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Shifting Sands

FDI, phantom investments and IFFs risk in the Arab Region

2023

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MISSION: Producing innovative knowledge, fosters regional consensus and delivering transformational policy advice.
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Understanding the Shadows: IFFs & FDI in the Arab Region

- **Phantom FDI** due to tax avoidance schemes, round-tripping, or other financial engineering techniques, **do not stem from or generate real economic activity or value** and **render artificially inflated statistics**
- **At the global level Phantom FDI** amounts to **approximately $15 trillion,** and climbed **from 30 percent to almost 40 percent of global FDI in less than a decade.**
- Tracing, mapping, and estimating such flows is challenging due to increasing sophistication of techniques and insufficient coordination and cooperation between regional/international/national authorities

Research questions:

- Which are the Arab countries most exposed to the risk of losing financing resources to IFFs concealed as outward FDI (anomalous outward FDI)?
- Which are the countries inside and outside the Arab region where such anomalous outward FDI flows are directed to?
- Which are the Arab countries that are most likely to be used as sinks or conduits for IFFs coming from investment partners (anomalous inward FDI)?
- Which are the countries inside and outside the Arab region where such anomalous FDI generate?
- Are such anomalies related to the financial/corporate regulatory strictness of country pairs?

The Analytical Compass:
ESCWA's Methodological Approach

Spotlight on Anomalies: Identifying patterns of overinvestment, underinvestment, and potential phantom investments.

Exploratory Lens: Unveiling the links between outward and inward FDI and indicators of IFF-risk.

Three-steps strategy:

Anomaly Assessment through Gravity Models

- Structural full-FE GMs (inward and outward FDI) +bilateral trade as control
- Studentized Residual to spot anomalous FDI (Gullo Montalbano, 2022)

Mapping anomalies

- Dyadic and country-specific anomalies integrated into synthetic indexes
- Map occurrence of positive and negative anomalies (inward and outward) over space and time

