Multinational profit shifting and illicit financial flows – can we measure them?

20 August 2019, ISI Congress

Welcome and background

The session was chaired by Mr. Fernando Cantu. He opened the session and introduced the topic of illicit financial flows and profit shifting in the context of the 2030 Agenda for Sustainable Development. The session discussed the significance of profit shifting and considered ways to measure these flows, as part of the Sustainable Development Goal indicator 16.4.1.

The financial flows related to profit shifting have been increasing in importance even when compared to global flows of goods and services. Therefore, these flows can no longer be ignored in the measurement of the economy. They influence significantly the interpretation of economic statistics and influence the availability of funds for social and health services and development. The foreign profits of global firms need to be looked at in the context of sustainable development.

Measuring global activity of multinational corporations

Ms. Mary Everett[1] made a presentation on measuring global activity of multinational enterprise groups (MNEs). She noted that the increasing integration of the global economy, implies growing tension between economic activity and its measurement system. It also causes difficulties for national policy making when national statistics do not reflect the domestic reality.

The national accounts are based on the concept of residence that defines the relationship between an entity and location. Residency is defined as "the economic territory with which the entity has the strongest connection, expressed as its centre of predominant economic interest". Domicile is a similar concept, often used to denote the location of firms' headquarters (HQ). An additional approach to residency-based statistics is to compile a consolidated view by assigning economic entities to the HQ country of the parent.

Global arrangements can take various forms. They can be related to the physical move of production to other locations, such as offshoring; redomiciliation referring to changing the HQ location; and movement of intangible assets. The increasing use of intellectual property (IP) as capital assets has had a critical impact on the measurement and interpretation of GDP and balance of payments statistics. Relocation of IP can change the locational where exports and income are recorded. This was evidenced in Ireland in July 2016, when the Irish Central Statistics Office (CSO) published an unusually high real GDP growth of 26.3% from 2014. The main reason relates to large MNEs relocating their IP to Ireland. As a result, production and sales generated from the use of that IP now contribute to Irish GDP rather than to other countries' GDP.

The emergence of legal and organisational arrangements to minimize global tax burden

Mr. Peter van de Ven[2] made a presentation on the emergence of legal and organisational arrangements to minimize global tax burden and its impact on monitoring domestic economic activities. He noted that even minor organizational changes by MNEs can have major impacts on how official statistics are compiled and on the resulting figures. These changing MNEs' behaviours and arrangements also seriously hamper international comparability of statistics. Even at the macro level, we can see that there are more exports than imports globally, which already shows signs of remarkable asymmetries, often related to the statistical treatment of the largest MNEs.

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[1] Senior Adviser, Central Bank of Ireland

[2] Heads of National Accounts, OECD

The large impact of financial flows related to tax and profit optimization raises the question if GDP and many other key economic statistics are still valid as measures of domestic production. Can they be used correctly for designing monetary policy and for decisions in the economic policy? Reallocating MNEs' profits according to their economic activity levels by country shows large impacts on GDP of certain countries, such as the United States and Ireland.

One of the vehicles of channeling profit shifting flows are so called Special Purpose Entities (SPEs) that have limited presence in the country. The balance sheet total of SPEs is around 600% of GDP in the Netherlands. We can say that the Bermuda triangle is not anymore about disappearing ships, it is about disappearing profits. The complex global production arrangements are making it difficult to account for business activities correctly. Domestic companies also end up being treated unfairly when looking at the tax burden. Export driven growth strategies of governments are no longer the most effective means for boosting economic growth, as they may coexist with low value added and low employment.

Multinational profit shifting - measurement challenges in the external account

Mr. Tjeerd Jellema[3] made a presentation on foreign direct investment (FDI) flows and how they relate to profit shifting and illicit financial flows. The European Central Bank (ECB) consolidate the intra Euro area flows to present the statistics as if Euro area was one country. This requires capturing residency-based income from financial flows of balance sheets as observed by national statistical compilers.

Globalization is a process of fragmentation of production and specialization of financial services. The European statistics significantly reflect this globalization process. An analysis of FDI and other statistics raises a question of what kinds of flows would we see without profit shifting. How to compare a shifted profit to what a non-shifted profit? We need to define the normal and abnormal behaviours.

We do not know if MNEs' decisions related to production are separable from their financial structure. This cannot be directly measured; it can only be estimated by looking at alternative realities. To do this, the ECB analysed countries that run a surplus or deficit in FDI. This analysis groups countries in three: asset (FDI assets exceed liabilities by over 10%), liability (FDI liabilities exceed assets by over 10%), balanced and conduit countries. Conduit countries include e.g. Belgium, Ireland, Netherlands and Luxembourg, asset countries e.g. Germany, Italy, Finland and France, and liability countries a number of new EU member states for instance. Getting the largest MNEs right globally would be a significant achievement. In the ECB analysis, for instance one MNE alone has more than 480 subsidiaries.

