**Transnational companies and finance**

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### 1. Introduction

The transnational companies (TNCs) are companies that own assets and conduct direct business activities in at least two countries. There are several modalities of cross-country business operations: from trade to joint ventures, franchising, licensing to foreign direct investment (FDI). It is the involvement in FDI that characterized a company as transnational.

Foreign direct investment can take place via greenfield investment – in which a plant, building, business is started from scratch – or via mergers and acquisitions (M&As), in which an existing foreign business is bought.

Most FDI between WWI and WWII was directed towards developing countries and was mainly in the primary sector. The decades after WWII saw a surge in FDI, particularly in manufacturing, with a shift in geographical direction towards developed countries. In the last 35 or so years there has been considerable growth in FDI alongside a shift in the sectoral shares towards FDI in services worldwide. In the last ten years there have been also growing amounts of FDI originating from emerging countries and directed mainly towards developing countries though with an increasing number of acquisitions of companies in some developed countries.

The surge of TNCs’ activities after WWII prompted economists to initiate special studies of them and their activities. The theory of the TNC started with the seminal work of a Canadian doctoral student (Hymer, 1960, published 1976) working in the US at the Massachusetts Institute of Technology. Many theories of the TNCs have been developed since.

The quantitative, sectoral and geographic trends in FDI are linked to worldwide economic, political and technological developments. On the economic front the growth rates of Europe after WWII and some developing countries – China, India, Brazil - in more recent decades account for some of the major trends and patterns.

### 2. The political context

On the political front the 1960s and early 1970s were characterized by critical attitudes towards the activities of TNCs. This has been seen as the period of confrontation between TNCs and national governments. Servan-Schreiber (1968) led the attack on American investment in Europe. Moreover, there were large numbers of nationalisations of foreign affiliates particularly in developing countries. UNCTAD PTC (1993: fig. 1, p. 17) shows that the number of nationalisations peaked in the mid-1970s and became non-existent after the mid-1980s.

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1 For general concepts and theories of the TNC see Ietto-Gillies (2001) Part I and III respectively.
The trend reversed and attitudes changed. Decades of co-operation followed those of confrontation between national governments and TNCs (Dunning, 1993: ch. 13). Far from threatening nationalisations many governments in developing countries followed in the footsteps of some developed countries with policies to attract FDI and with large-scale privatisation programmes from the 1980s onwards. The privatised assets of developing and transition economies were often bought by foreign companies.

The 1990s became a decade of confrontation but, this time, not between governments and TNCs (Ietto-Gillies, 2002a: ch. 10). It was a confrontation at global level by protesters – grouped around non-governmental organizations (NGOs) – against TNCs and those international institutions seen as the protectors of TNCs’ interests, such as the World Trade Organization (WTO).

A recent history of the successive departments dealing with TNCs within the United Nations (Sagafi-Nejad, 2008), allow us to map the changes just described against political relationships between the UN and the TNCs. Three politically-relevant phases can be identified within the life of the UNCTAD department dealing with TNCs. An early phase characterized by ‘severe turbulence’ (Moran, 2009: 92) in which the United Nations Centre on Transnational Corporations (UNCTC) was asked to look into the framing of a legally-binding code of conduct for TNCs. This call came in the aftermath of political turbulence following the report of an American journalist of a plot by the CIA and the International Telephone and Telegraph (ITT) company to overthrow the government of Salvador Allende in Chile. Meanwhile, the activities of the Swiss TNC Nestle in pushing baby formula milk against breast milk were also under scrutiny. After many years of discussions the efforts within the UN came to nothing and no code of conduct was agreed: the powerful TNCs via their developed countries’ politicians blocked the attempts by developing and socialist countries to establish such a code. In 1992 UNCTAD and the department for TNCs was moved to Geneva. A second phase followed in which political and ethical issues were avoided. In 1999, the UN Secretary-General Kofi Annan proposed a ‘Global Compact’ i.e. an ethical code of Social Corporate Responsibility asking ‘companies to embrace, support, and promote a set of ten principles related to human rights, labour, the environment, and anti-corruption.’ (Moran, 2009: 105). But this is a voluntary code: companies do not have to subscribe to it and, even when they do subscribe, they may wriggle out of it.

3. The technological and organizational innovation context

Over and above the impact of economic, political and ideological changes in the economy and society, major influences on the TNCs have also come from technological and organizational innovations.

Full control over direct business activities abroad requires equity control as well as strategic and managerial control. The exercise of the latter has been made progressively easier by the technological and organizational innovations of the XX century. The relevant innovations in this context are: (i) changes in the technology and cost of transportation and personal communications, the latter made possible, more recently, by the information and communication technologies (ICTs); and (ii) changes in the internal organization of companies.

Hymer (1970) follows Chandler (1962) in his analysis of the relationship between the evolution in the internal structure of the firm and multinationality and, in particular, considers how the former facilitated the latter2. He distinguishes three major stages in the development of companies and their internal organization. The moves from the single function, single industry firm to vertically integrated large companies, and later to diversified multi-products

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2 These points are considered at greater length in Ietto-Gillies(2011: ch 1).
ones led to changes in internal organization: from control concentrated into one or few people - usually the owners of the company – to a structure where different managers looked after different functions, and eventually to a structure where different products led to different divisions: the multidivisional form (M-Form) of organization. The latter was then used to manage a multinational firm in which the divisions where identified by geographies rather than – or alongside – the products.

Parallel to the evolution of the internal organization, there took place also an evolution in the division of labour within each division and, in many cases, between different subsidiaries of the corporation across different countries. In the last analysis, growth strategies (mass production, product diversification and internationalisation) led to changes in the internal organization and this, in turn, brought a sharper internal division of labour. It also had an impact on the international division of labour.

The increase in manufacturing FDI in developing countries has, largely, been made possible through a mixture of technological and organizational innovations. With the help of the ICTs, companies have split the production process into segments according to the level of skills required. This made possible the location of low-skill, labour-intensive segments of the production process in developing countries and high-skill segments in developed ones. This strategy of international vertical integration has given rise to a New International Division of Labour (NIDL) in which both developed and developing countries participate in manufacturing but for different segments of the value chain.

The ICTs have also had a large effect on services FDI. The electronic technologies allow the instant transmission of documents and form the basis for much of services FDI throughout the world. Moreover, we are seeing the emergence of a newer international division of labour in which pockets of skilled labour in developing countries – accountants, call centre operators, IT experts - are used by investors from developed countries: the new international division of labour in the electronic age (E-NIDL) 4.

These technological and organizational changes have led to an evolving geographical and sectoral pattern of FDI as well as to a greater and greater involvement in transnational activities by companies.

4. TNCs and finance
The very same political and innovation contexts that affected the TNCs, their activities and their relations with other stakeholders have also influenced the growth of the financial sector worldwide, specifically the neo-liberal agenda in politics and the ICTs.

But what is the relationship between TNCs and finance? 5 Quite a close one, for various reasons. For a start, there is a very large number of transnational firms operating in the financial sector. Indeed most large financial sector firms are transnationals. Financial products are easily transmittable and segments of their production processes can be embedded in different geographies and cultures. In 2008 the finance sector accounted for 22.7 percent of the total world stock of FDI.

Second, most large companies are diversified and many of the companies whose activities are largely in manufacturing or distribution are involved in financial activities and offer financial services: a visit to the local supermarket or department store usually ends with offers of financial services. In some cases the financial side outstrips their non-financial activities. Enron is a case in point: a company that began with activities in the primary sector,

3 See Frobel et al (1980).
4 See Ietto-Gillies (2002b).
5 I am not here considering the impact of the financial sector and of financial crises on the real economy including that for which many TNCs are responsible (see Epstein, 2005, particularly the chapters by Crotty, 2005 and Crotty and Lee, 2005).
moved into purely financial and speculative business. Following its collapse government and media criticisms concentrated on the (il)legal side of business, on the lack of transparency and on the collusion between management and auditors. Yet there are other – legal – more worrying aspects of the Enron saga which have to do with systems: the system of corporate governance; the system of industry (de)regulation; and the macro system. On the latter we are talking of a system in which the rent-seeking financial side of business became much more lucrative than the production of goods and services.6

Third, all large companies – and most large companies are transnationals – are involved not only in direct investment but also in portfolio investment i.e. investment in which the company does not have equity control and which, usually, undertaken not as a long term commitment but with more assets diversification and/or speculative aims.

The fourth point emerges from a closer analysis of the FDI modes: greenfield or M&As. (1) In the case of greenfield the investment results in new productive capacity for both the company and the host country where the investment takes place. (2) In the case of M&As the investment operation results in the creation of new productive capacity for the TNC but not for the host country. From the point of view of the host country all that is happening is a change of ownership: a firm and its productive capacity which were owned by nationals, are moved into the ownership of a foreign firm. Indeed, very often, following post-merger restructuring operations, the productive capacity in the host country is reduced in the short to medium term. There may, however, sometimes be further capacity-creation investment in the longer period.

Mergers and acquisitions can be seen as purely financial operations to which there is no corresponding creation of capacity but from which there are important consequences for the real sector. These derive from the restructuring operations just mentioned. Moreover, mergers have relevant effects on the structure of an industry as they usually lead to reduced competition. This is the reason why competition authorities in various countries often take an interest and rule on whether the deal can go ahead or not. In 2009 over 40 percent of the value of M&As purchases worldwide was attributed to the finance sector; this is an indicator of the relevance of finance for M&As and FDI. Moreover, the process leading to all M&As - whichever their sector of origin - involves the financial sector.

The fifth financial consequence derives from the different regulatory regimes of the nation-states in which TNCs operate. In Ietto-Gillies (2011: ch 14) it is argued that the different regulatory regimes of nations-states are the reason why we need special studies of the companies that operate direct business activities across countries. The difference in regulatory regimes generates opportunities for strategic behaviour. The regulatory regimes considered relevant for strategies are: currency regimes, fiscal regimes, social security/labour market regimes and environmental and safety standard regimes. The first two fall within the realm of financial economics directly or in terms of their effects.

Another major indirect effect may come about via the manipulation of transfer prices. These are prices charged by one part of the company (headquarters or one of the subsidiaries) to another part (any of the subsidiaries or headquarters) for the internal transfer of goods and services. The internal prices may or may not reflect actual costs and scarcity and therefore they may or may not be set at the same level as market prices i.e. the prices that are actually – or could potentially be - charged to independent, external clients for arm’s length transactions.

When the internal transfer of goods and services takes place across border as part of transnational activities, the corporations have the opportunity to develop pricing strategies

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6 Ietto-Gillies (2010) puts forward the view that the stagnationist tendency of advanced capitalist systems is at the basis of the shift of investment from the real to the financial sector.
that maximize the overall returns for the company as a whole. Such strategies may lead to the so called ‘manipulation of transfer prices’\(^7\). The word manipulation refers to the setting of prices for internal transfers at different levels compared to the prices which might be charged to external clients, i.e. different levels compared to the actual or potential market prices. