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**Globalisation - detecting and analysing MNE restructuring**

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This document has been prepared by Paul Konijn – Eurostat and will be presented under item 6 of the draft agenda

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## *Globalisation - detecting and analysing MNE restructuring*

### *Abstract*

*Eurostat has adopted an approach to study specific real-life cases related to changes in location, ownership of assets or economic control of multinational enterprises as well as global production arrangements. The aim is to agree on a coordinated recording of these events in the accounts of the countries concerned. An agreed treatment of these cases can provide examples for other similar cases and thus develop a body of methodological guidance. This paper describes a few of such globalisation cases that Eurostat has dealt with in recent months, including a discussion on conceptual aspects of these cases. In addition, the recently established "Early Warning System" will be presented, which aims to gain and share early information on such cases and to coordinate the approaches of the countries concerned.*

## 1. INTRODUCTION

1. To develop further methodological guidance on the national accounts recording of restructuring of multinational enterprises or global production arrangements, Eurostat has started to study real-life cases in order to ultimately agree on a coordinated recording in the accounts of the countries concerned. An agreed treatment of such globalisation cases can provide examples for other similar cases and thus aid the further development of conceptual guidance.
2. The cases can be triggered by events such as the move of an enterprise or assets from one country to another. Eurostat has established an "Early Warning System" (EWS) which aims to identify important restructuring cases, and to agree a common recording, preferably before they materialise or need to be incorporated in business statistics, balance of payments or national accounts.
3. This document describes three actual cases, which can be seen as pilot cases for the EWS. The cases are described in anonymised and stylised form, in order to draw out the most important underlying conceptual aspects.
4. Two of the three cases relate to online trade. Eurostat considers that such cases pose specific measurement issues: due to their intangible nature it can be challenging to determine where the productive activities actually take place. The number and size of such internet-based enterprises are quickly rising.

## 2. The early warning system

5. Recent economic decisions of multinational enterprise groups (MNEs) regarding their place of incorporation, ownership of their assets and economic control resulted in sizeable revisions of European business statistics and National Accounts/Balance of Payment statistics.

6. Recording such globalisation events in a timely and consistent way across all Member States concerned, and consequently in European statistics, is a major challenge. A close coordination between the Member States affected by such globalisation events and Eurostat is needed, in cooperation with the ECB and the OECD (where non-EU countries are involved).

7. To ensure consistency in terms of applied methods, statistical treatment and communication of results across the ESS, the "Early Warning System" has been set-up. It is intended as a clearly structured, but light (non-legislative) procedure based on the voluntary cooperation between national data compilers and Eurostat, as well as between business statisticians and national accountants. The EWS is a learning process that will be continuously improved with more experience.

8. The purpose of the EWS is:

1. to facilitate an early knowledge of restructuring cases across Member States directly concerned with the aim of achieving, to the degree possible, an agreed methodological treatment of the cases by the national data compilers;
2. to ensure the consistency of European statistics as regards such globalisation events;
3. to ensure a coordinated timing in the publication of first results and revisions;
4. to ensure a timely, harmonised and interlinked communication towards users of national and European statistics.

9. The EWS should be triggered in the following cases:

1. The restructuring of one or more MNEs affects not only one country, but two or more (these may also include non-EU countries). Restructuring of MNEs means that an MNE changes the group structure or distribution of its business model across countries (e.g. creation of new branches or other entities, the transfer of assets across borders, changes of global production arrangements such as contract manufacturing).
2. The restructuring has sizeable effects on national and on European statistics. This should be judged in looking at the published data. Special attention needs to be given to National Accounts main aggregates, the Principal European Economic Indicators (PEEIs) and similar data with a high visibility.
3. Since the countries concerned might be very different in economic size and structure, a single quantitative threshold for triggering the EWS does not look

appropriate. When dealing with restructuring cases, medium-sized and big countries should also consider the effects on smaller countries, in particular when they already know that such countries are affected.

4. The impact on the data published should also be considered in the light of the size of normal revisions for the statistics in question. Moreover, breaks in unadjusted, calendar adjusted and/or seasonally adjusted time series as well as revisions covering longer time intervals than usually in the unadjusted data should also trigger the system.
  5. The granularity of the data published as European statistics should be taken into account (e.g. the NACE breakdown of the data published).
  6. The EWS may also be consulted when national data compilers are in doubt regarding the correct treatment of a specific restructuring case.
10. Based on the experience from the start-up phase of the EWS, more precise criteria will be defined later on.
11. Member States should trigger the EWS as soon as they learn about the restructuring of an MNE with sizeable effects on national and European statistics. National data compilers should not wait until all facts about such cases are available. The EWS could also be triggered by information at the European level, for example by Eurostat.
12. As soon as a restructuring case has been reported to the EWS, an ad-hoc Task Force will be formed consisting of the countries concerned and Eurostat. This Task Force will provide an opinion on the case and possible ways to treat it in the national and European statistics concerned. This opinion and an anonymised summary of the case will be shared with the other Member States, who may offer their own views.
13. Information shared between (and among) countries and Eurostat in the context of the EWS is limited to what is absolutely necessary to achieve the EWS purpose and treated securely and confidentially.
14. Within Europe, the ECB and NCBs are important data compilers in some areas of official statistics, such as balance of payments and financial accounts. They are also major users of business statistics and National Accounts. The involvement of the OECD may be useful in cases where countries outside the EU are involved in a globalisation event. The details of the cooperation between the European Statistical System and the European System of Central Banks regarding the EWS are being further discussed. This will also happen for the OECD.

### 3. Three case studies

In this section, three cases are described that can be seen as pilot cases for the EWS.

#### 3.1. An online retailer

##### *Situation 1 (before restructuring)*

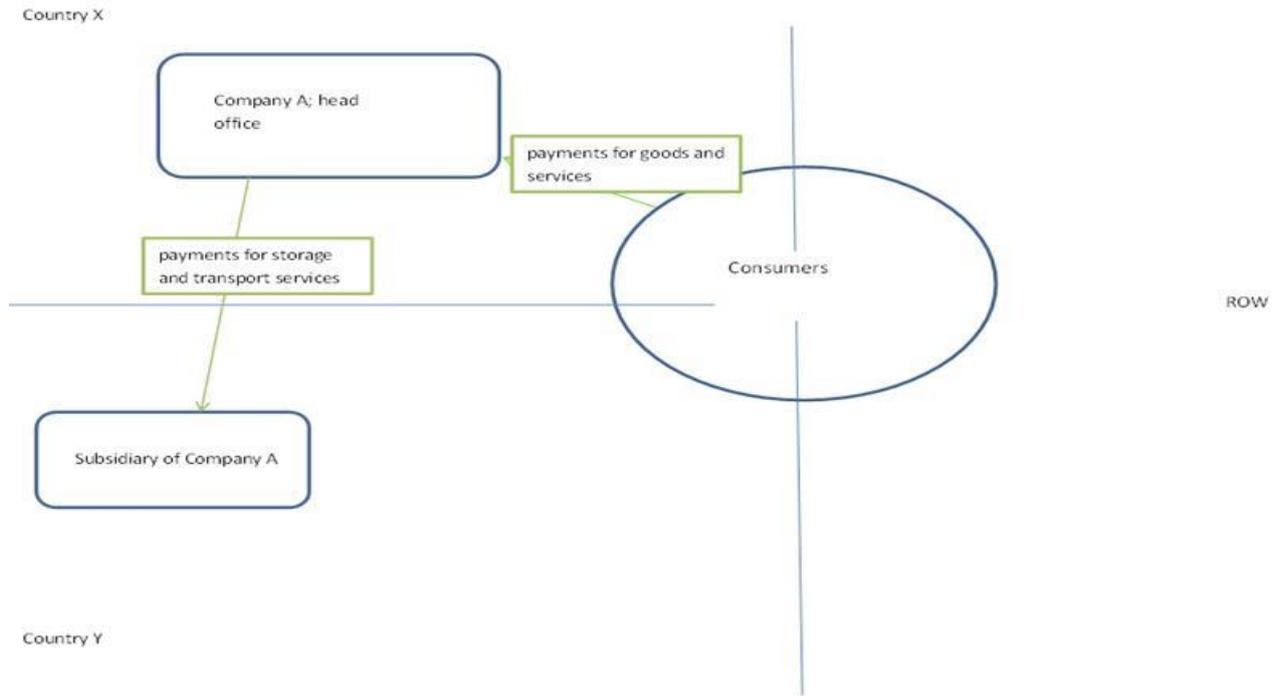
15. Company A is an online retailer with head office in country X. However, its website has domain name in country Y (i.e. the address is "www.website.y"). It keeps its stock of merchandise in country Y, managed (but not owned) by a subsidiary. A consumer in country Y that buys a product from the A website receives an invoice from country X, even though the product has not crossed the border. Consumers in other countries can also shop at the A website and receive the products from country Y and the invoice from country X. The IPP assets (the software behind the website, customer data, etc.) are held by the head office. The head office also controls the website. Company taxes are paid in X. Statistical reporting is only done in country X.

