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What to Do When Foreign Direct Investment Is Not Direct or Foreign

FDI Round Tripping

Dilek Aykut
Apurva Sanghi
Gina Kosmidou

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Abstract

As globalization has intensified, multinational enterprises' investments have become a sophisticated set of financial transactions that are difficult to monitor and classify by the home and host countries. In some cases, what is classified as foreign direct investment is rather "indirect foreign direct investment," channeled through a third country. Indirect flows have increased significantly in recent years, now accounting for almost 30 percent of global foreign direct investment flows. Indirect foreign direct investment flows also capture the flow of domestic funds channeled through offshore centers back to the local economy in the form of direct investment, also known as "foreign direct investment round tripping." These investments do not offer the benefits of typical foreign direct investment, and may lead to tax revenue and welfare losses. Round tripping is mostly channeled through offshore financial or transshipping centers. In most cases, domestic companies round trip their investments to benefit from preferential treatments reserved for certain countries and their firms. The most important policy measure to reduce round tripping activity and mitigate its impact is to improve the business environment for all firms; this can foster domestic and foreign investment, and may, to some extent, also curb foreign direct investment round tripping. Nevertheless, countries also need to adapt to the new playing field for foreign direct investment, and recognize the trade-offs of their national policies on capital flows. National policy measures must be complemented by international actions. At the same time, all indirect foreign direct investment flows should be closely monitored, something that is best conducted in coordination with international partners.

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Acronyms

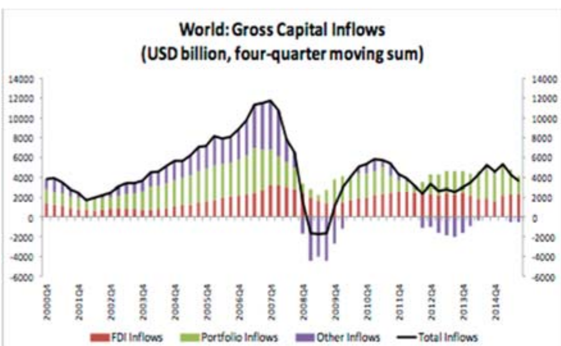
BIT	Bilateral Investment Treaty
FDI	Foreign Direct Investment
ISDS	Investor-state Dispute Settlement
MNE	Multinational Enterprise
OFC	Offshore Financial Center
SPE	Special Purpose Enterprise
SPV	Special Purpose Vehicle
UIC	Ultimate Investing Country

International financial flows have risen in recent decades but so have their ebbs and flows.

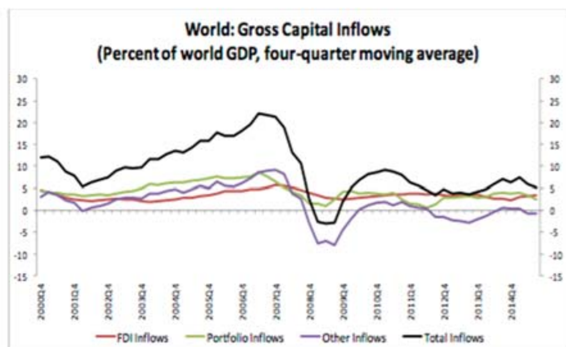
Over the last two decades, international capital flows have become an important aspect of the global economy as capital has increasingly moved across-borders, with investors searching for higher returns - and at times safe havens- and companies going after new markets for their products. Following the rapid increase in capital flows in the early 2000s, gross international capital flows peaked at US$12 trillion in 2007, accounting for over 20 percent of world GDP (Figure 1). Nevertheless, the 2008 global financial crisis was a bitter reminder of the risks associated with financial integration as gross capital flows declined sharply. The global financial crisis that followed the September 2008 collapse of Lehman Brothers severely constrained international flows as investors became extremely risk-averse. They deserted international assets for what were perceived to be safer assets such as treasury securities in the United States as well as gold. Alas, global capital flows have only recovered partially since then and have experienced increased ebbs and flows. After slight rebounds in 2010 and 2014, gross capital flows declined yet again in 2015, reflecting the ongoing uncertainty related to global growth and geopolitical developments. Currently, international capital flows are much lower in nominal terms, ranging from around US$3 to 4 trillion, and they represent only 5 percent of the world GDP.

Figure 1: Global capital flows:

a. Global capital inflows have demonstrated significant volatility since the early 2000s



b. FDI remains the most stable type of capital flows



Source: IMF "Capital Flows and Global Liquidity" (2016), authors' calculations

The effects of these developments on capital flows to developing countries were as dramatic.

International capital inflows in emerging and developing countries were almost halved in 2008, at US$ 758 billion compared to a peak of $1.3 trillion in 2007 (Figure 2).[1] While the downturn impacted almost all developing countries, Eastern Europe and Latin America bore the brunt of the financial crisis, accounting for 70 percent of the decline in capital flows. Nevertheless, unlike developed countries, the recovery was more pronounced for developing countries as international capital flows bounced back to $1.3 trillion in 2010.

[1] The group of emerging and developing countries used in this analysis comprises of selected economies including Argentina, Brazil, Chile, China, Colombia, the Czech Republic, El Salvador, Hungary, India, Indonesia, Kazakhstan, Korea, Malaysia, Mexico, Pakistan, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, and Ukraine.

Foreign direct investment has proved to be more stable than other capital flows…

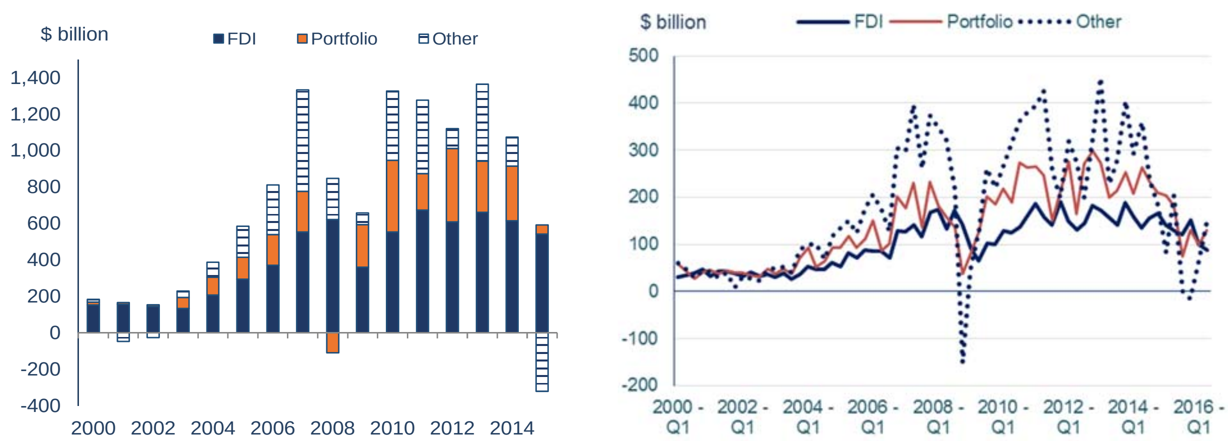
Swings in international capital flows have become larger and more frequent since the global financial crisis, driven mainly by portfolio and other investment flows, while FDI remains relatively more stable. In periods of past downturn, other investment flows decreased the most, followed by portfolio flows (Figure 1). [2] FDI investors—mostly multinational companies—take a longer-term view than most portfolio investors and lenders that search for high yields in various maturities.