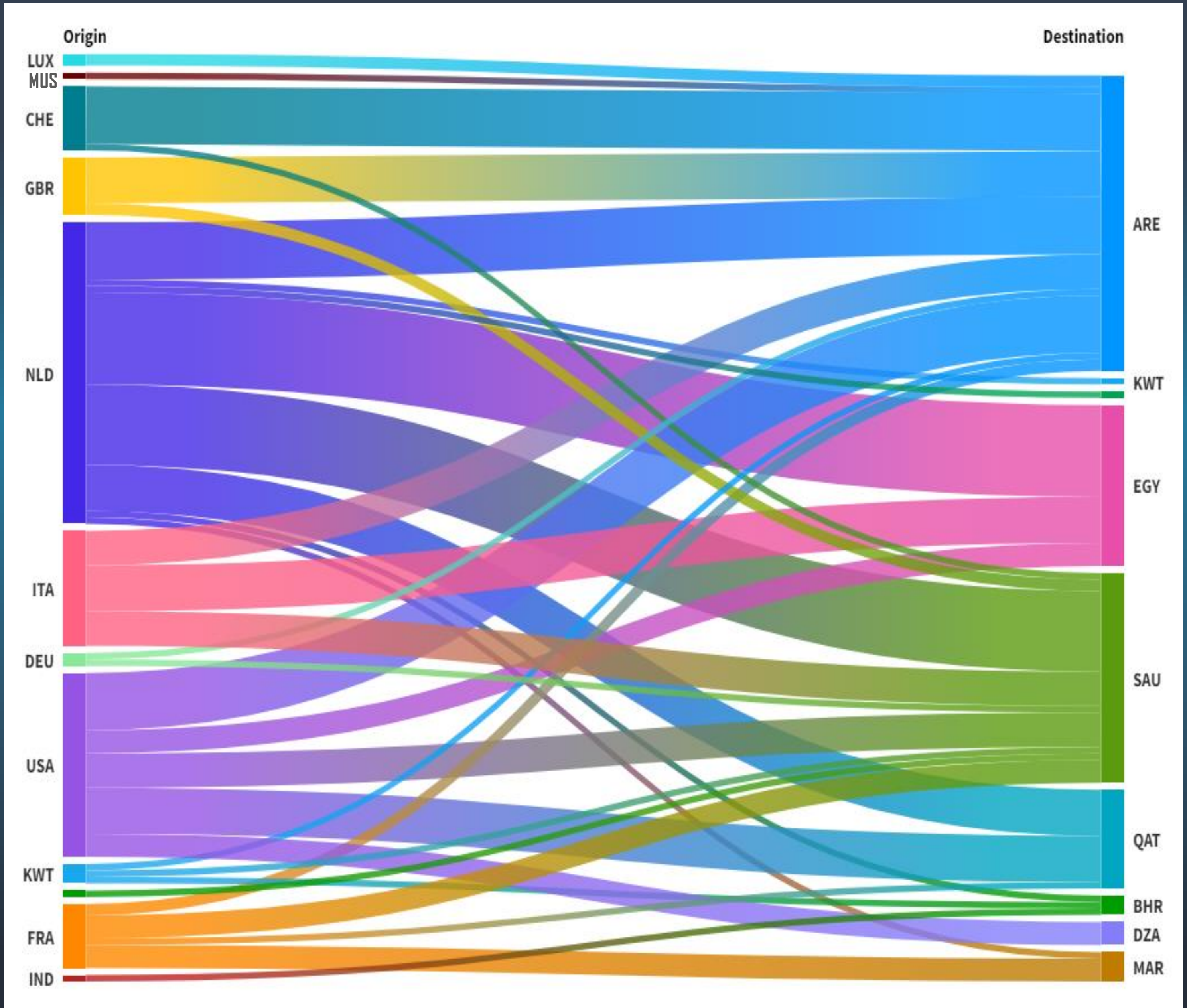
Linking Anomalies with IFF risk

- Explore correlation with potential IFF risk factors (Regulatory strictness, Tax treaties, Correspondent banking relationships…)

Incoming Tides

Inward FDI-IFFs risk in the Arab region

What are the “riskiest” country-pairs in terms of IFFs/phantom investments flowing into the Arab region?



Dyadic risk of anomalous inward FDI mapping

(ESCWA analysis on IMF CDIS data)

