BACKGROUND DOCUMENT FOR DITEG ISSUE #2

A PROPOSAL FOR A NEW DEFINITION OF FDI

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1 The views expressed in this document are those of the author and do not necessarily reflect those of STATEC.
A proposal for a new FDI definition

0. Introduction

Due to their composition, the overall total of FDI results loose their analytical strength and their comparability across the countries. One of the reasons is the aggregation of investments in the “real” economy and of operations via fiscal and financial vehicles.

The purpose of this short background paper is to present a new FDI definition and to propose the introduction of another investment item (section 3). The first two sections shortly provide the background of this issue (section 1) and deal with alternative treatments of SPEs (section 2). The last part mentions some consequences of this new definition and opens the discussion.

This paper is a background document to point 4.1 Economic definition of FDI presented in the DITEG Issue Paper 2

1. Background

In 2002 Luxembourg published for the first time separate data (from Belgium Luxembourg Economic Union) on FDI flows. Significant FDI inflows and outflows via SPEs, generated a large amount of total FDI flows. In the ranking of the UNCTAD World Investment Report (WIR), Luxembourg took the lead. And in box II.11 the WIR commented as follows:

2 This background paper is a revised version of a discussion paper prepared for the ECB BOP Thematic Meeting in Athens (7-8 June 2004). I thank Ayse Bertrand, Roger de Boeck and Carlos Sanchez Munoz for their comments on a previous version.
“In 2002 Luxembourg was the world’s largest outward investor and largest FDI recipient, accounting for about 19% ($126 billion) of world inflows and 24% ($154 billion) of outflows – and more than a third of the combined EU inflows and outflows. The country’s share of EU GDP is only 0.2%. Compared with the domestic investment of $4.4 billion in 2002, its FDI is impressive.” (WIR 2003, p.69)

These data were the result of a strict application of the present rules to record FDI.

Several users criticised the output of these statistics. Even the WIR addressed some caution by ending its comment by the following consideration:

“This highlights the fact that FDI statistics need to be interpreted carefully, with sufficient attention paid to the underlying methodology” (WIR 2003, p.69)

Despite this “warning”, the total FDI figures were frequently used by newspapers and other researchers - without sufficient attention paid to the underlying methodology.

The fact is that more than 90% of the inward and outward FDI flows of Luxembourg are realised by SPEs.

2. The special case of SPEs

In principle SPEs have mainly a fiscal or a specific financial purpose. In order to get a clearer picture of “real” FDI flows and stocks, some analysts suggest a different treatment for SPEs or the collection of separate statistics (Report of the Eurostat/ECB Task Force on Foreign Direct investment -TFFDI, p 126).

2.1 One proposal is to pass through the SPE – as in the following example the entity B - and to establish a direct link between the investor A and the invested company C.

This approach has a number of drawbacks:

- it seems hardly compatible with the residence concept of BPM5
- it would require the existence of a harmonised definition of a SPE, which is not available for the time being
- all FDI compilers would have to apply the same procedure which is difficult to ensure. In this regard, the need to ensure an appropriate geographical dimension as regards FDI flows and stocks may imply some problems.
For all these reasons, this proposal is not considered further in this paper.

2.2 Another option is to collect SPE flows separately on the level of FDI flows. Thus users could analyse separately the flows by SPEs and other operators.

This approach has also at least two caveats:

- the problem of definition (see 2.1);
- the problem of consistent historical series.

The next section introduces a proposal aimed at overcoming the common problem shared by both approaches, namely the lack of a single and widely accepted definition of SPE.

3. A new definition of FDI

The OECD work and the TFFDI report both stress very clearly that it is difficult to find an operational definition for SPEs. Despite this difficulty it is urgent to provide accurate data for FDI analytical purposes. The present debate on “outsourcing” (“delocalisation”) underlines the need to distinguish FDI in the “real” economy from FDI vehicles for financial and fiscal reasons.

Regarding SPEs, two aspects are clearly identified:

- It is commonly agreed that “financial and fiscal aspects” (TFFDI report, p.96) determine the establishment of SPEs.
- Furthermore it is generally observed that a very large majority of SPEs has “no significant employment” (TFFDI report, p.87)

3.1 An additional criterion: employment (in the definition of a FDI enterprise)

Given the “absence of a universal definition of SPEs and of a general recognition of the necessity of a separate identification of the activities of SPEs “ (TFFDI report, p. 97), it could be helpful to redefine FDI by adding a criterion that would exclude those entities (especially SPEs) which do not carry out a real economic activity on the territory in which they are located. Employment could be a reasonable criterion.

Concretely a FDI relation would be defined by three criteria:

- the present criterion:
  a. at least 10 % of the capital (ordinary shares or voting stock)

- completed by by one other criterion (only applicable to direct investment companies):
  b. at least X persons employed (on a non-consolidated basis)
The addition of an “employment criterion” could provide basic information to include under FDI investments in the “real” economy (and exclude investments for fiscal and financial purposes). In consequence, FDI statistics would be used less ambiguously for analytical purposes.

It could be added in the compilation guide of FDI stocks and flows, that entities - owned by more than 10 % by foreign capital, but employing less than x persons - should receive nearly as much inward FDI as outward FDI they channel abroad.

3.2 An additional sub item

In order to avoid any great disruption in statistical series, it is proposed to create a new item (a clear labelling has to be found) “Capital intensive FDI” \(^3\) (CIFDI) - covering the flows (and stocks) of units evidenced by an ownership of at least 10%, but having less than X employment.

The presentation in the new BOP classification would be as follows:

<table>
<thead>
<tr>
<th>FDI (new definition)</th>
<th>CIFDI</th>
<th>Portfolio Investment</th>
<th>Other investment</th>
</tr>
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<tbody>
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<td></td>
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In other words, the old FDI definition would be identical to the new FDI plus CIFDI:

\[ old\ FDI = \text{new FDI} + \text{CIFDI} \]

This presentation of four (investment) sub-items compared to the previous three has the advantage:

- to be easily operational (despite the absence of a universal definition of SPEs, but excluding most of SPEs from FDI – new definition)
- to provide separate figures for “real” FDI and “capital intensive” FDI
- to provide (to a great extent) consistent data for back data (by adding up to lines “FDI” (new) and “CIFDI”
- to avoid a confusion on the FDI concept, if SPE are integrated in the aggregate (as it is the case at present).

4. Consequences: The Treatment of dividends of CIFDI

**Dividends**

By analogy with mutual funds, any dividends received by a CIFDI (on its foreign assets as well as the dividends earned on its domestic assets) should pass on as a dividend directly to the shareholder (BOPCOM – 02/42).

\(^3\) or another labelling allowing a clear demarcation
Reinvested earnings

Due to the special treatment of dividend income, no reinvested earnings need to be calculated for CIFDI.

5. First comments

First comments from a compiler’s point of view:

Employment data are normally provided in the context of FDI surveys. Regarding the inward FDI they are even available in the specific registers given other sources. For outward FDI they should normally be available.

First comments from a user’s point of view

The new presentation provides data to be directly used for analytical purposes. The aggregation of the new FDI item and the CIFDI item would allow the continuity of the old FDI item.

A point for discussion: One could envisage applying a capital threshold in order not to include smaller enterprises that should be excluded for administrative and reporting burden purposes.

The overall implications in the BOP, FDI (flows and stocks) and Foreign Affiliates Statistics (FATS) framework have to be further investigated.

Reference documents


IMF Balance of Payments Textbook, 1996
IMF BOPCOM – 02/42
OECD Benchmark Definition of Foreign Direct Investment, third edition, 1996
UNCTAD World Investment Report 2003