Could a bad Brexit deal reduce workers' rights across Europe?

Estimating the risks of a 'race to the bottom'

Monica Andriescu and Lesley Giles

May 2017

About The Work Foundation

Through its rigorous research programmes targeting organisations, cities, regions and economies, now and for future trends; The Work Foundation is a leading provider of analysis, evaluation, policy advice and know-how in the UK and beyond.

The Work Foundation addresses the fundamental question of what Good Work means: this is a complex and evolving concept. Good Work for all by necessity encapsulates the importance of productivity and skills needs, the consequences of technological innovation, and of good working practices. The impact of local economic development, of potential disrupters to work from wider-economic governmental and societal pressures, as well as the business-needs of different types of organisations can all influence our understanding of what makes work good. Central to the concept of Good Work is how these and other factors impact on the well-being of the individual whether in employment or seeking to enter the workforce.

For further details, please visit: www.theworkfoundation.com

Acknowledgements

The authors would like to thank colleagues at the Work Foundation for their support with this report, in particular Professor Geraint Johnes and David Shoesmith.

This report is based on research that was funded by the Trades Union Congress (TUC). While TUC has reviewed the content to ensure technical accuracy, the Work Foundation has retained final editorial control and the conclusions do not necessarily reflect the views of TUC.

Picture credits

Cover: Thinkstock
Frances O'Grady: © Jess Hurd/reportdigital.co.uk

Foreword

by Frances O'Grady, General Secretary, Trades Union Congress

The UK's decision to leave the European Union will define our political and economic future for years if not decades to come. It will have huge implications for working people in Britain and in the rest of Europe.

The trade union movement wanted a different result in the referendum, but we accept the result. Our objective now is to secure the best Brexit for Britain's working people, and that will require hard work and much better information about the challenges ahead.

We need to work out the shape of a deal between the UK and the rest of the EU that has working people and their interests at its heart.

And although the rhetoric has been toned down recently, we also need to examine the alternative raised by Government ministers – as well as some employers, newspapers and politicians – of the low tax, low regulation Britain after Brexit that the Prime Minister and the Chancellor implicitly threatened the rest of Europe with earlier in the year.

We need to know what 'no deal' would look like, as well as what a good deal might include.

The TUC commissioned this report from the Work Foundation to add to our knowledge about how to answer the first part of that question, to inform the debate domestically and in the rest of Europe.

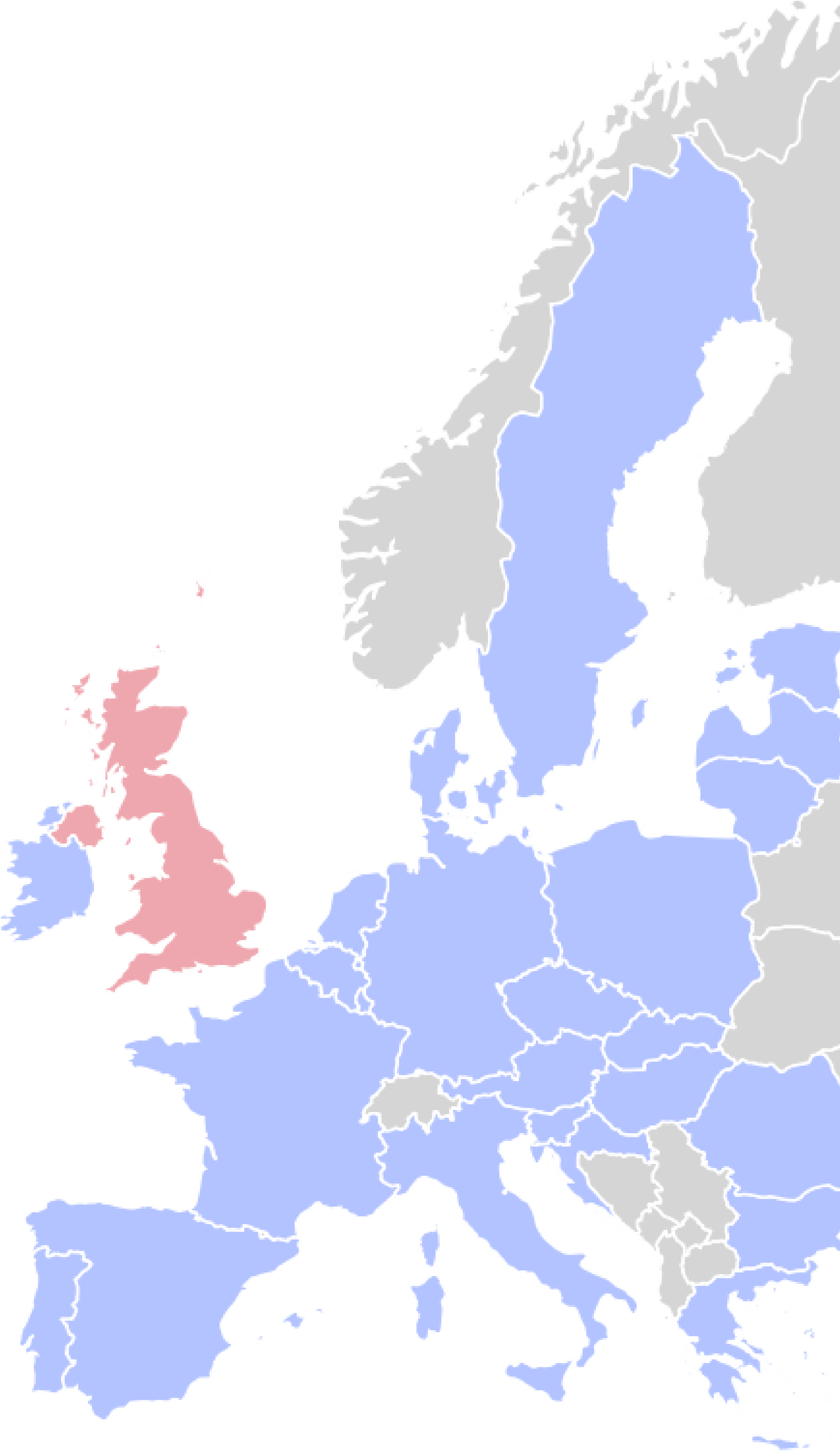
It reiterates what trade unions and others have been saying about employment protection regulation and the high road of decent jobs on good pay, skills, productivity and innovation. There is not only no contradiction between strong rights at work and successful economies, the two often go together. In that area, the Brexit Plan B of no deal with the rest of the EU and a low tax, low regulation future would leave the UK struggling to keep up with the high growth, high skills, high wage economies of Northern Europe.

But the report also reinforces our concerns about the impact of deregulation on British working people's lives and future prospects. Bluntly, the low road risks expanding the share of their economy which is composed of insecure, poorly rewarded, low skill, low productivity jobs. The sort of jobs that have bedevilled Britain's lacklustre recovery since the global financial crisis of nearly a decade ago and blighted the prospects of a lost generation of young people.

What is really new in this report is that as well as the race to the top and the race to the bottom, there is a third, more likely outcome of a deregulation strategy – what the authors call the 'polarised race' where the labour market becomes more and more divided between those who benefit and a potentially growing pool of those who do not, delivering poor pay and lousy jobs for many in both Britain and the rest of Europe.

Growing inequality, a low productivity equilibrium for many businesses and workers, and competitive deregulation across Europe are a serious possibility if we get Brexit wrong, and this report is a balanced and evidence-based contribution to the debate about how we avoid that.

I will be using this report to persuade British and European politicians how important a better Brexit deal is for working people at home and around the rest of Europe. I hope they deliver something that working people can live with, because the alternative is depressing and, ultimately, dangerous for democracy.



Executive Summary

The labour market deregulation reforms of the past decades have propelled the argument that globalisation may be driving a world-wide *'race to the bottom'*. Its predicted outcome is that, with increasing global competition, governments will face growing pressures to perpetually undercut each other by curtailing employment rights to attract higher foreign direct investment (FDI) levels. Greater FDI is believed to reinforce competitive advantage in the global market. On this reasoning, lower employment rights and labour costs (henceforth referenced as *employment standards*) are assumed to be the principal FDI determinant.

This report aims to review the basis for this position and assesses whether the empirical evidence is as straightforward as the prediction outlined above. It does so by specifically considering the European Union (EU) context and whether this hypothesis is likely to hold true in the case of Brexit. The report concludes that, while there is convincing evidence about converging trends of labour market deregulation and its negative effects on working individuals, the *'race to the bottom'* hypothesis oversimplifies highly complex empirical developments. Furthermore, it discloses too little of the existing variation. We reviewed a range of academic studies and reports that use different datasets and indicators, study different regions, investigate FDI flows in different years and reveal mixed results. Some of them reinforce the *'race to the bottom'* hypothesis with empirical evidence which indicates that FDI is more likely to be directed to countries with lower employment standards. Other studies argue that the evidence shows that FDI patterns are dependent on a series of factors that interact to cause diverse outcomes depending on a range of *host country features*, *investing firm characteristics*, and *supranational factors*. They reveal a nuanced picture of FDI patterns and their relationship with employment standards and require further investigation. Rather than clarifying the complexity of the topic, the literature has increasingly fragmented our knowledge of the phenomenon by focusing on the effect of single factors.

Considering all limitations, we derive a risk assessment framework as a basis to:

1. make sense of the complexity of Brexit and its potential implications by deriving possible post Brexit scenarios;
2. support estimations, management and mitigations of the risks; and,
3. set out what new research would be useful to advance this agenda in the future and provide a more consistent body of evidence to inform risk assessment and decision-making processes.

The three scenarios we develop from the evidence (*'race to the bottom'*, *'race to the top'*, and *'polarised racing'*) cannot predict the future. But we advance their potential use as a tool that can support stakeholders to monitor and influence the critical range of factors that are expected to play a role in how national economic models will develop over the coming period. The evidence review enables the conclusion that it is the *'polarised racing'* scenario that is the more likely post Brexit outcome.

Given the limitations of this study, caution is necessary when extrapolating meaning from the scenarios that we propose. They are meant to inform the debate about the consequences of the UK's exit from the EU rather than predict what will happen. The scenarios should therefore be used more as an aid to understand, structure and work through the practical implications of different FDI determinants (including but not limited to employment standards) on investment patterns. The intention is that this will then help shape further thinking about the long-term implications of the UK's withdrawal from the EU, as well as the core factors that are likely to play a role in future developments (posing risks or acting as mitigating factors depending on the circumstances). Whilst the evidence assumes actions might be informed by a rational, often economic logic, using the best available evidence, we do need to recognise of course that in practice decisions and actions of business and governments are informed by a range of incentives, and information, often informal, subjective and political. In that sense that makes the inferences that can be drawn from this research even more complex. These caveats need to be borne in mind.

Contents

List of Figures

List of Tables

Frequently used abbreviations

- Brexit UK's withdrawal from the European Union
- CEE Central-Eastern Europe
- ECJ European Court of Justice
- EU European Union
- FDI Foreign Direct Investment
- GDP Gross Domestic Product
- ILO International Labour Organization
- TFEU Treaty on the Functioning of the European Union
- US United States of America
- WTO World Trade Organization

1. Introduction

The debate around Brexit, and the possibility that the UK will readjust its economic model to preserve its competitive advantage, has reawakened concerns about the *'race to the bottom'* in Europe. Given the uncertain terms under which the Brexit negotiations will be carried out and the consequences of the policy and regulatory void that could follow, an accurate prediction of the Brexit implications for employment standards in the UK and the EU is problematic. In an attempt to contribute to the debate with evidence-based insight, this report extracts the most relevant and robust conclusions from the existing literature. It uses this evidence to:

- identify the role of employment standards and other factors in attracting FDI;
- assess the risk of a post Brexit *'race to the bottom'* in the EU driven by potential cutbacks in employment standards in the UK; and,
- propose an assessment framework that supports estimations, management and mitigation of any identified risks.

The report acknowledges that the evidence in the literature warrants increased attention to the risk of European economies succumbing to a *'race to the bottom'* in the future. After assessing the evidence, we apply a *necessity* and *sufficiency* type of conditional reasoning to develop three scenarios (the *'race to the bottom'*; the *'race to the top'*; and *'polarised racing'*) to help assess the possible post Brexit outcomes for employment standards. The framework takes into account the strategic risks that need to be tested post Brexit.

The evidence in the literature does not warrant the conclusion that a *'race to the bottom'* for *all* parts of the labour market is a likely outcome of the UK's exit from the EU. Instead, it generates the hypothesis that a phenomenon labelled here as *'polarised racing'* is more probable. The concept designates a series of potential concurrent developments at both the low- and the high-end of the European labour markets, which echo the polarisation of national labour markets, as reported by an increasing body of evidence (e.g. Goos et al. 2009).

Our review of the literature that investigates the relationship between employment standards and FDI shows that the role of employment standards in increasing countries' FDI attractiveness cannot be denied and should not be underestimated. At the same time, we also uncover substantial evidence that FDI levels are determined by a complex set of interacting factors, which include, but are not limited to, employment standards. One key conclusion is that different types of FDI are attracted by different levels of employment standards (low to high). We discuss this finding and argue that in a global context of enhanced competition between countries, countries are likely to pursue an economic strategy that maximises growth by: 1) pursuing a model defined by high productivity, skills and employment standards; and, 2) pursuing gains at the bottom end of the labour market by adopting a *low skills equilibrium model* (as defined by Finegold & Soskice 1988), generally characterised as the high road and the low road respectively.

Although the existing evidence does not support the conclusion that a general *'race to the bottom'* is likely in the EU following Brexit, the polarised tendencies which are observed in national labour markets and appear to be replicated at an international scale suggest that there is a risk of downward pressures on costs associated to employment standards which should not be undervalued. The report reflects on the factors that could mitigate the risks of such developments in the Brexit context. Overall, the empirical evidence informs us that across the board generalisations are neither informative nor true to the facts.

1.1. Report Structure

Section 2 sets the context of the *'race to the bottom'* debate and uses the evidence in the literature to identify a range of factors that have driven investment trends in the past, while reviewing the role of employment standards. It identifies the drivers of multinational corporations investment decisions (as proxied by FDI); interrogates the evidence of the relationship between FDI levels and variations in employment standards; and, reviews the evidence linking changes in employment standards in some countries to changes in other countries as a strategic response aimed at increasing FDI. Overall, the section weighs the strength of the evidence for or against the *'race to the bottom'* hypothesis and in concluding it starts to set out the FDI determinants and factors that appear to influence FDI investment patterns.

Section 3 complements the review by identifying examples to clarify the arguments that confirm or contest the *'race to the bottom'* scenario. It has three objectives. *First*, it sketches the profile of FDI in the UK and the role of EU Membership in raising it to unprecedented levels. *Second*, it contributes to an understanding of the topic and its manifestation in a regional area that is of utmost interest because of its role in previous debates about 'social dumping' as a mechanism that increases the pressure for a *'race to the bottom'* (i.e. Central-Eastern European Member States). *Third*, it reviews the EU regulatory framework around FDI and employment rights and identifies potential mechanisms that could be activated as a 'brake' or control mechanism to mitigate the risks and prevent countries from racing each other to the bottom. This allows us to assess the extent to which common EU standards can be protected or are vulnerable to dilution in the event that workers' rights will be diminished in the UK.

Section 4 draws on the previous two sections to construct a *framework* that enables the development of scenarios to assess the balance of the evidence and whether or not the *'race to the bottom'* is more likely versus other outcomes. This presents a tool that can be used to illustrate the range of factors that can potentially mediate the relationship between FDI and employment standards; identify the key risks that can escalate the *'race to the bottom'* scenario; illustrate the key conditions that are expected to either reinforce or offset the influence of a potential decrease in employment rights in the context of a *'race to the bottom'*; and, pinpoint the areas where actions to mitigate risks are possible (and can make alternative scenarios more likely). By exploring the arguments that both support and contradict the *'race to the bottom'* perspective we aim to highlight through the framework the potential of other alternative outcomes (e.g. a *'race to the top'*, or a polarisation phenomenon).

Finally, **Section 5** addresses the limitations of the review and suggests future research directions.

