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Dividends and Retained Earnings of Foreign Direct Investors: BOP and SNA Treatment in Canada

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BoP and SNA Treatment in Canada

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A note for the Balance of Payments Committee
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Introduction

The current reviews of BPM5 and SNA93 have led the System of National Accounts Branch[1] of Statistics Canada to review where the Canadian System of National Accounts (CSNA) and the Canadian international accounts as yet do not conform to international standards. When SNA93 and BPM5 were implemented in Canada it was decided in some instances to not follow exactly the international standards. The reasons for these deviations ranged from reservations with some of the recommendations in the standards to lack of sufficient data to undertake the needed statistical estimates.

Canadian Situation

One such instance where the international standard was not fully implemented in the CSNA was the imputation of a flow of investment income to the foreign direct investor equal to the value of the retained earnings. This imputation and the offsetting flows of reinvested earnings are included in the Canadian balance of payments. This change was not adopted in the national accounts at the time of the 1997 Historical Revision for a number of reasons. However, given the integrated nature of the CSNA, this situation led to the necessity of establishing a reconciliation table between the balance of payments accounts and the CSNA non-resident sector accounts. This reconciliation is published quarterly as part of the non-resident sector accounts.

The balance sheet accounts, both in the CSNA and the IIP, are as yet estimated on a book value basis[2]. The book values of corporate assets in both sets of balance sheets reflect the increased value of the investment positions of parent companies due to the increase in retained earnings of subsidiaries. However, while the related change in the IIP can be observed in the BOP financial account, in the CSNA sector accounts this change in valuation is excluded from the financial account and classified in the Other change in assets account.

CSNA Decision to Not Implement Retained Earnings Imputation

It was felt that the introduction of this imputation was not appropriate as it would affect the cyclical flow of investment income and thus net lending and would distort the savings investment relationship.

It is our experience that there is a cyclical pattern to the proportion of income earned by foreign direct investors that is returned as dividends and equivalent payments and that which is retained in the foreign investment enterprise. This pattern has an impact on the movements in the current account and it is felt that this cyclical signal should not be distorted by included in investment income an imputed flow for retained earnings.

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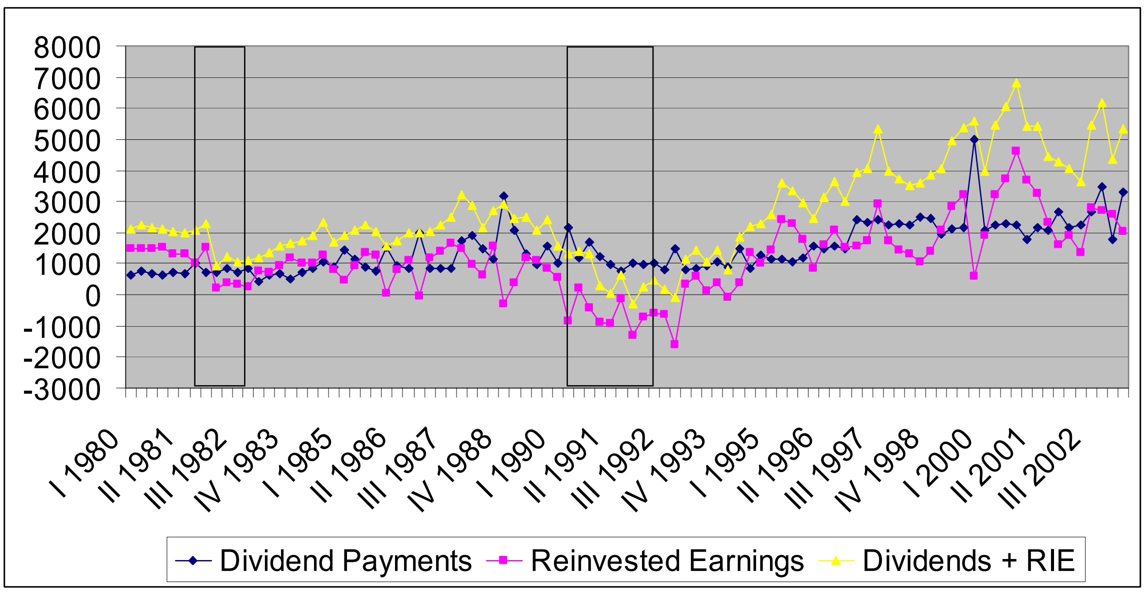
[1] This SNA Branch is responsible for the full sequence of accounts in the SNA and the international accounts in BPM5, as well as the GFS accounts.

[2] Both the IIP and the balance sheet accounts within the CSNA will move to partial market value estimates in June of 2004, with the remainder of the accounts moving to market value in June 2005.

The following chart shows the dividends, reinvested earnings and the sum of the two for Foreign Direct Investment into Canada from 1980 to the second quarter of 2003. The highlighted areas in the early eighties and nineties are the two periods of economic slow downs experienced in Canada during this period[3]. In the case of both periods of economic slowdown the dividend payments to foreign direct investors remained at virtually the same level. This occurred despite the fact that the total income earned (dividends plus RIE) on those investments fell through each of these periods. It is the retained earnings which take the brunt of the cyclical impact.

When the imputed flow for reinvested earnings is included in the estimate of investment income, the result is that the income flow to the foreign investor falls through the recession, particularly in the 1990 to 1992 period. However, the actual flow of income, the dividends paid, remains virtually unchanged.



Imputing Flows

There is also concern with any imputation for a flow that does not exist. The rational for this measure where the direct investor could have caused the income to flow goes beyond the usual realm of the economic statistician. Imputing for flows that are not or cannot be observed directly is a necessary part of national accounting if we are to have as complete a picture of the economy as possible.

However, this should not include imputing for income and other flows that could have happened.

[3] An article discussing the dates of Canadian business cycles since June 1929 is found in the *Canadian Economic Observer*, December 2001, Statistics Canada – Catalogue no. 11-010-XPB.

The case cited above where the reinvested earning turn negative through the recession of the early 1990s in Canada, direct investors of Canadian direct investment enterprises decided to pay out dividends in excess of current income. This decision should result in deterioration in the net lending position of the corporations but with the negative RIE the effect is less than one would expect. The imputation of the RIE moves some of the deterioration in saving to the non-resident sector which has continued to receive the full amount of the dividend.

Foreign Direct Investment

The very definition of foreign direct investment includes the idea of making a commitment for an extended period of time.

> **359.** *Direct investment* is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. (The resident entity is the direct investor and the enterprise is the direct investment enterprise.) The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. *Direct investment* comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

The current treatment focuses on the direct investor's capacity to influence the decisions of the firm including the decision on the amount of dividend to be paid. However, the fundamental focus of the definition of FDI is the lasting interest. The investor with a lasting interest must consider not only the current potential to repatriate income but also the long run viability of the firm. The withdrawal of too much income could lead to the value of his FDI asset falling sharply.

This is not to say that retained earnings are not an interesting value for economic analysis. Estimates of retained earnings should continue to be part of the information available through the international accounts. The decision to retain earnings and to save within the economy where the direct investment enterprise is located is important information in the analysis of how FDI contributed to the growth of different economies.

Given the above observations, it would be beneficial to have a thorough review of the current estimation of reinvested earnings during the current revision of BPM5.