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Support for outward investment: a questionable solution to a misdiagnosed problem

Blog post by Chief Economist Gregor Irwin, 26 September 2016

International Trade Secretary Liam Fox slipped out an important change in policy earlier this month when he told Conservative MPs that from now on the government would give the same weight to supporting outward investment as it does to inward investment. His concern is the deterioration in the current account. Inward investment may bring jobs, but foreign companies want a return on their investment which, according to Fox, is a problem, unless there is a matching flow coming in the opposite direction. Leaving aside questions about the economic rationale for the policy change, does the data suggest the government's concerns are justified in the first place?

The current account has dropped sharply since 2011, declining by £71bn to reach record deficit levels. During this time, the trade balance has not changed much, and a full £57bn of the current account fall is explained by a decline in the primary income balance, which measures the difference between earnings on investments flowing in and out of the UK. This suggests Fox is onto something. However, a closer look at the data raises some other, rather curious questions. One is that almost the entire £57bn can be explained by a fall in the net balance on reinvested earnings from direct investment. Changes to the net balance on all the other types of income are very small by comparison, including dividends and distributed branch profits from direct investment. Another is that more than two thirds of the fall in primary income is accounted for by just six countries – Singapore, Belgium, Switzerland, Netherlands, the USA and, ahead of the others, tiny Luxembourg. This isn't the list of countries you might first think of if the problem is falling returns on investments in under-performing economies, as some have suggested.

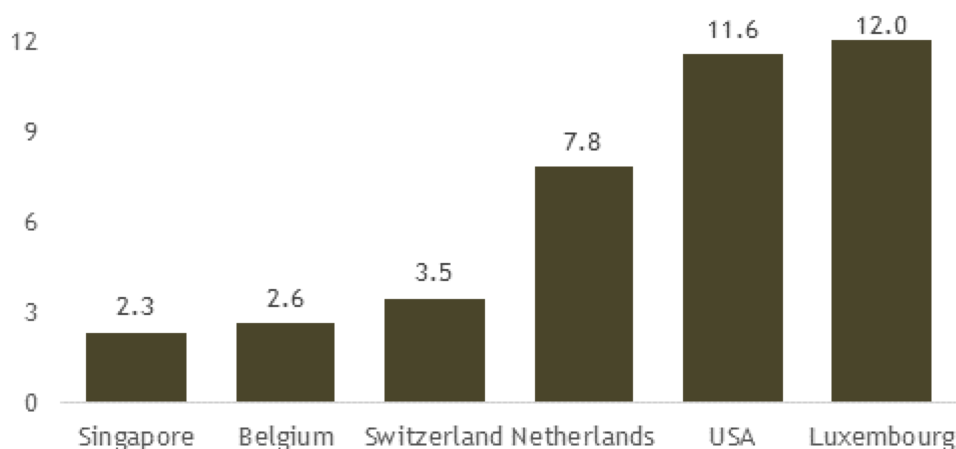

Fig: Change in net primary income balances from 2011 to 2015, £ billions

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There is another possible explanation, which Fox may not have considered – financial engineering. The way this can distort balance of payments data is explained with great clarity by Philip R. Lane. Essentially, if a 'British' company re-domiciles overseas in a lower tax jurisdiction this will mean a decrease in the net direct investment position of the UK and an increase in the net portfolio investment position, even though this is only really a paper transaction with no underlying change in the economic position. There are lots of factors affecting the value of direct and portfolio investments, such as currency changes and capital gains and losses, but this is in fact what we have seen, with the net position in direct investment declining by £360bn since 2011 and the net position in portfolio investment rising by £97bn.

Even more interesting, however, is a quirk in balance of payments accounting, which means investment income on FDI is recorded on an accruals basis, while for portfolio investments it's on a payment basis. This means that financial engineering can make the current account look worse than it really is as the inflows from higher portfolio income may only show up later, if some of those re-domiciling companies are reinvesting their earnings. It would explain why we see so much of the current account adjustment coming through reinvested earnings. And some of those countries that account for the fall in primary income are among the favourites of tax advisors.

The argument set out above does not prove this is all just down to financial engineering. The evidence is circumstantial. But it does point in the same direction. If it is right, then the government's new policy is a questionable solution to a misdiagnosed problem.

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