2. The 'Race to the Bottom' Hypothesis

2.1. FDI determinants: Employment standards and mediating factors

It has been repeatedly argued that the steady FDI increase around the world in the recent decades is likely to have reinforced competition between countries. By way of contrast, while the motivation that drives competition is evident, answering questions about its nature is still a challenging endeavour. Do countries show a preference for competing on lower labour and production costs, or by building up workforce skills and increasing productivity levels? Arguments about the detrimental effects of the competition on driving a *'race to the bottom'* in employment standards have often grabbed the headlines. They have also been investigated in the academic and non-academic literature, but findings show the evidence is inconclusive. In the context of the UK's pending withdrawal from the EU, foreign investment has become an even more critical issue that requires scientific evidence rather than anecdotal confirmation.

The analysis of macroeconomic factors has dominated the literature on FDI determinants for many years. Studies in this approach have tested theoretical expectations generally derived from investment theories, which emphasised elements such as market size and growth potential, corporate income taxes, as well as exchange rates and wage differentials as the key elements that determined investment decisions (Ailber 1970; Barrell & Pain 1996; Bellak & Leibrecht 2005). More recent developments in the literature have shown the need for a more nuanced approach in identifying the effects of different factors on FDI location. Various studies have been informed by elements of industrial organisation and trade theory, which has tapped into the impact of investing firm characteristics on the decision to invest abroad (Rasciute & Pentecost 2010; Krugman 1991). On the whole, prior studies identify a range of factors that interact in different ways to influence FDI levels in different socio-economic, legal, political and geographic contexts. Their greater or lesser importance appears to be context-dependent, as some factors offset or reinforce each other in determining FDI types and levels. No factor is a necessary and sufficient condition for FDI of its own accord. In fact, each secures more weight or becomes less relevant in context-specific interactions with the others.

More recently, employment standards have generated considerable interest in terms of their influence on foreign investment. This section zooms in on this relationship and explores the existing evidence about the *'race to the bottom'* hypothesis. It assesses the strength of the arguments made and reviews whether the methodological approaches enable conclusions about associations or causal relationships, and whether the interactions between the range of factors that are involved in companies' decisions to invest abroad are taken into account.

A set of core FDI determinants are identified, which are consequently subsumed under three dimensions: *host country characteristics*, *investing firm features* and *supranational factors*. Another core finding that emerges from the review is that different types of FDI are attracted by diverse levels of employment standards. The literature separates between two general types: ***vertical*** and ***horizontal*** FDI. In the case of the former, different stages of the production process are relocated to foreign markets with the purposes of gaining a competitive advantage[1]. In the case of the latter, investments include the entire production process and they are generally preferred in situations when the location provides strategic access to wider markets[2]. Because of their different rationales, *vertical* and *horizontal* FDI are likely to react differently to varying levels of employment standards (including rights and costs). As the brief literature review in the following two sub-sections shows, it has been argued that *vertical* FDI is more sensitive to lower employment standards than *horizontal* FDI. Nevertheless, existing studies have documented that investors weigh labour costs against other characteristics of the workforce in different locations depending on their product development strategies: higher skills are a sign of higher productivity, which is critical for investors that shape their competitive advantage by developing high-end products (Dunning & Lundan 2008: 470).

This section reviews the evidence and advances potential explanations about the puzzling diversity of findings around the relationship between employment standards and FDI. Less straightforward than projected, the empirical evidence is mixed and in fact contradictory. Some studies do find evidence of a negative effect of higher employment standards on foreign investment. Others, however, find evidence to the contrary. We assess the evidence and pin down the multilevel and multidimensional framework that determines FDI location. This critical stage is complemented in Section 3 by a case study of FDI patterns in selected EU countries (the UK and Central-Eastern EU countries) and by an assessment of the role of EU institutions in regulating FDI flows and common employment standards. Both sections build up the evidence that is analysed in Section 4 and developed into a risk assessment framework that estimates the likelihood of a *'race to the bottom'* and suggests alternative scenarios that could shape post Brexit FDI trends and employment standards levels.

2.1.1. Evidence supporting the 'race to the bottom' argument

Some empirical investigations appear to confirm that lower labour costs attract higher FDI levels (Botero et al. 2004: 1379; Lehmann & Muravyev 2009). The general argument is that higher labour costs stifle job creation and act as a disincentive for employers to recruit new employees due to higher hiring and firing costs (Javorcik & Spatareanu 2005). Furthermore, it is argued that companies are attracted to low labour costs especially in the case of more mobile types of FDI (i.e. the previously defined *vertical* FDI), when part of the production process is transferred abroad (Helpman 1984). There is a range of studies that find lower employment standards are associated with higher FDI levels (e.g. Benassy-Quere et al. 2007).

For example, FDI indicators are generally limited to greenfield investments (i.e. where a company begins a new venture in a location where no existing facilities are currently present), which leaves out other mechanisms by which foreign companies invest: for example, mergers and acquisitions are one of the key means of investment in European countries (e.g. the UK). The availability and reliability of statistical data on different types of

[1] ***Vertical FDI*** has generally been defined in the literature as occurring when companies invest in a foreign country as a cost minimising strategy (i.e. by relocating different parts or stages of the production system and then finalising the production process in the home country of the investing company) (see for example Helpman 1984).

[2] ***Horizontal FDI*** is also frequently cited in the literature as the type of investment that is driven by a distinct strategy, i.e. the duplication of the companies' activities in one or more countries, which is aimed at accessing and selling the final products or services to those markets rather than simply using the local labour pool and then shipping the products to be sold somewhere else. FDI is the preferred option to trade in this case (Markusen 1984).

foreign investment and employment standards has driven the focus on some indicators rather than others. As a result, studies have tended to focus on employment protection legislation and association rights to estimate the determinants of FDI (i.e. generally defined as greenfield investments)[3]. Some authors have recognised the limited power of proxies to measure multidimensional factors and predict complex relationships. Others, have, however, assumed that findings that are based on a narrow set of measurements can be generalised across the board without explicitly recognising potential measurement errors. Findings indicate that there is a negative association between employment protection legislation and the probability that FDI occurs (i.e. the lower the former, the higher the latter) (Javorcik & Spatareanu 2005). One qualification is that while employment standards influence FDI location and its volume, the comparison is relative to the standards established in the countries where FDI originates (Javorcik & Spatareanu 2005).

Different factors that represent incentives or disincentives for investment may interact and offset each other: e.g. higher employment standards may be offset by generous corporate tax systems, anticipation of higher efficiency of the production system due to higher skills and productivity levels, market size, GDP, other institutional characteristics, lower trade barriers etc. These factors are all part of any given country's bargaining position (Duanmu 2014) and may mitigate the *'race to the bottom'* as they are assessed in investing companies' decisions. There are also studies that have emphasised that it is not only the advantages that derive from the 'ease of entry' for foreign investors, but also from the 'ease of exit' that determine FDI inflows (Görg 2005). It was found that companies looking to invest abroad weigh entry incentives as well as exit costs before deciding where to invest (Görg 2005).The host of factors that are revealed illustrate the complexity of the decision-making process and the different trade-offs different types of companies face. The literature however has hardly explored the interactions between them despite this and generally draws on single factor effects.

Most studies assume that a negative relationship between employment rights and FDI flows (i.e. when the former increase, the latter decrease) implies hard evidence for the *'race to the bottom'* hypothesis. Few studies actually explicitly test if the key cause of the competition is the desire to attract foreign investment and if countries react to each other's changes in employment standards (Olney 2013; Davies & Vadlamannati 2013). There are hence **two levels of the 'race to the bottom' hypothesis** that are unevenly addressed.

William W. Olney (2013) makes a significant contribution in this sense by attempting to explicitly test the hypothesis that states actively engage in lowering employment rights with the aim of maintaining their competitive advantage over other countries by attracting higher FDI levels. The proxy that is used to measure employment standards is quite narrow: employment protection legislation. More importantly, this indicates that the relationship between FDI and employment standards varies depending on the nature of the investment, a finding that is confirmed by other studies referenced in this report. Olney also argues that his estimations indicate that countries are reactively lowering employment protection legislation as a response to their competitors' endeavours in this area (Olney 2013: 4).

Employment protection regulations have indeed on average decreased during the past two decades across OECD countries. Labour market deregulation reforms have specifically

[3] See details about the UK case in Driffield et al. (2013).

aimed at this outcome. While this is uncontested, other employment rights have been consolidated across many of the same countries, especially as a result of the European integration process and the set-up of a common core of employment standards (e.g. anti-discrimination legislation, working conditions, health and safety regulations, parental leave rights etc.). Olney's study is a valuable addition to the growing literature on FDI determinants, but his results should nevertheless be read with caution and not generalised to the entire employment rights framework, especially as his conclusions are derived from US outward foreign investment data and therefore explains the investment behaviour of US companies.

Another similar contribution that aims to test whether countries in fact undercut each other in terms of employment standards is that of Davies and Vadlamannati (2013). Analysing panel data on 135 developed and developing countries during 1985-2002, they estimate the extent to which countries race to the bottom by reacting to changes in employment rights regulations and/ or enforcement as a strategy to maintain their competitive advantage (Davies & Vadlamannati 2013). Using an index which covers rights such as freedom of association and collective bargaining, the right to unionise, the right to strike, and rights in export processing zones, they find evidence of a negative correlation between employment standards and FDI levels across countries (Davies & Vadlamannati 2013: 4). The index excludes wages, working conditions or benefit entitlements. An important contribution is the attempt to extend the measurement framework beyond regulations to include enforced rights (i.e. the number of *reported* violations relative to each right captured in the index). Possible under-reporting of violations may limit their conclusions. Davies & Vadlamannati suggest the evidence indicates that developing states compete by reducing enforcement mechanisms, while developed countries compete by changing regulations (2013: 11-12). The research does not however test whether this is driven by competition for FDI.

This brief review of an extensive literature enables us to derive some tentative conclusions. First, the complexity of the relationship between employment standards and foreign direct investment is far greater than is generally assumed by conventional wisdom. Second, the lack of comparable data across countries and years makes it difficult for studies to determine the direction and nature of the relationship, as well as the various patterns of interactions between employment standards and other factors which influence FDI location decisions. There is consequently limited empirical evidence to support the prediction that countries are racing to the bottom by rolling back employment standards to undercut competitors in attracting higher levels of foreign investment. Third, there is some evidence that countries have lowered their labour standards, at the same time as seeking foreign investment. However, the evidence cannot tell us whether they have done this in order to attract FDI, or whether this strategy has in fact been effective.

As echoed throughout this report, the gaps in existing research prevent the authors from reaching definitive conclusions. As follows, the fact that empirical evidence does not validate the *'race to the bottom'* scenario across all economic sectors in the post Brexit Europe does not overthrow the theoretical arguments that support this hypothesis. More research is needed to assess the full extent of the key risks and mitigating factors for a *'race to the bottom'* in the current political and economic context in the EU.

The next sub-section illustrates the complexity of this relationship by reviewing key findings that indicate that employment standards are not isolated factors, but that in fact the context in which they are embedded imposes a range of trade-offs that determines companies' decisions to invest in some locations rather than others.

2.1.2. Evidence disputing the 'race to the bottom' argument

The finding that FDI is attracted to countries with lower employment standards is not without challenge. Several studies show that some multinational corporations choose to invest in countries with higher levels of employment protection because of the associated incentives for 'incremental innovation' (Griffith & Macartney 2010), but the opposite appears to occur when companies aim at 'radical innovation' (Akkermans et al. 2005; Griffith & Macartney 2010)[4]. Clearly, the relationship between employment regulations and investment in innovation is not undisputed. It is likely to be mediated by the adjustment cost of the investing company. For example, radical innovation may be stifled in countries with higher employment protection because of the higher costs involved in sourcing the necessary skills. On the other hand, incremental innovation may be increased because of the unobserved effects of higher employment protection on workers' productivity and commitment (Griffith & Macartney 2010: 2). Likewise, studies find that countries with higher levels of employment protection experience higher productivity growth (Acharya et al. 2009), but there are indications that this is more likely to occur in coordinated economies because of the mechanisms that are available in countries with tripartite bargaining systems[5] (Bassanini & Ernst 2002). What this seems to indicate is that institutional structures are one factor that is likely to mediate the relationship between employment standards and multinational companies' decisions to invest in some countries rather than others. Even Olney's study (referenced in the previous section) confirms that there are significant differences between investments which aim to access wider markets (*horizontal* FDI) and those that aim to cut production costs by relocating parts of the production chain (*vertical* FDI) (Olney 2013: 3).

The characteristics of the workforce (e.g. skills, productivity, etc.) also vary extensively and are therefore another significant factor in determining FDI location. The reverse of the 'high appeal of low labour cost' argument is advanced by some studies: for investors with a longer term vision, higher labour costs might provide an incentive to invest in recruiting the best matched contenders for the jobs they create, as well as build and sustain the commitment of their workforce (Harcourt & Wood 2007). This represents an indication of a *virtuous circle* that captures the advantages foreign investors could benefit from if they choose to invest in services that thrive on high-skills and high productivity – and which therefore benefit from higher employment standards. This point is discussed in detail in Section 4 and represents one of the key dimensions that inform the construction of the post Brexit framework of scenarios and their implications. Locke & Romis (2007) reinforce this conclusion when they find that higher employee productivity is more likely in businesses that uphold higher employment standards.

These arguments raise questions about the type of competitiveness that is at the basis of foreign investments: FDI that is driven by low-cost competition is more likely to be attracted to locations that have lower labour costs (Wood et al. 2016: 155). In contrast, it was argued that for companies competing at the higher end of product quality and innovation, higher

[4] The literature generally defines 'incremental innovation' as the process which continuously improves existing products, as opposed to radical innovation, which creates original ones (see discussion in Acemoglu & Cao 2015 and Aghion & Howitt 1998).

[5] A type of collective bargaining or consultation that includes government institutions, trade unions and employer associations.

employment standards support the creation of conditions in which companies can develop their competitive advantage (e.g. training employees with specific sets of skills, incentivising higher commitment and lower staff turnover). Recent evidence about the high attractiveness levels of EU countries with higher employment standards supports these arguments.

For example, Wood et al. estimate the impact of non-wage labour costs on companies' decisions to invest and find evidence in support of the argument that countries with higher employment rights levels attract higher FDI levels, especially if the countries are in the EU (Wood et al. 2016: 157). The indicators they use are also limited, however: the rigidity of hours, the difficulty of redundancy and the overall rigidity of employment. The results are explained by means of the relationship between increased job security as well as employees' commitment and productivity, which is convergent with other estimations (Hall & Soskice 2001; Wood et al. 2016: 157). Another study that concludes there is a positive association between employment rights and FDI (i.e. the higher the former, the higher also the latter) argues that the relationship is mediated by factors such as productivity levels, workers' skills, and greater political and social stability (Kucera 2002: 33). Employment standards are proxied by the rights included in the ILO Declaration on Fundamental Principles and Rights at Work – Article 2 (Kucera 2002: 33). He estimates the effects of labour costs separately and finds that they impact FDI negatively (Kucera 2002: 33). This conclusion is in line with other findings (e.g. OECD 2000) and illustrates the imperfect overlap between these measures (Kucera 2002). The findings raise questions about the impact of alternative measures of employment standards on research findings, as well as the possibility that different dimensions of employment standards are weighed differently in companies' decisions to invest abroad (see previously discussed *trade-off* situation).

Comparatively fewer studies acknowledge that the relationship between employment rights and FDI is not unidirectional and specifically interrogate how this works empirically. Blanton & Blanton (2012) for example track this reciprocal relationship over time in 35 developing countries. The study argues that once investments are in place, *vicious* and respectively *virtuous* cycles occur: higher employment standards not only attract more investment, but are also reinforced by them; likewise, lower employment standards exert a downward pressure on foreign investment (Blanton & Blanton 2012). This indicates that although in aggregate terms there is evidence that confirms the negative relationship between employment standards and FDI flows, once FDI is disaggregated into different types and analysed across economic sectors, this overarching conclusion is no longer confirmed. More specifically, there are indications that while FDI in the service sector is negatively correlated with employment rights, FDI in manufacturing sector is positively correlated with it (Blanton & Blanton 2012). A possible explanation is the positive relationship between employment standards, skill levels and workforce productivity, which contributes to higher efficiency in production processes and therefore yields higher investment profitability. This explanation is similar with others that are hypothesised in the literature (e.g. Moran 2011). Interestingly, no significant relationship between FDI and employment standards is identified in the primary sector (Blanton & Blanton 2012).

2.2. Key FDI determinants: a multilevel and multidimensional framework

The existing studies converge in identifying **a relationship between employment standards and FDI**, which can be qualified as associative rather than causal. As reviewed in the previous two sub-sections, the evidence about the nature of the relationship and its outcomes is mixed and the results inconsistent. The literature generally assumes a one-way linear relationship between employment rights and FDI, and few contemplate the possibility of a **circular causal chain**, as identified by Mosley (2011), for example. There is evidence that the **relationship between employment standards and FDI levels is both positive and negative**. But this relationship is conditioned by a range of factors including: economic sectors, FDI types, geographical regions, firm characteristics, and employment standards indicators (defined as employment protection legislation, collective bargaining and association rights, or labour costs). These variations often make comparisons across studies difficult. The reviewed evidence shows that different categories of employment standards may affect FDI levels in different ways.

Further to the evidence review, we found that **different types of FDI (*vertical* and *horizontal*) are attracted by different types of employment standards** (lower and higher). Many studies investigate the effects of employment standards on aggregate FDI, but some studies find that different types of foreign investment react differently to different levels of employment standards: *horizontal* FDI appears to be encouraged by higher employment standards, whereas the reverse applies to *vertical* FDI, which seems to be attracted by lower employment standards. There appears to be a link between short-term investment strategies and the preference for lower labour standards, especially in the case of the production processes that do not require a skilled workforce. In contrast, in cases where investments are part of long-term expansion strategies, high staff turn-over and low skill levels accompanied by low productivity, will be seen as undesirable liabilities to business performance, and therefore such investments will seek action to avoid them. Higher employment standards under these circumstances are then more likely to be perceived as a way of ensuring competitive advantage and hence as levers to increase workers' commitment and productivity. Indeed, the review points to a growing body of evidence which indicates that workforce quality is a vital mechanism to secure greater returns to investment, being positively associated with higher innovation, digitisation and in turn performance.[6]

Having reviewed the literature, we think it is important to identify the set of factors that are shown to influence FDI as a way of beginning to assess the full range of influences on future FDI investment patterns and how they might be better managed. As outlined in Table 1 below, they can be condensed into two **main categories of FDI determinants**: *host country features* (which include employment standards), and *investing firm characteristics*. The table includes the core FDI determinants that are analysed in the literature, albeit to varying degrees of detail.

Table 1 also includes a third category of FDI determinants and pre-empts Section 3, which identifies the potentially critical role that *supranational factors* (in this case the EU) can also play in influencing Member States' decisions around how to compete in the post Brexit global market. EU levers (and indeed other supranational levers e.g. the WTO) that influence FDI flows could play a significant role in maintaining employment standards in the future. This is discussed in detail in Section 3. Figure 1, opposite, summarises the relationship between employment standards and different FDI types (*vertical* and *horizontal*) and the additional factors that mediate it.

[6] How good is your business really? Raising our ambitions for business performance, 2016, https://howgoodisyourbusinessreally.co.uk/downloads/reports/how-good-is-your-business-really.pdf, accessed in April 2017.

Table 1: Core FDI determinants

Host country factors	Investing firm characteristics	Supranational factors
▪ Employment standards ▪ Market access ▪ Market size & GDP ▪ Business & investment climate ▪ Workforce skills & productivity levels ▪ Economic sector composition (service & manufacturing) ▪ Corporate tax regimes & other financial (dis)incentives ▪ Geographic location ▪ Socio-political & legal stability ▪ Previous cultural and/or trade relations	▪ Productivity & profitability ▪ Operating in labour intensive sectors or not ▪ Firm size ▪ Capital-labour ratio ▪ Research & development (R&D)	▪ EU policies and regulations about inward and outward FDI ▪ EU minimum employment and human rights standards ▪ Commercial policy ▪ Competition policy

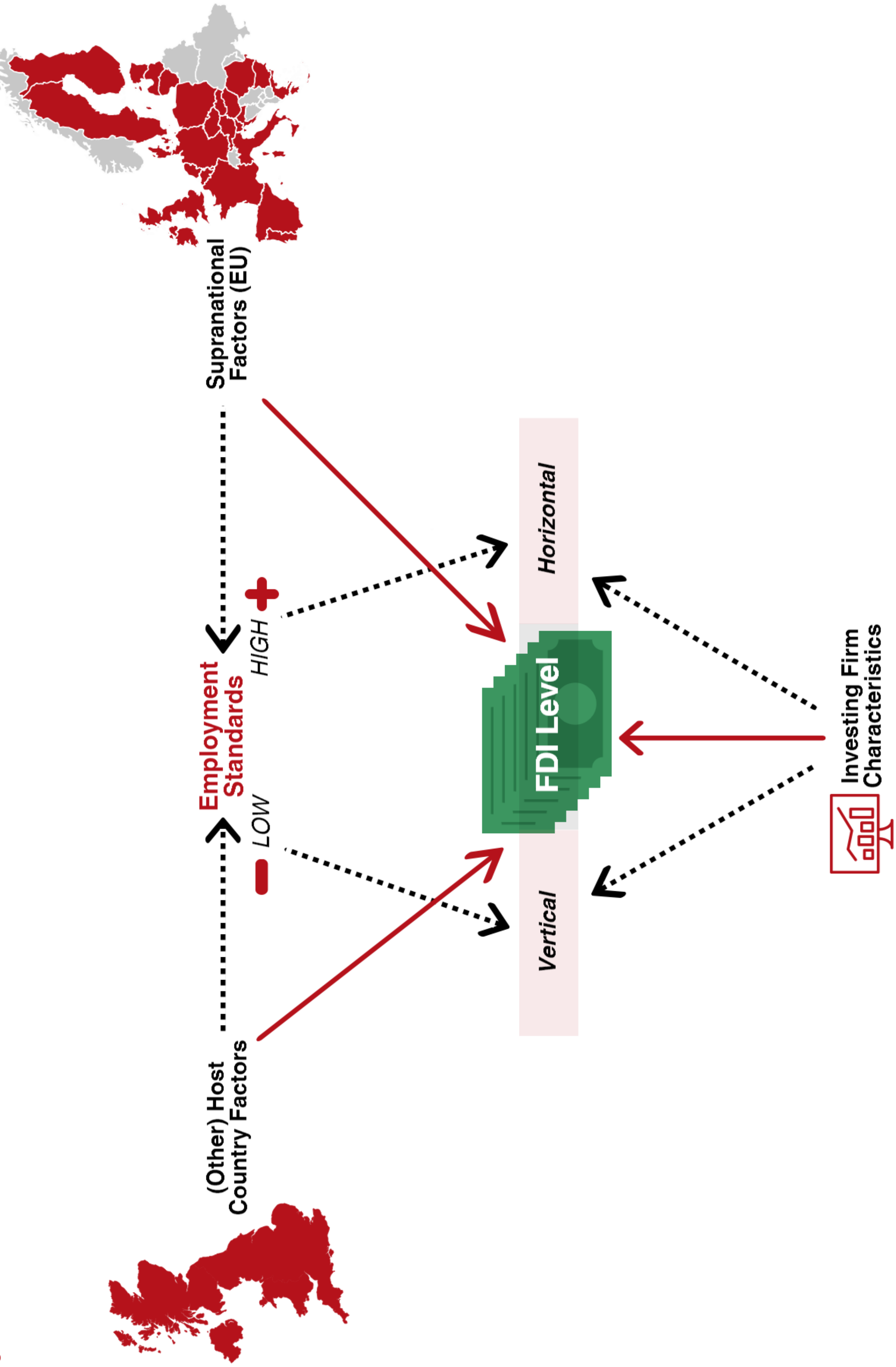


Figure 1: Multilevel & multidimensional framework: FDI determinants

3. Assessing EU Standards and FDI in context

3.1. UK inward FDI

For years, the UK has been one of the world's top receivers of foreign capital. According to the 2014-2015 estimates of the UK Department for International Trade, the UK ranked third in the world in terms of FDI stock (with $1.7 trillion), behind China (with $2.7 trillion) and the US (with $5.4 trillion) (Department for International Trade 2015). The ONS estimates that the largest foreign investments in the UK were from the US (£253.0 billion) and from EU countries such as the Netherlands, Luxembourg, France, and Germany (with an EU total value of £495.8 billion) (ONS 2016a). The total value of the investment makes the EU the largest source of foreign capital in the UK and makes up 47.9% of its inward FDI (ONS 2016a).

The UK has been the leading destination for FDI in Europe in the past years, in close competition with Germany (followed by France and Spain). Germany is the UK's close runner up and has increasingly attracted FDI despite more rigid labour market regulations that impose additional barriers relative to the UK[7]. One explanation is that their competitive positions are driven by a range of parameters that attract different types of FDI in different economic sectors. This is consistent with the literature reviewed in Section 2.

Economic growth is harboured by predictable regulations and institutions, workforce skills and productivity. As has been noted, these are factors that increase returns on investment. This combination of factors is a key driver of FDI in Europe despite its higher employment standards relative to other regions where lower labour costs are often complemented by economic and political instability (Ernst & Young 2016). A case in point, the bulk of UK inward FDI has been directed at service sectors that employ higher-skilled workforce, such as headquarters investments, research and development, sales and marketing – predominantly in the software, business and financial services (Ernst & Young 2016: 16). Notwithstanding recent growth, FDI in the UK manufacturing sectors is relatively limited.[8]

The ONS reports a decrease in net inward FDI earnings for 2015, which was largely generated by a drop of £1.5 billion from 2014 to 2015 in the production industries (i.e. transport equipment, food, beverages and tobacco products) (ONS 2016b). Net inward FDI earnings from the services sectors however increased by £1.1 billion in 2015 relative to 2014 (ONS 2016b). This increase was led by the financial, information, and communication services (ONS 2016b). The data therefore shows an increase in FDI in the higher skilled sectors and an opposite trend in the lower skilled sectors, which reflects on the balance between low-end and high-end foreign investment in the UK.

The UK's inward FDI growth during the past years has been driven by the North West, the North East and Yorkshire, followed by Scotland, the West Midlands and the East of England (Ernst & Young 2016: 12). While highlighting the increasing distribution of FDI away from

[7] e.g. although labour market deregulation reforms have been implemented in Germany during the past decade, hiring and firing costs are still larger in comparison with the UK. See OECD Employment Protection Legislation (EPL) Index at http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm, accessed in March 2017.

[8] This is in comparison with other sectors in the UK that attract FDI and also with other countries in the EU which attract the bulk of foreign investment in the manufacturing sector (e.g. Germany), see Ernst & Young (2016:16).

London, on a deeper level it exposes the heterogeneity of foreign investors that are attracted by different economic sectors, infrastructures, and workforce specialisation. These trends reinforce the earlier conclusions drawn from the evidence, i.e. that employment standards interact with various other factors to determine FDI levels in different sectors of the UK economy.

3.2. The EU effect: The impact of EU membership on FDI levels in the UK

Quantifying the impact of EU membership for the UK is extremely challenging given the complex nature of the EU integration process and its cumulative effects across time. Explaining what would have happened to the UK in the alternative scenario – i.e. had it not joined the European Economic Community in 1973 – is a near impossible task given the lack of adequate comparators on a range of economic, structural, social, geographic and political indicators. There are nonetheless several studies that support reflection on the likely effects of EU membership on the UK's economy. They speak to the positive association between the UK's economic growth, trade and foreign investment. They also consider how the EU's framework might have facilitated the positive developments in the UK.

The debate between EU supporters and Eurosceptics has focused on the balance between the UK's gains and losses in economic terms following the accession to the EU. The 'EU membership fee'[9] has often been as a key discontent in the public debate. Still, research confirms that during EU membership, the UK's macroeconomic performance has significantly improved on all counts: foreign investment, trade, productivity and GDP (Crafts 2016). Whether EU membership was the key cause for the positive developments remains at this stage a hypothesis in need of validating evidence. For now, the arguments that support it rest on evidence about a range of developments.

First, the Single Market enabled trade liberalisation, which increased the attractiveness of the UK to foreign investors outside of the EU because of the opportunities of accessing the wider EU market. Evidence indicates that EU membership has raised trade levels much more effectively than European Economic Area membership (Baier et al. 2008). Membership in the EU Single Market has also had implications for the level of competitiveness, which has had positive effects in raising the quality of products (Crafts 2016). Based on the patterns of associations that are identified, the literature converges in providing convincing evidence about the EU membership-related economic mechanisms that contributed to raising the UK's economic growth (Campos et al. 2014; Pain & Young 2004).

Second, FDI has recurrently increased in the decades following the UK's accession and has had a positive effect on productivity levels (Haskel et al. 2007). Third, increasing economic integration in the EU throughout the past decades is associated with a significant increase in GDP; counterfactual evidence estimates a 26.1% increase in GDP in 2000 for the EU15 countries, and a 25.5% increase for the UK (Badinger 2005). In terms of economic growth, the relationship was not estimated to be as straightforward as for GDP increase (Badinger 2005). Fourth, the economic benefits of joining the EU have outweighed the direct costs incurred as a result of mandatory payments made to the EU budget (e.g. the Common Agricultural Policy) (Crafts 2016: 9). Fifth, outside the Single Market, the UK would have likely been exposed to higher tariff and non-tariff barriers (Crafts 2016: 12).

[9] i.e. the mandatory contributions that the UK, as any other EU member state, needs to make to the EU budget.

Finally, the UK's attractiveness to foreign investors was increased because of its gateway position into the EU Single Market (HM Treasury 2016: 169). In line with the theoretical predictions of regional integration theory (Levy-Yeyati et al. 2003), it was estimated that on average, EU membership increased intra-EU investment by 35% and that FDI inflows from non-EU countries are also increased by the opportunity to set up base to export to other surrounding markets (Levy-Yeyati et al. 2003: 173).

On the whole, the existing body of evidence points to EU membership as a likely direct or indirect cause of the growth in the UK's inward FDI. This leads to the conclusion that although employment standards also increased in the UK as a result of the EU common employment standards (TUC 2016), FDI did not decrease. In fact, it increased. This shows that access to the EU Single Market (next to other UK specific factors) contributed to either offset the importance of higher employment standards in investors' decisions or to attracting higher levels of *horizontal* FDI. This yet again shows that the relationship between FDI and employment standards is complex, and mediated by a range of other factors.

3.3. FDI patterns in the EU: Case study review of FDI determinants in Central-Eastern Europe and the impact of EU enlargement on FDI flows

Allegations about 'social dumping' (i.e. unfair competition practices) driven by lower wages in different sectors across countries have been debated for many years. This has fuelled the *'race to the bottom'* debate (Erickson & Kuruvilla 1994). The most recent suspects have been Central-Eastern European countries (CEE). Trade and FDI barriers were eliminated for them following EU accession and EU membership has channelled higher levels of foreign investment into those countries. However, there are different patterns of foreign investment across CEE states, which reflects their diverse socio-economic structures and the characteristics of the transition to fully operational market economies.

As previously discussed, various studies argue that higher employment standards depress foreign investment due to higher associated costs. Following from this, the CEE countries with the cheapest costs derived from weak employment standards should have received the highest FDI inflows. Poland, the Czech Republic and Hungary were the leading beneficiaries of inward FDI during the past two decades, while countries such as Romania and Bulgaria lagged behind despite lower labour costs (Carstensen & Toubal 2004: 4). The empirical evidence hence does not validate the hypothesis and reveals a range of additional factors that co-determine FDI. CEE countries with more stable transition economies and the least risky socio-economic, political and legal environments have attracted the highest share of FDI in the region despite relatively higher labour costs (Carstensen & Toubal 2004: 4). Relative productivity-adjusted labour cost is another decisive factor that explains FDI locations decisions (Carstensen & Toubal 2004) and draws attention to the weight of labour costs relative to other factors – such as labour productivity – in companies' profitability ratio.

A shortcoming of many studies investigating FDI patterns in CEE countries is that they do not differentiate between *vertical* and *horizontal* FDI, economic sectors or investing firm characteristics. The few that do find that host country factors and investing firm characteristics interact to shape FDI location decisions (Rasciute & Pentecost 2010: 39)[10].

[10] Rasciute & Pentecost (2010) analyse 1,108 FDI location choices carried out by companies from the EU 15 countries as well as Norway, Switzerland, the US and Japan into Central-Eastern Europe for a ten-year period starting 1997.

