IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #5B

REINVESTED EARNINGS OF INDIRECTLY OWNED DIRECT INVESTMENT ENTERPRISES

Prepared by Marie Montanjees, IMF Statistics Department

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Direct Investment Technical Expert Group

Issues Paper (DITEG) #5B: Reinvested Earnings of Indirectly Owned Direct Investment Enterprises

Reinvested earnings comprise the direct investor's share—in proportion to equity held—of earnings that foreign subsidiaries and associated enterprises do not distribute as dividends, and are deemed to provide additional capital to the enterprises.

This paper addresses the possible need to change the present method of calculating reinvested earnings of indirectly owned direct investment enterprises in an extended chain of ownership.

I. Current international standards for the statistical treatment of the issue

- The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* recommends that the reinvested earnings of indirectly owned direct investment enterprises be included in the FDI data for each country in proportion to the indirect ownership of the equity of those enterprises. Tables in Annex 1 of the document illustrate the specific treatment:

    - Table 8*,* which shows an example involving a chain of fully-owned subsidiaries in four countries, indicates that the full amount of the reinvested earnings of an enterprise in Country 4 is included in the total reinvested earnings reported for Country 3, and again up the chain of ownership in the total reinvested earnings reported for Countries 2 and 1.

    - Table 4 gives examples of longer chains involving partially-owned enterprises using the same method of carrying forward up the chain of ownership the share of the reinvested earnings of indirectly owned direct investment enterprises.

- Although the fifth edition of the IMF *Balance of Payments Manual (BPM5*), the *Balance of Payments Textbook*, and the *Balance of Payments Compilation Guide* do not specifically address the issue of calculating reinvested earnings of indirectly owned direct investment enterprises, *BPM5* is deemed to be consistent with the *Benchmark Definition*.

II. Concerns/shortcomings of the current treatment

- The recommended treatment of carrying the reinvested earnings of an enterprise into the calculation of reinvested earnings for the country of residence of the indirect investor can lead to multiple-counting of those earnings at a global level. [1] To illustrate, in the case of a chain of fully-owned subsidiaries in four countries, the original amount of 550 of reinvested earnings of an enterprise in Country 4 at the bottom of the chain is included in the calculation of reinvested earnings not only of Country 3, but also of Country 2 and Country 1. As a result, the original amount of reinvested earnings has been included in the reinvested earnings of three different countries and has increased to 1,650 in the global total for reinvested earnings—a figure three times higher than the original earnings. [2] The more indirectly owned enterprises in the chain, the higher the multiple-counting of the reinvested earnings. [3]

- The treatment of reinvested earnings of indirectly owned enterprises appears to be inconsistent with the recommended treatment of other direct investment transactions, such as equity capital and other capital transactions, which are not carried up the ownership chain, but are shown only in the direct investment data of the two countries directly involved in the transaction.

- The *Annotated Outline (AO)* for the revision of *BPM5* raises the option of changing the method of recording reinvested earnings to eliminate multiple counting at a global level in instances of extended chains of ownership.

III. Possible alternative treatments

- Retain the present system of including the amount of reinvested earnings of an enterprise in a given country all the way up the chain of indirect ownership, recognizing both the apparent inconsistency with the treatment of other direct investment transactions, and the fact that it leads to multiple-counting of the amount of reinvested earnings at the global level.

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[1] These concerns were discussed in an IMF note to the March 2003 meeting of the OECD Workshop on International Investment, which agreed that the present treatment should be reviewed.

[2] See Table 8 of Annex 1 of the *Benchmark Definition*.

[3] The problem also exists in cases of partially-owned subsidiaries. Table 4 of Annex 1 of the *Benchmark Definition* illustrates a situation where the percentage ownership of the parent company in the direct investment enterprise is 51 percent in all instances, and the reinvested earnings of Company E in Country 5 attributable to the direct investor is an amount of 51. In this instance, the 51 in reinvested earnings of Company E is included in the reinvested earnings of related enterprises as follows: Company D in Country 4 = 51, Company C in Country 3 = 26, Company B in Country 2 = 13, and Company A in Country 1 = 7. As a result, the original 51 in reinvested earnings of Company E has increased in the global data to 97, almost double the original amount.

- Limit the inclusion of reinvested earnings of an enterprise in a given country to the country directly above it in the chain of ownership, i.e. to treat the calculation of reinvested earnings in a manner similar to the treatment of other direct investment transactions involving indirectly owned enterprises, namely to include them only in the data of the two countries that are directly involved in the imputed transaction.

- Establish an arbitrary limit to the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included.

IV. Points for discussion

1. Do DITEG members consider that the present treatment of reinvested earnings of indirectly owned enterprises in an extended chain of ownership is conceptually correct and should therefore be retained, notwithstanding (i) the potential for multiple-counting, and (ii) the apparent inconsistency with the treatment of other direct investment transactions between direct investors and indirectly owned direct investment enterprises? If so, what is the conceptual rationale for the present treatment?

2. Do DITEG members consider that the inclusion of reinvested earnings of an enterprise in a given country should be limited to the country directly above it in the chain of ownership, i.e. the reinvested earnings should be included only in the data of the two countries that are directly involved in the imputed transaction?

3. Do DITEG members consider that an arbitrary limit should be established on the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included? If so, what should that limit be?

References

Benchmark Definition of Foreign Direct Investment, third edition, OECD, 1996.
Table 4 of Annex 1. Earnings of Partially Owned Enterprises.
Table 8, Annex 1. Earnings of Fully Owned Subsidiaries

The Fully Consolidated System, Note by the IMF presented to the OECD Workshop on International Investment Statistics, March 2003 (DAFFE/MC/STAT(2003)8 for background information on the issue.

Annotated Outline for the Revision of BPM5, IMF, April 2004
Chapter 10, paragraph 10.42, and the appendix that includes changes raised as an option.