Treatment in national accounts:

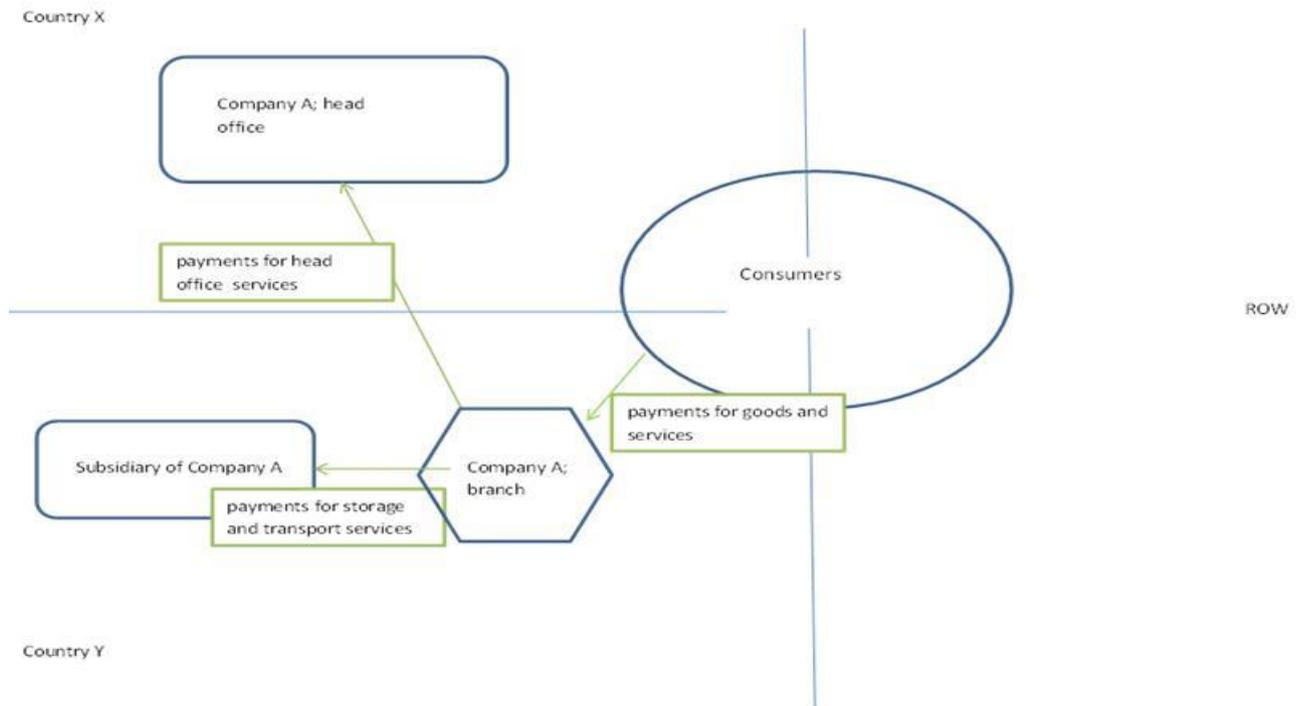
*Option a):* All trade activities are produced in country X and booked as merchanting. The value added generated by A thus contribute only to the GDP of X. In country Y, the production or import of the merchandise is recorded, as well as their household consumption or export. In addition, an import of merchanting services from country X is recorded.

*Option b):* As the website is considered to have substantial operations in country Y, a notional unit is created to which the trade turnover is attributed, as well as the stock of merchandise. Thus, the unit will also contribute to the GDP of Y.

Situation 1:



Situation 2:



### Situation 2 (after restructuring)

16. At a certain moment, the company decides to restructure its operations. The tax authorities in country Y have raised the question why company A does not pay income taxes in Y. Thus, it creates a branch, i.e. an unincorporated unit, in country Y. The company states that the branch now takes care of the sales from the website and invoices are sent from country Y. The company starts paying company tax in Y and also start reporting turnover and employment to the statistical office of country Y. The published annual accounts of company A are consolidated.