They conclude that investors in the more traditional sectors, that are reliant on low-skilled manual labour (i.e. large parts of the service sectors), are more likely to be attracted to countries where labour costs are lower and low-skilled workers are more readily available (Rasciute & Pentecost 2010: 35). On the other hand, investors in sectors driven by product innovation are more likely to invest in locations where the workforce has the relevant skills to allow the capital that is invested to be profitable, despite higher labour costs (Rasciute & Pentecost 2010: 35). This finding reinforces previous conclusions in the literature about the divide between economic sectors that seek to compete on the basis of *high skills equilibrium* (i.e. high skills, high productivity and high employment standards) vs those which seek to compete on *low skills equilibrium* (i.e. low skills, low productivity and low employment standards). The report discusses this divide in detail in Section 4.

In like manner, Wood et al. (2016) test the effect of labour market flexibility (including decreasing employment rights) on the differences in FDI flows across countries. They investigate whether foreign investment has increased in 10 South-Eastern European countries[11] following labour market deregulation reforms, which included reductions in various employment rights. They find that contrary to expectations derived from the literature, FDI decreases in countries where employment rights are weakened (Wood et al. 2016).

In contrast, the argument that FDI location is responsive to employment standards is reinforced by evidence that protection against dismissals is negatively correlated with FDI levels (Krzywdzinski 2014). These results however vary across industrial sectors and the investors' countries of origin (Krzywdzinski 2014). The degree of unionisation (often believed to have negative effects on FDI levels) is found to yield no effect on decisions to invest (Krzywdzinski 2014). Although labour costs are lower in CEE states, employment protection regulations are often stricter than in some Western countries (especially the UK or Denmark) (Krzywdzinski 2014: 929).

What this then shows is that even within the wider 'employment standards' framework, labour costs and employment rights can have different (if not opposite) effects. In the case of Central-Eastern Europe and FDI inward flows, both dimensions were concurrently present, which suggests that the different dimensions that make up countries' employment standards are not necessarily correlated, as often assumed in the literature. The inconsistencies between the different components can result in contradicting *push and pull* pressures on inward FDI. It follows that low labour costs are not the single determinant of FDI inflows and that the emerging hypothesis is that only under specific sets of conditions does FDI function as a 'social dumping' mechanism. This discussion is extended in sub-section 3.4.2.

All in all, the economic trends after the EU's Eastward enlargement do not appear to validate the simple *'race to the bottom'* hypothesis, but this conclusion requires qualification. This is primarily driven by the narrow approach to measuring employment standards (i.e. either wage levels or employment protection legislation). A closer review of the literature than allowed by the scope of this report would need to probe into potential changes in the employment standards framework in CEE countries during and after their accession to the EU. As in other geographic areas, while changes in regulations might be easier to identify, changes in the enforcement of the existing legislation is likely to be more difficult to assess

[11] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYRO Macedonia, Greece, Montenegro, Romania, Serbia, and Serbia and Montenegro (NB Serbia and Montenegro ceased to exist in 2006).

(primarily due to the lack of reliable comparable data). Given the context, it could be that FDI has reached a ceiling during the past years. Moreover, despite continuing lower labour costs, the most developed 'old' EU Member States continue to attract the highest FDI levels in the EU (as was shown in sub-section 3.1. on the UK's FDI profile). Even so, there is not enough evidence about FDI determinants at the low and high-end of the Central-Eastern European labour markets. There are also unanswered questions about the patterns of competition with more developed EU Member States in specific sectors of the economy.

3.4. EU-level regulatory framework on employment rights and FDI

This sub-section reviews four dimensions of EU-level regulations that are likely to determine the bloc's position regarding competition for FDI and trade in the future. Our aim is to investigate whether the EU could dispose of mechanisms to resist potential downward pressures initiated by eroding employment standards in the UK. We review the EU common employment standards, commercial and competition policies, as well as anti-dumping measures.

3.4.1. Common employment standards in the EU

Although labour market deregulation reforms have had negative effects on some employment rights in the past two decades[12], the opposite is true for other categories of rights. EU integration is one of the mechanisms that have driven these positive developments in EU Member States. Articles 145-150 (Title IX) of the *Treaty on the Functioning of the European Union* (TFEU) set up an EU-wide strategy for employment that aims to respond to labour market changes with policies which invest in a 'skilled, trained, and adaptable workforce' (TFEU, Title IX, Article 145). Articles 151-161 (Title X) on Social Policy, link employment to improved living and working standards, as well as securing social protection standards for EU citizens as a building block of higher employment levels and a counterweight to exclusion (TFEU, Article 151). The EU has competence over common health and safety regulations, working conditions, social security, consultation and representation of workers, the integration of individuals who are excluded from the labour market, and the equality between men and women with a view to opportunities in the labour market (TFEU, Article 153). However, there is no EU competence to regulate in a way that harmonises Member State regulations or fundamentally alters their social security systems (TFEU, Article 153).

The EU labour law timeline shows improvements in the adoption of EU-wide minimum standards prompted by EU directives in two main areas – working conditions and worker consultation processes (European Commission 2014). Several directives and regulations were adopted at the EU level, among which: in the 1970s – the protection of workers against collective dismissal and redundancies; in the 1990s – equality on grounds of religious affiliation, gender, sexual orientation, age and ethnicity; parental leave rights; health and safety regulations; in the 1990s and 2000s – the working time for different sectors and categories of workers; and the posted workers directive; and subsequently – information, participation and engagement of working individuals in their work environment; the protection from discrimination related to working and employment conditions of workers engaged in non-standard forms of work (part-time, fixed-term and temporary agency work); and equal

[12] According to Olney (2013: 38), this is especially on employment protection legislation, particularly in countries such as Spain, Denmark, Italy and Sweden.

opportunities and equal treatment in matters of employment and occupation of men and women (European Commission 2014).

Some of the afore-mentioned employment standards were aimed at counter-balancing the risks that labour market deregulation placed on working individuals. For the new EU member states, these laws and regulations were part of the *acquis communautaire*[13] they needed to adopt and implement in their national legislation when they joined the EU.

Despite protracted debates regarding the adoption and implementation of EU employment directives in national legislation, they represent a remarkable advance in the coordination of employment standards across the EU. In the UK too, employment standards have risen considerably as a result of the country's EU membership and its adoption of the EU common standards listed above (TUC 2016). While these standards were adopted at a minimum level and several countries' regulatory frameworks include higher levels of employment standards, they prevent individual governments from reducing them to a level below the common EU norm. This does not mean that some countries may not still have considerable leeway in rolling back rights and labour costs before reaching that minimum threshold. However, common EU employment standards prevent wide-reaching changes in legislation that would restrict employment standards below that threshold. In that sense, whereas a race to a relative bottom could be envisaged if the countries that have the most generous levels of employment standards in the EU decided to detract from them, a race to the absolute bottom is unlikely given the current configuration of standards at the EU level. However, should the UK pursue a competitive strategy based on lower employment standards on the different component dimensions, it is possible that the countries which enforce standards above the EU minimum requirements could have incentives to lower them and thus be more competitive. The likelihood of that happening would nevertheless depend on the different national contexts and the weight of other factors (i.e. importance of high skilled sectors relative to low skilled sectors, etc.). Whether *enforcement* mechanisms could be relaxed to replace or supplement changes in regulations could be a different issue, and has some support in the literature (Davies & Vadlamannati 2013). Although the EU common employment standards are designed to prevent a race to the absolute bottom, it is conceivable that the enforcement of these standards could be relaxed as a mechanism to roll them back without in fact considerably changing the regulatory framework.

The European Court of Justice (ECJ) and the European Commission are the two institutions at the EU level whose role in safeguarding common EU employment standards is critical to consider in discussing scenarios related to future post Brexit developments. The ECJ would hold Member States accountable for their obligations under EU law should they be faced with a choice to decrease employment standards in response to such a UK-led competitive strategy. One of the mechanisms that the European Commission has at its disposal (TFEU, Article 258 [ex Article 226 TEC]) is to commence infringement proceedings against the countries where Community law is not adequately implemented or in cases where countries are deemed to be in breach of Community law[14]. The final stage of these proceedings can be a referral to the ECJ, following previous unsuccessful deliberations, whereby the

[13] See https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/acquis_en for more information, accessed in April 2017.

[14] See: https://ec.europa.eu/transport/media/media-corner/infringements-proceedings_en, accessed in March 2017; EU infringement procedures at http://europa.eu/rapid/press-release_MEMO-12-12_en.htm?locale=en%20%20%20MEMO/13/907, accessed in March 2017.

European Commission can pursue legal action against Member States if they do not comply with EU law[15]. During the past decades the Commission has issued 5 formal notices, 50 reasoned opinions, and 7 referrals to the ECJ (European Commission 2017). Some of the most recent – issued in February 2017 – were in the policy area of employment, social affairs and inclusion[16]. In both cases, failure to comply by the respective national governments may result in a referral to the ECJ for infringement under Article 258 [ex Article 226 TEC] of the TFEU.[17]

The centrality of employment standards to the freedom of movement of people, capital and services principles governing the EU integration process cannot be underestimated. Although the EU's institutions, procedures and regulations are significantly more complex than briefly summarised here, we can arrive at the fairly straightforward conclusion that the EU could in theory action these mechanisms to prevent a race to the absolute bottom in the EU even if the UK chose to undercut its competitors by decreasing employment standards. Admittedly, the EU is not independent from its Member States, which allows us to infer that regulations may be changed following pressures from the countries that would see certain sectors of their labour markets threatened by a potential UK undercutting economic strategy. Although the EU's legitimacy in exercising competences over employment standards has not gone unchallenged, it can be inferred that under the current institutional design, EU levers can be wrought to influence companies' and national governments' behaviour in the Single Market in the area of labour law and employment standards.

Still, the question that remains unanswered is whether the countries whose employment standards – on various dimensions – are currently higher than the EU minimum threshold would have an incentive to decrease them. While they could not lower them below the common threshold, they could still be decreased in relative terms. For reasons discussed in detail in Section 4, there is evidence to suggest that this is more likely to happen on some dimensions rather than others (i.e. at the low-end of the labour market). This analysis requires a deeper investigation into individual countries' FDI, economic sector, as well as workforce skills and productivity levels to provide an informed answer. The limited remit of this report does not allow us to consider the implications of the variations between different countries' employment standards disaggregated on the different dimensions. One hypothesis that can be generated, however, on the basis of the reviewed evidence is that the post Brexit competition between the UK and EU countries will be multileveled across economic sectors, categories of skills and occupations and geographic regions. The core

[15] See: https://ec.europa.eu/transport/media/media-corner/infringements-proceedings_en, accessed in March 2017.

[16] Among which: reasoned opinions addressed to Austria, Cyprus, the Czech Republic, Estonia, Lithuania, Luxembourg, Portugal and Romania about their failure to notify the Commission by end of May 2016 about the full incorporation of Directive 2014/54/EU (the Directive concerning EU citizens' right to work in another Member State which facilitates the mobility and employment of EU citizens within the EU borders) in their national law; and reasoned opinions addressed to the Czech Republic, Cyprus, Spain, Croatia, Luxembourg, Portugal, Romania, Sweden and Slovenia about the failure to notify the Commission about the full incorporation of EU Directive 2014/67/EU and the enforcement of the EU Directive 96/71/EC regulating the posting of workers in the EU. See details in European Commission – Fact Sheet, February infringements package: key decisions, at http://europa.eu/rapid/press-release_MEMO-17-234_en.htm, accessed in March 2017.

[17] Article 258 [ex Article 226 TEC] of the TFEU stipulates that *'If the Commission considers that a Member State has failed to fulfil an obligation under the Treaties, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations. If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice of the European Union'*, at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E258, accessed in March 2017.

challenge with the EU 'level playing field' in employment standards is in fact that it has pursued the standardisation of employment standards at a lower rather than a higher threshold.

3.4.2. Anti-dumping measures and competition in the EU

The scope of the EU's competences in regulating inward and outward FDI has been gradually expanding during the past decade. Following the Lisbon Treaty, the TFEU introduced in its Article 207 the EU's competence to regulate over foreign direct investment. There are strong drivers to increase EU competence in this field, and implicitly limit national governments' authority to negotiate Bilateral Investment Treaties. The developments in this area are likely to have a bearing on the EU-wide employment standards framework. The debate surrounding FDI and 'social dumping' in the EU has constantly indicated that unequal labour standards across EU countries are one of the risks that need to be recognised and addressed.

Directives regulating the posting of foreign workers (Directive 96/71/EC) and cross-border enforcement of financial administrative penalties and/or fines (Directive 2014/67/EU) go in the direction of curbing unfair competition, or 'social dumping' as otherwise termed. Despite protracted debates, enforceable results are scarce. Still, the attention that the topic has received at the highest levels of the political echelons indicates that it is perceived to be a high risk to the competitive climate of the EU (Juncker 2014). A recent report called for a European Parliament Resolution on 'social dumping' in the EU (Committee on Employment and Social Affairs 2016). It defines 'social dumping' as spanning over *"a wide range of intentionally abusive practices and the circumvention of existing European and national legislation (including laws and universally applicable collective agreements), which enable the development of unfair competition by unlawfully minimising labour and operation costs and lead to violations of workers' rights and exploitation of workers"* (Committee on Employment and Social Affairs 2016: 8). The report highlights alternative mechanisms through which governments can alter competition and undermine the social protection of workers, extending the framework beyond the usually flagged lower labour costs and reduced rights. These include undeclared work, bogus self-employment, outsourcing and subcontracting chains, as well as inequality in employment contracts and pay having high potential of weakening social security systems, circumventing labour regulations and increasing risks for individuals in the labour market (Committee on Employment and Social Affairs 2016: 8).

Elsewhere in the literature, 'social dumping' has been defined as a way in which governments embark on a low-wage low-rights strategy to encourage investments that will boost the economy (Mosley 1990). Here too the author identifies other mechanisms that can lead to the same outcome, for example the displacement of high-cost producers by low-cost producers, the relocation of companies from high-cost economies to low-cost economies, as well the migration of individuals from economies where wages are lower to economies where wages are higher (Mosley 1990: 160).

In response, the European Parliament is calling for strengthened enforcement mechanisms for the existing legislation at the national and European levels; reforms regarding the use of undeclared labour; and, steps towards the coordination of social security systems and the enforcement of social security contributions payments. The report also emphasises that workers in the transport sector and women are among those most at risk from experiencing forms of 'social dumping' (Committee on Employment and Social Affairs 2016).

EU anti-dumping measures have a role in preventing unfair competition across the Member States. In practice, the EU will investigate if imports can be labelled as being 'dumped' into the EU following a complaint filed by either affected companies or an EU country[18]. If identified as 'dumping', i.e. importing at lower prices than the respective EU country's value (price or production cost) and therefore affecting the market position of domestic producers, various types of duties or price undertakings are imposed on the importing company[19]. One of the recent cases where the European Commission decided to impose such 'anti-dumping' measures was on steel products imported into the EU from China and Taiwan[20]. As a result, anti-dumping duties will be applied to Chinese (from 30.7% to 64.9%) and Taiwanese steel product imports (from 5.1% to 12.1%)[21]. This decision is but one of the several dozen similar anti-dumping measures adopted by the European Commission targeting unfair imports of steel products from outside the EU.[22]

The literature on 'social dumping' reflects the same conclusions as the FDI literature[23]: despite the theoretical motivations to expect that lower labour costs attract more foreign investments, the literature does not find systematic indications that there are large differences between FDI flows into countries with lower labour costs and those with higher labour costs (Erickson & Kuruvilla 1994). That there is a 'labour cost incentive' (Erickson & Kuruvilla 1994: 28) for FDI cannot be negated, however.

During the past years, efforts have also been made towards a common EU international investment policy. The European Commission outlined its view about the role and development of a common outward investment policy as part of the EU's commercial policy in a 2010 communication (COM(2010)343). According to the *Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union*, the ***EU common Commercial Policy*** – an area of exclusive competence pursuant to Article 3(1) of the TFEU – is aimed at enabling a harmonised development of international trade and foreign direct investment (TFEU, Title II, Article 206 [ex Article 131 TEC]). A combination between trade liberalisation and protectionist measures are listed as the key components of the EU's common commercial policy: on the one hand, lower tariff rates are seen to encourage trade; on the other hand, uniform measures to protect against dumping is equally important (TFEU, Title II, Article 207(1) [ex Article 133 TEC]).

