

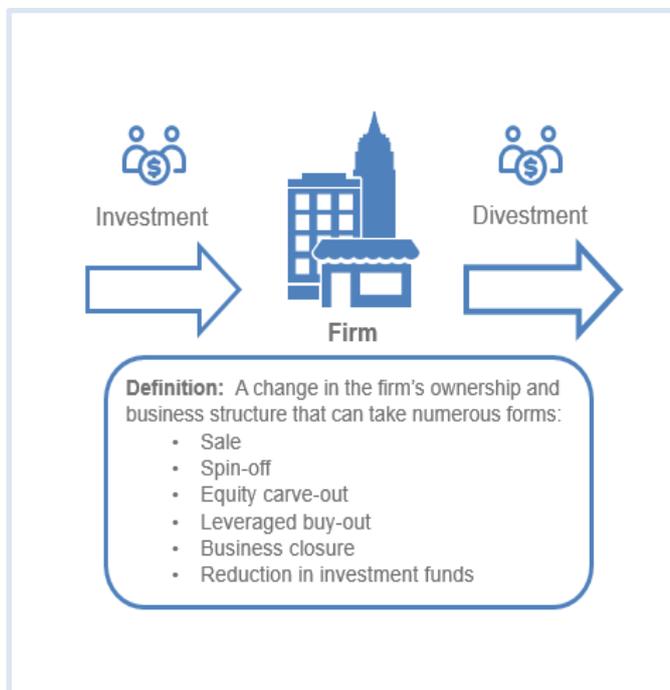
## DIVESTMENTS BY MULTINATIONAL ENTERPRISES

Maria Borga, Perla Ibarlucea-Flores and Monika Sztajerowska

*International divestment by multinational enterprises (MNEs) is an important global phenomenon. It can affect the performance of both parent and affiliate firms as well as the economies in which they are located. Divestments, however, remain understudied and poorly understood. This document describes the main findings from a new OECD study that sheds more light on the frequency and consequences of divestments with a view to helping governments design better FDI retention policies that maximise the value for firms and local communities.*

### What is divestment?

**Figure 1** What is divestment?



Corporate divestment is an adjustment in the firm ownership and business portfolio structure that involves the partial or full disposal of an asset or a business unit. This can take numerous forms ranging from sales and spin-offs to business closures (Figure 1).

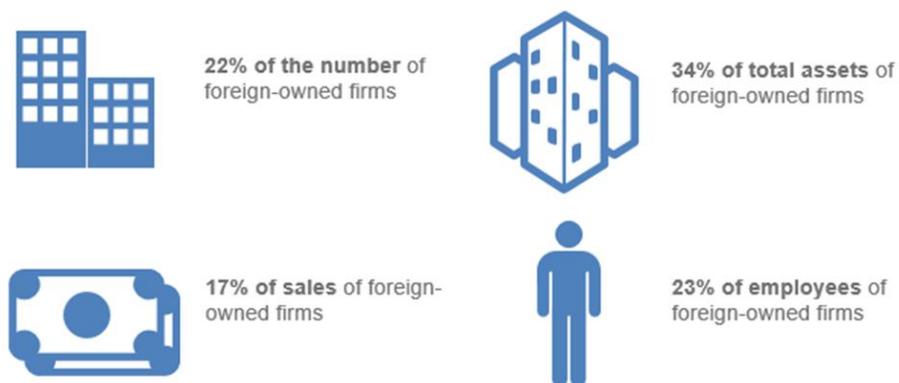
In other words, just as firms buy, build and expand their business operations, they also sell, downscale and close them down. A recent global survey shows that firms continuously pursue divestments to adjust to changing market conditions and shareholder requirements: 84% of surveyed firms announced that they plan to divest at least some of their operations in the next two years (Ernst & Young, 2019).

As foreign divestments (i.e. sales of foreign affiliates by MNEs in the domestic economy) are relevant to understanding the forces shaping foreign direct investment (FDI), and to the design of FDI attraction and retention policies, they may require policy makers' particular attention.<sup>1</sup>