17. However, total employment in country X is not reduced. The branch is registered on the same address as the subsidiary that manages the stock of merchandise. In Y, total employment of the affiliate company plus the branch is not substantially increased. The branch starts paying "head office fees" that also cover payments for the use of the website.

Statistical reporting is done in countries X and Y, but no retail trade turnover is reported in country X.

Treatment in national accounts:

*Option a):* The branch is deemed not to have sufficiently substantial operations (but exists merely in legal form) and is thus not a separate institutional unit. The national accounts in X and Y should continue to record the activities of company A as in situation 1, option a), the only difference being that the company starts paying taxes on income to country Y.

*Option b):* The branch is an institutional unit in country Y (as it is deemed to have substantial operations in country Y) and all trade turnover is recorded in this country. Value added is recorded in countries X (mostly capital) and Y (mostly labour). Thus, the recording will be the same as in situation 1, option b).

### Discussion

Where should the online trade activities of company A be recorded? A's trade services, the actual buying and selling of goods, are a prime example of production that happens "in the cloud". They have no (or practically no) physical component; the subsidiaries managing the stock do not count as they do not produce trade services.

Irrespective of the fact that the company is registered in country X, most consumers (and, apparently, the tax authorities in Y) will see "www.website.y" as a website based in Y selling to a clientele that is mostly from Y. The website itself gears its selection of products to the tastes of Y's consumers. Furthermore, allocating the turnover that is realised mainly in country Y entirely to the accounts of country X will distort the latter especially if country Y is much larger than X.:

The recording in national accounts depends specifically on whether the company (or its branch) is seen as having substantial operations in country Y. ESA 2010, para 18.12 states:

*"A branch is an unincorporated enterprise that belongs to a non-resident unit, known as the parent. It is treated as a resident and a quasi-corporation in the territory where it is situated. The identification of branches as separate institutional units requires indications of substantial operations that can be separated from the rest of the entity."*

18. On the one hand, the branch in country Y reports turnover and employment to the statistical office. On the other hand, the restructuring may not be much more than a legal

operation. If it is considered that the branch has substantial operations, and given the fact that the restructuring did not materially alter capital or labour inputs in the two countries, the logical conclusion must be that A already had substantial operations in Y before restructuring. This would then lead to the conclusion that notional branches should be created in situation 1.

19. Allocating the trade activity to country Y in situation 1 would raise the question if the IPP assets also should be moved. In the situation after restructuring, where a branch is created, this would not be the case (only the stock of merchandise would be visible on the accounts of the branch, otherwise no selling of merchandise by the branch is possible). The UNECE Guide to Measuring Global Production, figure 4.1, would lead to treating the IPP as owned by the unit in X (case 1.2.1.1. or 1.2.1.3 of the decision tree), both before and after restructuring. However, ownership of assets can be difficult to define in the case of companies with branches, as a branch cannot own an asset independently of its parent (as they are legally and economically the same company).

### Outcome of May NAWG

20. This case was discussed at the May 2017 meeting of Eurostat's National Accounts Working Group (NAWG). The NAWG noted that the case was complex and that the particular difficulty was to determine economic ownership (e.g. of the merchandise stock). This is due to two specific characteristics: that the trade is internet-based and the branch-structure of the company in question. The NAWG was not in favour of creating notional branches where actual branches do not exist, but where the company has an online presence in a country.

21. Eurostat proposed therefore, to the countries concerned, to treat the case in national accounts and balance of payment in line with the business statistics. Concretely, this means choosing option a) in situation 1 (before restructuring) and option b) in situation 2 (after restructuring). The countries agreed with this (and are currently implementing it). Although it was recognised that it could not be fully ascertained that an actual change of economic ownership took place during the restructuring, it was considered to be the most plausible assumption.

### **3.2. An online media content seller**

22. Company T, registered in country W, sells downloadable music over the internet. It makes its sales through online stores in many countries. The online stores are different across countries, depending on the rights the company has to sell the content in each country. Prices vary between countries. A consumer will need a physical address and a credit card in the country in order to be able to purchase content in that countries' store.

