Throughout its membership, UK has opt-outs from the single currency and the social chapter of European Union in the 90s. But soon after Tony Blair was elected as Prime Minister, he quickly patched things up between UK and Europe. He signed Britain up to the social chapter and setting his sights on the Euro. Due to Britain's economy was doing well at that time, support for euro entry was not widespread, and Chancellor Gordon Brown put the plans on hold (Troitiño, D. R., et.al, 2018). Since the end of 2009 the rapidly evolving Euro-zone crisis influenced the stability of the European Union, as several members of Euro-zone met difficulties to repay or refinance their governmental debts. The United Kingdom, although being outside the Euro-zone, still suffered under the negative impact of the crisis through its extensive business contacts, but the worst consequence of the crisis was in promoting distrust against the European integration, which emerged not just in always euro critic Britain, but all over the European Union (Troitiño, D. R., et.al, 2018). The idea to renegotiate the UK's future membership in the European Union to avoid dealing with the EU's shortcomings gained popularity. The Euro-zone crisis, later followed by the migration crisis, helped to reinforce fear-based narratives that the European integration will jeopardize the British sovereignty. In December 2011, as EU leaders tried to tackle their problems through a treaty setting new budget rules,

David Cameron demanded exemptions and then vetoed the pact. Soon enough, the Prime Minister promised a referendum on British membership (Troitiño, D. R., et.al, 2018).

As promised back in 2012, Prime Minister David Cameron held a national referendum of European Union membership on June 23, 2016 with the idea of settling the question once and for all. The options it would offer were Remain and Leave, and Prime Minister was convinced that Remain would win easily. Turned out, as a refugee crisis made migration a subject of political rage not just in Britain but also across Europe, the referendum result was UK to leave European Union by 52 percent to 48 percent (Walker, N. 2017). The breakdown as shown in the map below: England voted for brexit, by 53.4% to 46.6%. Wales also voted for brexit, with Leave getting 52.5% of the vote and Remain 47.5%. Scotland and Northern Ireland both backed staying in the EU. Scotland backed Remain by 62% to 38%, while 55.8% in Northern Ireland voted Remain and 44.2% Leave.

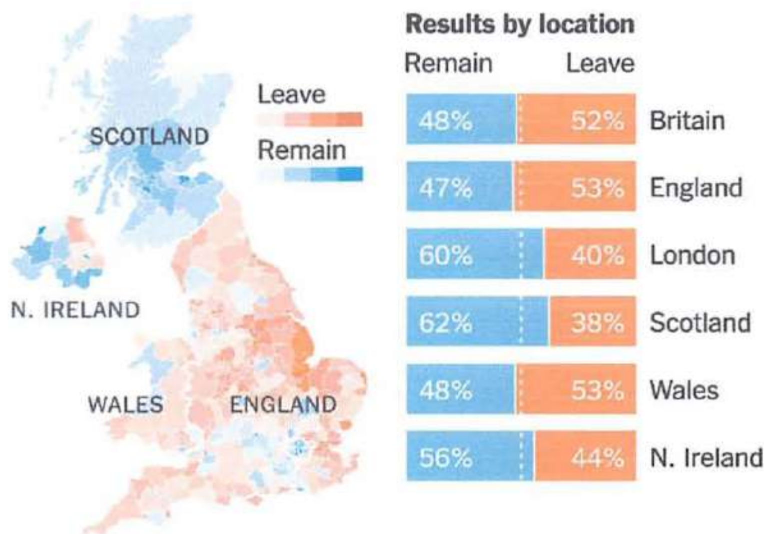

Figure 2.1: Brexit referendum result

Source: The New York Times, 2019

2.1.3. After Referendum Situation of Brexit Deal

The first European Council meeting for brexit took place directly after the UK's referendum in 2016. Prime Minister David Cameroon announced UK's referendum to withdraw its EU membership to the council in 28 June 2016. Since then, the negotiation of brexit has been taken up by David

Cameroon's successor, Theresa May (Walker, N. 2017). Theresa May promised to end free movement to ensure that UK will not be further oversupply by immigrants. Additionally, brexit ideal outcome for Theresa May is Britain can retain its own sovereignty without EU's influence, while still remain trading and economic exchange with EU (Walker, N. 2017). The main concern if brexit happening is the single border UK has with EU, the invisible line between Ireland, another member state of the bloc, and Northern Ireland, which remains part of the United Kingdom (New York Times, 2019). On account of this, Theresa May has been proposing a brexit scenario called "Backstop", which will be explained further in the next subsection. Brexit day will happen on 29th March 2019 and UK is hoping for a deal with transition time and a possible of trade deal afterwards.

2.1.4. Different Scenarios of Brexit Deal

In the event of brexit, there will be several different scenarios which likely to happen for brexit deal. These different scenarios have both positive and negative effect towards UK's future after Brexit. The effect can be in terms of economy, trade, investment, migration, etc. These scenarios do not have official phrase in term of addressing. In this research, these scenarios will be explained and addressed in 4 categories, which are: soft brexit, hard brexit, no-deal brexit, and backstop brexit.

2.1.4.1. Soft Brexit

The first type of Brexit is known as soft brexit. Soft brexit has a significant characteristic of the membership possibility of European Economic Area or commonly known as EEA. This deal also commonly known as "The Norway Model". It is based on two key European organizations: The European Free Trade Association (EFTA) and European Economic Area (EEA). Norway, along with Lichtenstein and Iceland, is a member of both. In this brexit scenario, UK will be part of EEA which means that UK will be able to access the single market and will share common external export-import tariff with EU. However, EEA requires its members to join the free movement of people in support of the single market, which is different from what British citizen desire. The upside of this scenario is that UK will no longer bound to customs unions within the EU and can retain its sovereignty (Harari, D. 2018). In order to join EEA membership, UK will have to be either EU or EFTA member states. Thus under

this Norway model, Britain would leave the European Union, join EFTA, and then become the 31st full member of the EEA. This soft brexit is different from the agreement EU has with Switzerland. While Switzerland is able to access single market and Schengen passport-free area, it is not a member of EEA. If at the end UK has soft brexit deal, it will still not be part of Schengen passport-free area even though still has to join the free movement of people. The way this model applied in Norway is there is customs checks on goods exchanged with the EU because Norway is outside a customs union, but UK has the intention if the EEA agreement could be renegotiated to cover customs and prevent border checks (Harari, D. 2018).

2.1.4.2. Hard Brexit

The second form of Brexit is called hard Brexit. This type of brexit is in line with trade agreement EU has with Canada, thus hard brexit commonly known as "Canada Style" brexit. Hard brexit has different characteristic from soft brexit. The main distinguish from soft brexit is there is no frictionless trade between UK and EU after brexit. Without frictionless trade, meaning UK has no access to European single market (of which non-EU countries are also members). All goods from EU to UK, and vice versa, will have to go through customs checks and tariff on export-import goods will be applied here. This also apply to service likewise. Nevertheless, an agreement to remove most tariffs on goods is still achievable, even though most EU 27 countries refuse to agree in favor of benefiting UK only (Erken, H., et.al. 2017). The similarity of hard brexit and soft brexit is in both scenarios, UK do not have to pursue EU customs union (of which non-EU countries are also members). In addition, UK will not be subject to the European Court of Justice and free from contribution to the EU budget. Under hard brexit, UK is prohibited to stay in EU agencies such as Europol or the European Medicines Agency. As with the government's plan, services – which make up the vast majority of the UK economy – would lose their special ability to do business in the EU. This includes financial services, which would lose their pass porting rights to do business on the continent. The upside of this scenario is UK will not participate in the free movement of people, because UK is not part of the EEA and unable to access European single market. Moreover, UK has the freedom to sign free trade deals with other countries outside of Europe. However, the UK is unlikely to be able to sign a free trade

deal with the EU or other countries before it leaves the EU in March 2019 (Erken, H., et.al. 2017).