## Why it matters?

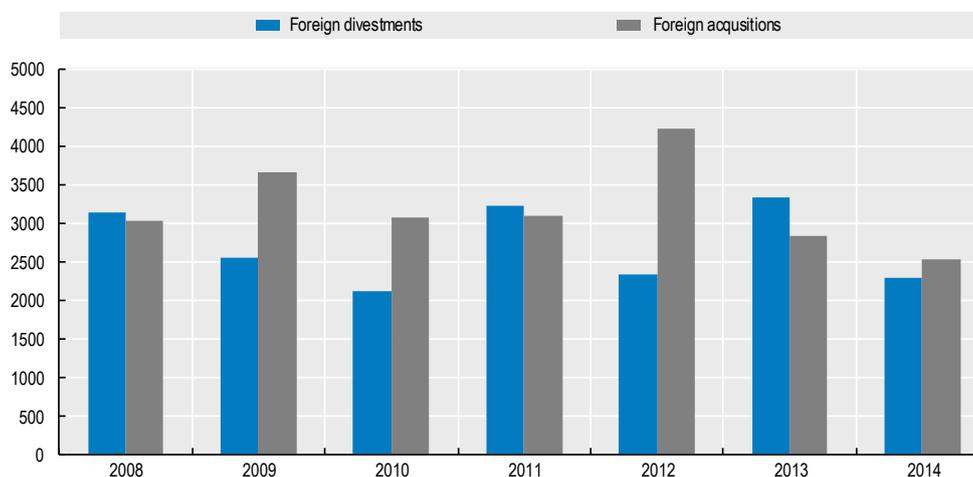
Foreign divestments are a frequent economic phenomenon. Using a new large firm-level database of 62,000 affiliates globally and the parents that could be tracked each year between 2007 and 2014, OECD analysis finds that MNEs divested one of every five foreign-owned affiliates over this period of time.<sup>2</sup> This means that divestments can affect a substantial share of global economic activity. By one measure, 34% of all total assets of foreign-owned firms in 2007, accounting for 17% of their sales and 23% of their employees, had been divested by 2014 (Figure 2). In some years, foreign divestments outnumber acquisitions (Figure 3).

**Figure 2. How important is the foreign divestment phenomenon**



Source: Authors' using ORBIS © data

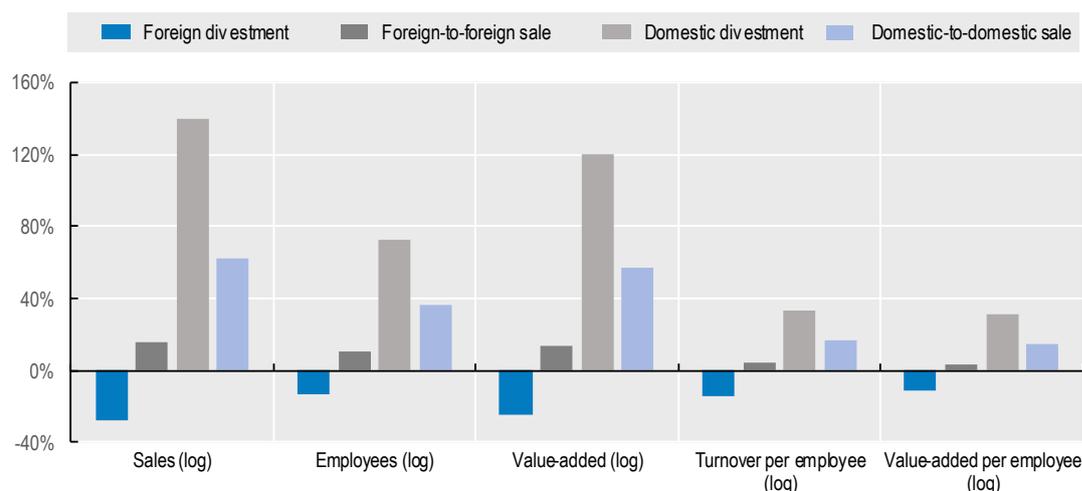
**Figure 3. Number of foreign divestments and acquisitions.**



Source: Borga, Ibarlucea-Flores and Sztajerowska (2020)

Foreign divestments can also have non-trivial consequences for the divested firms and, by extension, local communities and local economies. Divested affiliates experience on average 28% lower sales, 24% lower value-added and 13% lower employment compared to firms that stay foreign-owned (Figure 4). These negative effects are associated only with foreign divestments as opposed to other types of sales of affiliates. These formerly foreign-owned firms still outperform firms that have never had a foreign owner. Some earlier studies find similar results for selected economies.<sup>3</sup>

**Figure 4. Overview of direct impact of divestments on firm performance**



*Note:* The graph shows coefficients from a regression that are statistically significant at least at 10% level.

*Source:* Borgia, Ibarlucea-Flores and Sztajerowska (2020)

These findings mean that policy makers, as well as business leaders and the general public, could benefit from knowing why MNEs divest, which factors dominate, and the scope for policy action. To date, however, evidence of this nature has been scarce and previous studies have focused almost exclusively on business considerations. Filling this gap, this study sheds light on the patterns and drivers of foreign divestments across 41 OECD and G20 economies.

## What drives MNE divestments?

### Investment climate policies

Both policy and business factors matter for MNE divestments. Larger and more distant host markets are less prone to experience divestments by MNEs, while more advanced economies (i.e. with higher levels of per capita income) experience higher divestment rates, all else being equal.

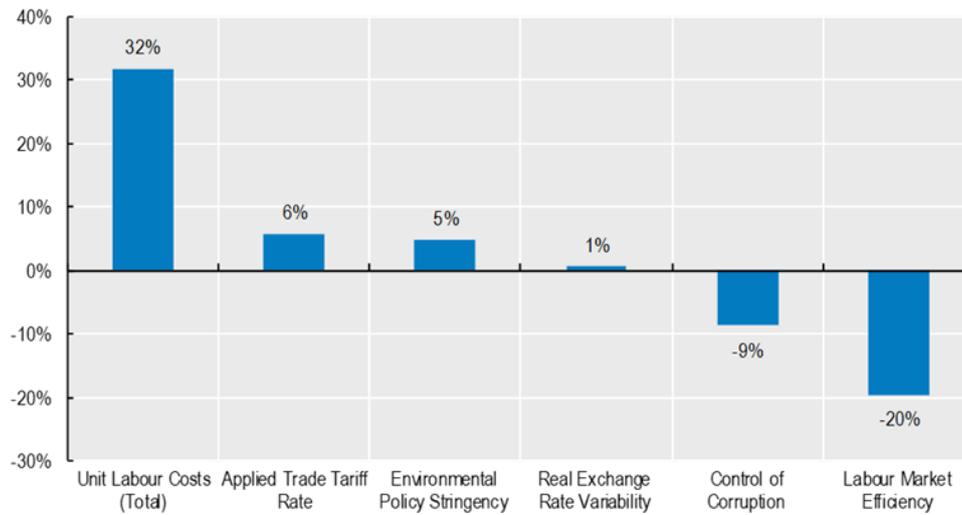
Several host country investment climate policies matter for both FDI attraction and retention, with potential cumulative effects on FDI flows. For example:

- **Unit labour costs (ULCs)** – often treated as a proxy of countries’ competitiveness – are associated with a higher MNE divestment probability.<sup>4</sup>
- **Higher labour market efficiency**, in turn, reduces MNE divestments.<sup>5</sup>
- **Governance and trade policy factors, notably better control of corruption<sup>6</sup>, and lower trade tariffs<sup>7</sup>**, also reduce MNE divestment probability.
- **Increased regulatory environmental stringency** increases foreign divestment probability, albeit by a small margin.<sup>8</sup>

Meanwhile, some factors are specific to FDI retention:

- **Economic stability**, as proxied by real exchange rate volatility, reduces MNE divestment probability,<sup>9</sup> even beyond the effect of political stability.<sup>10</sup>
- **Tax policy changes** do not appear to be a significant driver of divestments, in contrast to initial MNE investment decisions, which may be related to firms’ ability to shift profits without having to divest their real operations.<sup>11</sup>
- **The quality of education and infrastructure** does not significantly influence divestments, while it tends to be a determinant of investment decisions.

**Figure 5. The role of host country investment climate factors**

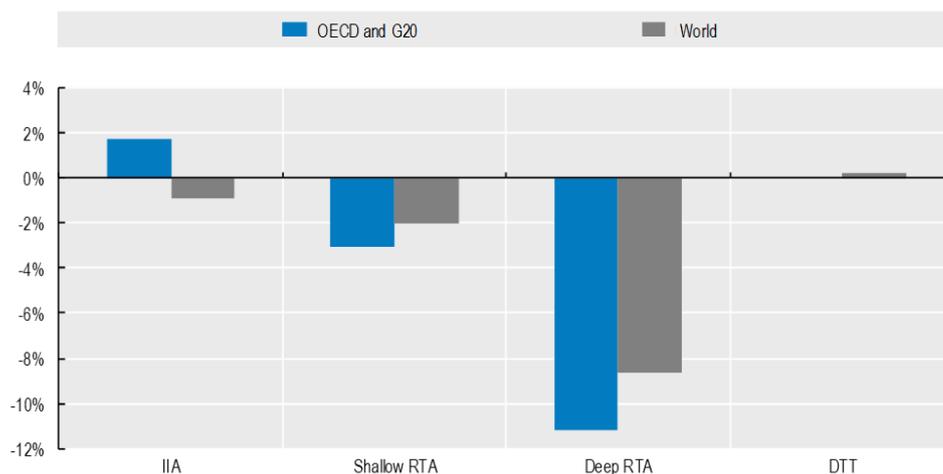


*Note:* The graph shows coefficients from a regression that are statistically significant at least at 10% level.  
*Source:* Borga, Ibarlucea-Flores and Sztajerowska (2020)

## International trade, investment and tax agreements

International economic integration agreements tend to play a significant role in firm divestment decisions. This includes regional trade agreement (RTAs), international investment agreements (IIAs) and double taxation treaties (DTTs). In particular, the existence of a deep RTA between the home country of an MNE and the host country of an affiliate (i.e. a single market or customs union) reduces the probability of foreign divestment by 11% in OECD and G20 economies and has a similar effect elsewhere (see Figure 6).<sup>12</sup> The effect of IIAs and DTTs is more nuanced and depends on the type of economy.

**Figure 6. The role of international agreements**



*Note:* *Shallow RTA* refers to a regional trade agreement with less advanced provisions (i.e. preferential and free trade agreements) and *Deep RTA* refers to customs unions, customs markets and economic unions. The graph shows coefficients from a regression that are statistically significant at least at 10% level.  
*Source:* Borga, Ibarlucea-Flores and Sztajerowska (2020)

## The role of business considerations

Firm-specific considerations, notably at the level of the economic group as a whole, also play a significant role in divestment decisions. For example, parents with larger and more international groups are more likely to divest and so are MNEs in poorer financial condition.<sup>13</sup> The poor performance of an affiliate itself also matters, but less systematically and has a small effect on the divestment decision of an MNE.<sup>14</sup> The data shows no strong evidence on the role of some of the strategic factors found in the management studies, such as the parent's overall level of sectoral diversification or a business relationship with the affiliate, once other factors are accounted for. This could merit further attention as it may suggest that opportunistic divestments may be relatively more common than strategic ones that aim to refocus the business direction.

## What are the lessons for policymaking?

The findings most relevant for policy makers and interested business leaders include:

1. **Divestments should not be underappreciated** as a corporate and economic phenomenon and may require policy-makers' further attention.
2. **Policies have a clear role to play** as several types of domestic regulations and international agreements are found to influence divestments.
3. **FDI retention and attraction are not necessarily two sides of the same coin** as firms react differently with investment and divestment decisions.

This means that:

- **Governments should consider a more focused stance towards FDI retention.** This may involve routinely considering the risk of firm divestment in reflections on the optimal policy design. Also, policies that are found to influence both MNE investments and divestments – notably, more efficient labour markets, lower trade tariffs, stricter control of corruption, and use of regional trade agreements – may merit policy makers' particular attention due to their possible cumulative effect on FDI flows (i.e. via increased new investments and decreased divestments).
- **There may be trade-offs between the goal of reducing MNE divestments and achieving other policy objectives.** Higher labour market efficiency, lower unit labour costs, and lower environmental regulatory stringency reduce the risk of MNE divestments. Yet, these divestments may be desirable based on other socio-economic objectives, such as the protection of the environment or the well-being of workers. To assist in the balancing act between these various considerations, governments may wish to consider the possibility of firm divestments alongside other socio-economic dimensions, for example in the regulatory impact assessments (RIA) they undertake when preparing new regulations.
- **Future trade negotiations may consider the effect on MNE divestments.** The existence of regional trade agreements between the home country of an MNE and the host country of an affiliate – and in particular those with deep provisions (e.g. the single market or a custom union) – is strongly associated with a reduced divestment probability. In the context of forthcoming (re)-negotiations of such treaties, both the general public and policy makers may wish to bear this relationship in mind. To the extent that the presence of MNEs may be associated with both direct and indirect benefits, such as job creation, their decision to leave may not be a good omen.
- **In sum, it is not old wine in new bottles.** As mentioned earlier, MNEs react to different parameters in their investment and divestment choices. For example, tax policy changes do not appear to be a significant driver of MNE divestments.<sup>16</sup> Other factors routinely targeted by countries in their FDI attraction efforts, such as infrastructure development or improvements in the level of education, also seem to play a lesser role. Future analysis could shed further light on these issues to help countries develop FDI retention policies that respond to business reality.

## Endnotes:

<sup>1</sup> Divestment is defined as a change in the affiliate's ownership structure that involves a transfer of majority-control over a firm from a foreign to a domestic owner. Business closures are not taken into account due to data limitations and for conceptual reasons. See Borga, Ibarlucea-Flores and Sztajerowska (2020).<sup>17</sup>

<sup>2</sup> The OECD database contains firm-level financial and ownership information for over 62,000 foreign-owned affiliates from 41 selected OECD and G20 countries as well as their economic groups of their parents from 164 home countries for the period 2007-2014. The database is built using ORBIS © data. See Borga, Ibarlucea-Flores and Sztajerowska (2020) and OECD (forthcoming) for more information.