The TFEU also establishes the exclusive competences of the EU over the ***competition regulations*** that are deemed necessary for the functioning of the Single Market (Article 3). Member States cannot engage in commercial activities that distort competition and contribute to creating market monopoly (TFEU, Title VII, Article 101 [ex Article 81 TEC]). The so-called 'dominant positions' in the market are generally considered likely to be conducive

---

[18] EU anti-dumping policy, at http://ec.europa.eu/trade/policy/accessing-markets/trade-defence/actions-against-imports-into-the-eu/anti-dumping/index_en.htm, accessed in April 2017.
[19] Ibid.
[20] European Commission imposes anti-dumping duties on steel products from China and Taiwan, 27 January 2017, at http://trade.ec.europa.eu/doclib/press/index.cfm?id=1615, accessed in April 2017.
[21] Ibid.
[22] A similar course of action has been reported in the USA, where an investigation into steel imports that allegedly threaten to undercut local suppliers has recently been launched. For details see BBC news report at http://www.bbc.co.uk/news/business-39664532, accessed in April 2017.
[23] Despite a similar interest, the two do not appear to communicate extensively.

to abusive practices that negatively affect competition within the Single Market (with the exception of those situations where monopoly over services is warranted, for example in security matters, etc.)[24]. Overall, any type of state aid that is granted directly or indirectly by a Member State which represents a distortion to competition by creating advantageous conditions for some goods/services rather than others is not deemed to be compatible with the labour market if it affects trade between the Member States (TFEU, Title VII, Article 107 [ex Article 87 TEC]). It is, however, a key EU level mechanism that limits discretionary powers of national governments to support companies in ways that would distort competition in the internal market.

The ***EU Merger Regulation*** tackles mergers, acquisitions and joint ventures in the EU[25], which is one of the main types of FDI. The regulation establishes the conditions under which the European Commission or the national competition authorities of the Member States should investigate 'concentrations' (i.e. mergers, acquisitions, and joint ventures) (Slaughter and May 2016). The European Commission is required to investigate only in situations where 'concentrations' have an 'EU dimension' (with specific turnover thresholds) (Slaughter and May 2016). The key emphasis in these investigations is to deter potential competition distortions that could arise from oligopolistic market structures (which enable prices to be raised, affect output quality, or halt product innovation without a realistic danger of a loss of customers for the companies that engage in such activities). As follows, the main concern is to investigate whether the respective proposed merger affects competitive forces negatively (i.e. reducing it) because of the competitive advantage (i.e. increase in market share or power) deriving from a lower number of competitors (Slaughter and May 2016).

Given these points, the EU could action various levers to intervene and prevent or limit a *'race to the bottom'* in employment standards across the territory of its Member States, but the EU's capacity to act effectively has often been questioned. The current context may accelerate decisions related to a prospective EU common FDI framework and strengthen the EU's competence in this area by harmonising national FDI policies. It is presumed that governments have strong incentives to reduce employment standards so as to attract foreign investment. In contrast, it can also be argued that there are equally valid incentives to implement competition policies which ensure that national labour markets attract superior types of investment, i.e. conducive to macro as well as micro-level improvements. In this sense, EU and national competition policies could act as a counterweight that could limit negative effects on employment standards, mitigate labour market risks for individuals, and favour the creation of sustainable business models that increase job quality and promote growth (Work Foundation 2016).

[24] Unfair dominant positions in the market are considered to be the following situations: *"(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts"*, according to TFEU, Title VII, Article 102 [ex Article 82 TEC], at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E102, accessed in March 2017.

[25] It was revised and came into force in May 2004. See EU Merger Regulation, Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) Official Journal L 24, 29.01.2004, p. 1-22 at http://ec.europa.eu/competition/mergers/legislation/regulations.html, accessed in March 2017.

4. The 'Race to the Bottom' and alternative scenarios in the European Union

The debate about the *'race to the bottom'* has been around for several decades. In the European space, Ireland, Southern EU countries and eventually Central-Eastern European (CEE) states have, over the course of time, been suspected of building their competitive advantage on low labour costs and frail employment rights frameworks. This argument has held considerable appeal and been backed by a range of competitive advantage and international trade theoretical claims. Empirical evidence of the alleged race is however less straightforward and invites further investigation and reflection. With Brexit looming and withdrawal conditions far from certain, the UK is seen as a key suspect in unleashing a prospective *'race to the bottom'* that would attract higher FDI inflow. The erosion of employment standards is seen as one of the core enablers.

This section draws on the previous two by developing a *framework* that enables the creation of scenarios to assess the balance of the evidence and whether or not the *'race to the bottom'* is more likely versus other outcomes. Its intention is that this could be used as a tool that can support stakeholders to monitor and influence the critical range of factors that are expected to play a role in how national economic models will develop over the coming period. It could also be used to shape future areas for research and analysis to strengthen the evidence base. **Three theoretically possible scenarios** have been developed from the evidence that could characterise post Brexit Europe: **'race to the bottom'**, **'race to the top'**, and **'polarised racing'**.

These scenarios are intended to inform the debate about the consequences of the UK's exit from the EU rather than predict precisely what will happen. The scenarios should therefore be used more as an aid to understand, structure and work through the practical implications of different FDI determinants or factors (including, but not limited to, employment standards) on investment patterns. The intention is that this will then help shape further thinking about the long-term implications of the UK's withdrawal from the EU, as well as the core factors that are likely to play a role in future developments (posing risks or acting as mitigating factors depending on the circumstances).

Given the current uncertainty surrounding the negotiating positions for Brexit[26], as well as the 'deal' that the UK will obtain after its withdrawal from the EU, we have sought to shape the scenarios through the lens of three different Brexit outcomes. These scenarios, whilst unable to predict the future, seek to explore some of the potential spectrum of outcomes: separation from the EU; alignment with the EU; and, a unique, as yet under-determined middle way. At the time of writing this report, Article 50 of the Treaty of Lisbon had just been triggered. As follows, a slew of developments with unknown outcomes have been set in motion. Our analysis therefore must remain tentative until relevant information about the negotiation process and its outcomes becomes available.

Figure 2, opposite, pulls together the different elements we have analysed thus far and

[26] At the time of writing, the UK's Prime Minister, Theresa May, has called a general election to take place on 8th June 2017. As often emphasised in this report, foreign investors seek stability. As follows, the impact of a UK general election is yet another factor of uncertainty that is likely to contribute to foreign companies' decisions to invest in the UK, at least for the short-term.

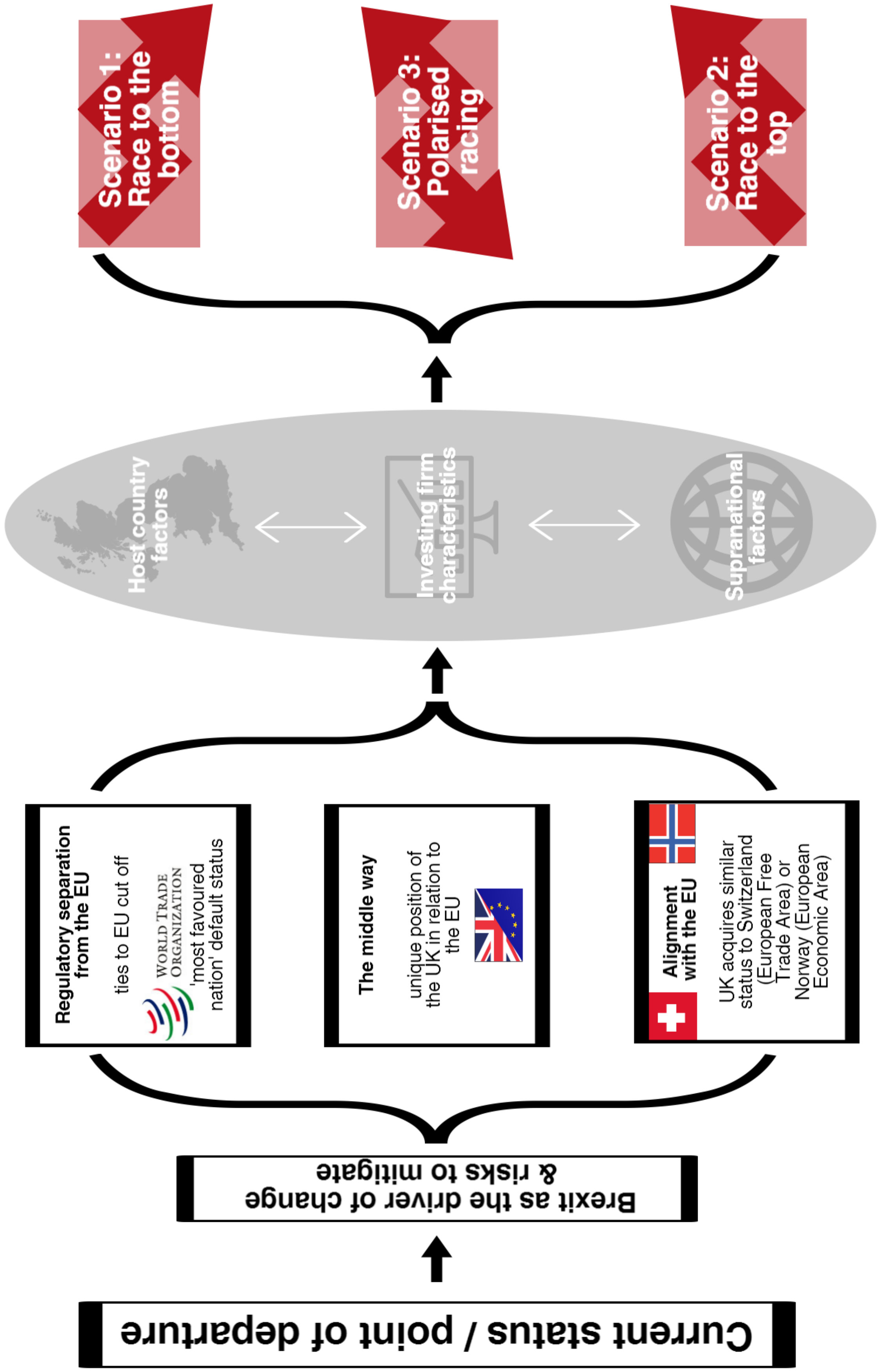


Figure 2: Brexit outcomes and possible scenarios

places them in the context of the different potential Brexit outcomes. It also attempts to illustrate the chain of impact that might be helpful, thinking through the relationship between FDI and employment standards, the factors that mediate this relationship, how these might be affected by Brexit and therefore deducing the most likely scenario outcomes, although of course this undoubtedly remains uncertain.

Whilst the evidence assumes actions might be informed by a rational, often economic logic, using the best available evidence, we do need to recognise of course that in practice decisions and actions of business and governments are informed by a range of incentives, and information, often informal, subjective and even political. In that sense it makes the inferences that can be drawn from this research even more complex. These caveats need to be borne in mind.

Table 2 unpacks the different implications in more detail. In particular, we have extracted the **key factors** identified in the literature that may intervene and shape the direction and nature of the relationship between the level of employment standards and FDI in the EU. These can be listed under three dimensions as set out in Section 2 earlier: *host country characteristics* (including, but not limited to, employment standards), *investing firm characteristics* and *supranational factors*.[27]

Overall, the previous sections of the report sought to determine whether the existing evidence in the literature supports the argument that lower employment standards attract higher FDI levels. Rather than uncovering strong evidence of a strong causal and linear relationship, our review showed that while employment standards are significant to companies' decisions to invest abroad, the nature of the association is not only negative (i.e. lower employment standards are correlated with higher FDI), but also positive (higher employment standards are correlated with higher FDI). Based on the evidence and a set of logical inferences, we identify below the one which is empirically estimated as the most likely outcome.

4.1. Assessing the scenarios: *what's most likely?*

The evidence reviewed in Sections 2 and 3 and translated in Figure 2 and Table 2, enables the following inferences.[28]

- **First, the literature does not convincingly demonstrate that the studied relationship between employment standards and FDI levels is a causal one**. What the evidence points to is an association between employment standards and FDI levels. This means **eroding employment standards** are:
    - ***not a necessary condition* for FDI levels to increase** because the evidence in the literature does not always conclusively support the relationship. In fact higher employment standards can drive higher FDI levels.
    - **also *not a sufficient condition* for FDI levels to increase**, as the literature clearly evidences that there are additional factors that influence investing firms' decisions to expand their business in other countries. In other words, FDI levels can increase even if employment standards do not decrease.

[27] Our review suggests that given the contradictory evidence that characterises the literature, that FDI determinants are still not well understood so this needs to be borne in mind by the inferences drawn so far. This will require further research – see Section 5.

[28] The basis for these inferences are the core theories in the social sciences about the role and implications of necessary and sufficient conditions (see for example Goertz & Starr 2002).

  - **only a *contributory condition* that impacts in certain circumstances to increasing FDI levels**. As the evidence indicates, this appears more likely in certain economic sectors (i.e. those that attract *vertical* types of FDI that benefit from low labour costs and employment rights).
- **Second, employment standards** – while a key determinant of companies' decisions to invest abroad – **should be assessed in a wider context** which is shaped by interactions with other **relevant factors** that can reinforce or offset each other. Existing research generally focuses on the unilateral effects of employment standards on FDI levels without exploring the multidirectional and multidimensional nature of the relationship. Table 2 attempts to consider the different weights and measures of these various factors and how they determine the most likely outcome.
- **Third**, investigating the effects of employment standards (or other factors) on aggregate FDI conceals variations that are driven by **differences between varying FDI types** which aim to tap into **different economic sectors** and utilise varying workforce skills at the low- and high-end of the labour market. By identifying the different areas and individuals and assessing these risks it's possible to hypothesise who could be most exposed to the threat of downward pressures on employment standards.

The evidence does not therefore conclusively validate the 'race to the bottom' scenario. Moreover, if any previous indications of a continuous race to the bottom had existed in the past, we would have had to observe continuous changes in employment regulations and labour laws, which are nevertheless relatively stable over time despite some noted reductions in employment protection regulations (Aleksynska & Schmidt 2014). The **'race to the top'** scenario also seems unlikely, as types of FDI that look for cheap labour and companies whose profit is based on *low skills equilibrium* are likely to endure in the future.

The evidence in the literature on FDI determinants as well as wider trends in the labour markets of many EU countries (Goos & Manning 2007; Goos et al. 2009) enable us to argue that **the most realistic scenario** is the third one (i.e. **'polarised racing'**). This is where countries and companies attempt to **rationally maximise profit by adapting their economic and business models to attract FDI at both the lower and the higher end** of product quality, skills, productivity and performance. There are convincing indications in the literature on FDI patterns that give weight to the argument that a polarisation phenomenon (which replicates national labour market polarisation at an international level) is currently developing.

There are signals that in the future we may witness a more polarised specialisation of countries in economic sectors and sub-sectors that may require different skill levels and productivity levels. The countries that move toward high-skills equilibria would have a strong incentive to preserve higher employment standards to attract companies that are looking to invest in that segment. In turn, the investing companies are likely to be attracted by higher employment standards, because that guarantees they can hold on to their skilled workforce and implement high-performance working that maximises returns on investment. Given the current economic and skills profile of advanced economies in the EU, moving towards the high-performance model is likely for some sectors. The increased higher-skilled investment in the total FDI flows (Moran 2011) in the recent years supports this argument.