2.1.4.3. No-deal Brexit

The third type of brexit is referred to No-deal brexit. Many believes that no-deal brexit will be the most difficult scenario to endure. Some even say there will be economic chaos with huge disruption to business and concerns about whether the lapsing of agreements in areas such as aviation, medicine and nuclear materials could cause even more serious problems (Independent, 2018). The issue most likely to trigger no-deal is Northern Ireland. EU and UK are attempting on how to prevent a hard border. The backstop favored by the UK would keep the entire country in customs arrangements with the EU. But EU insists that regulatory and customs rules should apply to the province alone. If both refuse to apply on the backstop, the whole brexit deal will fail (Financial times, 2018).

Under a no-deal brexit, the UK would leave the existing structures of the EU without anything to replace them, at least initially. There would be immediate border checks with the EU and tariffs on goods and services. Additionally, British citizens living in the EU would technically become illegal after 29 March 2019, because there is no migration agreement will cover this immediately. Thus, under no-deal brexit, Britain will lose its preferred access to the EU and will trade on World Trade Organization's (WTO) terms and rules. This is possible because the U.K. is once part of the WTO, and will remain so after its departure from the EU. The Geneva-based WTO oversees a set of baseline terms for trade in goods and services. All 164 member states agree to deal with each other equally according to a principle known as most-favored nation treatment. The WTO also monitors how countries implement trade agreements and helps settle international trade disputes (Erken, H., et.al. 2017).

Under WTO terms and rules, EU accounts for 48 percent of U.K. goods exports and the shift could increase costs, paperwork and controls that haven't existed for decades. Tariffs on goods entering the EU from the U.K. would differ for various products, but the EU's average tariff rate is 3 percent. Meanwhile, European goods and services going to the U.K. may face increased import controls and tariffs equivalent to the EU's WTO commitments. For example, EU-made cars sold in the U.K. would face a 10 percent tariff in line

with the forthcoming EU duties on British cars. U.K. Additionally, The U.K. could lose continuity of trade relations with the 71 nations that have forged preferential trade agreements with the EU — including Canada, Japan, South Korea and Turkey. The U.K. is in talks to roll over its participation in those agreements. Heretofore, the British government has secured agreements with Chile, the Faroe Islands, Switzerland and various African nations to protect their bilateral trade relations after brexit. If the U.K. is unable to roll over the EU's other trade agreements, WTO tariffs will apply to British goods and services exported to those nations (Bloomberg, 2019).

2.1.4.4. Backstop

The last type of brexit scenario is called Backstop. Backstop is an alternative brexit scenario proposed by UK due to the single border UK has with EU, the invisible line between Ireland, another member state of the bloc, and Northern Ireland, which remains part of the United Kingdom. Backstop is not meant for permanent situation, it will merely to be used "unless and until" a better arrangement is agreed between the two sides after brexit (New York Times, 2019). The backstop is a set of arrangements contained in a dedicated Protocol on Ireland/Northern Ireland annexed to the Withdrawal Agreement. These will generally enter into force only if the terms of the UK-EU relationship to be negotiated during the transition period fail to deliver on the shared UK and EU commitments 'to address the unique circumstances on the island of Ireland, maintain the necessary conditions for continued North-South cooperation, avoid a hard border and protect the 1998 [Belfast/Good Friday] Agreement in all its dimensions'. In this sense, the arrangements are an insurance policy (Menon, A., et.al. 2019). Backstop arrangement cover a range of issues, including: the rights of individuals; the Common Travel Area between the UK and Ireland; customs; regulatory alignment to ensure the free movement of goods; the maintenance of north-south co-operation; and the single electricity market on the island of Ireland. Assuming the Withdrawal Agreement enters into force, and in the absence of alternative arrangements being agreed in time, the Protocol's backstop provisions will apply from 1 January 2021, or—given the option of a two-year extension to the transition period—1 January 2023 (Menon, A., et.al. 2019).

EU has been in doubt and had main concern regarding backstop scenario. Since the backstop would last until a better arrangement was agreed, it is potentially indefinite. Assumed that the backstop covers the entire UK, it raises the question why it should be included in a withdrawal agreement rather than in an orthodox trade deal, agreed after brexit. The bigger issue is political. Most member states are open to a customs union with Britain, not least because the EU has a £95bn surplus in goods trade with the UK. However, some countries want assurances about the way it will operate, and not in favor of Britain to be offered such an important concession complementary. The countries most exercised about the issue include France and close UK trading partners such as the Netherlands, Belgium and Denmark (Financial Times, 2018).

Backstop has been getting several mix respond. For brexit supporters, the backstop is seen as tying the UK indefinitely to the EU by preventing unilateral withdrawal from the EU customs union unless a future UK-EU trade agreement has been agreed. Remaining in the customs union would mean that the UK could not credibly pursue free-trade deals around the world. For the European Research Group (ERG) of Eurosceptic Conservative MPs in particular, the triggering of the backstop would undermine this key ambition for life outside the EU. It is unacceptable to them because it would effectively keep the UK within the EU's orbit until such time as both jointly decided on a future relationship (Menon, A., et.al. 2019). Meanwhile, Research from a detailed report on public attitudes in 2018 showed both communities in Northern Ireland were supportive of the kind of soft UK-wide brexit that would obviate any north-south or east-west border concerns. This would involve the UK leaving the EU, but remaining in the (or a) customs union and single market. This exit option was supported, as shown in table below, by 61% of all respondents, including almost identical proportions of Catholics (61%) and Protestants (62%), and was by far the preferred type of exit favored by Remain voters (69%) and marginally the most preferred by Leave voters (44%). (Menon, A., et.al. 2019).

Preferred Type of Exit by Northern Ireland					
	All	Protestant	Catholic	Leave Voters	Remain Voters
A "Hard Brexit" for all the UK	15.2	24.4	5.3	42.9	3.8
A "Soft Brexit" for all the UK	61.3	61.9	60.6	44.3	69.4
A "Hard Brexit" for Great Britain A "Soft Brexit" for Northern Ireland	23.6	13.7	34.1	12.8	26.8

Table 2.1: Northern Ireland's brexit preference

Source: Gary, J., et.al. 2018

2.1.5. Current Situation

According to the new research done by the Policy Institute at King's College London, RAND Europe, and Cambridge University, turns out that there is an increasing number of British who prefer soft brexit with EEA membership and single market access. This was indicated by almost a third of respondents have switched their preference in favor of a closer relationship with the EU after brexit. The polling also found One in three Leave voters (34%) would now opt for EEA membership in 2018, up from one in four (24%) in 2017; Nearly one in five (18%) Remain voters have shifted from preferring EEA membership in 2017 to simply remaining in the EU; Nearly 9 in 10 Remain voters now prefer EEA membership or remaining in the EU. Overall, an increasing number of British see a close relationship with the EU after Brexit as a positive outcome. Supporters of this form of Brexit say it is the best way of preserving the Irish border and frictionless trade (Grant, J., et. al .2018).

As Brexit day on 29th March 2019 is approaching, UK's Prime Minister Theresa May's Brexit deal has been rejected by British legislators (MPs) on 13 March 2019. MPs have voted against leaving with no deal and now voted in favor of delay of brexit day to June 2019 (BBC, 2019). As of 14 March 2019, UK's situation and options are limited to whether they can reach a deal around 18-24 March 2019 as explained in Figure 2.2 below. Theresa May has to request an extension to Article 50 from the EU. Assuming the other member states all agreed, Brexit would be postponed. Theresa May suggested this would be for no longer than three months. Aside from that, if MPs will not support the deal as proposed,

therefore there will be a longer extension needed (BBC, 2019). There are still plenty of possible outcomes that may happen, such as:

- No deal at a later date: If the EU will not grant a delay, or if the UK and the EU unable to sign off a deal during any extension, this would still be the default outcome. Thus, although a majority of MPs have repeatedly indicated they are against no deal they would need to do something else to prevent it from happening as a matter of course (BBC, 2019).

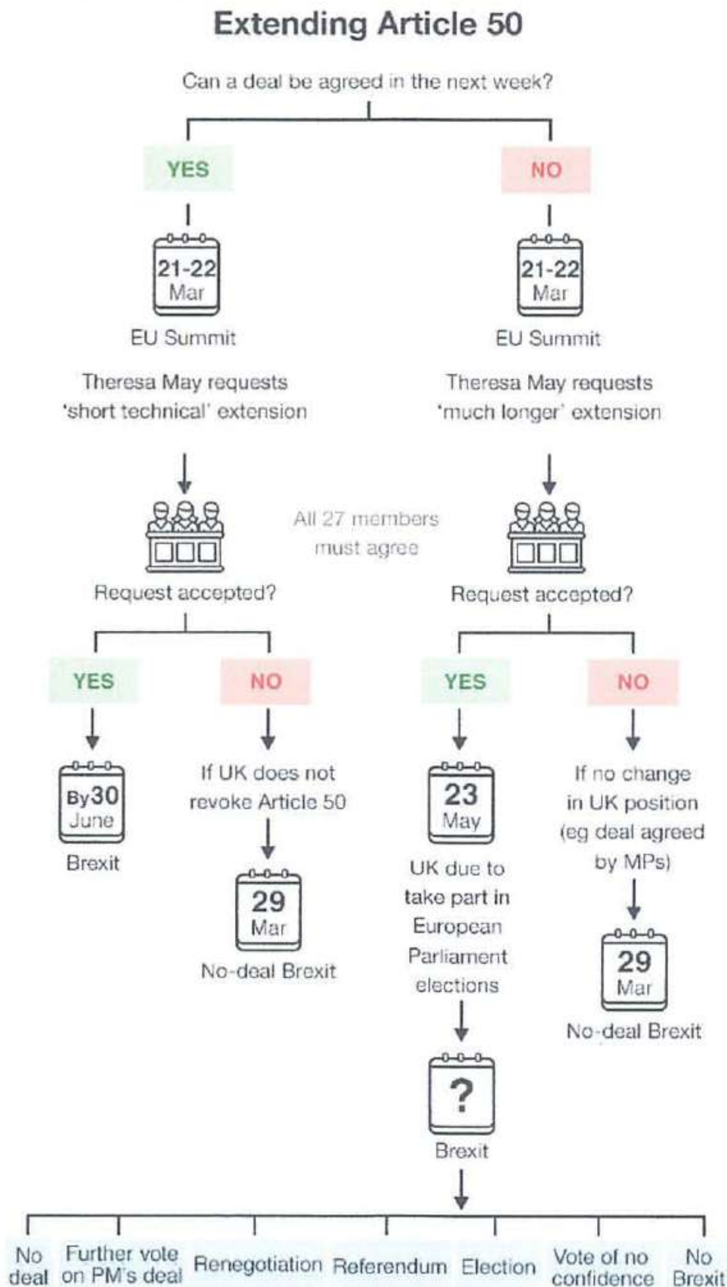

Figure 2.2: extending article 50 possibilities outcome

Source: BBC 2019

- Further vote on Prime minister's deal: The government plans to hold another vote. If it was successful, the Prime Minister could go to the EU summit on 21 March and request the short extension. However, there is a rule that the House of Commons should not be asked to vote twice on exactly the same question during a single parliamentary session. Nevertheless, it will be up to the Speaker to decide whether to allow the vote. If it is allowed, the prime minister will present the vote as a choice between passing the deal with a short brexit delay or rejecting it and facing a longer extension (BBC, 2019)
- Major renegotiation: If there is a longer extension, the government could propose to negotiate a completely new brexit deal - possibly after Parliament has had a chance to express its view about alternative deals. The government could pivot towards one of the other models of deal that has been suggested - perhaps something close to the so-called "Norway model" which would involve a closer relationship with the EU than the current deal proposes (BBC, 2019)
- No brexit: The European Court of Justice has ruled that it would be legal for the UK to unilaterally revoke Article 50 to cancel Brexit, without the need for agreement from the other 27 EU countries (BBC, 2019)

2.2. Insight on Foreign Direct Investment (FDI)

In this section, it will be explained thoroughly about Foreign Direct Investment or commonly known as FDI. This section will be divided into four sub-sections, each have direct relation to FDI. These sub-sections are: Definition of FDI, Vertical FDI, Horizontal FDI, and UK's FDI level in relation to EU's membership.

2.2.1. Definition of FDI

Foreign direct investment (FDI) represents investments made by companies from other countries in a host country for various purposes: expansion of current establishments, acquisition of local firms or creation of new subsidiaries (Simionescu, M. (2016)). Other definition by The United Nations Conference on Trade and Development (UNCTAD) (2013), defines FDI as an investment made to gain a stable interest in enterprises operating outside of the economy of the investor. FDI implies that the investor has a certain level of influence on the management of the enterprise (Chung, C.W.

2014). FDI has three components: equity capital, reinvested earnings and intra-company loans. Equity capital refers to the investor's investment in shares of an enterprise in another country than its own. Reinvested earnings are the investor's earnings from its share in the foreign enterprise, which are not distributed as dividends or not transferred to the investor, but are reinvested by the affiliates. Intra-company loans comprise the short and long term borrowing and lending of capital between the parent enterprise (investor) and the affiliate enterprise (Chung, C.W. 2014).

FDI is an important measurement for a country's welfare. FDI can raises national productivity and therefore raises output and wages. FDI also stimulates domestic firms to improve – for example, through stronger supply chains and tougher competition (Dhingra, S.et. al. (2016)). The FDI advantages are direct (foreign companies are more productive and ensure higher wages) and indirect (new managerial practices and technologies brought by foreign companies can be adopted by local firms; competitive pressure brings improvements in performance) (Simionescu, M. (2016)). FDI can also increase competitive pressure, which forces managers to improve their performance (Dhingra, S., Ottaviano, et al. (2016)). FDI can occur in two ways: directly or through spillover effects. Direct effects are characterized by the increase in capital stock, employment and tax revenue. Spillover effects have an indirect impact on growth and take place through various channels, such as linkages between multinationals and local suppliers and customers, training of local employees, copying technologies of multinationals by local firms, and increasing competition (Chung, C.W. 2014). When the potential host country is small, the potential savings in trade costs (with accrue per unit of exports to the country) are insufficient to offset the fixed costs of setting up a production facility there; hence, exports are chosen over FDI as the method for serving the market abroad. However, when a host country is large enough for the fixed costs of the plant to be offset by the trade costs saved, FDI is chosen over exports. Although the relative importance of each will vary between different sectors, the main theoretical determinants of FDI in recent literature can be summarized as:

- Market access / transport costs – firms will choose to undertake horizontal investment and locate in a market if the costs of exporting to

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a market are high. However, this will discourage vertical investment designed to source intermediate production more cheaply.

- Size of the host market – access to a larger market will offer firms choosing to locate there greater returns from economies of scale and scope, thereby reducing marginal production costs. This will have a particular effect on horizontal FDI. Agglomeration effects – horizontal and vertical FDI can provide firms with access to economic clusters with pools of valued resources, leading to reduced costs, enhanced knowledge spillovers, and increased returns.
- Factor costs – lower factor costs encourage vertical FDI, and depending on the size of the market, horizontal FDI. Skill levels in the economy may also be an important determinant – a higher skilled workforce will be more attractive to investors.
- Trade barriers / openness – horizontal FDI will be less attracted to a market if trade barriers are lower, as the relative cost of exporting goods and services decreases. This includes both tariffs and non-tariff barriers to trade. However, the more open the economy the more incentives there will be for vertical FDI.
- Fiscal incentives – fiscal incentives can render a country more attractive for both vertical and horizontal investment. However, it is not always clear that the benefits from investment justify the level of incentive provided.
- Imperfect competition – a situation of imperfect competition can stimulate horizontal FDI as firms with informational advantages seek to protect their assets by establishing their own operations rather than exporting.
- Business / investment climate – reduced costs of doing business will help attract FDI. Of particular importance are regulation and bureaucracy, property rights, the judicial environment, contract enforceability, labor regulations, and political and macroeconomic stability.

This research and... Qatrunnada Rahmadhani

- Exchange rate – reduced volatility that reduces exchange rate transaction costs can stimulate vertical investment, but can discourage horizontal investment as trading incurs fewer transaction costs.

2.2.2. Vertical FDI

The first type is called vertical FDI. The vertical model entails the geographical separation of production and headquarter activities so as to exploit factor-cost differentials caused by different relative factor supplies. In vertical FDI models, the home country is usually thought of as being much larger than the host country (Lankhuizen, M. (2014). Vertical multinationals invest abroad in order to reduce the productions costs. They produce intermediate products in one country and ship them for further processing to their affiliates located in other countries. In vertical FDI models, the question is typically how best to serve the domestic market. Helpman (1984) and Krugman (1985) developed a basic framework for vertical fragmentation. Bowen et al. (2012) extended this framework. They assume that the Headquarter is located in the home country and the plant is placed in the host country (Chung, C.W. 2014). They divided the production process in three stages. The first stage is the production of headquarter services by means of capital and labor. The second stage involves the manufacture of components and the last stage is the assembly of components. They assume that headquarter services are the most capital intensive, followed by the intermediate production (manufacture of components), and the assembly of components is the least capital intensive. Vertical multinationals replace their labor intensive production stages, like assembling and intermediate production, to cheap labor countries to reduce their costs. Therefore, vertical FDI is also known as efficiency seeking FDI (Chung, C.W. 2014).

Vertical FDI dominates when countries differ in size and relative skill endowments. The knowledge-capital model assumes that production can be geographically separated from the location of the knowledge assets (typically associated with headquarter activities). The activities associated with headquarters, i.e. the knowledge-based and knowledge-generating activities, and the managing and coordinating of plants, are skilled-labor intensive relative to production. These properties give rise to vertical model of multinational enterprises (MNEs): when relative skill endowments differ between countries

this motivates firms to locate production and headquarters in different countries. In particular, if the parent country X is small and relatively skilled-labor abundant, while the host country Y is large and relatively skilled-labor scarce, this motivates firms to locate headquarters in country X and production in country Y (Lankhuizen, M. (2014).

2.2.3. Horizontal FDI

The second type of FDI is Horizontal FDI. In the horizontal model of FDI firms set up plants in multiple markets to exploit firm-specific assets and to avoid transport costs and trade barriers (Lankhuizen, M. (2014). Horizontal FDI dominates when markets in both countries are large and countries are similar in relative skill endowments, in other meaning the two countries are often envisioned as being of similar size. Horizontal multinationals invest abroad in order to serve new markets. In horizontal FDI models, the question is how best to serve the host market (abroad) (Lankhuizen, M. (2014). Therefore, horizontal FDI is also called market-seeking FDI. They produce the same or similar products in different countries. Roughly saying, the production processes in the countries are identical. Usually, the headquarter is established in the home country, where it provides both the home and the host countries with its services. All countries have their own plant, where each plant is serving its local market with products. In this way, horizontal FDI act as a substitute for exports and therefore avoiding transportation costs, import tariffs and other trade barriers (Chung, C.W. 2014). Horizontal multinationals are dominant if countries are similar in size and in relative factor endowments and trade costs are high. The reasoning is that if countries are similar in relative endowments but differ in sizes, national firms in the larger country will be more dominant because they do not have the costly capacity in the smaller country (Chung, C.W. 2014). Standard models of horizontal FDI revolve around the trade-off between plant-level fixed costs and trade costs (Markusen, 1984).

2.2.4. European Union (EU) and United Kingdom's (UK) FDI

Market integration has given mostly positive impact to countries in EU. Inflows of FDI into the EU rose sharply from the mid 1980's as barriers between markets were removed – by over 350% between 1985 and 1992 alone, and, given that this is almost double the increase of global FDI over the same period, part of this FDI boost should be attributable to EU market integration. This

significant increase of EU inflow FDI compared to other advanced economies and emerging market economies (EMEs) inflow FDI can be seen in figure 2.3 below (UK's government report, 2018).

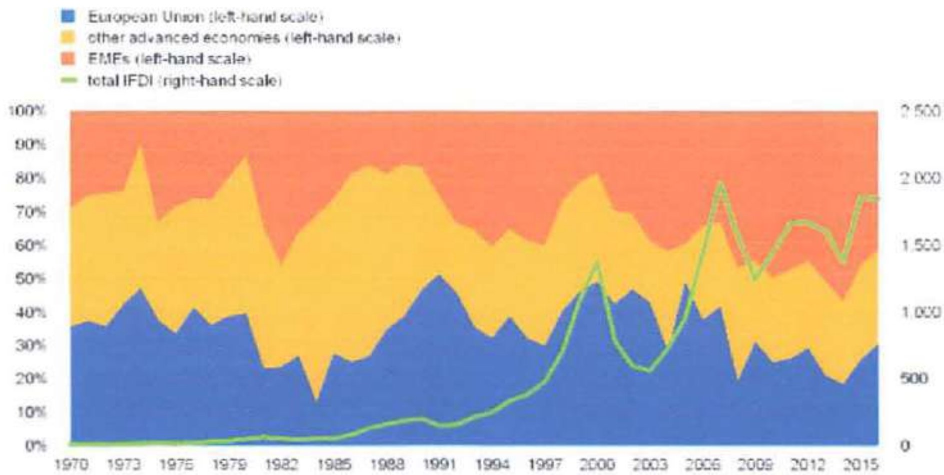

Figure 2.3 EU, EMEs, and other advanced economies FDI inflow
Source: ECB Economic Bulletin, 2018

While for FDI outflow, EU did not rise as high as its FDI inflow for the same period, but steadily increased during mid-1990s to the beginning of 2000s. However, this achievement is still better than other advanced economies FDI outflow which steadily decreased with small increase from time to time. Yet, both European Union and other advanced economies have been decreasing while Emerging Market Economies have steadily increased with total 41% of total global FDI outflow in 2014.

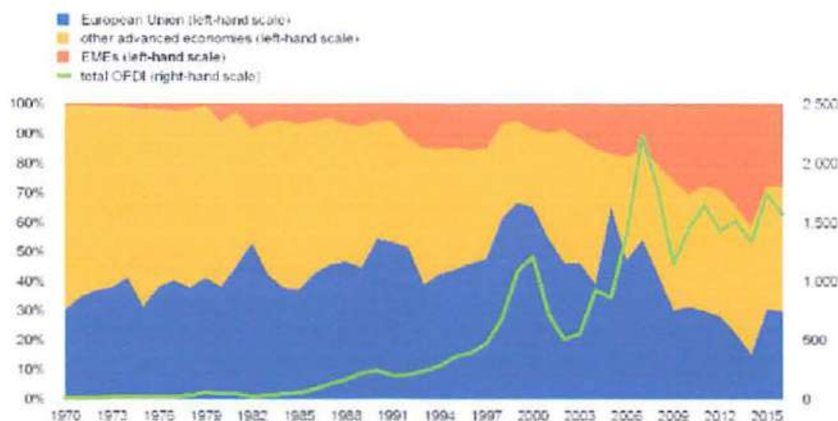

Figure 2.4 EU, EMEs, and other advanced economies FDI outflow
Source: ECB Economic Bulletin, 2018

As for the UK itself has seen substantial growth in both inward and outward FDI since accession to the EU, although determining how far the EU was responsible for this is complicated by other factors – in particular the global surge in FDI at the same time. However, the stylized facts support the theory that membership of the EU is a key factor in attracting investment to the UK, and demonstrates the importance of this investment for the UK. EU membership has positive effect on UK's FDI growth, through reducing access cost larger market, enabling greater economies of scale and returns on investment, increasing competition and facilitating agglomeration (UK's government report, 2018). UK's FDI before and after EU's membership compared to Ireland and Denmark which also joining European Union in 1973 can be seen below on figure 2.5.

