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Government Involvement in Private Enterprises: The Case of Foreign Direct Investment

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Context

1. One of the results of the recent global financial crisis has been governments' intervention/participation in private enterprises. The much publicized bail-outs and investment in corporations can provide measurement challenges for statisticians.

2. For Canada these interventions normally take place within Canada − that is, with no impact on the international accounts. What is interesting in this crisis context is that, given some of the multinational corporations involved, governments in different countries may be providing assistance to non-resident enterprises with affiliates operating in their countries.

3. In this short note, issues will be examined in the context of impact on foreign direct investment statistics.

Modes of government involvement in the private sector

4. Governments' intervention/participation in the private sector can materialise in a number of ways. Grants, cash advances or loans can be provided to enterprises with liquidity problems. Tax deferrals may also be used. Debt issued/borrowed by companies with leverage problems can be guaranteed by governments. Governments can also be involved in the acquisition of the equity of enterprises that require re-capitalization and other forms of support. While such cases generally involve support to enterprises resident in the same economy as the government furnishing the support, there may be cases when support is offered to a non-resident firm. In this case, the equity participation can be comprised of either direct or portfolio investment. Both can take place through various types of arrangements.

5. Government participation in industries has often taken the form of acquisition of a company and the subsequent conversion of that entity into a government business enterprise − a significant participation (inter-company investment, akin to direct investment) and the exercise of some degree of control. This was common in Canada in the 1970's and early 1980's. Since the late 1980's, there has been a trend away from this type of involvement, with a number of "privatizations" of former government business enterprises[1].

[1] In recent years, government involvement with enterprises has often taken the for of partnerships on projects. These arrangements do not typically involve equity participation..

6. Government participation in the private sector can be accomplished by the government directly holding equity in the firm or by investing via existing government business enterprises.

International accounts' considerations

7. The current global crisis has brought to the fore government involvement in providing assistance to non-resident enterprises. It can be argued that this is another consequence of the growth of multinational enterprises and globalization.

Public sector investment in the equity of foreign enterprises

8. Governments might invest in foreign enterprises, with domestic affiliates, experiencing financial difficulties. These may be assigned a priority for domestic governments, given the exposure of the domestic affiliate and the potential impact(s) of the overall enterprise's financial distress on the domestic economy. This situation may have implications for the international accounts, in terms of investment flows. This is the case of the domestic government investing in the foreign enterprise as opposed to the domestic affiliate of this enterprise. Let us look at this possibility, in terms of direct investment.

Involvement by government

9. While it may be quite unusual for a government to become an outward direct investor, there is nothing (outside of legislation specific to some countries), that would preclude this arrangement.

Involvement by government investment funds

10. In some countries institutional investors, including government investment funds, are undertaking cross-border investment[2]. More recently, these entities are acquiring direct investment positions in foreign companies, sometimes via their ownership of domestic corporations. This does not necessarily apply to the case of financial assistance to foreign corporations. However, government investment funds could become involved if there is a perception of growth after financial rehabilitation.

Involvement of a public enterprise

11. In practice, there are many instances of governments using government business enterprises as a means of equity participation in private enterprises. For these purposes, the government enterprise may be a new or existing investment management company (financial corporation) or a new or existing operating company in the same, similar or related industry as the private company. The arrangement may also involve more than

[2] From a legislative perspective, in 2005 the ceiling on foreign investment in tax-deferred retirement savings in Canada was eliminated. This generated a corresponding increase in investment abroad.

one government enterprise. An example would be: Financial and non-financial enterprises; or, a financial investment company with a domestic financial subsidiary.

12. In this scenario, the government business enterprise becomes the direct investor. Essentially, the government enterprise receives government funding to acquire the voting shares of a foreign enterprise. Disregarding the source of funds, this arrangement certainly has the appearance of outward direct investment from one domestic enterprise to a foreign enterprise.

Measurement consideration I: The threshold issue

13. In the instance that the 10% threshold of voting shares participation by governments in the foreign enterprise is not reached, then convention would dictate that the participation be treated as portfolio investment. In Canada, if more than one level of government is involved in an initiative with respect to a foreign enterprise, each investment would be treated separately; and, if none of the individual shares amounted to more than 10%, then each of the government participations would be treated as portfolio investment (see diagrams 1 and 2 of the annex).

14. In Canada, the same application of the threshold rule would hold if the initiative involved participation by government and its government enterprise or enterprises. This could be done with the direct participation of government, or with the participation of government via one of its government business enterprise, or both (see diagram 3 of the annex).

15. The case of involvement by government business enterprises would be more typical in Canada, as these public enterprises normally make the investments in private enterprises on behalf of their parent government. In this case, government owns the government enterprise but the direct investor becomes the government business enterprise, although a direct investment relationship exists between the government and a foreign enterprise. If both government and their enterprise(s) are separately involved in acquiring shares of a foreign enterprise, each entity's participation would be treated separately, in evaluating whether the cross-border investment is direct or portfolio by the threshold rule.[3] It could also be imagined that Government would be involved directly as well as with one of its Government business enterprise (GBE) (see diagram 3 of the annex).

16. It may be that more than one government business entity is involved. In this case, different government business enterprises' participations would not be additive in the context of the threshold rule.. However, it may be that two such entities have claims on a third government business enterprise that undertakes the investment in a foreign enterprise; and this investment can either be direct or portfolio using the 10% voting shares criteria (see diagram 4 and 5 of the annex).

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[3] It is doubtful that any jurisdictions would consider consolidating a government business enterprise with – in government when applying the threshold rule in determining direct investment.

17. In summary, either the level(s) government in question and or government business (s) would individually have to hold in excess of 10% of voting shares in a foreign corporation for the participation to be treated as direct investment. The diagrams at the end of the paper present some possible investment structures.

18. In other jurisdictions, it may be that sector economic accounts are collapsed to the main sectors of the economy and that those sectors are presented on a consolidated basis. If so, it may also be the case that the construction of international statistics would reflect this aggregation-consolidation treatment of sector accounts. More specifically, it could be that the overall consolidated government or corporate sector (the latter including government enterprises) are the relevant units for measuring direct investment. This type of consolidation could yield different results from above in terms of determining direct investment, with potentially larger recorded holdings of equity in a foreign corporation.

Measurement consideration II: Lasting interest

19. While the investment may comply with the threshold rules, the intent-purpose of this type of direct investment in distressed companies is also an interesting matter. Although there might be some government officials or government business enterprise executives appointed to the Board of Directors of the foreign enterprise, the relationship does not seemingly meet the BD4 criteria for lasting investment − that is, "… *reflect the objective of establishing a lasting interest by a resident enterprise in one economy in an enterprise that is resident in an economy other that of the direct investo*r"[4].

20. In fact, the government reaction in our example could be interpreted as a temporary measure. This investment complies however with the recommended methodology which states that it "does not allow any qualification of the 10% threshold and recommends its strict application to ensure statistical consistency across countries" [4].

Measurement consideration III: Broader participation and the value of total investment

21. On top of equity participation in foreign companies there can be parallel injections of funds through cash or loans, from government and a government business enterprise. If a loan is granted in addition to share acquisition, both would be reflected in overall direct investment at book value. In the case where the government loan − either provided directly or via a government enterprise − is provided to the domestic affiliate (and not to the foreign parent), the direct investment would only include the equity portion. In other words, the governments' FDI participation may not reflect all the funds injected into the globally-consolidated foreign enterprise (see diagram 5 of the annex).

22. An interesting aside involves the valuation of the equity participation. The direct investment can be valued at book (original cost). Estimating a BD4 recommended

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[4] OECD Benchmark Definition of Foreign Direct Investment, 4th Edition, paragraph 117.

market valuation for this investment, especially if an entity is unlisted, is far more challenging.

Measurement consideration IV: Other complications

23. Another interesting complication, in the context of a global financial crisis, is the involvement of a foreign government and/or its agencies. A large multinational company in financial distress may well generate government participation from more than one country, given the potential impact on its foreign affiliates and subsidiaries.

24. This begs the question: What about the instance of a foreign government's (directly or via government enterprises) involvement − specifically, in the form of equity in the foreign direct investor within its borders? Applying ownership claims and control may become blurred and certainly somewhat unusual. The concept of ultimate owner becomes interesting to sort out.

Summary

25. Government involvement in foreign enterprises has implications for foreign direct investment compilers. This note has summarized modes of participation and has underlined the case of foreign direct investment. Government FDI participation brings to the fore conceptual issues in BD4, including thresholds and lasting interest. In concert with those issues are measurement considerations.

Annex

Governments' investment in a foreign enterprise

Diagram #1:

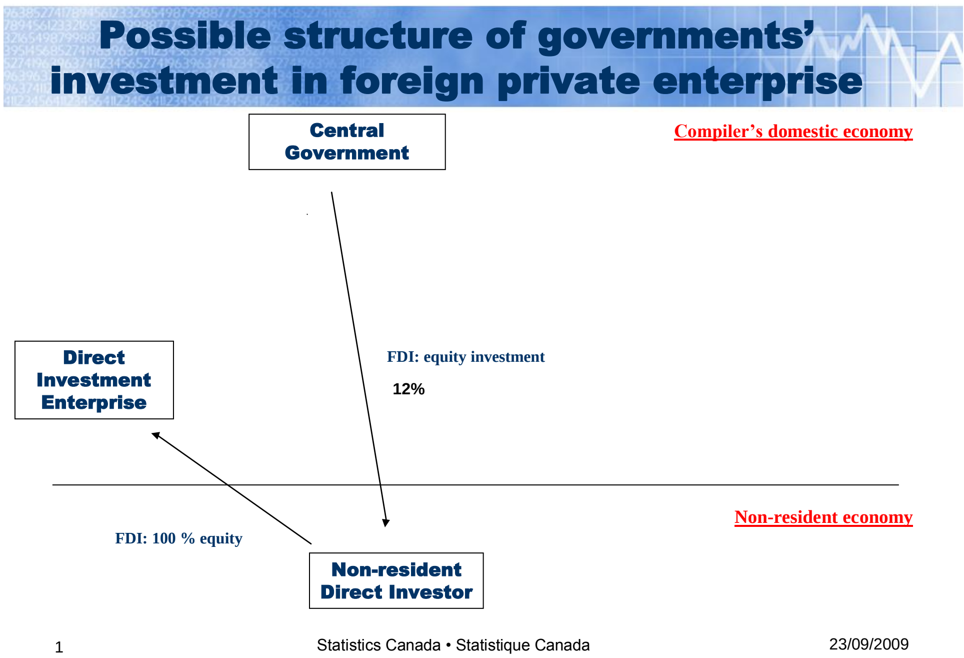


Diagram #2:

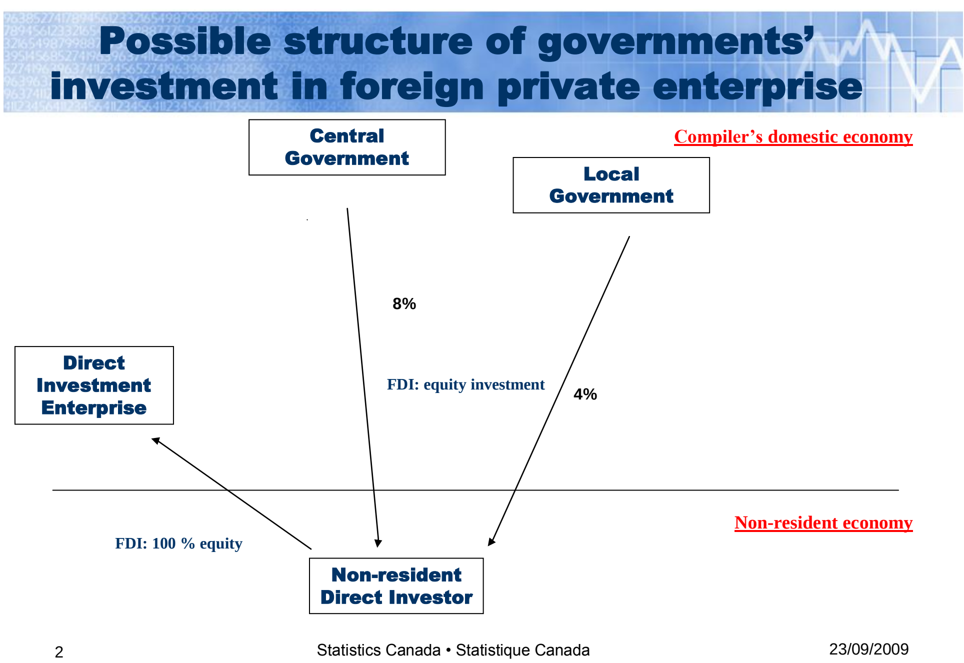


Diagram #3:

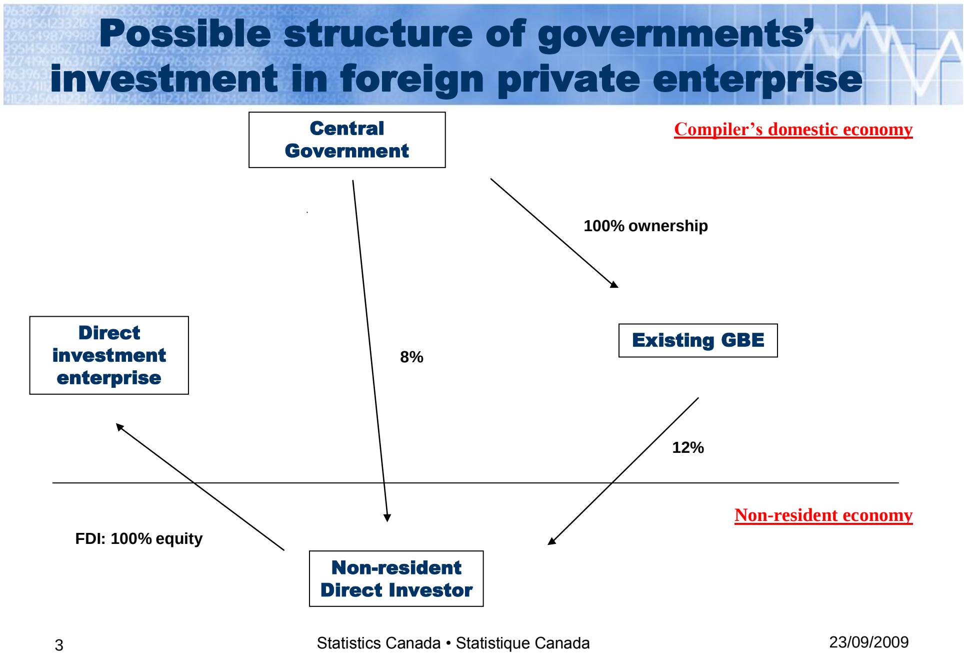


Diagram #4:

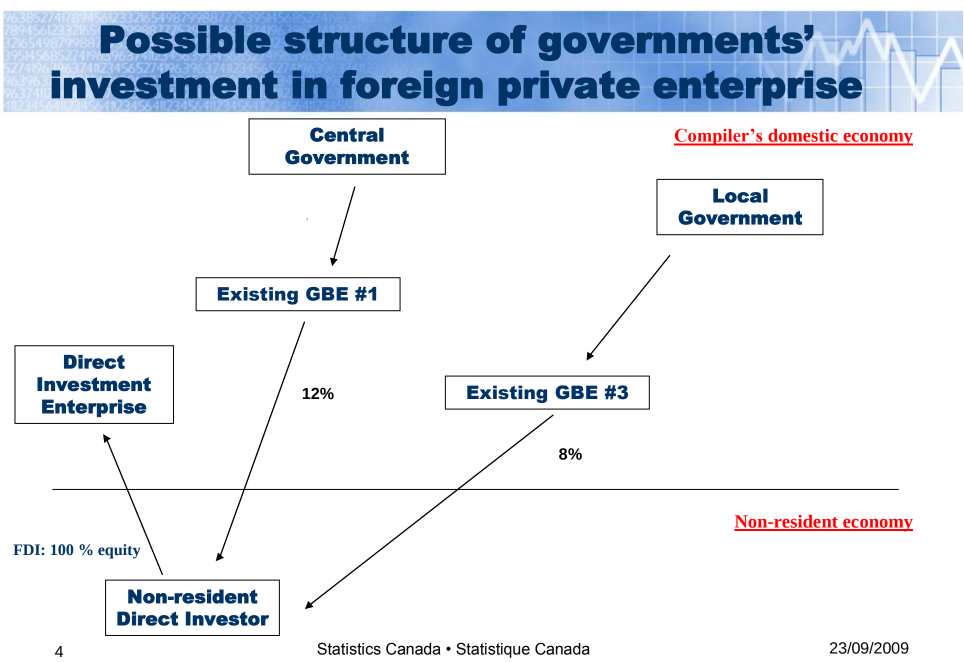
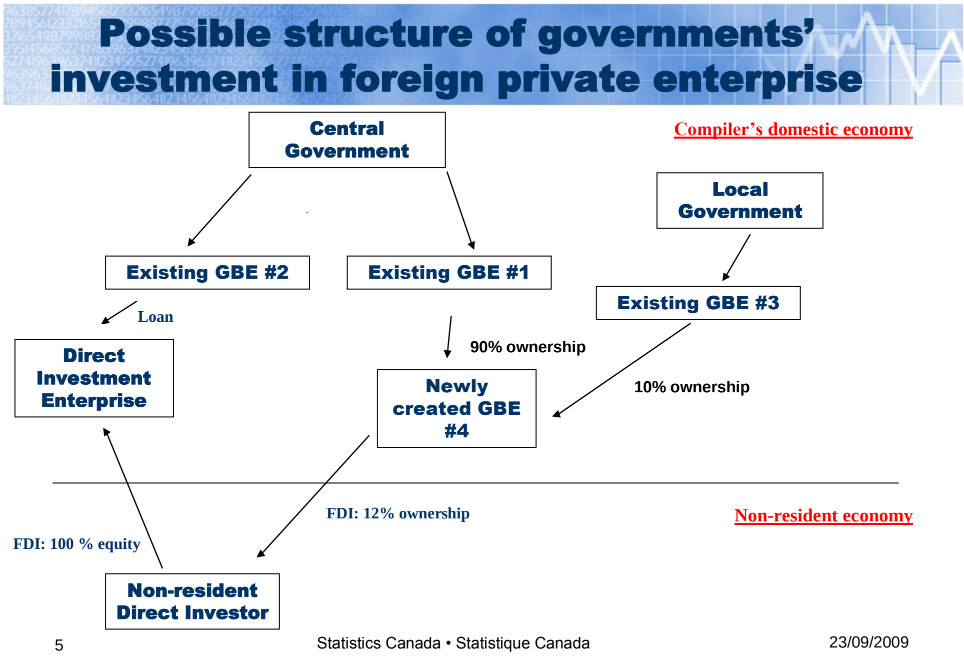


Diagram #5:


Possible structure of governments' investment in foreign private enterprise
Central Government
Compiler's domestic economy
Local Government
Existing GBE #2
Existing GBE #1
Existing GBE #3
Loan
Direct Investment Enterprise
90% ownership
Newly created GBE #4
10% ownership
FDI: 12% ownership
Non-resident economy
FDI: 100 % equity
Non-resident Direct Investor
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