23. The company does not own the content, but pays for the right to distribute them. Hence, no significant intellectual property (originals or licenses to reproduce) appears on its balance sheet.

24. The company employs around 30 people in country W. The company's main activity is to arrange the invoicing. The company is not responsible for the software that is needed to use the content on computers or mobile devices, or for the management of the content of the store.

25. Company T reports to the statistical office of country W. Hence, its entire activity appears in country W's business statistics and national accounts (as merchanting). The value added generated is however relatively modest.

26. At a certain moment, the mother company of T decides to merge T into another existing unit in country V. It disappears entirely from country W. The output and value added thus would move from W to V if the new legal arrangements are followed in the accounts.

27. However, the company could at any time decide to again relocate the unit managing these sales to another country. Such relocations affect the national accounts (GDP to a limited extent, but distributions of output by industry are affected more) but the actual economic impact is limited to a small number of staff and a change in the country of taxation.

#### Discussion

28. There are some similarities with the case described in section 2.1. For example, consumers will consider each country's store as a separate outlet in their country, as if there were a physical presence. In this case, however, consumers can only buy from the store in their own country, whereas in the first case consumers can buy in any store.

29. Hence, there may again be some arguments for interpreting this case as one of a "multi-territory" enterprise that operates seamlessly across countries, without having established branches (see ESA 18.17). It could be said that the company has substantial operations in each country, even if there is no actual physical presence. It could therefore be argued that each of the stores should be seen, in the national accounts, as a separate notional branch of company T. This would amount to distributing the total sales of T over all countries where it operates. National VAT data should give information on sales in each country.

30. This would of course be a complex operation in reality, as there are many countries involved in this case. It is also not immediately clear which inputs should be allocated to such notional branches.

#### Outcome of May NAWG

31. This case was also discussed at the May 2017 meeting of Eurostat's NAWG. The meeting considered the relocation a real economic change and was not in favour of creating notional branches. The countries concerned have in the meantime implemented the relocation.

### **3.3. Outsourcing between affiliated enterprises**

32. A large global company has a factory in country B, employing about 2000 people. This factory, according to the published annual accounts, produces only manufacturing services worth around 275 M€, giving a profit of around 35 M€. It reports to the statistics office that these services are invoiced to another unit of the same company based in country C. Hence, it records an export of processing services to country C.

33. The respective unit in country C employs only 10 people. However, its published (consolidated) annual accounts report sales of goods of around 1300 M€, giving a profit of around 360 M€. Both units include inventories of materials and finished products on its accounts, as well as a small amount of IPP. The unit in country B declares that the produced goods and the inputs are legally owned by the unit in country C.

34. The unit in country C has a branch in country B, based at the same address as the factory mentioned above, employing one person. The statistics office of country C receives data from the unit that includes only the activities of the resident part of the unit,

to be included in the BOP and national accounts. The branch in country B is considered non-resident by the statistics office of country C. The statistics office of country C states that the 1300 M€ sales of goods is booked in the accounts of the branch and should thus be included in the national accounts of country B. As a consequence, country C does not record an import of processing services, as these are considered to be purchased by the branch in country B. Hence, an asymmetry between the BOP of countries B and C arises. Moreover, the output of 1300 M€ seems to be recorded nowhere. Country C records only a minor amount of royalties received from third parties in its accounts.

35. The crucial question is who is in control of the production process? The answer to that question can probably only be found in joint profiling of the company by the two countries involved.

36. In Eurostat's view, the most plausible recording of this production arrangement would be based on the assumption that control is exercised from country B. It is not realistic to assume that the small unit in country C controls the production process of the large factory in country B.

37. The production value that is allocated in the accounts of the company to the branch should, in national accounts and BOP, be assigned to the factory in country B, de facto merging the two units for statistical purposes. There should then be no export of manufacturing services from country B to C.

38. This case is still being discussed with the countries concerned.

## 4. Conclusions

39. This paper presents three separate cases where globalisation (and, in two of them, also digitalisation) plays a role. The three cases presented raise some interesting questions, e.g.

- how to determine the location where internet services are produced?
- should notional branches be created for internet services in order to allocate production to those countries where substantial operations are deemed to exist?
- in general, how to deal with branches in relation to ownership of assets and control of production?
- how to ensure consistent recording of transactions within MNEs across countries, in the sense that no output or value added goes unrecorded or double counted?