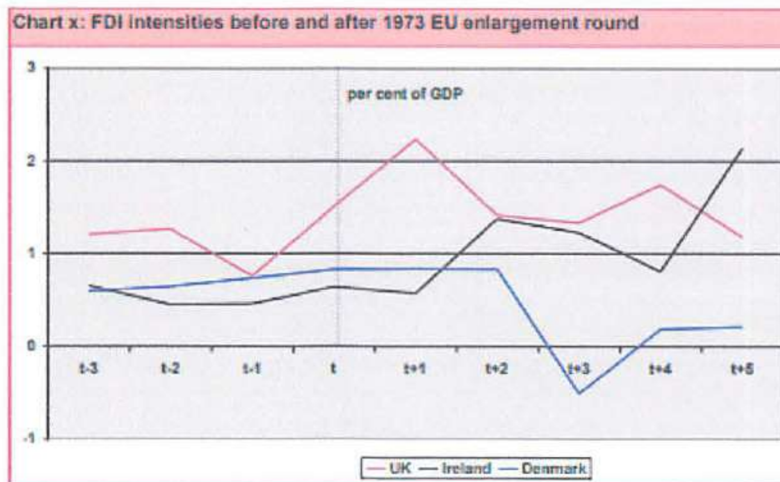

Figure 2.5 UK FDI before and after EU compared to Ireland and Denmark

Source: UK Government Report 2018

Looking at intra-EU investment using data on German investment in the EEA since 1980, Hubert and Pain found evidence of significant structural change since 1990, with nearly all locations and industries seeing a higher level of cross-border investment than might have been expected. They also found that the growth in the share of manufacturing investment located in the UK since 1981 can be seen to have been driven largely by developments in transport and other manufacturing, with considerable gains also in financial services (UK's government report). Accession to the EU had a clear initial impact on FDI

inflows, although this does then tend to tail off slightly. In the UK's case, the boost in FDI inflows appears to tail off and return to the level prior to accession in the early 2000s, but this may be due to domestic economic issues at the time and global FDI plunge during that time (UK's government report, 2018). UK has been able to attract relatively more FDI than the US. This could be as a result of market integration in the EU, which UK has an access to participate in it, while US has no market integration access like UK. Other than that, UK is closer geographically with a lot of EU countries which UK has free trading with. In the meantime US is only close to Canada and Mexico, which it has large trading with, but has no special free trading arrangement like UK has with EU. The comparison can be seen in figure 2.6 below

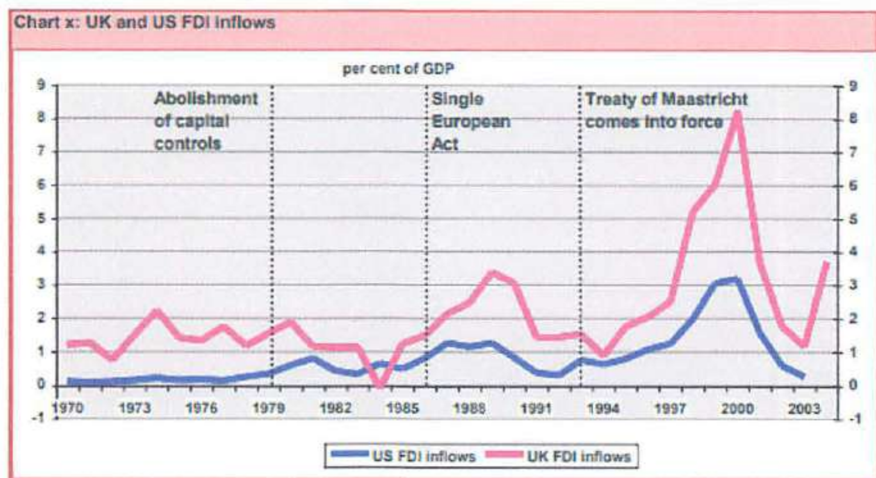

Figure 2.6 UK vs US FDI

Source: UK Government Report 2018

Derived from the figure above, it can be seen that although the UK's FDI inflows are to some extent in line with global trends, the various stages of European integration appear to have increased the UK's FDI performance relative to the US (UK's government report, 2018). For Illustration, after 1979 abolishment of capital controls UK's FDI inflow slightly rising. The same went for 1987 with single European Act, UK's FDI steadily increasing with its peak in 1989. The highest increase was after Treaty of Maastricht in 1993. UK's FDI level increasing significantly until the beginning of 2000s. There are also decreases in some years, the largest decrease was around 2000 – 2003. This decrease was due to may be due to domestic economic issues at the time and global FDI plunge during that time (UK's government report, 2018). During

this time manufacturing growth in UK was negative. One important factor has been the high value of the exchange rate which has made it difficult for UK firms to compete in overseas markets and has made foreign goods relatively more competitive in UK markets (Turner, P., 2001).

Since 1999, the EU has been the UK's most important FDI relationship, for both inward and outward FDI. At the end of 2003, the total stock at book value of direct investment into the UK (inward FDI) stood at £341.2 billion. Europe accounted for 46% of this (with the Netherlands and France alone responsible for 13% and 11% respectively – or over 8% of nominal GDP). At the end of 2003 the book value level of direct investment abroad by UK (outward FDI) companies stood at £692.5 billion. The EU accounted for £388.9 billion, a share of 56% and equivalent to over 35% of UK nominal GDP. Since 2000 the Netherlands has been the most favored location for UK direct investment abroad, with a 25% share of UK owned assets at the end of 2003. In 2003, 52% of total UK earnings from foreign investment came from Europe and 32% from the Americas – the Netherlands alone accounted for £12.1 billion, being 22% of the total and 43% of European earnings. This went on until 2010s (UK's government report, 2018).

Figure 2.7 shows the chronological development of foreign direct investments (FDI) in the United Kingdom between 2001 and 2012. During the time before the financial crisis, FDI in the UK more than doubled. And FDI from other EU member countries increased from around US$250 billion to more than US$500 billion in this timeframe. During the financial crisis years, a significant decline emerged in FDI from the EU and even more from the total FDI. However, FDI (total and from the EU) began to increase again starting in 2009.

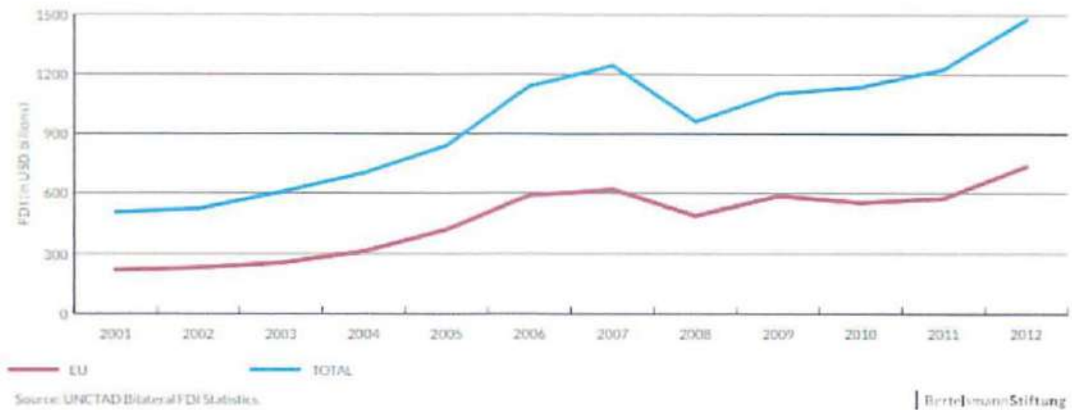

Figure 2.7

EU and total FDI stock in the UK

Source: Office for national statistics, 2018.

The top-ten EU partner countries included in Table 2.2 are in the same order in 2016 as they were in 2015. The Netherlands and Luxembourg had the first- and second-largest stock of UK assets respectively and together accounted for 45.2% of total UK assets in the EU. This is a slightly lower proportion than in 2015 (46.3%) yet, at 91.6%, the cumulative proportion of UK assets in the EU within the top-ten destinations remained the same in both years (Office for national statistics, 2018). Looking at the proportions for each country indicates that the largest increase in the proportion of UK FDI assets among these member states was in Germany, from 5.0% of UK FDI assets in the EU in 2015 to 6.1% in 2016. Despite some changes in the individual country proportions of UK assets among the top-ten EU member states by asset value, these ten still accounted for over 95% of all UK assets in the EU in 2016. Therefore, the other 17 member states together accounted for less than 5% of total UK assets in the EU (Office for national statistics, 2018).

Member state		FDI assets (£ billion)	FDI credits (£ billion)	Implied rate of return (%)	Cumulative percentage of total EU assets
1	Netherlands	166.5	3.9	2.4	25.8
2	Luxembourg	125.2	2.2	1.7	45.2
3	France	87.1	2.4	2.8	58.7
4	Ireland	69.3	4.7	6.8	69.5
5	Spain	58.3	1.2	2.1	78.5
6	Germany	39.1	2.5	6.4	84.6
7	Belgium	29.3	1.5	5.2	89.1
8	Sweden	21.4	2.4	11.4	92.4
9	Italy	15.9	0.5	3.4	94.9
10	Denmark	7.8	0.6	7.7	96.1
	Other	25.2	1.5	5.8	100.0

Table 2.2 UK foreign direct investment by EU member state, top ten by asset value, 2016.

Source: Office for national statistic, 2018

2.3. Correlation of Brexit and FDI in different scenarios

In this section, it will be explained thoroughly the impact of four possible brexit scenarios on FDI level in the UK post-brexit and the long term effect that might happen afterwards. The four sub-sections are: Scenario 1: Soft Brexit, Scenario 2: Hard Brexit, Scenario 3: No deal Brexit, Scenario 4: Backstop Brexit.

2.3.1. Scenario 1: Soft Brexit

The first scenario is soft Brexit. As explained in the previous section, in soft brexit scenario there is a possibility of membership in European Economic Area or commonly known as EEA. This means that UK will have the access to European single market and will share common external export-import tariff with EU, additionally British firms would continue to benefit from the EU's trade deals with other countries. These three components are important for trading and investment sectors. If the UK opt to soft brexit, international firms in UK are able to benefit from export shares and productivity with the EU, a factor that can influence investment decision. A working paper published by Barrell et al. (2017) found that single market will effect bilateral FDI stocks between countries in the market. It was stated that bilateral FDI stocks are at least 50% higher if both countries are members of the EU. This mean that when

UK left its EU membership, UK will not receive this benefit in its horizontal FDI with EU even though they still share single market with EU under soft brexit. Furthermore, a decline in exchange rate volatility may leads to increasing horizontal FDI under soft brexit if only UK can maintain Pound Sterling rate stability against Euro. Concerning vertical FDI under soft brexit scenario, UK still be able to use trade deal between EU and developing countries around the world. UK has the possibility to source its FDI from mainly horizontal within EU to vertical FDI in developing countries, in order to benefit from lower cost production. If UK still granted access and to single market and EU trade deal with the rest of the world after brexit, as well as maintaining its investment relation with EU countries as UK's most important FDI partners, UK FDI level might have slight change post-brexit both horizontal and vertical FDI. This due to the little difference of investment atmosphere and the same investment and trade benefit before and after brexit. Other additional remark on soft brexit is trade openness also has a significant impact on FDI flows, with a 1% increase in openness leading to a 0.6% increase in FDI flows according to Welfens et all (2018).

According to Lattore et all (2018) total rest of Europe (REU) and UK exports related FDI to the rest of the world (ROW) increase by 0.43% in the soft Brexit simulation. Additionally, both the REU and UK experience a small reduction of services imports from third countries by approximately -0.2%, small reduction compared to hard brexit simulation with decrease of -0.79%. This is possible effect on using the common external export-import tariff with the EU as well as benefit from the EU's trade deals with other countries in case soft brexit happen. International firms which have FDI in UK as well as British firms which have FDI in EU are able to adjust directly with their trading cost after brexit happen. This can be important factor for investor to consider FDI in UK in case of soft brexit. If investors are willing to take risk and soft brexit is bound to happen, UK's FDI level is possible stay stable and have little compromised for short term after brexit. This due to smaller risk for investing in UK (FDI inflow) after brexit with soft brexit scenario compared to other scenarios.

In terms of the type of activity of the inward UK FDI in soft brexit scenario, it is predicted there will be upsurge in R&D related FDI. This part due

to the retained free movement of labour in these outcomes. Free movement of labour can often play a key role in R&D projects, which can be international and collaborative in nature (Royal Society 2016). Indeed, Loewendahl et al (2016) note the importance of EU talent as a locational determinant of R&D, HQ and outsourcing projects within FDI in the UK. Out of all the seemingly positive impact of soft brexit, there is still possibility that soft brexit could lead to 5-10% less FDI into the UK over a 15-year time frame (long term effect) according research done by Sheffield Hallam University. Yet still lower than impact in such scenario of hard brexit and no deal brexit.

2.3.2. Scenario 2: Hard Brexit

The second scenario is hard brexit. The situation of hard brexit as explained previously that there is no frictionless trade between UK and EU after brexit. Without frictionless trade, meaning UK has no access to European single market (of which non-EU countries are also members). All goods from EU to UK, and vice versa, will have to go through customs checks and tariff on export-import goods will be applied here. According to research done by Sheffield Hallam University, a hard brexit, which favored by some members of the current British government, could have a significant adverse impact on foreign direct investment (FDI) in the UK. Seen by some, such as Piris (2016) as the most likely outcome, seemingly reinforced by the UK Government's stance on restricting inward migration. HM Treasury (2016) claimed that such an outcome would reduce inward FDI to the UK by between 10-15% after 15 years. Loewendahl et al (2016) claim that a lack of access to the single European Market could render 41% of inward FDI into the UK at medium or high risk.

According Loewendahlet al (2016) that UK market seeking FDI or commonly known as horizontal FDI, in industries such as retail, construction, transport and electricity is less likely to be affected by brexit than FDI with other motives, as the external arrangements of the UK are often less significant here. If UK or EU's companies want to avoid import tariffs and other trade barriers under hard brexit, they will likely to increase horizontal FDI in each other countries. However, in terms of the UK as a destination for export platform FDI, all the brexit outcomes explained in the previous section could adversely affect investors' perceptions of the UK (Head, J. 2017). As for vertical FDI, it is likely to be more difficult for UK as it lost the access to EU trade deals with other

countries. UK need to established new trade deal which can protect its vertical FDI in those countries. Such deal is difficult to achieve in short term right ater brexit happen. This will left UK with better option to invest in horizontal FDI which its already has within EU.

Hard brexit can also adversely affect export platform FDI. This is due to the lack of certainty over market access in different sectors, higher costs of access that this outcome would entail, and possible differences in product regulations between the UK and the EU. This would particularly be the case in industries with integrated supply chains, such as the car industry (Head, J. 2017). A study done PwC, asserted there would also be a negative impact on the financial services industry, with gross value added (GVA) reduced by 5.7% by 2020 under hard brexit (Head, J. 2017). Such things may lead to fear from investors to invest on FDI in UK under the condition of hard brexit and no deal brexit. It is proven by request from Japanese companies with significant investments in the UK to the EU in order to ensure continuation of current tariff rates and customs procedures between the UK and the EU (The Guardian, 2016).

2.3.3. Scenario 3: No-deal Brexit

The third scenario is no deal Brexit. In no deal brexit, as previously explained, the UK would leave the existing structures of the EU without anything to replace them, at least initially. There would be immediate border checks with the EU and tariffs on goods and services. Additionally, British citizens living in the EU would technically become illegal. Thus, under no-deal brexit, Britain will lose its preferred access to the EU and will trade on World Trade Organization's (WTO) terms and rules. Such an outcome would place the UK in a similar position to countries lacking trade agreements with the EU such as China and India. UK exporters to the EU would be faced with the Common External Tariff (CET). It is anticipated that there would be a re-establishment of customs controls at borders with EU members. There could be a wider range of both tariff and non-tariff barriers (Head, J. 2017). Ebell and Warren (2016) assert that a WTO style agreement, with no membership of free trade agreements for goods or services with the EU, would reduce UK inward FDI by a mid-point estimate of 23.7% in general, the worst outcome for the UK. Similarly, HM Treasury (2016) claimed that such an outcome would reduce

inward FDI to the UK by between 18-26% after 15 years (long term effect), also the worst outcome for the UK (Head, J. 2017). Firms exporting from the UK may have to pay the EU CET, which could be a threat to FDI in some sectors, especially export platform FDI. Piris (2016) notes that this tariff is 10% on car engines, and that such tariffs could mean producers relocating such production from the UK to the EU. This shows that UK Company which focus with complex supply chain across Europe and UK, will likely to do horizontal FDI in Europe to avoid such tariffs and regulation with supply chain originating from UK. On the other hand, set against these risks though, there is the possibility that some companies might invest more in the UK in the advent of external tariffs with the EU, a process referred to as "tariff jumping" (Blonigen et al 2004). This might increase UK's inward horizontal FDI from EU under no deal brexit. However, efficiency seeking FDI into the UK could also be at threat, particularly where such FDI also involves exports (and imports). This would especially be the case in terms of an outcome outside of the single European Market, where extra trade related costs could undermine any efficiency benefits that foreign investors may enjoy in the UK. In this context, FDI could be at risk in sectors where the UK has a strong recent record of inward FDI, such as the automotive, clothing, footwear and fashion sectors (UKTI 2015).

In terms of the impact on the financial services industry, according to Head (2017), quoting a study done by PwC, there would be a negative impact with gross value added reduced by 9.5% by 2020 under a WTO outcome. There are concerns that the loss of free movement would have negative consequences for the City of London's position. Dinghra et al (2016) also foresaw negative repercussions for the financial services industry, if there were to be restrictions on companies in the sector being able to access markets in the rest of the EU. Indeed, it has been noted that the ability of firms to continue being able to do this in a post Brexit scenario is far from certain (Jenkins 2016). For instance, Begg and Featherstone (2016) note such market access is threatened by the fact that the UK has a large trade surplus with the EU in this industry, and business services more generally, which could constrain the ability of the UK to negotiate good access here (Head, J. 2017). There is also a potential of 35000 lost job accordance with lower inwards FDI under WTO scenario (Head, J. 2017).

2.3.4. Scenario 4: Backstop Brexit

The fourth and last brexit scenario is Backstop brexit. Backstop is an alternative brexit scenario proposed by UK due to the single border UK has with EU, the invisible line between Ireland, another member state of the bloc, and Northern Ireland, which remains part of the United Kingdom. Backstop is not meant for permanent situation, it will merely to be used "unless and until" a better arrangement is agreed between the two sides after brexit (New York Times, 2019). Under backstop brexit, there will be arrangement between UK and EU on several topics, including trade. There would no border checks between Northern Ireland (UK) and Ireland. A lot will not change after brexit under backstop scenario. Exporter and importer would not have been confronted by export-import tariff and delay due to border check. The possibility of free movement can lead to steady FDI in human resource activity like how it would have been without brexit consistently. The only problem lies in backstop brexit is the fact that this scenario is far from permanent. Backstop brexit will be come in force during transition period after brexit until further brexit deal are agreed between UK and EU. This will lead to uncertainty in investment and trading sectors. Investors will need to predict whether the outcome after backstop will be soft brexit or hard brexit. If at the end the deal will be soft brexit, then there will be not much change to customs that have been run during backstop period. Meanwhile if the outcome is hard brexit, then it will be possible that exporter and importer will suffer a hard consequence due to the imposing border and customs check. Further, there will be a risk for company with complex and integrated supply chain that lies beyond countries border. This uncertainty will give FDI in UK a possible fluctuation during backstop period. It is likely that investors' prediction impact the level of investment inflows in UK, as well as the level of British firms' investment outflow, especially to EU countries.

Subsequently, it is difficult to analyze and conclude the impact of brexit under backstop scenario on FDI level in the UK. This has to do with the lack of previous research and analysis regarding this matter. Additionally, backstop scenario is not yet properly planned and discussed until now. It is still full of uncertainty whether it will be implemented if it will come to that. Thus it will be difficult to determine whether backstop will have positive or negative impact on FDI level in the UK, and whether it will be short term or long term effect.

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CHAPTER III

CONCLUSION

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Chapter III

Conclusion

In the event of Brexit, there will be various scenarios which will be enforced to assist the relation between UK and EU. In this research, four scenarios are discussed and analyzed in relation of the effect on UK FDI level after brexit. These scenarios are soft brexit (Norway model), hard brexit (Canada style), no deal brexit, and backstop brexit (UK-Ireland border).

In the case of soft brexit, it was stated that bilateral FDI stocks are at least 50% higher if both countries are members of the EU. This mean that when UK left its EU membership, UK will not receive this benefit in its horizontal FDI with EU even though they still share single market with EU under soft brexit. Furthermore, a decline in exchange rate volatility may leads to increasing horizontal FDI under soft brexit if only UK can maintain Pound Sterling rate stability against Euro. Concerning vertical FDI under soft brexit scenario, UK still be able to use trade deal between EU and developing countries around the world. UK has the possibility to source its FDI from mainly horizontal within EU to vertical FDI in developing countries, in order to benefit from lower cost production. Other additional remark on soft brexit is trade openness also has a significant impact on FDI flows, with a 1% increase in openness leading to a 0.6% increase in FDI flows. In terms of the type of activity of the inward UK FDI in soft brexit scenario, it is predicted there will be upsurge in R&D related FDI. This part due to the retained free movement of labour in these outcomes. Free movement of labour can often play a key role in R&D projects, which can be international and collaborative in nature. There is still possibility that soft brexit could lead to 5-10% less FDI into the UK over a 15-year time frame. Yet still lower than impact in such scenario of hard brexit and no deal brexit.

On condition of hard brexit, which favored by some members of the current British government, could have a significant adverse impact on foreign direct investment (FDI) in the UK of reduce in inward FDI to the UK by between 10-15% after 15 years. Loewendahl et al (2016) claim that a lack of access to the single European Market could render 41% of inward FDI into the UK at medium or high risk. UK horizontal FDI, in industries such as retail, construction, transport and electricity is less likely to be affected by brexit than FDI with other motives, as the external arrangements of the UK are often less significant here. As for vertical FDI, it is likely to be more difficult for UK as it lost the access to EU trade deals with other countries. UK need to established new trade deal which can protect its vertical FDI in those countries. Such deal is difficult to achieve in short term right ater brexit happen. This will left

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UK with better option to invest in horizontal FDI which its already has within EU. Hard brexit can adversely affect export platform FDI. This is due to the lack of certainty over market access in different sectors, higher costs of access that this outcome would entail, and possible differences in product regulations between the UK and the EU. This would particularly be the case in industries with integrated supply chains, such as the car industry. There would also be a negative impact on the financial services industry, with gross value added (GVA) reduced by 5.7% by 2020 under hard brexit. Such things may lead to fear from investors to invest on FDI in UK under the condition of hard brexit and no deal brexit. It is proven by request from Japanese companies with significant investments in the UK to the EU in order to ensure continuation of current tariff rates and customs procedures between the UK and the EU.

No deal brexit circumstance would lead UK to trade on World Trade Organization's (WTO) terms and rules. A WTO style agreement would reduce UK inward FDI by a mid-point estimate of 23.7% in general, the worst outcome for the UK. Similarly, HM Treasury (2016) claimed that such an outcome would reduce inward FDI to the UK by between 18-26% after 15 years (long term effect), also the worst outcome for the UK. UK Company which focus on complex supply chain across Europe and UK, will likely to do horizontal FDI in Europe to avoid such tariffs and regulation with supply chain originating from UK. On the other hand, set against these risks though, there is the possibility that some companies might invest more in the UK in the advent of external tariffs with the EU, a process referred to as "tariff jumping" (Blonigen et al 2004). This might increase UK's inward horizontal FDI from EU under no deal brexit. In terms of the impact on the financial services industry there would be a negative impact with gross value added reduced by 9.5% by 2020 under a WTO outcome. There is also a potential of 35000 lost job accordance with lower inwards FDI under WTO scenario.

As for backstop scenario, it is still unsure on whatever may happen to UK FDI level after brexit commence. Backstop is an alternative brexit scenario proposed by UK due to the single border UK has with EU, the invisible line between Ireland, another member state of the bloc, and Northern Ireland, which remains part of the United Kingdom. Backstop is not meant for permanent situation, it will merely to be used "unless and until" a better arrangement is agreed between the two sides after brexit. Exporter and importer would not have been confronted by export-import tariff and delay due to border check. The possibility of free movement can lead to steady FDI in human resource activity like how it would have been without brexit consistently. The only problem lies in backstop brexit is the fact that this scenario is far from permanent. This will lead to uncertainty in investment and trading sectors. Investors

will need to predict whether the outcome after backstop will be soft brexit or hard brexit. If at the end the deal will be soft brexit, then there will be not much change to customs that have been run during backstop period. Meanwhile if the outcome is hard brexit, then it will be possible that exporter and importer will suffer a hard consequence due to the imposing border and customs check. Subsequently, it is difficult to analyze and conclude the impact of brexit under backstop scenario on FDI level in the UK. This has to do with the lack of previous research and analysis regarding this matter.

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CHAPTER IV

POLICY AND LIMITATION

Chapter IV

Policy and limitation

This research is based on Unilever which had a proposition in September 2018 to move its entire London headquarter to Rotterdam by December 2018. At the end, Unilever management had to change their plans due to opposing by majority of their British shareholders as they feared of of being ejected from FTSE 100 and forced to sell their shares. Even though Unilever revoked the accusation of moving decision because of the brexit, it cannot be denied that this might have played a significant part. Furthermore, several other big corporations which have main operation in UK, such as Honda, Airbus, Jaguar, and JPMorgan Chase, also are facing this same conundrum of moving out from UK to other countries in EU in the commence of brexit. There are several recommendations the author would like to address in this section of the paper regarding this matter. These suggestions are aimed for companies which have consideration to move out from UK in the event brexit, in order to avoid negative effect on their companies' operation. The author gives these recommendations based on the current situations, controversial issues, and implementations in real life which happen during the writing process of this research.

The event of Brexit and which scenario would follow is still a big question which needs to be answered. Which Brexit scenario is solely based on which deal UK will have with EU in commence of Brexit. Up until this research is written, there is no certain agreement between UK and EU on brexit deal yet. The possibility of a soft brexit will likely to have minimal effect on company's operation, while the options of a hard brexit and no deal brexit will likely to have more negative effect on companies, as shown in previous chapters. Hard brexit and no deal brexit are the scenarios need to be considered further, as they are likely to happen and could have adverse impact. Under hard brexit and no deal brexit, companies need to consider tariff import and additional trade barriers which can increase cost of production. If the company transport intermediate parts from UK to other countries and then ship back the final product to UK, they will need to tend about the double immigration cost occur here. For example in Airbus case, they produce wing part in England, then ship it to Europe to be assembled and then sold again in UK. It will cost Airbus double in tariff cost and time delay in border following this plan after brexit. Regarding this matter for companies which have bigger European market rather than British market, it is better for company to have entire production plan in EU countries. Through this, companies can access the free movement of people and product in

most part of EU. It will be cheaper for companies because they can outsource their raw material and labor throughout EU without having to deal with customs and tariff. After that companies can ship their final product to UK and will only have to pay one time UK import tariff. Once the products are in UK, companies should have larger warehouses throughout UK and Northern Ireland, preferably in bigger cities with lots of customers, to store their final goods from EU before they are send to end customer. By doing this, companies like Unilever will not have to worry about their on-shelf availability. On the other hand, companies which have bigger British market, should have their entire production plan concentrated throughout UK. It is also better to have suppliers locally from UK rather than from EU countries. If a company doing this, they can cut down their warehouses in UK to apply just-in-time logistic in UK and invest more of warehouses in EU countries. This also apply to companies with fast moving goods as their main operation.

The author also would like to recommend European companies to source their suppliers locally. In case of Unilever, many of its suppliers in UK and European region come across both area. As mentioned before, companies which have production plan in UK should have sourced their suppliers locally in UK if that is possible, especially for strategic and leverage suppliers. Others can be supplied from countries which offer lower prices like China or Africa (source globally). Meanwhile, companies which have production plan in EU countries should have sourced their suppliers within EU or globally from cheaper countries rather than UK. By doing this, it will be cheaper, easier, and more efficient for companies to have their production plan and most of their suppliers in the same country. Additionally, companies can rely on transportation services provided by transportation companies. Companies should do delivery in a big amount in one time for economic of scales. By doing this, companies do not have to provide transportation and logistics for themselves, rather to save efficiency and time, outsource it to transportation services.

In terms of foreign direct investment, European companies which seeking market in UK after brexit, should do horizontal inward FDI in UK. This means that companies in Europe will need to open their operation in UK to serve British market only. It should not be a complex or big operation as it will only serve a market, but it is to avoid the uncertainty of brexit if company only rely on export and import to UK. Other things need to be consider also the fact that UK is one of the largest market in Europe especially in financial industry. This suggestion also go the same for British companies. In order to save their European market, British companies need to execute market seeking FDI or horizontal FDI. Through horizontal outward

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FDI, British companies can serve its European market without having the risk of dealing with the outcome of trade deals between UK and the rest of EU.

At the end, companies which consider to move out their operation entirely from UK, like Unilever and many others, should not take decision in such a hurry. It is need to be considered that companies should not lose majority of their British market by moving out of UK. Companies can consider to open more warehouse in UK and do productions in EU countries. Other option is to open production plan solely for UK market only and apply just-in-time by delivering good through transportation services and reduce their warehouses amount in UK to reduce cost.

The author would like to mention some limitation regarding this research. The uncertainty of brexit, both the scenarios which will happen and the exact time of brexit commence, make it is difficult to analyze and foreseen what would happen after brexit executed. Different scenarios will result in different outcome, especially in FDI matter. It is still unknown what will happen to FDI in UK, as the event such as brexit is rarely happen in real life. Other limitation is the limited literature source and previous research. As brexit is considered new topic and not yet to happen, there is not much source found to support the hypothesis and theories in this research. All previous research are based on predication and pre assumption, not real life data and evidence. Hence it is difficult to determine the result of brexit before it yet happen. Therefore further research regarding FDI and brexit need to be conducted, preferably after brexit happen and the effect and evidence can be analyzed.

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CHAPTER V

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