Discussion

Ms. Anu Peltola launched the discussion with the speakers followed by an open discussion. The speakers and participants raised the following issues:

1. How much do we know about MNE profit shifting? How significant are the flows and which items of national accounts and balance of payments are affected?

There is a pressing need for better accounting of MNEs' global production arrangements. Profit shifting flows are huge and may affect all key economic statistics, including GDP. Almost all items of national accounts and balance of payments can be affected. The significance of the impact depends on the country and its role in the global value chains. In several countries, economic statistics are

[3] Adviser, European Central Bank

disconnected from the domestic reality, as they reflect the large flows related to MNEs' global arrangements. The increase of GDP by 26 per cent in Ireland in 2015, for instance, did not affect people in Ireland even though GDP is often used as a measure of national economic development.

2. How to maintain the relevance of national accounts and other official statistics in these conditions? To what extent our current statistics just reflect global arrangements of MNEs?

The relevance of statistics depends on the use of statistics and the policy or research question that needs to be addressed. The measurement challenges, illustrated by the speakers, imply that users of statistics should exercise caution and seek advice for interpretation. While we lack statistics to analyse the full picture, there are several useful indicators of profit shifting that can be used looking at commonly available data. The ratio of profits to compensation of employees is a useful indicator of potential profit shifting.

Statisticians need to improve consistency of the treatment of MNEs first at the national level, as one MNE may be treated differently across statistics. But in addition, we should work as a priority to arrive at better international consistency, and we will need to develop additional statistics that reflect better the domestic economy. This can include more disaggregation and new indicators. In addition, consolidated accounting frameworks can provide complementary information to the current residency-based accounting.

3. What is the way forward? Can we measure profit shifting?

There are some initiatives that assess the size and forms of profit shifting based on existing data and statistics, including the OECD Base Erosion and Profit Shifting (BEPS) indicators, the Eurogroups register, the ADIMA database and country initiatives, such as the survey of MNEs by the Bureau of Economic Analysis of the United States (BEA). We should extend and build on these approaches

The increased importance of direct investment flows suggests that we need to know more about corporate profits. In 2016, in Ireland the Economic Statistics Review Group recommended compiling an adjusted level indicator of domestic economy, removing large and volatile items from gross national income (GNI), including depreciation on foreign-owned domestic capital assets and retained earnings of redomiciliation.

International collaboration within the statistical community will be key to addressing the challenge. Having global business Identifiers, building global registers and engaging in data sharing will be essential. Data exchange should focus on the largest MNEs and transactions (above €10 billion in Europe) and we should monitor the status of large transactions more carefully. More efforts should be put in mirror analysis and resolution of asymmetries. In addition, we should not only look at gross trade flows, but in particular trade in value added. This calls for international input-output tables, which are being compiled by OECD.

It would be useful for the statistical community to revisit the agreed treatment of IP. We should look at who owns IP in the multinational context. Often IP is truly a corporate asset. Perhaps IP should be allocated proportionally to the various parts of the MNE, or to the parent company in the true headquarter (HQ) country? Many MNEs engage in corporate inversions (moving their HQ to another country) or create holding companies in other countries that do not reflect the real HQ country. It would be important to distinguish between these in statistical production.

One option would be to consolidate SPEs, created for tax avoidance purposes in other countries, back to the true HQ country. The many creative global arrangements challenge statistical data collection. MNEs are also often lost as respondents on how and what to report to statistics.

Summary and conclusions

Economic statistics should be disaggregated further, and a discussion is needed on which alternative realities should be measured to allow for a more detailed analysis of:

- intra-MNE flows (real and financial) vs. other flows
- economic statistics with and without MNEs
- economic vs. legal ownership / centre of economic interest vs. centre of decisions
- following monetary flows vs. assessing economic realities
- foreign-owned businesses vs. domestic businesses
- mismatches between economic activity or employment and profits or taxes paid
- the number of corporate inversions, holding companies and the role of entities in the MNE
- the link of profit shifting and services exports, IP flows, financial service centres, management fees etc.

The need for domestically relevant statistics remains pressing to inform governments and hold them to account. Statistical offices need to be well resourced to address the call to make MNEs more visible in economic statistics and allow users to make correct conclusions by selecting the type of disaggregation or alternative statistics they need. The treatment of IP and the principle of economic ownership should be debated in view of the future update of the System of National Accounts (SNA) and the Balance of Payments guidance.