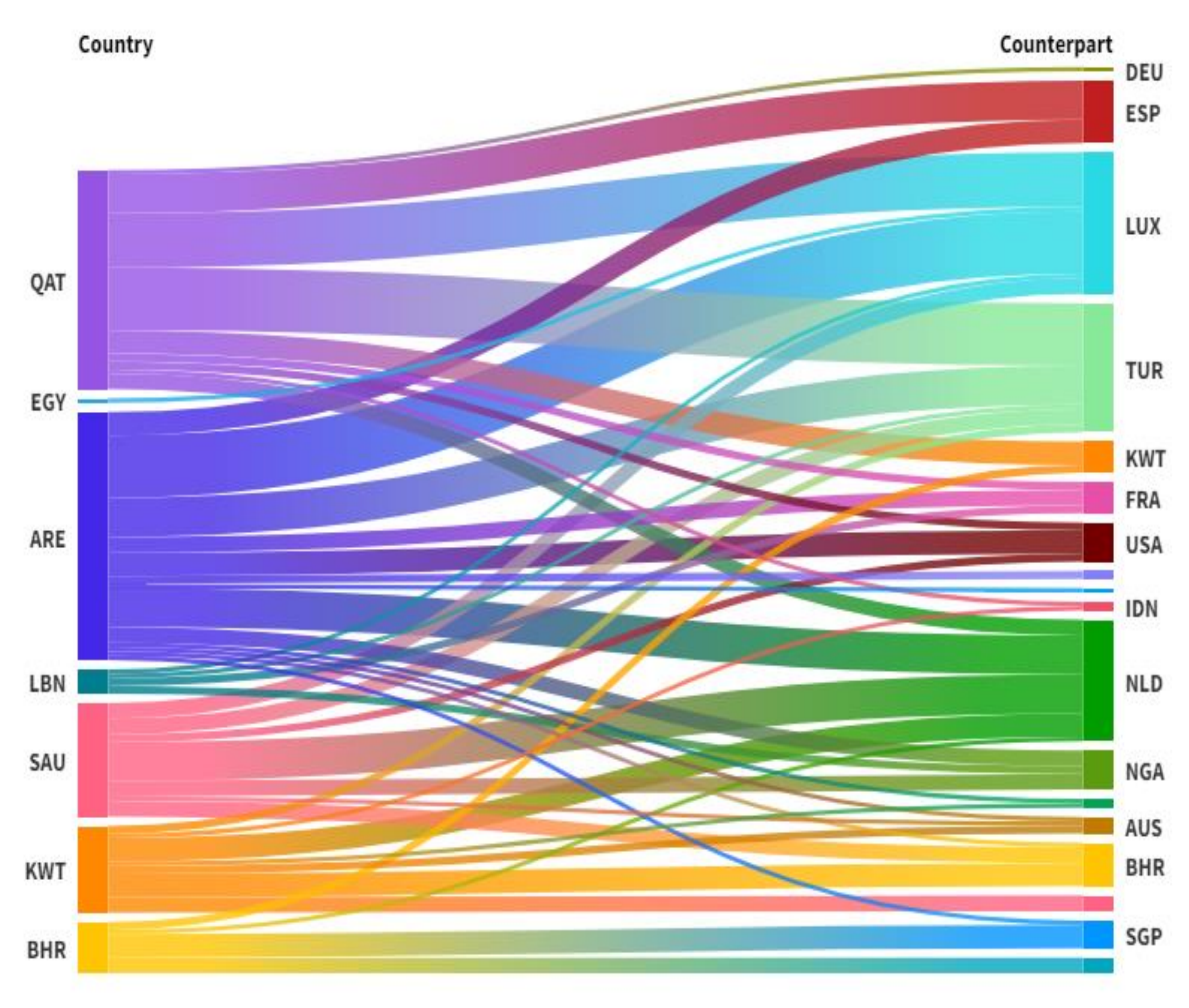
The Exodus

Outward FDI-IFFs risk in the Arab region

What are the “riskiest”country-pairs in terms of IFFs/phantom investments flowing out from the Arab region?

Dyadic risk of anomalous outward FDI mapping

(ESCWA analysis on IMF CDIS data)



Linking the Nodes

Arab FDI Networks & Risk Metrics - key insights

Co-movement of inward and outward FDI may reflect short-term or speculative investments flowing in and out based on financial market and favorable regulatory conditions rather than long-term strategic investments.

Countries with higher FDI, especially when the FDI/GDP ratio is skewed towards FDI, are prone to more phantom FDI instances, often related to pass-through capital flows via Special Purpose Entities (SPEs).

Investment hubs (with high volumes of FDI, offering low-tax environment, generous exemptions and in some cases financially secretive environments) are potential hotspots for corporate tax abuse in the Arab region.

Arab countries' tax treaties may have loopholes that MNCs exploit for "treaty shopping" (OECD, 2015).

Balancing anti-money-laundering policies with financial integration to avoid negative impact of corresponding banking relations' reduction de is crucial for holistic development.

Conclusions and policy recommendations

ESCWA's FDI-IFFs risk mapping helps countries identify potential instances of phantom investments and capital round-tripping, emphasizing the need for heightened vigilance in FDI integrity.

- Risk of IFFs and phantom investments is associated with anomalies in FDI patterns, especially in countries with substantial capital inflows and outward investments.
  - **Boost Transparency:** Improve data collection, sharing mechanisms, and inter-country coordination
  - **Promote International Cooperation:** Enhance the consistent exchange of tax information, guaranteeing access and benefit to developing countries.

- Correlation between FDI and tax haven indicators accentuates the necessity of regional strategies to trace phantom investments and combat tax abuse, especially for countries acting as investment hubs.
  - **Address Digital Financial Manipulation:** Collaborate on strategies targeting offshore accounts, shell companies, and complex financial structures, while enhancing International Reporting Standards like CBCR
  - **Reform Corporate Tax Enforcement:** Work towards a truly reformed multilateral tax system through a UN intergovernmental process, addressing diverse needs of countries.

Conclusions and policy recommendations

- The balance between taxing rights and FDI dynamics is nuanced. The risks related to treaty shopping, especially for developing nations, need to be addressed, ensuring both an attractive environment for productive investments and adequate tax leverage to mobilize revenues.

  - **Review Tax Treaties:** Conduct comprehensive reviews of existing tax treaties and bilateral agreements to protect Arab revenue interests.

- **Balance AML Efforts with Banking Integration:** Ensure strategies mitigate IFF risks while promoting access to essential cross-border banking services, such as:

  - **Create platforms FinTech platforms** to facilitate information sharing between correspondent and respondent banks,
  - Provide **training and support** for financial institutions to improve their risk management capabilities,
  - Encourage financial institutions to adopt a **risk-based approach** rather than broad strategies offering clear guidelines,
  - Periodically **review the impact of AML/CTF regulations** on the banking sector at the national level,
  - **Tailor capacity-building** to national circumstances to tackle financial crimes effectively.

Steps forward

(work in progress...)

- Improvement of data quality through Bidirectional Recurrent Neural Networks (RNNs)

- Regulatory impact assessment - does the change in tax/investment/banking regulations in Arab countries over time impact FDI, phantom investments and IFFs in the Arab region?

- Assessment on the tradeoffs of FDI restrictiveness

- Tax treaties impact assessment - Which among the tax treaties signed by Arab countries foster or inhibit FDI? and what is their impact on FDI anomalies/phantom investments?

Thank you