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Does it matter who invests in your country?

by
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When Opel invested in car assembly operations in Gliwice in 1998, Poland registered this project as German because Opel is headquartered in, and managed from, Germany. However Opel has been owned by General Motors (United States) since 1929. Such utilization of foreign affiliates for investment in third countries is "indirect foreign direct investment" (indirect FDI). At first sight the term is contradictory, although it is not so: "direct" refers to the degree of control over a foreign affiliate, while "indirect" denotes the way the *ultimate owner* arrives at such control.

Indirect FDI matters for host countries because an investor follows a distinct corporate strategy, which is influenced by the management culture of the investor's home country. If projects are transparent, host countries face few problems with indirect FDI. There are however cases in which the ultimate owners conceal their identities to circumvent sensitivities about their nationalities, such as Russian firms investing through Cyprus. A special form of indirect FDI is *round tripping*: the ultimate owners come from the same country in which the foreign affiliates are located. Round tripping is important for example between China and Hong Kong (China) and between the Russian Federation and Cyprus. Indirect FDI can be financed through *transshipment investment* by using foreign affiliates in third countries or more transient constructions such as *special purpose entities* (SPEs).[1] SPEs are concentrated in hubs, such as Luxembourg, Austria and Hungary, in that order.

Indirect FDI distorts global FDI statistics (see the tables below), although it reflects well corporate financial strategies. In part due to round tripping, host countries' statistics provide a misleading picture of the geography of FDI. For example, FDI by

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[1] An SPE is a separate legal person established to pursue temporary objectives such as the financing of an affiliate abroad. Different from ordinary projects, it allows limiting the risk of the transaction to the value of the SPE.

ultimate owners is reported by a handful of countries only. In one of them, the United States, the immediate and ultimate owners were different in at least 18% of inward FDI projects (in terms of value of investment) in 2010. UNCTAD data indicate that other countries provide less perfect proxies of the extent of indirect FDI.[2] For example, in 2008, 60% of the outward FDI stock of Brazil was registered in three Caribbean offshore centers, to be transshipped to third countries. For the Russian Federation, Cyprus accounted for 30% of the outflows and 22% of the inflows over the period 2007-2011; for Hong Kong, China accounted for 37% of the inward stock and 42% of the outward stock in 2010. Finally, the combined inward and outward FDI stocks of each Austria, Hungary and Luxembourg in SPEs topped US$ 1.7 trillion in 2010 and their ratios to global FDI stocks exceeded 8%.

Companies undertake indirect FDI for various reasons. The most important is corporate strategy, that is, delegating investment decisions in third countries to geographically close regional headquarters or to foreign affiliates with cultural affinity. For example, multinational enterprises ask their Slovenian affiliates to invest in the Balkans, due to their better understanding of local business conditions. Delegation to foreign affiliates may also make sense for managing global value chains. Tax advantages are another key consideration, since lower taxes can result from transshipment through financial centers and investment through countries that have favorable double taxation treaties (DTTs) with the target host country. Taxation matters also for round tripping: a company that is registered as foreign can benefit from incentives, and can also invoke the DTT signed with the transshipment country. Some firms undertaking capital-intensive and risky projects use indirect FDI to obtain protection from the bilateral investment treaties (BITs) of transit countries. As indicated, there are also firms that wish to conceal their origins as much as possible in order to avoid scrutiny by the host country. For round tripping, escaping from potential uncertainties in the country of origin could also be a motive.

Indirect FDI has implications for development. Ultimate owners have a say in the operations of the affiliates they control indirectly. Indirect FDI influences the amount and distribution of taxes among countries. It also leverages protection for investors and can provide better access to dispute settlement. Finally, when there are sensitivities about ultimate investors, national security considerations may arise.

In principle, host countries could formulate an effective policy response because often their own regulatory systems encourage indirect FDI. They need not fully suppress indirect FDI but rather deal with its negative consequences. Tax laws encouraging indirect FDI leading to welfare losses could be revised, especially through cooperation of the jurisdictions concerned. International action on transfer pricing also needs to be strengthened. The role of BITs and DTTs needs to be revaluated. Treaty shopping is difficult to contain; but one could envisage clauses limiting the importation of protections from other BITs, following the example of exemptions to the most-favored-nation clause. Policy makers could also consider BIT clauses on transparency regarding ultimate owners.

[2] See, UNCTAD's *World Investment Report 2012*, to be launched on July 5, 2012.

Investment (www.vcc.columbia.edu)." A copy should kindly be sent to the Vale Columbia Center at vcc@law.columbia.edu.

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Table 1. Inward FDI stock of the United States from selected economies of origin, by immediate investor and ultimate beneficial owner, 2010
(Billions of dollars)

Economy	**By immediate investor**	**By ultimate beneficial owner**	**Difference**
Bermuda	5.1	124.8	119.7
United Kingdom	432.5	497.5	65.0
Germany	212.9	257.2	44.3
Canada	206.1	238.1	31.9
United States	–	31.6	31.6
Ireland	30.6	61.7	31.1
France	184.8	209.7	24.9
Mexico	12.6	34.0	21.4
Brazil	1.1	15.5	14.4
United Arab Emirates	0.6	13.3	12.7
Israel	7.2	19.5	12.2
Belgium	43.2	52.2	9.0
Netherlands Antilles	3.7	12.4	8.7
Hong Kong (China)	4.3	11.6	7.3
Italy	15.7	23.0	7.3
Japan	257.3	263.2	6.0
Norway	10.4	14.4	4.1
India	3.3	7.1	3.8
Spain	40.7	44.2	3.5
Finland	6.6	10.0	3.5
Australia	49.5	52.9	3.4
New Zealand	0.6	3.3	2.7
China	3.2	5.8	2.7
South Africa	0.7	2.2	1.5
Korea, Republic of	15.2	16.6	1.4
Kuwait	0.3	1.5	1.1
Taiwan Province of China	5.2	6.0	0.8
Malaysia	0.4	1.0	0.6
Denmark	9.3	9.9	0.6
Venezuela, Bolivarian Republic of	2.9	3.1	0.3
Bahamas	0.1	0.2	0.1
Total difference (+)	-	-	477.7
Singapore	21.8	21.3	-0.5
Panama	1.5	0.8	-0.7
Austria	4.4	2.5	-1.8
Sweden	40.8	36.0	-4.7
United Kingdom Islands, Caribbean	31.2	0.8	-30.3
Netherlands	217.1	118.2	-98.8
Switzerland	192.2	61.6	-130.6
Luxembourg	181.2	24.4	-156.8
Total difference (-)	–	–	-424.4
All economies	2 342.8	2 342.8	–

Source: The author's calculations, based on U.S. Bureau of Economic Analysis data.

Note: Data for various economies have been suppressed; therefore the total value of differences (+) and (-) differ.

Table 2. SPE and non-SPE related FDI stocks of Austria, Hungary and Luxembourg, 2010
(Stocks in billions of US$ and shares in %)

	Inward FDI			Outward FDI		
Country	**Through SPEs**	**Excluding SPEs**	**Ratio of SPE to non-SPE** (%)	**Through SPEs**	**Excluding SPEs**	**Ratio of SPE to non-SPE** (%)
Austria	170	103	166	177	98	180
Hungary	120	89	134	122	20	623
Luxembourg	1 579	287	551	1 403	499	281
Total	1 869	479	390	1 702	617	276
Memorandum item:						
Ratio to world FDI stock (%)[a]	9.77			8.34		

Source: The author's calculations, based on UNCTAD, FDI/TNC database, and national statistics.
[a] Global FDI stock data usually exclude SPEs.