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## Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues

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### **Divestments by MNEs: What do we know about why they happen?\***

by

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Divestments are frequent corporate phenomena. Firms routinely invest and expand their operations as well as downsize and sell their business activities at home and abroad. In fact, about one in five foreign affiliates is divested every five years.<sup>1</sup> A 2020 global business survey also suggested that 78% of surveyed firms planned to divest some operations in 2021.<sup>2</sup> With the global pandemic, cross-border divestments may rise if rising debt levels and liquidity constraints drive companies to sell off some of their foreign operations. In the longer term, the COVID-19 outbreak, together with such factors as digitalization and trade tensions, could lead companies to rethink their global supply chains. Even before the current crisis, investment retention was discussed within the [WTO](#), the G20 Trade and Investment Working Group and the [World Bank Group](#).

However, governments that proactively attract FDI may wish to retain it. For example, investment promotion agencies (IPAs) increasingly focus on investment facilitation and aftercare services and engage in broader policy advocacy.<sup>3</sup> Nevertheless, divestment enables MNEs to optimize their business portfolios by shifting resources from less productive to more productive uses and may reflect a natural evolution of firms' local investment activities. From that perspective, divestments may be a positive signal for host economies if they, for example, result from host economies developing and becoming less attractive for low-wage or pollution-intensive activities.

There is a large literature on factors influencing MNE investment decisions. These studies explore the importance of tax policy, institutions, education, infrastructure, and international agreements, including free trade agreements (FTAs), and firm characteristics, among others. There are also numerous studies analyzing the role of business factors, such the geographic and sectoral diversification of parent firms. Yet, little is known about the relative role of different divestment drivers across a large group of countries, and the importance of public policies. What can we say about drivers of MNE divestments?

First, policies clearly matter, on top of traditionally-studied business factors such as divested business units' performance or the financial health of MNEs' economic groups. For example, domestic regulations affecting labor market efficiency and unit labor costs play a prominent role. International trade and investment rules clearly matter to MNEs, as higher applied trade tariffs increase divestments. An FTA between the countries of an affiliate and its parent firm also reduces the divestment probability by about 10 percentage points, all else equal. The effect is stronger for deeper FTAs (e.g., customs or economic

unions) that include rules beyond trade tariffs, including provisions on international investment. Among business factors, group-wide considerations—such as overall financial health or liquidity constraints—are stronger predictors of divestments than affiliate performance itself.

What are the main policy lessons learned?

- The risk of divestment should be explicitly taken into account when designing investment policies. Whether negotiating new, or exiting old, trade and investment agreements or deciding on the overall framework for regulating FDI, investment incentives or IPA services, the possibility of divestment must be reflected in the policy design.
- There may be trade-offs between investment retention goals and wider policy objectives. As such, far from pursuing investment retention as a goal, policymakers will need to balance different objectives. It is important that investment-retention policies do not introduce distortions, such as those that can occur when governments offer incentives to preclude divestments.
- Countries should start reflecting divestments in official FDI statistics. Only a few countries regularly report data for both equity capital increases and decreases.<sup>4</sup> Yet, such data could help researchers and policymakers better understand FDI dynamics.

Finally, much is still to learn: studies using granular data on policy design and local country and firm characteristics can make useful contributions. A business reality, yet far from the mere flipside of investment, divestments clearly merit more of policymakers' and researchers' attention.

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<sup>1</sup> The focus is here on voluntary sale of business units by foreign investors to domestic investors using a firm-level dataset covering foreign affiliates in selected OECD and G20 economies between 2007 and 2014. The definition of divestment, geographic scope and time frame were limited by data availability. Yet, it did enable the analysis of divestment drivers and the impact of the loss of foreign investors on the operations of firms for a large number of countries. The time frame captured the global financial crisis' effects on firm divestment. (This may mean that the drivers differed from other periods, but it may also make the findings relevant to understanding the pandemic's effects on divestment.) This is relevant because there is a large literature on the possible positive effects of foreign ownership on performance of firms and potential second-order effects on host economies.

<sup>2</sup> [Ernst & Young, \*Global Corporate Divestment Study 2020\* \(London: Ernst & Young, 2020\), p. 1.](#)

<sup>3</sup> [OECD, \*Mapping of Investment Promotion Agencies in OECD Countries\* \(Paris: OECD, 2018\).](#)

<sup>4</sup> For example, the [US Bureau of Economic Analysis](#) provides such information annually.

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