Table 2: Summary of the scenarios

Factors	Description	Scenario 1: Race to the bottom	Scenario 2: Race to the top	Scenario 3: Polarised racing
Employment standards	*employment rights and labour costs*	Standards tend to decrease as part of a strategy to increase competitive advantage and attract more *vertical* FDI → *low skills equilibrium* (low product quality, low value, low skills, low productivity).	Standards tend to increase as part of a strategy to increase platform for competitive advantage at the higher end and attract more *horizontal* FDI → *high skills equilibrium* (high product quality, high value, high skills, high productivity).	In an attempt to maximise profit by competing for both *vertical* and *horizontal* FDI, governments tend to decrease employment standards for individuals working in low-skilled sectors and maintain employment standards at a relatively higher level for individuals working in the higher-skilled sectors. Changes lead to a 'double standards' framework in terms of employment for various categories of workers depending on employment status. These may take place in the form of regulatory changes or by relaxing enforcement of regulations. In both cases, atypical or precarious workers at the lower end of the labour market are the most likely to see a further decrease in employment standards. This is possible by reducing those dimensions of employment standards which have a particular impact on the lower ends of the labour market. This might in practice mean that they either only apply to individuals working at the lower end of the labour market, or they are a result of the lack of similar mechanisms that those individuals have at their disposal relative to higher paid workers (e.g. including, but not limited to, collective bargaining agreements).
Economic context	*health of the economy*	Repeated or prolonged crisis and recession periods increase fiscal constraints and decrease public resources that support relatively high levels of	Conditions that support economic growth provide the necessary financial resources for governments to uphold high employment standards	Slow economic growth imposes financial constraints on governments that are pressured to prioritise investment in some policy areas while reducing them in others. Overall context must show some degree of

Economic context (cont.)		employment standards (regulations and enforcement).	(regulations and enforcement). Overall context must show stability.	stability.
FDI incentives system	*regulatory restrictiveness vs openness, corporate tax regime and other financial incentives, etc.*	An economic model based on low corporate tax, removal of restrictions that previously imposed screening of potential FDI. An approach that does not filter foreign investment. Actions are taken which actively encourage foreign investment in the low value, low skills pathway.	An economic model that strategically discriminates between different types of FDI (decisions about long-term sustainability and suitability of different types of FDI to countries' economic context, policy context, economic sector and workforce composition, etc.). Actions are taken which actively encourage foreign investment in the high value, high skills pathway.	An economic model that strategically aims at maximising economic profit in all sectors and at all skills levels.
Economic sector composition	*i.e. balance between 1) low-skilled and higher skilled sectors and 2) the balance between services and manufacturing sectors*	Low-skilled sector size increases and higher-skilled sector decreases.	Higher-skilled sector size increases, while the low-skilled sectors decrease or offer better in-work progression routes.	Both trends are visible. Increased polarisation between low-skilled and high-skilled employment opportunities with a hollowing out of the middle, especially in countries with a less developed manufacturing sector.
Workforce composition	*i.e. skills profile and levels as well as productivity levels*	Financial constraints reduce skills and training funding, access to education is more and more limited given increasing costs and the lack of incentives to invest in higher skills as the economy doesn't need / use them, and the share of low-skilled working age individuals increases.	Incentives to increase investment in skills and training throughout the life course, as well as access to formal education channels. The share of higher-skilled individuals increases and becomes more specialised to support specialisation at the higher end of the economy which reinforces competitive advantage and attracts even more FDI that is aimed at innovation, R&D, etc.	Realistic economic conditions limit incentives to invest in skills and training and education across the board, so investment is likely in certain occupations / professions and at certain skills levels and unlikely in others, which reinforces polarisation and inequality / divisions within the working age population.

Table 2 (continued)

Factors	Description	Scenario 1: Race to the bottom	Scenario 2: Race to the top	Scenario 3: Polarised racing
Employment policy context	*labour market deregulation / flexibility*	The labour market is increasingly deregulated at all levels and across sectors and occupations to facilitate FDI as well as domestic business creation (e.g. hiring and firing costs are reduced, flexible contractual terms are reinforced, reduced security of employment, etc.).	Employment policy aims in parallel at providing businesses with the flexibility they require to create more jobs, but at the same time ensuring a counterweight to the negative effects of employer flexibility on working individuals (i.e. compensating for the risks they face in a flexible labour market and reinforcing social security). Policy mitigates labour market risks for individuals in this scenario.	Employment policy strengthens existing divisions between different categories of working individuals (divided according to employment status type, skill levels, occupation, etc.). Employment policy reinforces insider / outsider divisions in the labour market and therefore increases segmentation / polarisation.
National actors	*government, private stake-holders, non-for-profit sector stakeholders*	Governments make decisions that prioritise short-term gains (i.e. from *vertical* FDI). Overall political context must show some degree of stability.	Governments make decisions that prioritise long-term sustainable growth (i.e. from *horizontal* FDI). Overall political context must show some degree of stability.	Governments prioritise different economic sectors and attempt to combine short-termism with economic strategies aimed at sustainable growth and high performance levels.
Supranational actors	*i.e. EU-level regulations that act as a counter-weight to national govern-ments' decisions regarding employ-ment standards and FDI*	International organisations (e.g. ILO, UN, WTO) and supranational institutions (e.g. EU) no longer hold any decision-making or enforcement capacities that would act as a brake / constraint to the lowering of employment standards, ongoing labour market deregulation, etc.	International organisations (e.g. ILO, UN, WTO) and supra-national institutions (e.g. EU) would have a mandate to either directly increase measures and mechanisms that support working individuals and compensate for the risks they are exposed to in the labour market (i.e. increasing social security etc.) or to act as a check against negative measures taken by individual states which attempt to lower standards for working individuals.	International organisations (e.g. ILO, UN, WTO) and supra-national institutions (e.g. EU) are limited in their capacity to decide and act as a counterweight to national decision-makers and have a limited capacity for acting on a number of policy areas that remain under the exclusive competence of national governments (e.g. economic and employment policy, social security / welfare, etc.).

Immigration policy context	*this factor is not included in the literature, but since it is so important in Brexit, its role should be acknowledged.*	In this scenario, countries would profit from immigration regimes that allow the recruitment of low-skilled foreign workers to work in the low-skilled sectors on lower wages than the native population would accept. However such a decision could have ruinous effects, driving wages downward for native workers too, if such employer behaviour is not only not kept in check by authorities, but is in fact condoned or even supported. Moreover, a high share of low-skilled immigrants would inevitably add pressures to the public budget (e.g. unemployment and other types of benefits). On the other hand, higher skilled immigrants would be attracted to countries where they would receive the highest rewards for their skills and expertise (i.e. the countries that preserve relatively higher levels of employ-ment standards in comparison with others).	In this scenario, countries would benefit from an open immigration system that enables the recruitment of highly-skilled immigrants that would fuel countries' competitive advantage. A race for attracting the best skills would be part and parcel and countries would compete for the highest skilled individuals.	In this scenario, both alternatives combine: governments would actively pursue recruitment of both low-skilled and highly-skilled immigrants, but in both cases the immigration regime will be relatively restrictive and shaped to select the skills that match labour market shortages. Recruiting low-skilled individuals would nevertheless have a range of disadvantages, including pressures on public spending on in and out of work benefits, especially if the workers are not only recruited for seasonal work. This is because their permanent presence is likely to increase the risk of unemployment.

That is not to say that in these countries, low-skilled sectors will be removed from the economic model. The reverse is equally valid, i.e. some countries will have an incentive to compete at the lower end and companies which operate in the low-skills environment will have an incentive to expand their activities there (this is not to say that higher-end investments are excluded in those countries). There is another side to these developments, too. The economic crisis has resulted in governments across the EU shifting the burdens on individuals and employers as a means of reducing public spending. This vision has been implemented through welfare and employment reforms that have prioritised high employment targets and paid less attention to job quality dimensions. In such an economic context, employment insecurity has increased and inequalities between those at the bottom and the top of the labour market have expanded. The danger that short-termism will feed on an expanding *low skills equilibrium* is real and should not be underrated. It is this contradiction that the 'polarised racing' scenario intends to capture.

These inferences will also be conditioned by different possible Brexit outcomes. In developing the afore-mentioned scenarios, it is important to capture the range of possibilities and assess the key emerging risks, and the factors that could mitigate them. In what follows we outline our thinking around the possible outcomes of the UK-EU negotiations. We then organise the different elements that were previously analysed and place them in the context of the potential Brexit outcomes to deduce the most likely post Brexit scenario with regard to employment standards and FDI (see Figure 2, above). Subsequently, we identify several risk factors for unfair competition and inherently recognise the mitigating factors (Table 3).

Our current thinking around possible Brexit outcomes is as follows.

- **Regulatory separation from the EU**. In our analysis, this type of outcome where existing regulatory ties with the EU are cut off, including access to the Single Market, and the default status defers to the World Trade Organization, enhances conditions for the *'race to the bottom'* scenario. This is because a regulatory void is possible in the absence of arrangements to extend the existing EU laws into UK domestic legislation, as envisaged in the Great Repeal Bill. This situation would increase pressures on the UK to compete for investment in the absence of access to the EU Single Market. As a consequence, the UK will have to compensate for a whole range of shortcomings, such as a loss of its advantage of trading with EU countries and the risk to the investments made by non-EU countries that aimed at accessing the wider EU market.
- **Alignment with the EU**. In this outcome, the UK would likely have a position that is similar to Switzerland or Norway, which means that it would continue to coordinate key policy areas with the EU including to adopt common employment standards. The incentives and indeed scope to race other EU countries to the bottom would in all likelihood diminish. In this outcome, of retaining access to the Single Market, the UK is likely to have to maintain a variety of EU standards, and to comply with regulations related to FDI flows. Any free hand in rolling back employment standards will undoubtedly be limited under such terms.
- **The middle way**. The characteristics and implications of this third type of outcome that lies between the polar coordinates outlined above are the most difficult to map. This is caused by the uncertainty that surrounds its terms. We hypothesise however that there would be incentives for countries to compete to attract FDI at both extremes: investments which aim at lowering costs by using cheap labour, as well as

the investments that aim at tapping into a highly-skilled and productive workforce. There would nevertheless be an assumption that whatever the UK-EU deal will look like, it will not be in the vicinity of a type of outcome that would lead to a separation between the UK and the EU (as described above).

Table 3: Risk matrix

Level	Type of risk	Description
MACRO	The wider international regulatory framework	The regulatory changes resulting from the UK's exit from the EU are likely to impact on UK-EU trade relations and FDI inward and outwards flows (especially as the EU accounts for the highest percentage of UK inward FDI). The terms of the UK's exit from the EU will have an impact on the future of the UK's legal and institutional recalibration.
	Strategic actions of the UK government	The economic strategies that the current and future UK governments will adopt around labour market, employment and investment policies are bound to have a significant effect on the future development of the UK's economic sector composition (i.e. a move toward higher or lower skilled sectors and the balance between services and manufacturing).
	Post Brexit legal and institutional framework in the UK	A regulatory void is possible unless arrangements are put in place to extend existing EU laws into UK domestic legislation, as envisaged in the Great Repeal Bill. This is likely to increase uncertainty for foreign investors. Skills strategies for example are also likely to have an important role in labour market developments given the prospective challenges of utilising and shaping the skills employers need to fill shortages.
	Health of the UK economy	Overall performance of the UK economy in the aftermath of Brexit (GDP growth rate, business and investment climate, unemployment rate etc.). Given the current local economic disparities in the UK and the spatial patterns of inequality it causes (i.e. income inequality, unemployment rate), geographical industry concentration (e.g. knowledge intensive services, utilities services, manufacturing sector), it is expected that Brexit impact will vary across UK regions.
MESO	Behaviour of foreign investors (current and prospective)	The decisions of foreign investors to continue to invest in the UK (i.e. either keep current businesses and/or invest additional capital or to relocate in other EU countries).
	Behaviour of UK employers	Filling skills and labour shortages is likely to become more difficult in the absence of free movement within the EU, as regulatory change is likely to slow down the recruitment of foreign staff. As a result, UK employers' behaviour under these conditions is likely to have an impact on the training and utilisation of skills of the local workforce. These strategies are likely to impact on improving the match between supply and demand in the UK labour market.
MICRO	Individuals' occupational and skills profile (among other socio-demographic indicators), as well as their economic sector and geographic distribution	The macro and meso-level risk factors outlined above are likely to affect individuals with certain levels of skills (lower rather than higher), working in certain economic sectors (some service sub-sectors rather than in the manufacturing sector), and living in certain locations (e.g. areas where low-skilled sectors are concentrated, with a relatively larger share of temporary job opportunities, with higher unemployment rates etc.) more than their counterparts.

4.2. Where is polarisation more likely?

In the context that the most likely scenario is polarised racing, we have considered how the **effects** of Brexit and the ensuing competition to attract FDI on employment standards **would be different across various categories of workers**[29], because of their varying occupational profile and economic sector distribution. It can be inferred that the risks of gradually eroding employment standards will be higher for workers with particular types of employment status (i.e. temporary / casual work) and occupational profiles, in particular sectors (low-skilled service sectors), and on particular dimensions of employment standards (some hypothetical examples could be employment protection and minimum wages regulations). There is also evidence in the literature that lower employment standards are more important for international companies that invest in the low-skilled services sectors (because they are more labour-intensive) than in the manufacturing sectors (e.g. Javorcik & Spatareanu 2005). A lack of comparable data makes it difficult to estimate differences between **FDI flows into different sectors, sub-sectors and across geographical regions**. Getting at these investment patterns and determinants is even more difficult – for the same reason – if we are interested in determining how companies with different characteristics behave and decide about where to target capital. Different types of FDI should therefore be investigated separately to illustrate the heterogeneity of investments and their variations in relation to employment standards and other critical factors.

In our assessment there are likely to be different implications for different sectors in the UK and the other EU countries. The UK economy is dominated by services, which have been growing constantly over the past two decades. The service industries made up close to 80% of the UK's GDP in 2016. The service sub-sectors with the highest weight were transport, storage and communication; business services and finance; government and other services; and distribution, hotels and restaurants (ONS 2016c). A significant portion of this sector is moving towards high value, high skilled activities. That said, according to recent data, the transport, storage and communication as well as the distribution, hotels and restaurants sub-sectors have high shares of low-wage jobs in the UK (e.g. Wilson et al. 2014). The studies that were reviewed in the previous sections show that workers' skills and productivity levels are also a key factor that shapes foreign investment decisions. Nevertheless, there is evidence which shows that the UK's low-wage sectors are less productive and less skilled than their counterparts in comparator developed countries in Europe (Thompson et al. 2016). This indicates that once labour costs are adjusted for productivity, investing in sectors that create and depend on low-skilled low-waged job opportunities might not be market efficient. Still, low-skilled sectors are expanding throughout Europe, albeit to a different extent (Goos & Manning 2007; Goos et al. 2009).

Although EU countries vary in terms of the GDP weight of manufacturing and services sectors, services currently make up the larger part of the economies of EU Member States (Stehrer et al. 2014: 23). Countries such as Germany, Ireland, Romania, Slovakia, Slovenia, Poland and the Czech Republic have more developed manufacturing sectors, but the overall service sectors also make up the largest share of the economy (Stehrer et al. 2014: 23). Distribution and financial services have during the past decade become two of the largest sub-sector components in the majority of EU countries (Stehrer et al. 2014: 23). Non-market or public services also have a significant weight (app. 15-25% of GDP in 2011) (Stehrer et

[29] Defined in this report as all working-age individuals.

al. 2014: 23). Given the current tendencies, services are likely to become increasingly important in the future. The ratio between low-waged and higher-waged job opportunities within these services could be determining the attractiveness of the respective sectors to foreign investment.

A review of the high and low-skill sectors of the UK economy that are most likely to face competition from EU countries is a topic in itself and should be thoroughly investigated in the near future. Given the extent of this topic, our objective here is to review some key concerns and contribute to shaping the debate and actions in this area. A variety of forecasts and analysis estimate a significant loss in UK trade (i.e. exports and imports of goods and services) and living standards of the order of tens of billions of pounds every year, significantly higher than the costs to the EU economy (Dhingra et al. 2016; London First 2016). These pessimistic estimations often warn of the toll of the short and long-term costs to the UK economy in a type of outcome that would separate the UK from the regulatory framework of the EU and disconnect the UK from the Single Market. Various sectors in the UK are dependent on trade with the other EU countries, have been considerably shaped by EU regulations, and are likely to be negatively affected in this case, which would entail the removal of ties to the Single Market and adds tariff and non-tariff barriers (e.g. bureaucratic delays at borders): such as retail/wholesale trade, manufacturing, agriculture and fisheries, as well as the distribution and supply chains (Cebr & Open Britain 2016). Many of these are also heavily reliant on EU labour migrants which arrived in the UK as a consequence of free movement within the EU. Notwithstanding the general approach to analyse economic sectors independently, knock on effects for the sectors that are less dependent on links to the Single Market and EU common policies are predictable (Cebr & Open Britain 2016). This is due to the inherent links between the country's primary, secondary and services sectors. One of the industries that is likely to be the hardest hit after Brexit is the automotive industry, which represented approximately 4% of the UK's GDP and was responsible for around 700,000 jobs in 2014 (KPMG 2014).