<sup>3</sup> For example, using firm-level data for Indonesia, Javorcik and Poelhekke (2017) find that sold-off plants experienced a drop in productivity, output, mark-ups, as well as export and import intensities.

<sup>4</sup> The information on ULCs come from the OECD Productivity database and are defined as the average cost of labour per unit of output produced (see OECD, 2018). A 10% increase in ULCs is associated with an increase in foreign divestment probability by 3 percentage points, on average.

<sup>5</sup> The World Economic Forum's Labour Market Efficiency Index covers a series of different labour practices (e.g. cooperation in labour-employer relations, flexibility of wage determination, hiring and firing practices, redundancy costs, effects of taxation on incentives to work, pay and productivity). A 10% increase in a country's labour market efficiency reduces foreign divestment probability by 2 percentage points.

<sup>6</sup> Control of corruption is measured by the Transparency International Corruption Perception Index (CPI) (where 0 means "highly corrupt" and 100 means "very clean"). An improvement by 10% in a country's level of control of corruption is associated with a reduction in foreign divestment probability of 1 percentage point, on average. Alternative metrics of control of corruption sourced from the World Bank's Worldwide Governance Indicators are also used and yield similar results.

<sup>7</sup> The information on trade-weighted average tariff rate comes from the International Trade Centre (ITC). A 10% increase in a country's tariffs is associated with an increase in foreign divestment probability of 0.5 percentage points, on average. Trade openness itself, measured as the ratio of trade (exports plus imports) to GDP, also increases divestment probability, all else being equal.

<sup>8</sup> The level of stringency of environmental protection is measured by the OECD Environmental Policy Stringency Index (see Botta and Kozłuk, 2014). A 10% increase in a country's stringency of environmental protection is associated with an increase in foreign divestment probability of 0.5 percentage points, on average. This result is in line with earlier studies on FDI (Garsous and Kozłuk, 2017).

<sup>9</sup> The information on the real exchange rate comes from the World Bank's World Development Indicators and its volatility is calculated as a standard deviation in real exchange rate changes over a three-year period (following Berry, 2013). Annual inflation rate in consumer prices is included as an additional measure of instability. Once exchange rate variability is controlled for, its level as well as inflation rate are not statistically significant.

<sup>10</sup> A measure of political stability is based on the Political Instability and Absence of Violence Index from the World Bank's Worldwide Governance Indicators.

<sup>11</sup> This is consistent with FDI trends. For example, while the U.S. tax reform has led to a 28% drop in FDI flows in 2018, so far it has been driven by disposals of financial rather than real assets (see OECD, 2019a),

<sup>12</sup> The estimates for OECD and G20 economies are done for 41 countries while the estimates for the world include a sample of 146 economies worldwide for which data are available in ORBIS ©.

<sup>13</sup> The size of the economic group is measured as the total assets (reported in the financial accounts at the consolidated level) and the internationalisation ratio is calculated as a share of foreign to domestic affiliates. Financial condition of the parent is proxied by the solvency ratio of the economic group, defined as a ratio of shareholders' funds to total assets in the group (reported at the consolidated level).

<sup>14</sup> The performance of the affiliate is measured as the return on assets (ROA), calculated as the ratio of EBITDA to total assets (reported in the financial accounts at the unconsolidated level).

<sup>15</sup> For more information on the use of RIA, see e.g. Deighton-Smith, et al. (2016).

<sup>16</sup> This may be because firms are able to repatriate profits without divesting real assets, which may change with advances in the Base erosion and profit shifting (BEPS) project (OECD, 2019b).

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## Links

- OECD FDI Statistics database, [www.oecd.org/investment/statistics.htm](http://www.oecd.org/investment/statistics.htm)
- OECD FDI Regulatory Restrictiveness Index, [www.oecd.org/investment/fdiindex.htm](http://www.oecd.org/investment/fdiindex.htm)
- OECD Investment policy tools, [www.oecd.org/investment/oecdinvestmentpolicytools.htm](http://www.oecd.org/investment/oecdinvestmentpolicytools.htm)

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For more information, please contact [maria.borga@oecd.org](mailto:maria.borga@oecd.org), [monika.sztajerowska@oecd.org](mailto:monika.sztajerowska@oecd.org), or [perla.ibarluceaflores@oecd.org](mailto:perla.ibarluceaflores@oecd.org)

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