For emerging and developing countries, while FDI flows have remained more or less stable following a short-lived dip in 2009, non-FDI capital flows experienced a considerable rebound as well. Despite being shut out of international bond markets for a number of months in 2008, several of these countries have managed to access international capital markets. This is mainly because global financial market conditions have been favorable to bond issuances with low interest rate policies by high-income central banks since 2010. Syndicated bank lending has remained weak as banks deleveraged for several years. Nevertheless, FDI is still the largest component of capital flows, accounting for more than half of the investment flows to developing countries.

Figure 2: International capital flows to developing countries:

a. The effects of the global financial crisis were also evident for developing countries….

b. Following the short-lived dip in 2010, FDI inflows to developing countries recovered and have remained stable



Source: International Financial Statistics, IMF.

Aside from its relative stability compared to the other capital flows, FDI inflows are favored by emerging and developing countries because of the potential benefits they bring to host countries.

Several country experiences and literature over the years show that when multinational enterprises (MNEs) invest in a country, the investment can potentially create jobs, increase productivity through

[2] IMF, 2016, "Capital Flows and Global Liquidity."

the provision of capital and technology, as well as advance R&D. [3] Moreover, it might also have spillover effects, such as the development of managerial and technological skills and the improvement of companies' access to international markets. As a result, FDI can bring increased revenues for the host state and a boost in the growth of the economy. Hence, these benefits render FDI as not simply a capital flow but more importantly, a package of resources. Therefore, emerging and developing countries are interested in attracting higher levels of FDI, not only due to its stability, but also for its potentially broad set of benefits for the host country.

FDI flows are driven by various push and pull factors. While host country (pull) factors, (including the size of the domestic and/or regional markets, and growth prospects, especially the regulatory environment and overall investment climate), can determine who will receive the investment flows, global financial conditions (such as growth prospects in developed countries, high global liquidity, and low interest rates in advanced economies) support FDI flows.

As global production and corporate structures of MNEs have evolved over the years, their investments have become a sophisticated set of financial transactions that are hard to monitor and classify by the home and host countries…

The increasing fragmentation of production and the creation of global value chains (GVCs) results in MNEs governing such chains to break up their business in smaller parts. In so doing, they take advantage of the most favorable production locations for each production part of their final product or they dispose of certain parts deemed non-core and focus on others. As a result, MNEs and their affiliates often have multiple passports: "The top 100 MNEs in UNCTAD's Transnationality Index have on average more than 500 affiliates each, across more than 50 countries. They have 7 hierarchical levels in their ownership structure (i.e. ownership links to affiliates could potentially cross 6 borders), they have about 20 holding companies owning affiliates across multiple jurisdictions, and they have almost 70 entities in offshore investment hubs." [4]

As MNEs manage their global operations to protect their intellectual property rights or to leverage financial opportunities offered in a host country or at an investment hub, their ownership and corporate structures have become extremely complex. Moreover, MNEs restructure their operations and investments to seize opportunities for "tax arbitrage" to reduce their tax obligations, and they shop for "investment treaties" to ease regulatory burdens or to increase their rights and protections. In recent years, companies have also increasingly been using various financial flow techniques such as special purpose enterprises (SPEs). An SPE is a legal person, separate from its final owner, established to pursue specific, temporary objectives such as the financing of an affiliate abroad. This allows for the limitation of the risk of the transaction to the value of the SPE, while saving taxes. [5] Moreover, MNEs often change corporate structures rapidly due to reevaluations of their portfolio of activities and the resulting merger and acquisitions (M&As).

[3] Alfaro et al., 2004; Dunning, 2013; Harrison,1994; Kokko et al., 2007; McGuigan, 2007; Roy et al., 2006.

[4] UNCTAD, 2016, "Global Investment Trends."

[5] ibid

Given the complexity of their operations and investment transactions, the development impact of cross-border investments by MNEs can be narrower than the development impact of a project that is traditionally considered as typical FDI, especially in terms of job creation, skills development, transfer of technology, and creation of new capacities. Nevertheless, in this complex environment, there are also non-equity transactions—hence not FDI by definition—undertaken by MNEs that can generate similar benefits for the host economy as well. For example, MNEs can form different forms of partnerships to carry out production such as joint ventures, contract manufacturing, business process outsourcing, licensing, and franchising. Nevertheless production under these partnerships is still heavily dependent on the requirements imposed by the MNE organizing the given value chain. Hence, these types of partnerships can generate positive spillover effects without any cross-border investment.

Even if an investment is classified as an FDI transaction, it may not be direct investment or even foreign-sourced…

In some cases, MNEs invest in a country through intermediaries in third countries, constituting the so-called *indirect forms of FDI*. These investments can be undertaken through permanently established foreign affiliates or through established SPEs in a third country. While this form of investment should be considered FDI, the nationality of the immediate investor and the ultimate beneficiary owner will not match. [6] In the case of the SPE, the immediate investor is in fact only a financial entity.

MNEs might prefer to invest in a country indirectly through another country perhaps to take advantage of better tax regimes or less stringent corporate governance—through *corporate inversions*—, or simply to leverage the cultural and geographic proximity—through *nearshoring*. [7] For example, when the German telecom company, Deutsche Telekom, wanted to invest in the former Yugoslav Republic of Macedonia, it did so through its majority owned affiliate Magyar Telekom (Hungary) in order to benefit from the proximity between these two countries. Nevertheless, the investment in Makedonski Telekom was as if it came directly from Germany, with all the top management being German rather than Hungarian." [8] Nonetheless, in some cases, the specific intent might be to conceal the identity of the ultimate investor for various reasons.

Furthermore, indirect FDI flows may also capture funds that are not necessarily foreign sourced. These are actually domestic funds channeled through offshore centers to the local economy in the form of direct investment. As discussed later in detail, such behavior by domestic investors is called *round tripping* and is triggered by various reasons including special treatment of foreign investors, tax benefits, as well as governance and institutional concerns.

The rise of indirect FDI flows has implications both in the home and host economies.

[6] This can include affiliates ever further removed from corporate headquarters in chains of ownership: dispersed shareholdings of affiliates, with individual affiliates being owned indirectly through multiple shareholders; cross-shareholdings, with affiliates owning shares in each other; and shared ownerships (e.g. in joint ventures).

[7] K. Kalotay, 2012, "Indirect FDI."

[8] Ibid

The trend of FDI being directed towards "indirect" forms is not really new and has been well documented since the 1990s. However, the share of these flows has increased in recent years in tandem with an increase in globalization. It now accounts for about 30 percent of the global FDI flows and has implications both in the home and host economies.