According to recent data, 77% of the cars that are produced in the UK are exported to other countries (58% of which are exported to the EU)[30]. As an illustration of how Brexit is likely to impact the car manufacturing industry in the UK, we reference Toyota's press statement about the decision to invest in the UK, which gives clear indications that one of the key factors that attracted the Japanese manufacturer to the UK was its *"open and free access to the European market"* and the skills of the workforce[31]. There are similar confirmations in the wider community of manufacturers and traders (SMMT), where 78% of member survey

[30] Society of Motor Manufacturers and Traders (SMMT), Key Facts, 2016, at https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-2016_v2-1.pdf, accessed in April 2017.

[31] *"Back in 1992, Toyota chose the UK for its first major manufacturing operations in Europe because of the open and free access to the European market, the availability of a skilled workforce, and the presence of a strong network of suppliers. Today, we are very pleased with the performance and competitiveness of our UK operations, which are wholly integrated into our European business. We support thousands of jobs in our manufacturing operations and more widely in our supply chain and distribution network. We manufacture vehicles, engines and parts and nearly 90 per cent of our UK-built vehicles are exported. […] We have carefully considered the implications for our manufacturing operations, should the UK leave the European Union. We are committed to our people and investments, so we are concerned that leaving would create additional business challenges. As a result we believe continued British membership of the EU is best for our operations and their long term competitiveness."* See Statement from Toyota in regards to the UK/EU Referendum, 23 June 2016, at http://media.toyota.co.uk/2016/02/statement-from-toyota-in-regards-to-the-uk-eu-referendum-june-23rd-2016/, accessed in April 2017.

respondents said in 2014 that the UK's withdrawal from the EU would have a negative or a very negative impact on their access to the other EU countries' markets (KPMG 2014).

The car industry is one where the significance of the supply chain can be easily spotted: even in cases where the assembly is carried out in the UK factories (by robots or individuals alike), a large share of the various car parts are imported from or developed in other EU countries. The EU-wide supply chain that supports car assembly processes is hence as important to consider as the post-production processes and the export strategies to EU and non-EU countries. As it is currently set up to function, the supply chain in the UK car industry includes multiple stages where the different car components cross EU territory. In this sense, it is not only the car manufacturers' investment that Brexit is likely to impact, but also the EU-wide suppliers'. In the case of a Brexit outcome that would separate the UK from the EU regulatory framework and disconnect the UK from the Single Market, tariffs would have to be imposed repeatedly, which would result in significant monetary and efficiency costs. An alternative to this scenario would be a possible relocation of the various car companies in other EU countries where supply chains and the required workforce skills already exist (e.g. Germany, France, Italy, etc.). This would reduce the potentially high transaction costs. An alternative would be a shift of costs to the customers, which could place the competitiveness of these brands under question if the price-quality ratio of their EU comparators were higher. Job losses could also feature because of employers' need to reduce expenses related to the production system, which would result in a higher pace towards automating car industry jobs in the future. That said, there is a wide diversity of car manufacturers in the UK's regions (KPMG 2014) – concentrated mostly in England – and supply chains, which is an indicator that Brexit impact could potentially be divergent. Recent discussions have suggested that FDI could seek to enhance the UK supply chain and consolidate this position. It is therefore difficult to imagine that the EU market will cease to be of key strategic importance for UK-based car manufacturers – given its potential for innovation and its established global dominance – or that it will be replaced in the future by other markets. This is of course just one sector case study to illustrate the complexity of understanding and forecasting the effects of Brexit on FDI investment decisions and how they may be affected by varying competitive, trading and economic conditions of sectors and the different sector profiles. Moreover, it illustrates that supply chains and higher tariffs are in such cases an additional factor whose importance is weighed by investors in context along with employment standards. Further work is clearly warranted to work through these implications more generally. That said certain baseline positions may be taken.

4.3. Implications for the UK

For post Brexit UK, the rational choice expectation would be to maximise conditions that attract both FDI types (*vertical* and *horizontal*). This could have different implications depending on the outcome of Brexit negotiations. In both 'regulatory separation' and 'alignment' Brexit outcomes, it is expected that the UK would seek to **maximise profit from the higher-skilled economic sectors** where it has already successfully attracted FDI during the past decades (e.g. financial services, or manufacturing sub-sectors such as the automotive industry).

The **implications at the low-end of the labour market** are those that are likely to vary depending on the outcome of the UK-EU negotiations. In the case of a closer **'alignment with the EU'**, the UK would retain access to the Single Market and comply with current employment standards, it is likely that the *status quo* will be maintained, as the magnitude of the post Brexit adjustment process for the UK economy is unlikely to be high. In this scenario, the UK would continue to maximise FDI at both the low and the high-end of the labour market without significant changes. **On the other hand**, if the outcome of the negotiations is a **'separation from the EU'** including from the Single Market and the EU regulatory framework[32], the UK is likely to find higher incentives to undercut EU countries by lowering employment standards. For the reasons discussed above related to high-end competition (i.e. the correlation between employment standards, skills and productivity levels), this is unlikely to occur across all sectors and skills levels. As illustrated in Table 2, such outcome can vary by employment status, for example making self-employed individuals and agency workers from lower skilled occupations more vulnerable to seeing employment standards eroded. This is conceivable not only in terms of changing regulations, but also in relaxing the enforcement of employment standards. Such possible actions could leave the low-end sectors at a higher risk of rollbacks in employment standards. This implies that there is a possibility that employment standards on selected dimensions (i.e. in certain sectors and skills levels) may be decreased to ensure that the UK is competitive at the lower end.

It is, however, unlikely (*ceteris paribus*) that the UK could compete with countries where employment standards (rights and labour costs) are at a much lower level (e.g. countries in Asia and Africa where many of the so-called 'sweatshops' are located). This is because the adjustment level that is required to compete against low-wage countries is likely to be too high, and consequently lead to disastrous outcomes for the country's financial and social equilibrium. It therefore seems improbable that the UK would pursue a widespread rollback of employment standards simply with the aim of attracting FDI, despite those who have argued in favour of using Brexit to deregulate the UK labour market. A reduction of employment standards in the low-skilled sectors of the economy would however allow the UK to be more competitive on labour costs relative to other EU comparator countries (e.g. Germany, France). This could result in downward **pressures on some EU countries** to either adjust employment standards in these sectors or undermine their attractiveness for low-end *vertical* FDI. Seen from a normative perspective, economies that operate according to high performance models and minimise the weight of low-skilled, low-wage jobs are preferable. One reason is because of the conditions they create for career progression pathways and their positive effects on increasing job quality and individuals' socio-economic outcomes, as well as productivity levels and performance. Whether a *low skills equilibrium* (Finegold & Soskice 1988: 22) is empirically an effective market strategy is still a matter of debate, as is also the contention that the UK is trapped in such a situation (Morris & Morris 2016).

The inherent claim in the *low skills equilibrium* argument is that supply and demand factors interact in a vicious cycle that leads to an outcome where individuals have increasingly less incentives to train and employers to create jobs requiring high skills. The debate in the literature about the position of the UK economy in rankings that evaluate workforce skill levels and the quality of products and services (Wilson & Hogarth 2003) in developed economies warrants the conclusion that the risk of the UK undercutting other comparator economies at the low-end of the labour market exists and should not be underestimated. However, due to the range of factors that attract foreign investors and the social and

[32] i.e. a trade deal which would not require that the UK complies with EU common employment standards and other rights.

electoral costs associated with a radical reduction of employment rights, one hypothesis is that the preferred strategy to undercut other EU economies would include other facilities, such as more generous corporate tax regimes, aside from reduced employment standards at the low-end of the economy. The key question is, however, whether such facilities could counterweight the uncertainty caused by (especially a 'separation' type of) Brexit, which is likely to severely affect the UK's legal and socio-economic equilibrium. As evidence by the literature review, uncertainty is a barrier for FDI because it increases the (perceived or real) investment risks.

In conclusion, while competing for both *vertical* and *horizontal* FDI, the UK could decrease employment standards for workers in the low-skilled sectors as part of a strategy to attract higher levels of *vertical* FDI. Such a strategy may disproportionately affect workers at the lower end of the labour market – i.e. those in atypical employment relationships, which are sometimes also referred to as precarious (as illustrated in Table 2 above). It could also keep standards as low as possible within the competition margin for workers in the higher skilled sectors that attract *horizontal* FDI, but this would arguably not involve an extensive erosion of existing standards across all sectors. Overall, a core hypothesis that emerges is that **employment standards could potentially be reduced in the UK on selected dimensions**. If these reductions in employment standards could empirically be targeted at areas of the economy where the UK would not compete with low-wage economies for tradable goods or services but would occupy a niche position (e.g. for non-tradable goods) domestically, then the UK would possibly attract higher FDI levels than other EU countries in the specified niche. Nevertheless, this outcome is dependent on the other factors that were previously emphasised, as employment standards alone are neither necessary nor sufficient for FDI levels to increase.

4.4. Implications for the EU

In the case of post Brexit Europe, a UK strategy that seeks to undercut EU countries by reducing employment standards and aiming to capture relatively higher levels of FDI as a result is likely to result in a *tit-for-tat* type of reaction. If the UK attempts to reduce employment standards at the lower end, the EU countries which have developed high-skilled sectors would have strong incentives to adopt the most rational approach (i.e. compete with the UK by adopting a strategy that aims to attract investments that profit from a higher skilled and more productive workforce). As a corollary of this assumed rational economic behaviour on the global market, EU countries are also likely to seek to expand their market by attracting FDI that was previously directed at the UK and capitalise on the incentives investors have in relocating to Member States that enable access to the wider EU market. There are several considerations that back this argument. The EU receives the largest share of FDI in the world according to recent data. The UK does indeed (with Germany as its close runner-up) currently attract the highest FDI levels in the EU. But as revealed by the evidence review, part of it is due to the access to the wider EU markets that investors get by investing in the UK. After Brexit, it is likely that at least part of these foreign investors will relocate to other EU countries. As a result, Germany could replace the UK in attracting the highest levels of FDI in the EU, and the EU overall would henceforth attract higher FDI levels than the UK by continuing to use its current FDI investment strategy.

The question that is hence raised is whether and why EU countries would have an incentive to decrease employment standards under these conditions. Some of them (e.g. Germany, Luxembourg, Scandinavian countries) are in fact more likely to benefit from the UK's withdrawal from the EU by attracting the companies that will look to relocate their businesses so as to retain access to the EU market. The expectation according to the literature and recent public statements[33] is that the companies which are likely to decide to relocate mostly operate in the *high-end labour market* and are attracted by *large* markets. As a result, the EU could decide to maintain employment standards as they are in the higher skilled sectors of the labour market. Our reasoning about the likelihood of the 'polarised racing' scenario however raises particular concerns about individuals' outcomes at the lower end of the labour market. In the absence of a Brexit agreement that the UK will retain current employment standards, EU countries could succumb to a competition with the UK at the low-end of the labour market as well as at the higher end. EU measures and regulations may mitigate this risk, but changes to the current framework cannot be excluded and may follow from a variety of mechanisms such as pressures from Member State governments, or more relaxed enforcement of current legislation.

In our assessment, if the outcome of the UK-EU negotiations leads to an 'alignment with the EU' outcome, the EU is likely (*ceteris paribus*) to continue 'business as usual' where it maintains current employment standards across the economy. A Brexit outcome that would lead to the separation of the UK from the EU regulatory framework and the Single Market is nevertheless likely to threaten the EU employment standards *status quo* especially at the lower end of the labour market (either in the form of changes in the legislation or in enforcement practices). **While this does not follow from expectations of rational economic decision-making implied by the evidence, it can be a risk that originates in a less-than-rational behaviour of key stakeholders**. Statements made in the course of the public debate leading up to the EU Referendum and further on suggest that political decisions do not always stay the course of economic rationality. In fact, as has been observed on numerous occasions, the behaviour of political (and economic) actors is not always consistent with rational choice predictions.

[33] e.g. statement from Lloyd's regarding the set-up of a new insurance company in Brussels following Brexit, at https://www.lloyds.com/news-and-insight/lloyds-plans-in-europe, accessed in April 2017.

5. Concluding remarks

The literature has documented the variety of factors that influence FDI, but although the topic has become very popular during the past two decades, a variety of relevant issues remain unaddressed. What we are still lacking, among others, is an understanding of which of the analysed factors are indeed critical and which are less decisive in determining higher levels of foreign investment in different countries. While there is not clarity around that question so far, there are convincing indications that there is no silver bullet: FDI attractiveness of various countries and / or regions depends on a variety of factors that have been classified in this report under three dimensions: *host country features*, *investing firm characteristics* and *supranational factors*. On the ground of the reviewed evidence it can be hypothesised that across the three above-mentioned dimensions there are different combinations of factors that enable countries to be more or less attractive to foreign companies that are looking to invest in different economic sectors.

Although in theoretical terms a *'race to the bottom'* caused by countries' competitive drive can be envisaged, in empirical terms it has neither been proven that there is a systematic causal link between reductions in employment standards and higher foreign investment levels, nor that countries engage in decreasing employment standards as a response to competing countries' actions. In fact, despite its important contributions to date, the existing literature raises as many questions as it helps clarify. Overall, the evidence reviewed in this report warrants the conclusion that a race to the absolute bottom across all components of the employment standards framework is unlikely in the EU in the existing socio-economic and political context. It can, nevertheless, be argued that there is a risk – one which should not be underestimated – that changes can occur at the low-end of the labour market. The reviewed evidence directs us toward the tentative conclusion that certain economic sectors and categories of workers[34] may be more vulnerable to potential limitations of employment standards (e.g. those in atypical, precarious employment relations that may have different manifestations across the EU labour markets). As our previous reasoning showed, it is also possible that certain dimensions of rights could be limited *if* this could empirically be targeted at areas of the economy which would not be in competition with low-wage economies, but would occupy a niche position (e.g. for non-tradable goods). We have tentatively assigned this set of possible post Brexit risks to the 'polarised racing' scenario, which on balance appears to be the most likely under the given EU context (comprising economic models, workforce skills profiles and previous FDI patterns into the region). That said, although this is the more likely scenario (*ceteris paribus*), a type of outcome of the UK-EU withdrawal negotiations that would separate the UK from the EU regulatory framework and the Single Market might derail the competition and offer the UK more incentives to undercut other EU countries (if not in terms of employment standards, then by other means, e.g. the corporate tax regime). The threat of a gear towards a *low skills equilibrium* economic model may not necessarily derive from swift policy changes, but from a series of cumulative changes, resultant from legislation as well as the failure to enforce it.

We acknowledge that our research has several limitations, which we briefly discuss here. They are primarily driven by two factors: first, the high uncertainty caused by the outcomes of the UK-EU negotiations; and second, the manifold research gaps that our evidence review

[34] Defined in this report are all working-age individuals.

has uncovered. It is plausible that the knowledge gaps that we reported above may distort our understanding of the relationship we studied and its wider causes, consequences and implications. This exemplifies how critical robust empirical data is for informing decisions across the board.

The following months and years are likely to determine and shape changes at every level in the UK, starting with regulatory and legal aspects and ending with business models and individuals' lives. While this is a process that is fraught with immense challenges, there are also some opportunities. The critical aspect is whether the UK's negotiation strategy will capitalise on them. Our evidence review indicates that one of the opportunities is to shape the backbone of the UK's economic model in the future by investing in people's skills, creating *Good Work* and developing high-performance working models as the core components of the UK's competitive advantage on the global market. The current UK labour market is already leaning towards high-value, high-skilled activities as a vital route of competitive advantage in an ever more knowledge intensive global economy. At the time of writing with an industrial strategy under development, the bases for exploiting this opportunity are already being put in place. The real test will be in how seriously this is followed through given the uncertainties that undoubtedly lie ahead, particularly in the context of snap elections and their consequences for politics and policy in the UK.

References

Secondary literature

Acharya, V., Baghai-Wadji, R. & Subramarian, K. (2009). *Labor Laws and Innovation*, CEPR Discussion Paper, no. 7171.

Acemoglu, D., Cao, D. (2015) Innovation by entrants and incumbents, Journal of Economic Theory 157, 255–294.

Aghion, P. and Howitt, P. (1998). “Endogenous Growth Theory”. Cambridge: MIT Press.

Aleksynska, M. & Schmidt, A. (2014). *A chronology of employment protection legislation in some selected European countries.* International Labour Office, Inclusive Labour Markets, Labour Relations and Working Conditions Branch. Geneva: ILO (Conditions of work and employment series; No. 53, at http://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---travail/documents/publication/wcms_324647.pdf, accessed in February 2017.

Ailber, R.Z. (1970). A theory of direct foreign investment. In: Kindleberger, C.P. (Ed.), *The International Corporation*, 17-34. MIT Press, Cambridge Mass.

Akkermans, D., Castaldi, C. & Los, B. (2005). Do Liberal Market Economies Really Innovate More Radically than Coordinated Market Economies? Hall and Soskice Reconsidered, *Research Policy*, 38(1), 181-191.

Baier, S. L., Bergstrand, J. H., Egger, P. & McLaughlin, P. A. (2008). Do Economic Integration Agreements Actually Work? Issues in Understanding the Causes and Consequences of the Growth of Regionalism, *The World Economy*, 31, 461-497.

Badinger, H. (2005), Growth Effects of Economic Integration: Evidence from the EU Member States, *Review of World Economics*, 141, 50-78.

Barrell, R., Pain, N. (1996). An econometric analysis of US foreign direct investment. Review of Economics and Statistics 78(2), 200–207.

Bassanini, A. & Ernst, E. (2002). Labour Market Regulation, Industrial Relations, and Technological Regimes: A Tale of Comparative Advantage, *Industrial and Corporate Change*, 11(3), 391-426.

Bellak, C. & Leibrecht, M. (2005). *Do Low Corporate Income Tax Rates Attract FDI? Evidence from Eight Central- and East European Countries,* Research Paper Series, Globalisation, Productivity and Technology. Research Paper 2005/43, The University of Nottingham. Leverhulme Centre for Research on Globalisation and Economic Policy.

Benassy-Quere, A., Coupet, M. & Mayer, T. (2007). Institutional Determinants of Foreign Direct Investment. *The World Economy*, 30(5), 764-782.

Blanton, R.G. & Blanton, S.L. (2012). Labor Rights and Foreign Direct Investment: Is There a Race to the Bottom? *International Interactions*, 38(3), 267-294.

Botero, J., Djankov S., La Porta R. & Lopez-de-Silanes F. (2004). The regulation of labour. *Quarterly Journal of Economics*, 119(4), 1339-82.

Campos, N.F., Coricelli, F. & Moretti, L. (2014). *Economic Growth and Political Integration: Estimating the Benefits from Membership of the European Union using the Synthetic Counterfactuals Method*, CEPR Discussion Paper No. 9968.

Carstensen, K. & Toubal, F. (2004). *Foreign direct investment in Central and Eastern European countries: A dynamic panel analysis*, IDEAS Working Paper Series from RePEc. St. Louis.

Crafts, N. (2016). *The Growth Effects of EU Membership for the UK: Review of the evidence*, Global Perspectives Series: Paper 7, at http://www.smf.co.uk/wp-content/uploads/2016/04/SMF-CAGE-The-Growth-Effects-of-EU-Membership-for-the-UK-a-Review-of-the-Evidence-.pdf, accessed in February 2017.

Davies, R.B. & Chaitanya Vadlamannati, K. (2013). A race to the bottom in labor standards? An empirical investigation, *Journal of Development Economics*, 103, 1–14.

Driffield, N., Love, J., Lancheros, S. & Temouri, Y. (2013). *How attractive is the UK for future manufacturing foreign direct investment?* Government Office for Science, at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/277171/ep7-foreign-direct-investment-trends-manufacturing.pdf, accessed in March 2017.

Duanmu, J. (2014). A race to lower standards? Labor standards and location choice of outward FDI from the BRIC countries, *International Business Review*, 23(3), 620-634.

Dunning, J.H. & Lundan, S. (2008). *Multinational enterprises and the global economy* (2nd edn) Cheltenham.

Erickson, C.L. & Kuruvilla, S. (1994). Labour costs and the social dumping debate in the European Union, *Industrial and Labor Relations Review*, 48(1), 28-47.

Finegold, D. & Soskice, D. (1988). The failure of training in Britain: analysis and prescription, *Oxford Review of Economic Policy*, 4(3), 21-53.

Goertz, G. & Starr, H. (eds.). (2002). *Necessary Conditions: Theory, Methodology, and Applications*. Rowman & Littlefield Publishers.

Goos, M. & Manning, A. (2007). Lousy and Lovely Jobs: The Rising Polarization of Work in Britain, *The Review of Economics and Statistics*, 89(1), 118-133.

Goos, M., Manning, A. & Salomons, A. (2009). Job Polarization in Europe. *American Economic Review*, 99(2), 58-63.

Görg, H. (2005). Fancy a Stay at the 'Hotel California'? The Role of Easy Entry and Exit for FDI. *Kyklos*, 58(4), 519-535.

Griffith, R. & Macartney, G. (2010). *Employment Protection Legislation, Multinational Firms and Innovation*, IFS Working Paper (W10/01), at https://www.ifs.org.uk/wps/wp1001.pdf, accessed in March 2017.

Hall, P.A. & Soskice, D. (2001). *An Introduction to Varieties of Capitalism, Varieties of Capitalism. The Institutional Foundations of Comparative Advantage*, Oxford University Press, 1-68.

Haskel, J.E., Pereira, S.C. & Slaughter, M.J. (2007). Does Inward Foreign Direct Investment Boost the Productivity of Domestic Firms? *Review of Economics and Statistics*, 89, 482-496.

Harcourt, M. & Wood, G. (2007). The Importance of Employment Protection for Skill Development in Coordinated Market Economies, *European Journal of Industrial Relations*, 13(2), 141-159.

Helpman, E. (1984). A Simple Theory of International Trade with Multinational Corporations. *Journal of Political Economy*, 92(3), 451-471.

Javorcik, B.S. & Spatareanu, M. (2005) Do Foreign Investors Care about Labor Market Regulations? *Review of World Economics*, 141(3), 375-403.

Krugman, P. (1991). Increasing returns and economic-geography. *Journal of Political Economy,* 99(3), 483-499.

Krzywdzinski, M. (2014). Do investors avoid strong trade unions and labour regulation? Social dumping in the European automotive and chemical industries, *Work, employment and society*, 28(6), 926-945.

Kucera, D. (2002). Core Labour Standards and Foreign Direct Investment. *International Labour Review*, 141, 31-69.

Lehmann H. & Muravyev A. (2009). *How Important are Labour Market Institutions for Labour Market Performance in Transition Countries?* Discussion Paper no. 4673, Institute for the Study of Labour.

Levy-Yeyati, E.L., Stein, E. & Daude, C. (2003) *Regional Integration and the Location of FDI.* IDB Working Paper No. 414. At http://dx.doi.org/10.2139/ssrn.1818703, accessed in March 2017.

Locke, R.M. & Romis, M. (2007). Improving work conditions in a global supply chain, *MIT Sloan Management Review*, 48(2), 54-62.

Markusen, J.R. (1984). Multinationals, Multiplant Economies, and the Gains from Trade. *Journal of International Economics*, 16(3-4), 205-226.

Martin, W. & Maskus, K.E. (2001). Core Labor Standards and Competitiveness: Implications for Global Trade Policy. *Review of International Economics*, 9(2), 317-328.

Mosley, H. (1990). The Social Dimension of European Integration, *International Labour Review*, 129(2), 147-64.

Mosley, L. (2011). *Labor Rights and Multinational Production*. New York: Cambridge University Press.

Moran, T.H. (2011). *Foreign Direct Investment and Development: Launching a Second Generation of Policy Research: Avoiding the Mistakes of the First, Reevaluating Policies for Developed and Developing Countries*. Washington, DC: Peterson Institute for International Economics.

Morris, D. & Morris, D. (2016). *Skill Shortages and Firm Response: Is the UK Heading for Low Skill Equilibrium?* at https://www.sheffield.ac.uk/polopoly_fs/1.669931!/file/D2_1_Morris.pdf, accessed in April 2017.

Olney, W.W. (2013). A *Race to the Bottom? Employment Protection and Foreign Direct Investment,* Department of Economics Working Papers series, at http://web.williams.edu/Economics/wp/OlneyEmploymentProtectionAndFDI.pdf, accessed in March 2017.

Pain, N. & Young, G. (2004). The Macroeconomic Impact of UK Withdrawal from the EU, *Economic Modelling*, 21, 387-408.

Rasciute, S. & Pentecost, E.J. (2010). A Nested logit approach to modelling the location of foreign direct investment in the Central and Eastern European Countries, *Economic Modelling*, 27, 32-39.

Thompson, S., Colebrook, C., Hatfield, I. & Doyle, P. (2016). *Boosting Britain's low-wage sectors: A strategy for productivity, innovation and growth*, Institute for Public Policy Research, at http://www.ippr.org/files/publications/pdf/low-wage-sectors_May2016.pdf?noredirect=1, accessed in March 2017.

Wilson, R. & Hogarth, T. (eds.). (2003). *Tackling the Low Skills Equilibrium: A Review of Issues and Some New Evidence*, Institute for Employment Research – University of Warwick, at https://www2.warwick.ac.uk/fac/soc/ier/publications/2003/wilson_et_al_2003_low_skills.pdf, accessed in April 2017.

Wood, G., Yin, S., Mazouz, K. & Eng-Tuck Cheah, J. (2016). Foreign direct investment and employment rights in South-Eastern Europe, *Cambridge J Econ,* 40(1), 141-163.

Reports

Cebr & Open Britain. (2016). *How the UK economy's key sectors link to the EU's Single Market*, at https://www.cebr.com/reports/how-the-uk-economys-key-sectors-link-to-the-eus-single-market/, accessed in April 2016.

Committee on Employment and Social Affairs. (2016). *Report on social dumping in the European Union* (2015/2255(INI)), Rapporteur: Guillaume Balas, at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2016-0255+0+DOC+PDF+V0//EN, accessed in March 2017.

Department for International Trade (2015). *UK Inward investment results 2014 to 2015*, at https://www.gov.uk/government/publications/ukti-inward-investment-report-2014-to-2015/ukti-inward-investment-report-2014-to-2015-online-viewing, accessed in February 2017.

Dhingra, S., Ottaviano, G., Sampson, T. & Van Reenen, J. (2016). *The consequences of Brexit for UK trade and living standards*, Brexit Analysis no. 2, Centre for Economic Performance - London School of Economics and Political Science, at http://cep.lse.ac.uk, accessed in April 2017.

European Commission. (2014). *Directorate-General for Employment, Social Affairs and Inclusion, Labour law and working conditions, Social Europe guide*, Volume 6, Chapter 3, 33-51, at http://www.ab.gov.tr/files/ardb/evt/Labour-law-and-working-conditions-2014.pdf, accessed in March 2017

European Commission. (2017). *Fact Sheet, February infringements package: key decisions*, at http://europa.eu/rapid/press-release_MEMO-17-234_en.htm, accessed in March 2017.

Ernst & Young LLP. (2016). *EY's attractiveness survey UK 2016: Positive rebalancing?* at http://www.ey.com/Publication/vwLUAssets/2016-UK-Attractiveness-Survey/$FILE/EY-UK-Attractiveness-Survey-2016.pdf, accessed in March 2017.

How good is your business really? (2016). H*ow good is your business really? Raising our ambitions for business performance*. at https://howgoodisyourbusinessreally.co.uk/downloads/reports/how-good-is-your-business-really.pdf, accessed in April 2017.

HM Treasury (2016). *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives. Part 2: Estimating the impact of different EU relationships on UK foreign direct investment*, at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf, accessed in March 2017.

KPMG. (2014). *The UK Automotive Industry and the EU: An economic assessment of the interaction of the UK's Automotive Industry with the European Union*, at https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-KPMG-EU-Report.pdf, accessed in April 2017.

London First. (2016). *Leaving the EU: an assessment of its impact on services and trade*, at http://londonfirst.co.uk/wp-content/uploads/2016/06/Leaving-the-EU-impact-on-trade-June-2016.pdf, accessed in April 2017.

OECD. (2000). *International Trade and Core Labour Standards.* Paris.

OECD. *OECD Indicators of Employment Protection* at http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm, accessed in March 2017.

ONS. (2016a). *International perspective on UK foreign direct investment (FDI): 2014*, at https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/articles/internationalperspectiveonukforeigndirectinvestmentfdi/2014, accessed in February 2017.

ONS (2016b). *Statistical bulletin: Foreign direct investment involving UK companies: 2015*, at https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/foreigndirectinvestmentinvolvingukcompanies/2015, accessed in March 2017

ONS. (2016c). *Statistical Bulletin, UK index of services: August 2016*, at https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/indexofservices/august2016, accessed in March 2017.

Slaughter and May. (2016) *The EU Merger Regulation: An Overview of the European Merger Control Rules*, at https://www.slaughterandmay.com/media/64572/the-eu-merger-regulation.pdf, accessed in March 2017.

Society of Motor Manufacturers and Traders (SMMT). (2016). *Key Facts*, at https://www.smmt.co.uk/wp-content/uploads/sites/2/SMMT-Motor-Industry-Facts-2016_v2-1.pdf, accessed in April 2017.

Stehrer, R., Baker, P., Foster-McGregor, N., Koenen, J., Leitner, S., Schricker, J., Strobel, T., Vieweg, H-G., Vermeulen, J. & Yagafarova, A. (2014). *Study on the relation between industry and services in terms of productivity and value creation. Final report*, Study for the Directorate-General for Enterprise and Industry, Vienna, at http://ec.europa.eu/DocsRoom/documents/8528/attachments/1/translations/en/renditions/native, accessed in March 2017.

TUC. (2016). *UK Employment Rights and the EU*, at https://www.tuc.org.uk/sites/default/files/UK%20employment%20rights%20and%20the%20EU.pdf, accessed in March 2017.

Wilson, R. Beaven, R., May-Gillings, M., Hay, G. & Stevens, J. (2014). *Working Futures 2012-2022*, Evidence Report 83/ 2014, UKCES at https://skillmakers.co.uk/library/downloads/working-futures-2012-2022-main-report.pdf, accessed in April 2017.

Work Foundation. (2016). *The Commission on Good Work*, at http://www.theworkfoundation.com/wp-content/uploads/2016/10/The-Commission-on-Good-Work.pdf, accessed in March 2017.

Legislation

Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions. (2010). Towards a comprehensive European international investment policy, Brussels, 7.7.2010, COM(2010)343 final, at http://trade.ec.europa.eu/doclib/docs/2011/may/tradoc_147884.pdf, accessed in March 2017.

Consolidated version of the Treaty on the Functioning of the European Union, Title IX-X, at http://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_2&format=PDF, accessed in March 2017.

EU infringement procedures at http://europa.eu/rapid/press-release_MEMO-12-12_en.htm?locale=en%20%20%20MEMO/13/907, accessed in March 2017.

EU Merger Regulation, Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) Official Journal L 24, 29.01.2004, p. 1-22 at http://ec.europa.eu/competition/mergers/legislation/regulations.html, accessed in March 2017.

EU anti-dumping policy, at http://ec.europa.eu/trade/policy/accessing-markets/trade-defence/actions-against-imports-into-the-eu/anti-dumping/index_en.htm, accessed in April 2017.

European Commission imposes anti-dumping duties on steel products from China and Taiwan, 27 January 2017, at http://trade.ec.europa.eu/doclib/press/index.cfm?id=1615, accessed in April 2017.

Public statements & articles

Juncker, J-C., *Opening Statement in the European Parliament Plenary Session*. 15 July 2014. at http://www.eesc.europa.eu/resources/docs/jean-claude-juncker---political-guidelines.pdf, accessed in March 2017.

Statement from Lloyd's about setting-up an insurance company in Brussels following Brexit, at https://www.lloyds.com/news-and-insight/lloyds-plans-in-europe, accessed in April 2017.

Statement from Toyota in regards to the UK/EU Referendum, 23 June 2016, at http://media.toyota.co.uk/2016/02/statement-from-toyota-in-regards-to-the-uk-eu-referendum-june-23rd-2016/, accessed in April 2017.

Trump launches investigation into steel dumping, BBC News 21 April 2017, at http://www.bbc.co.uk/news/business-39664532, accessed in April 2017.

May 2017