First, these flows are hard to monitor and properly classify. Even when indirect FDI is the result of a legitimate corporate decision, it still distorts the data collection on FDI by altering the origin of the flows. This prevents policymakers from having a clear understanding of the role of MNEs and of the country of origin of the most important investors in their economy. Furthermore, distorted statistics do not allow for accurate cross-country comparisons, which inform a country about the status and attractiveness of its investment environment compared to its competitors.

Additionally, the lack of clarity regarding the actual country of origin in a host country's FDI hinders the sustainability and effectiveness of its investment policy. Most nations' investment policies tend to focus on the direct owners of an affiliate, as do bilateral and multilateral investment treaties. Therefore, concrete investment policy measures, such as ownership restrictions, joint venture requirements, or eligibility criteria for facilitation, tend to operate at the direct ownership level: "Almost 80 percent of countries worldwide prohibit majority foreign ownership in at least one industry". [9] The blurring of the nationality of the investor has rendered these policies obsolete, but better monitoring and targeted efforts to register the ultimate beneficiary of an FDI project can help to alleviate some of these negative impacts.

Moreover, indirect FDI does not necessarily have the prescribed longer-term view of more traditional FDI, and in fact has resulted in increased FDI volatility over the last ten years. [10] Investment coming through an SPE does not constitute any real industrial activity in the host economy since they are based on tax and regulation considerations rather than productivity and competitiveness. This delinking of FDI and production is worrisome if it results in losses in terms of tax revenues, missed job creation, and missed transfer of technology for the most affected countries. This type of indirect FDI shares many similarities with foreign portfolio investment in the sense that they can both be more volatile, highly reversible, and driven by cyclical factors, including interest rates differentials, business cycle conditions, market sentiments, and herd behavior.

And in the case of round tripping, these investments do not offer the benefits that one expects from FDI, and they can lead to tax revenue and welfare loses.

Given that round-tripped investments are actually domestic investments classified as foreign direct investments, they do not represent additional investment in the economy. Therefore, they will not generate the spillover effects in terms of technology and know-how transfers that FDI flows are expected to generate. At the same time, more often than not, indirect FDI is undertaken for reasons that relate to tax arbitrage and institution shopping and will cause tax revenue losses in the host country. Additionally, it can be linked to non-transparent activities, in the case of using offshore financial centers, or even to illegal activities, such as corruption or money laundering. This reduces the regulatory oversight and possibly even weakens the rule of law. Finally, round-tripped investments create distortions in the investment environment and render the establishment of a level playing field

[9] UNCTAD, 2016, "Investor Nationality: Policy Challenges."

[10] UNCTAD, 2016, "Global Investment Trends."

for the regulator difficult. Therefore, it is important to know how much of an economy's FDI is due to round tripping and what the main motivations for these types of activities are.

But round tripping activities might also reflect the increased sophistication of firms in developing countries to address some of the shortcomings of their country of origin.

Round tripping activities might also indicate the increased sophistication of firms in developing countries since they require an additional layer of expertise and knowledge to navigate the laws and regulations of a foreign jurisdiction to set up an SPE/affiliate that will be used for round tripping. Furthermore, the essential motivation might be to circumvent the institutional and financial shortcomings of their country of origin rather than just tax avoidance or illegal activities.

Firms in developing countries might choose to operate from locations that offer them more services and opportunities to access financing through listing companies in more developed stock exchanges or raising funds in international markets. [11] For example, Hong Kong, with its better-developed international stock and financial markets, offers opportunities for Chinese firms to raise funds in the stock market or solicit better lending terms. In this case, the round-tripped investment may not translate into a loss for the host country, China. This might be an important step for developing country firms to expand their operations globally. For example, in the case of South African Breweries (SAB), the company was originally established in South Africa but later moved its main listing on the London Stock Exchange in 1999 to raise capital for acquisitions. The company made several global acquisitions, changed its name to SABMiller plc, and became a globally successful firm. The firm now operates in South Africa through its local subsidiary, and its assets are now classified as foreign direct investment.

Similarly, companies might use round tripping to escape from the perceived excesses in state control/intervention ("system escape" motive) and other uncertainties in the country of origin. Similarly, operating from more "stable" locations, where the regulatory environment is perceived as being more advantageous, constitutes the so-called "safety nests" motive. For example, Mittal Steel (now part of ArcelorMittal), whose founders were born in India but resided in London, registered their firm in the Netherlands to circumvent the heavy and bureaucratic Indian regulations, and they have expanded their operations both in India and globally. Mittal Steel acquired the European steel company Arcelor in 2006, and the merged company, ArcelorMittal, chose Luxembourg for its official headquarters and is now the world's largest steel producer.

Investing through another country might enable firms to secure some of the protections extended by the bilateral investment treaty (BIT) of the transit country. For example, treaty rights such as property rights and protections related to investor-state dispute settlement (ISDS) options are especially important to firms that undertake capital-intensive and risky projects. This is because the ISDS option provides an explicit option to foreign investors to bring their claims to domestic courts or international arbitration under the framework of UNCITRAL or ICSID. This allows the round trip investor to choose the forum where a dispute with the host country will be settled, while a domestic investor would automatically be subjected to the national court system without the option of international arbitration. Another added benefit of international arbitration is that it uses the investment agreement

[11] For the literature on motivation for round tripping see: Wein, 2010; Ledyaeva, 2015; Haberly and Wójcik, 2014; and Kalotay, 2012.

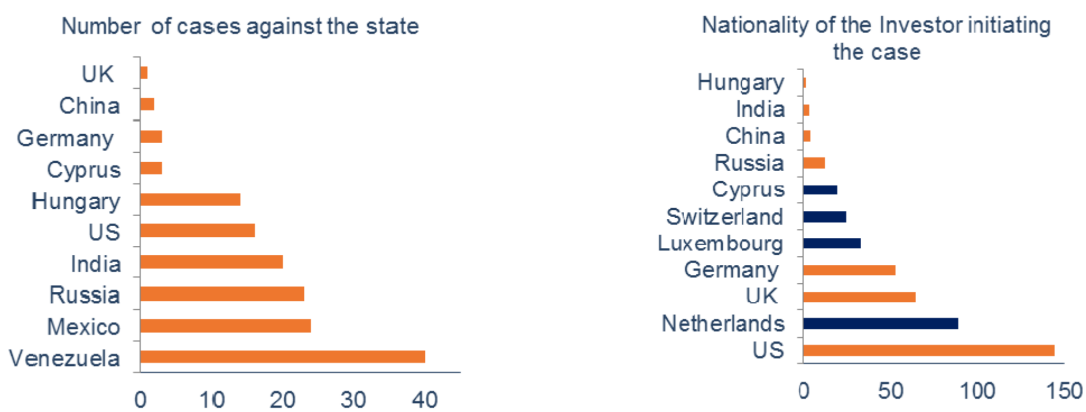
to determine the enforceable legal framework. For example, a dispute between a firm headquartered in Mauritius and the Indian state can be adjudicated according to British law if British law is specified as the applicable law in the investment agreement.

The institutional concerns seem to be justified given that international arbitration appears to be an important tool for foreign firms operating in several middle-income countries (MICs). In fact, it is middle-income countries that are subject to the highest number of ISDS cases against the state (Figure 3a). Additionally, it seems that some of these investments might be indirect since transshipment centers and offshore financial centers (OFCs) such as Luxembourg, Switzerland, and Cyprus, as well as the Netherlands host a considerable number of firms that seek international arbitration (Figure 3b). Among the concluded original arbitration proceedings, 36 percent of the cases were decided in favor of the state, 27 percent were decided in favor of the investor, while the rest were settled or discontinued.

Figure 3: International arbitration:

a. MICs are subject to the highest number of ISDS cases against the state…

b. While several offshore centers seem to host some of these firms that seek arbitration.



Source: Investment Policy Hub UNCTAD

Seeking institutional protection through round tripping might be not that easy, however, as states might dispute the nationality of the firm. For example, the Netherlands has grown notorious as a site for 'treaty shopping' given that the country has more than 100 BITs, many of which have particularly broad and strong ISDS provisions and hosts a considerable number of firms that seek international arbitration. The complex national profiles of Dutch filers in particular have not gone unnoticed by respondent states. In fact, Venezuela, South Africa and Indonesia have specifically withdrawn from their BITs with the Netherlands, citing treaty shopping concerns.[12]

Several large emerging and developing countries, faced with challenges of FDI round tripping, have taken steps to manage and reduce it, but with mixed results…

[12] Rachel L. Wellhausen, 2016, "Recent Trends in Investor–State Dispute Settlement" Journal of International Dispute Settlement.

There are several well-documented cases of round-tripping corridors in the case of emerging and developing countries: Hong Kong (for China), Mauritius (for India), the Caribbean financial centers, especially the British Virgin Islands (for Brazil, and partly the Russian Federation), and Cyprus (for the Russian Federation). Offshore financial centers (OFCs) and transshipment centers are the destination of a sizeable portion of the outflowing FDI from BRICs.[13]

China and Hong Kong

The FDI round tripping case between China and Hong Kong and other OFCs is one of the most well-known. In the 1990s, in an effort to attract FDI flows, China introduced large financial incentives for FDI, including concessions on taxes, leasing of land and property, and special arrangements regarding the retention and repatriation of foreign exchange. [14]This preferential treatment for foreign capital encouraged not only foreign but also domestic investors to move their money offshore, mainly to Hong Kong and the British Virgin Islands, and bring it back as foreign investment. As a result, the round tripping of domestic investment accounted for an estimated 30 to 50 percent of FDI inflows to China between 1994 and 2008. [15]These round-tripping activities have decreased since 2008, when China withdrew the tax incentives for foreign investment and adopted a uniform tax system for domestic and foreign enterprises. As a result, the level of round tripping between China and OFCs declined to an estimated 14 percent of its FDI in 2010. [16] In July 2014, Chinese authorities took additional steps to further reduce the remaining preferential treatment for foreign investors, allowing domestic investors to use SPEs to move their money where there are “real and reasonable needs”, and removing repatriation restrictions on earnings.[17]

India and Mauritius

In the case of India, Mauritius accounts for a large share of India’s FDI inflows (Figure 4a). While not all the flows from Mauritius constitute round-tripped Indian capital, about 10 percent of FDI inflows over the last decade are attributed to round tripping through Mauritius, a strategy used by Indian companies for tax evasion and, in some cases, money laundering. [18] The reason for this was the 1983 Double Taxation Avoidance Agreement between India and Mauritius that gave only Mauritius the right to tax capital gains arising from sales of shares of an Indian company by a resident of Mauritius. However, Mauritius does not tax capital gains; therefore, Indian companies based in Mauritius could fully avoid taxation in both jurisdictions. As a result, the small island was, for many years, the top country of origin for India’s FDI. The Indian Finance Ministry has estimated the cost of round tripping of FDI to India, in terms of loss of tax revenue, to be around $600 million

[13] According to the recognized definition, OFC is a center which provides some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity. See Svetlana et al., 2013.

[14] Wladimir Andreff, 2014, “Outward foreign direct investment by Brazilian and Indian multinational companies: comparison with Russian-Chinese multinationals.”; Balashova and Matyushok, 2014, The Trajectory of Growth and Structural Transformation of the World Economy Amid International Instability.

[15] Carlos Casanova, 2015, “Chinese outbound foreign direct investment: How much goes where after round- tripping and offshoring?”

[16] K. Davies, 2013, “China Investment Policy: An Update.”

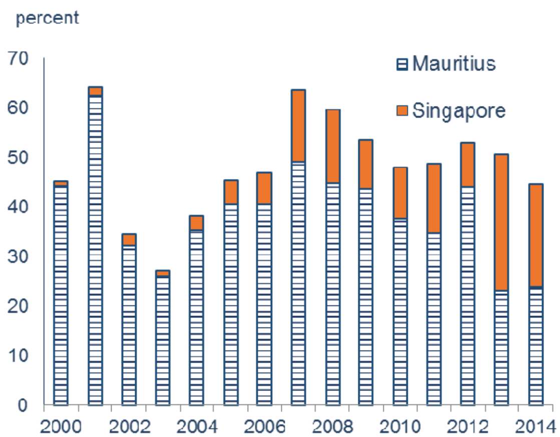
[17] Woon-Wah Siu, and Lu Wang, 2014, “China’s New Foreign Exchange Control Rule on Outbound and Round-Trip Investment.”

[18] Not all the flows from Mauritius are round-tripped Indian capital. See K.S. Chalapati Rao, and Biswajit Dhar, 2011.

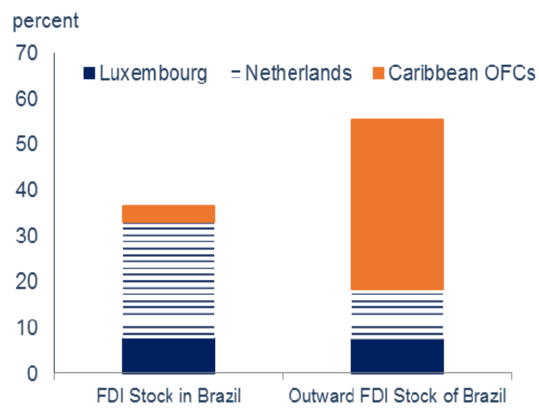
annually. [19] The two countries signed an amendment to this treaty in 2016 hoping to curb tax evasion and the accompanying welfare losses. [20]

Figure 4: Bilateral FDI flows in selected middle-income economies:

a. Almost half of India's FDI comes from Mauritius and Singapore …



b. Caribbean OFCs, Luxembourg, and the Netherlands accounted for 55 percent of Brazilian OFDI in 2014.



Source: UNCTAD

Critics of the amendment pointed out that changing the current preferential investment policies or placing too high a burden of proof regarding the ultimate investment beneficiary would divert legitimate investments away from India. Furthermore, this policy proved to be ineffective since Mauritius was not the only country to which India had granted exclusive taxing rights with respect to capital gains; Singapore and Cyprus had similar rights. [21] Hence, the mere announcement of the signing of the clause with Mauritius led to a diversion of Indian companies from Mauritius to Singapore (Figure 4a).[22]

[19] Ian Taylor, 2014, "Africa Rising: BRICS - Diversifying Dependency."

[20] The amendment, which goes into effect on April 1, 2017, has the following characteristics: i) Source-based taxation of capital gains on shares; ii) Grandfathering clause: Once the agreement enters into effect, the sale of shares of a company that operates in India will be taxed at 50% of the applicable rate until March 2019; iii) Limitation of Benefits (LOB) clause: The benefit of 50% reduction in tax rate during the transition period will not be extended to shell and conduit companies. A resident is deemed to be a shell/ conduit company if its total 2016 expenditure on operations in Mauritius is less than Mauritian Rupees 1,500,000.

Financial Express Online, "India-Mauritius sign landmark tax pact; move aimed at tackling black money, round tripping: Key features", 10 May 2016, available at: http://www.financialexpress.com/economy/india-mauritius-sign-landmark-tax-pact-india-can-tax-capital-gains-arising-from-alienation-of-shares/252398/

[21] The "Comprehensive Economic Cooperation Agreement" signed between India and Singapore in 2005. https://halshs.archives-ouvertes.fr/halshs-01279896/document

[22] Shreesh, 2016, "The FDI Report: India Got $40 Billion in FY16, Singapore Overtakes Mauritius, Real Estate Loses Love."

Brazil and Caribbean OFCs

Brazil's bureaucratic regulations and heavy taxation on domestic earnings have created incentives for companies to invest overseas. As a result, the Caribbean OFCs (especially the Bahamas, the British Virgin Islands, the Cayman Islands, and the former Netherlands Antilles) have become an important Brazilian outward FDI destination, accounting for one-third of Brazil's $300 billion FDI stock (Figure 4b). The capital is later either transshipped from tax havens to third-countries or round-tripped back to Brazil as FDI. Interestingly, the main source countries for FDI inflows in Brazil are the Netherlands and Luxembourg, accounting for some 30 percent of the $700 billion FDI stock. These two countries are within the network of around 30 countries that have double taxation prevention treaties with Brazil.[23] While the actual level has yet to be estimated, a considerable portion of investment coming from these two countries is believed to be round tripped Brazilian investment, partly through OFCs. Interestingly, in 2009, following the global financial crisis, Brazilian companies repatriated intra-company loans from their affiliates to the parent companies at home to combat the global recession that had a negative impact on Brazil.[24] While tax treaties with certain countries provide incentives, improving the regulatory framework and simplifying the tax regime should help to reduce and mitigate the effects of round tripping.

Ukraine and Cyprus

Cyprus has long been a destination favored by companies investing in Ukraine primarily due to the favorable double tax treaty in place between Cyprus and USSR since 1983. Obviously, there have been drastic changes in the region since then, but the benefits provided by the Cyprus treaty for investors to Ukraine still remain very favorable, with no withholding tax charged on dividends, interest, or royalty payments from Ukraine to Cyprus, and capital gains not taxed in Ukraine. Moreover, Cyprus, with its favorable tax regime, common-law based traditions, and offshore services (such as trusts to preserve anonymity of beneficial owners), is viewed as a close and attractive jurisdiction to funnel profits. Some Ukrainian firms are also motivated to channel their capital through Cyprus because of the instability of the Ukrainian banking system, high taxes, and lack of convertibility of the Ukrainian hryvnia. As a result, Cyprus has become an important destination for Ukrainian companies that move their money to Cyprus and eventually reinvest into Ukraine. While Cyprus is now the largest source of FDI into the Ukrainian economy, representing nearly 30 percent of FDI inflows, Cyprus is coincidentally also one of the largest destinations for Ukrainian investment abroad, commanding an impressive share of 92 percent of the outward FDI stock.[25]

Both Ukraine and Cyprus experienced major crises in recent years. In order to deal with the repercussions of the European banking crisis and its large exposure to the Greek economy, Cyprus and the European Union reached an agreement on a bailout package on March 25, 2013, under the condition that the depositors of two large banks share a portion of each bank's losses. Temporary restrictions on bank transactions were introduced and virtually all money transfers out of Cyprus and within Cyprus were subject to various restrictions. Similarly, Ukraine introduced capital control restrictions, such as the prohibition of the transfer of dividends and sales proceeds abroad, to limit the

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[23] KPMG, 2012, "High Growth Markets - Investing in Brazil."

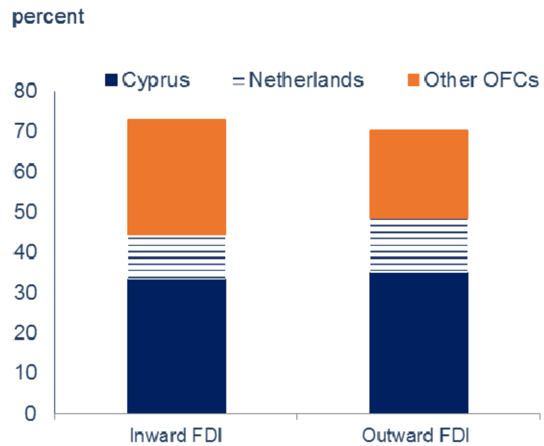
[24] Mike Peng, and Ronaldo Parente, 2012, "Institution-based weaknesses behind emerging multinationals."

[25] Robert Kirchner et al., 2015, "Foreign Direct Investment in Ukraine: Past, Present, and Future."

capital flight following the geopolitical crisis between 2014 and 2015.[26] These, however, also served as a brake on all inflows.

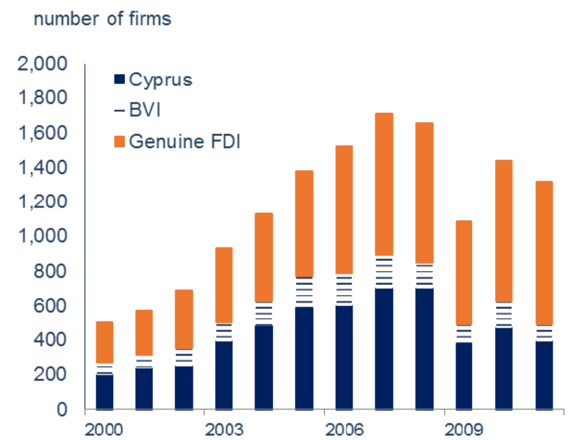
Figure 5: FDI Round tripping in Russia:

a. Cyprus, the Netherlands, and other transshipment centers command around 70 percent of inward and outward FDI of Russia (2014)…



Other transshipment centers include the British Virgin Islands, Bermuda, Luxembourg, the Bahamas, and Switzerland.

b. Half of the foreign firms investing in Russia come from Cyprus and the British Virgin Islands (BVI)



Source: "Offshore Foreign Direct Investment, Capital Round-Tripping, and Corruption: Empirical Analysis of Russian Regions" (Ledyaeva et al. 2015)

Russia and Cyprus & OFCs

Similar to Ukraine, round tripping of capital is a prevalent problem for Russia. It has mainly taken place through Cyprus and OFCs, which account for 70 percent of inward/outward FDI stock of Russia. Cyprus leads as the main destination of FDI inflows and outflows for Russia, followed by the Netherlands (Figure 5).

The factors that drive the round tripping by Russian companies are not necessarily related to the preferential treatment granted to foreign investors since many Russian regional authorities, rather than aiding foreign investors, have erected barriers in order to protect incumbent firms from outside competition. Rather, *system escape motives*, such as the avoidance of domestic regulatory uncertainties, play a more prominent role for the round tripping activities by Russian companies and investors. As discussed earlier, companies may try to overcome the institutional weaknesses in their home economies through this kind of capital round tripping that allows the companies to engage in institutional and regulatory arbitrage. This also provides an insurance against political risk and

[26] The temporary restrictions include the repatriation of proceeds received by non-resident investors as a result of sale of securities issued by Ukrainian issuers (except sovereign bonds); repatriation of proceeds received by non-resident investors as a result of the sale of equity stakes in Ukrainian enterprises other than securities (e.g. equity in a limited liability company); and the repatriation of dividends by non-resident investors (except for dividends received from securities listed at one of the local stock).

uncertainty stemming from the political economy of the country. Given that the FDI round tripping between Russia and OFCs is widely discussed among politicians and analysts, there are a few analytical studies try to understand the motivation for round tripping, as well as the differences between these types of investors and genuine foreign direct investors especially in light of the governance environment (Box 1).

While tax avoidance might also play an important role through double taxation treaties with some of the OFCs, the main motivation for Russian round tripping is believed to be *institutional arbitrage*. The detailed analysis of firm-level FDI data that distinguished genuine foreign direct investors from round-trip investors indicates that the use of offshore financial centers as "home base" would provide Russian companies access to more developed infrastructure for financial operations vis-à-vis purely domestic firms. In addition, an understanding of the Russian culture and business environment would put the round-trip investors in a superior position when compared to genuine foreign investors. This significant advantage allows Russian investors to better exploit economic opportunities in Russia while concealing their identity and using the institutional benefits that foreign jurisdictions offer (such as financing opportunities).

One study also underscores significant differences between round-trip Russian investors and genuine foreign investors; While round-trip investors tend to invest in Russian regions that are resource-abundant and illustrate poor governance indicators (corruption), genuine FDI investors tend to go to regions with seaports and higher level of skilled labor.[27] As a result, the share of round-trip investment in total FDI is significantly higher in corrupt regions.

The high level of FDI round tripping in Russia also partly reflects *concealed investments* as investors can hide their identity from local authorities in Russia via "offshore schemes".[28] Furthermore, as discussed earlier, investing through another country might enable firms to secure some of the protections extended by the bilateral investment treaty of the transit country. Given that there is room for improvement on several fronts measured by the *Doing Business* indicators and beyond- in particular to increase competition in the economy-, being covered by an international treaty becomes a significant relative advantage for an investor,[29] though it is not always easy to claim their rights.[30]

[27] Svetlana Ledyaeva et al., 2015, "Offshore Foreign Direct Investment, Capital Round-Tripping, and Corruption: Empirical Analysis of Russian Regions."

[28] Olga Kuzmina et al., 2014, "Foreign direct investment and governance quality in Russia."

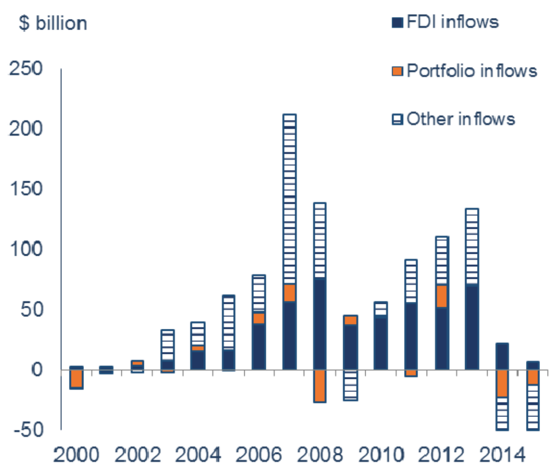
[29] In past years, Russia has been active in undertaking reforms across multiple areas of business regulation. In some aspects of Doing Business, the business regulatory environment of Russia is now closer to best practice. However, to foster more growth opportunities for local firms, there is room for improvement on several fronts measured by the Doing Business indicators and beyond, in particular to increase competition in the economy. In the area of Trading Across Borders, streamlining the formalities for border compliance would reduce the time and cost involved in trading across borders, thereby benefiting both exporters and importers. For more see: "Russia Continues to Improve its Business Environment, says Doing Business report", Press Release, October 25, 2016 available at: http://www.worldbank.org/en/news/press-release/2016/10/25/russia-continues-to-improve-its-business-environment-says-doing-business-report

[30] Svetlana Ledyaeva et al., 2015

By the same token, the concealed investment through OFCs might be a way of laundering the proceeds of corruption.[31]
The socio-economic implications of the high level of round-tripped FDI in Russia might be quite significant. Although it might not be the main motivation, it is likely that some tax revenue has been lost through double taxation treaties. More importantly, the nature of the FDI round tripping seems to reinforce corruption in certain regions that are already perceived as more corrupt. This in turn puts them in a disadvantaged position to receive genuine FDI flows that are more technologically advanced than round-trip investments. Genuine FDI increases by more than 150 percent when a region improves its governance quality from average to the top level. [32] The majority of real FDI in Russia comes from developed countries and hence, it brings modern technologies and know-how into the host regions. Therefore, in the long run, the high diversity in regional corruption might lead to uneven technological development across Russian regions and thus, further deepen the inequality in Russia's economic geography.[33]

Round-tripped or not, FDI inflows have played an important role in the Russian economy and have remained stable since the financial crisis (Figure 6). Nevertheless, all flows, including FDI, dried up since 2014 as international sanctions, falling oil prices, and geopolitical tensions continued to damage economic growth prospects and erode investor interests in the country.

Figure 6: ***All capital flows to Russia, including FDI inflows, fell sharply in 2014 and 2015.***



In addition to economic difficulties, a new Russian anti-offshore law adopted at the end of 2014 is also impacting FDI flows. It has already reduced the scale and scope of round tripped FDI: In less than two years, from 2013 to September 2015, the FDI stock of Cyprus in Russia, and the Russian FDI stock in Cyprus decreased by 50 percent. Nevertheless, because of the new law, Russian investors that used Cyprus as an offshore base to reinvest back in the country transshipped some of their investment to third countries rather than recycling them back into the home country. This trend is also the main reason for the drop of the British Virgin Islands from second place in 2009 to eighth in the 2015 rankings of the largest foreign investors in the Russian Federation, although it still remains the second largest destination of Russian outward FDI stock according to the Bank of Russia.[34]

[31] Olga Kuzmina et al., 2014

[32] ibid.

[33] supra, Svetlana Ledyaeva et al., 2015

[34] UNCTAD, 2016, World Investment Report.

Table 1: **Russian Federation: Inward foreign direct investment 2007-2015, millions of US dollars**

Top 5 for 2015	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
WORLD	**55,874**	**74,783**	**36,583**	**43,168**	**55,084**	**50,588**	**69,219**	**22,031**	**6,478**
BAHAMAS	354	-524	1,731	2,282	1,829	2,111	2,791	3,638	5,090
BRITISH VIRGIN ISLANDS	3,962	5,519	1,761	2,139	7,225	2,475	9,379	3,123	2,242
JERSEY	104	8	68	126	775	642	509	-717	2,122
BERMUDA	8,369	9,959	2,243	436	594	-320	404	1,777	1,692
FRANCE	415	604	696	2,592	1,107	1,232	2,121	2,224	1,686
Bottom 5 for 2015	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
NETHERLANDS	10,268	10,184	-3,391	3,733	7,383	10,330	5,716	1,102	-249
FINLAND	677	1,415	518	347	217	349	216	124	-272
HUNGARY	61	171	112	374	454	683	736	534	-452
LUXEMBOURG	-2,062	1,403	6,195	2,892	4,106	10,814	11,638	-693	-5,770
CYPRUS	11,917	20,428	4,182	12,287	12,999	1,985	8,266	3,158	-7,057

Source: *ROSSTAT 2016*

Round tripping is a phenomenon that affects all capital flows and is not limited to FDI. Transshipment and round tripping of funds also take place in Russian Portfolio flows since Luxembourg, Cyprus, and other OFCs top the list of countries of origin for these flows (Table 2). However, the vast majority of these funds come into Russia as long-term debt securities (securities with a maturity longer than 12 months). The long-term nature of the inflows somewhat limit the potential volatility and consequently, the potential negative impacts on the economy. As a result, in this case, portfolio investment, which usually is more volatile by nature, behaves more like FDI.

Table 2: **Russian Federation inward portfolio investments 2015, millions of US dollars**

Country of residence of issuer:	Equity securities	Debt securities	(of which) long term	(of which) short term	Total portfolio investment assets
Luxembourg	355	24,257	22,457	1,800	24,612
Ireland	42	19,337	19,279	58	19,379
Netherlands	241	4,179	4,118	61	4,420
United States	546	2,968	--	--	3,514
Cyprus	437	2,031	1,711	320	2,468
Other OFCs	39	90	90	--	1,475
Rest of countries	1,197	12,112	14,082	998	11,963
Total value of investment	2,857	64,974	61,738	3,237	67,831

Source: The Russian Institute of National Statistics

Box 1: Literature on Russian round tripping

The idiosyncratic nature of the round tripping phenomenon for Russia led to three main academic studies, which try to understand the motivation for round tripping as well as differences between these types of investors and genuine foreign direct investors.

The study *"Offshore Foreign Direct Investment, Capital Round-Tripping, and Corruption: Empirical Analysis of Russian Regions"* (Ledyaeva et al. 2015) introduces the term secrecy arbitrage, a novel concept used in this study, which is explained as both licit capital looking for shelter from corrupt home country authorities and illicit capital generated by corruption that needs to disguise its origin. The paper argues that part of the round-tripped FDI consists of proceeds from corruption, laundered in OFCs and reinvested back to the location of origin. However, some portion is the round tripping of licit capital, as businesses use the secrecy provided by OFCs to hide their true identities as a way to deal with weak governance in local governments. Using firm-level data from the enterprise registry of the Russian State Statistics Service (Rosstat), the paper uses econometric methods to detect the relationship between region-level corruption in Russia, proxied by the Corruption dimension of the Index of Democracy provided by the Moscow Carnegie Center for the period 2000-2004, and the volume of round tripped FDI. The Rosstat data set provides information on 20,165 firms with foreign capital registered in Russia over the period 1997–2011. The study underscores the interconnections between political and business elites and their interventions in the political decision-making process, and establishes the link between round tripped FDI and corruption.

The paper titled *"Foreign Direct Investment and Governance Quality in Russia"* (Kuzmina et al. 2014) studies the effect of poor governance quality on foreign direct investment in Russia. Using a survey of businesses across forty administrative districts, it finds that moving from the average to the top governance quality across Russian regions more than doubles the FDI stock. The governance quality data are derived from the Index of Support ("Index Opory") survey conducted in 2011. The paper concluded that poor governance quality had a significantly negative effect on foreign direct investment in Russia.

The paper *"If Foreign Investment is not Foreign: Round-trip versus genuine foreign investment in Russia"* (Ledyaeva et al. 2013) uses the knowledge-capital model of the multinational enterprise to provide a formal empirical proof of the phenomenon of round-trip investment in Russia and studies the differences in location strategies between round-tripped and genuine FDI. Using the firm-level data from Rosstat between 1997 and 2011, the paper extracts two types of firms: firms owned by offshore owners (Cyprus and British Virgin Islands), and firms with genuine foreign owners. The paper looks into the question if and to what extent the role of regional factors in the location decisions of foreign investors across Russian regions differs between round-trip and genuine foreign investors. The analysis shows that round-trip investors leverage the "Dutch disease" in Russia while genuine foreign investors tend to invest more in regions with higher levels of skilled labor and more technological advancement.

United States and OFCs

It is not only developing countries that have to deal with round tripping FDI. A recent paper estimated that when U.S. taxes go up by 1 percentage point, the capital inflows from OFCs increases by 2.8 percentage points. [35] Unsurprisingly, these inflows slow down when the IRS tightens its controls for

[35] H.R.297, "Stop Tax Haven Abuse Act 114th Congress (2015-2016)."

tax fraud. The study's authors estimate that as a result, the U.S. has forgone up to $27 billion in tax revenue since 2008.[36] To address this problem, in 2015, the "Stop Tax Haven Abuse Act" was introduced by the US Congress. Should this bill get approved, new restrictions on U.S. corporations and other entities with foreign income will be introduced with respect to: "(1) tax deductions allocable to deferred foreign income, (2) the recalculation of foreign income taxes, (3) intangible property transferred overseas, (4) tax evasion activities by U.S. corporations reincorporating in a foreign country, and (5) the interest expense tax deduction of certain subsidiaries of foreign corporations with excess domestic indebtedness."[37]

While reducing FDI round tripping has proven to be challenging, countries can try to limit the incentives by eliminating any treatment differentials based on nationality of firms.

In an increasingly globalized world where OFCs facilitate the growing mobility of finance by providing no/low tax, no/low regulation, secrecy and anonymity, MNEs and investors will continue to seize any arbitrage opportunities to reduce their tax cost, circumvent restrictions and regulations that limit the scope of their operations and profits, and mitigate operational and other business risks. Of course, OFCs also facilitate illicit capital movements such as money laundering.

While core factors driving round tripping differ in each country case, such as tax and institutional arbitrage, in all cases companies choose to round trip their investments to benefit from some preferential treatment provided to certain countries and their firms. Hence, it is important for countries to work towards eliminating any treatment differentials to limit these arbitrage opportunities as the successful Chinese example indicated. This should apply both to the preferential treatment of either foreign firms or domestic firms, as well as the preferential treatment applied by the nationality of investors. In the same vein, modernizing the investment attraction system, by ensuring equal access to incentives and special economic zones for foreign and local firms, will reduce the incentives for round tripping. If any differentiation is required between firms, it should be according to the degree of substantive business activity of the country, irrespective of the firm's nationality.

In reality, the blurring of investor nationality of the MNEs has already made the application of rules and regulations on foreign ownership more challenging, if not impossible. A range of mechanisms to safeguard the effectiveness of foreign ownership rules has been developed, including anti-dummy laws, general anti-abuse rules to prevent foreign control, and disclosure requirements. However, they have yielded mixed results (like in the case of India). Even in the case of international and bilateral trade agreements, policymakers should be aware of the de facto "multilateralization effect". Almost one-third of foreign companies that operate under major intra-regional investment treaty areas (such as TPP, TTIP, and RCEP) are actually owned by parent companies outside the region, raising questions about the ultimate beneficiaries.[38]

[36] M. Hanlon et al., 2015, "Taking The Long Way Home: U.S. Tax Evasion And Offshore Investments In U.S. Equity And Debt Markets."
[37] H.R.297, "Stop Tax Haven Abuse Act 114th Congress (2015-2016)."
[38] UNCTAD, 2016, *World Investment Report 2016 Investor Nationality: Policy Challenges*.

In fact, the most important policy measure to reduce round tripping activity and mitigate its impact is to improve the business environment for all firms, foreign and domestic.

This goes hand in hand with focusing on the stability of the host economy and trust in its regulatory environment. As discussed, round tripping activities are also motivated by the firms' desire to circumvent the institutional and financial shortcomings of their country of origin. Hence, strengthening the institutions can foster not only domestic and foreign investment, but may, to some extent, curb investments from flowing out to tax havens or being round tripped.[39] Moreover, even if capital outflows and investment round tripping occur, a country can receive genuine FDI inflows that will create jobs, bring positive externalities, and stimulate growth. For example, in Denmark, which has a good business environment for all investors, FDI inflows created jobs that outnumbered the jobs lost due to FDI outflows. Moreover, FDI inflows created highly skilled and specialized jobs, while some medium-skilled administrative, customer relations, and trade functions jobs might have been lost.[40] This indicates that when a country operates as an open, flexible economy with a good investment climate for all investors, it can benefit from the positive effects of international capital movements.

Nevertheless, countries also need to adapt to the new playing field for FDI and recognize the trade-offs of their national policies on capital flows.

Countries have to adapt to the fact that not all FDI is linked to production, and MNEs can carry out activities that register as FDI even though they are purely financial in nature. This would require a new mindset for the policymaker to be fully aware of the complexity of modern corporate structures and MNE activities, which will possibly persist in the future. Policymakers need to better understand the nature, motivations, size and impact of FDI round tripping in their countries to adopt a holistic approach towards the problematic aspects of round tripping. As discussed earlier, FDI round tripping may have various consequences for the host economy, ranging from foregone tax revenues, distortions of the information and domestic competition, support of corruption, as well as possible welfare and efficiency losses.

Nevertheless, any policy choice to reduce round tripping activities should be evaluated against its possible trade-offs since it might also have undesired consequences. In some cases, measures to limit round-tripped investment may lead to capital flight, where investment never makes it back home, and reduce the investment levels in the host country. For example, Russia's newly introduced anti-offshore law might have achieved what it intended to do, at least partially, but at the same time, some Russian investors transshipped part of their investment to third countries rather than recycling it back into the home country. The new law was a contributing factor for the sharp decline in FDI inflows in 2015.[41]

Capital controls in general are complex instruments and might have a much broader effect than what is intended. In the case of capital controls related to round-tripping FDI, such as on outward capital flows, they would likely also deter legitimate and productive capital flows, including by genuine

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[39] M. Chari, and S. Acikgoz, 2015, "What drives emerging economy firm acquisitions in tax havens?"

[40] Peter Jensen et al., 2006, "Offshoring in Europe—Evidence of a Two-Way Street from Denmark."

[41] UNCTAD, 2016, World Investment Report 2016 Investor Nationality: Policy Challenges.

foreign direct investors, and worsen short-run foreign-exchange and long-run growth prospects. Additionally, these policies tend to be “leaky” and have a mixed success record with eroding effectiveness over time as companies find new ways to circumvent them. Furthermore, they can be difficult and costly to enforce, even in countries with strong government institutions.

Nevertheless, several countries have, over the years, used them, as have Iceland, Greece, and Ukraine more recently. In most of these cases, capital controls that were introduced in a transparent and temporary manner on outflows of capital were more or less effective to “stop the bleeding”. International co-operation, as discussed below, is also an important factor since the trade and investment treaties across the world may prohibit the use of such measures.

All indirect FDI flows need to be closely monitored.

Ownership schemes such as SPEs and OFCs used by MNEs can obscure the ultimate source of FDI coming into countries. Moreover, it is often difficult to ascertain the true nature of funds due to the added challenge of obtaining information from a special purpose vehicle (SPV) company.[42] These challenges lead to considerable inconsistencies in FDI inflows/outflows statistics provided by different countries. For instance, according to Rosstat (2005), Russian FDI in Kazakhstan for the period 2000-2004 amounted to a mere USD 121 million whereas the respective figure provided by the National Bank of Kazakhstan (2007) was USD 987 million.[43]

To mitigate such inconsistencies, the latest international guidelines by OECD provide a method to produce FDI statistics by ultimate investing country (UIC).[44] This method would offer policymakers information on who ultimately controls the investment, reaps its rewards, and bears its risks. This approach also allows for the identification of round tripping activities. Six countries are currently reporting data on the inward stock of FDI by the ultimate investing country criteria: Austria, Estonia, Finland, France, Poland, and the United States. Examination of their statistics reveals some common patterns. Countries, such as Luxembourg, Cyprus, and the Netherlands, that are known as countries MNEs pass investments through on the way to other destinations, are much less important as sources of direct investment when measured according to the UIC than when measured according to the immediate investing country. Round tripping was present in each country examined and was large enough to make investors from the home country rank among the top ten sources of FDI in each of the countries. However, with the exception of Estonia, they accounted for 5 percent or less of the total inward investment position. [45] Nonetheless, for the success of this calculation method, it is vital for countries to increase their disclosure requirements. This should be the case both for inward and outward investors, especially concerning the origin of funds and information about the final beneficiary owners.

National policy measures have to be complemented by international actions.

[42] IMF, 2004, “Issues Paper #13: Round Tripping.”

[43] Valtteri Kaartemo, 2007, New role of Russian enterprises in international business.

[44] OECD, 2015, “Implementing the latest international standards for compiling foreign direct investment statistics, FDI Statistics by the Ultimate Investment Country.”

[45] OECD (2015)

International cooperation is essential for leveraging the efficiency of national policy interventions. For an issue that transcends national borders, any national policy response will prove inadequate without international cooperation. An international coordinated response can better address the complex problems of globalized markets. Such international efforts would include: a review of international investment agreements; the closing of the scope for treaty shopping; a revision of rules on access to investor-state dispute settlement (ISDS); tax cooperation and gradual harmonization of tax rules with partners to reduce the scope for tax arbitrage; cooperation on the methods used to measure and report FDI, its origin, and its destination; as well as continued international cooperation in money laundering and criminal matters.[46]

[46] UNCTAD, 2016,(pp. 159-187)

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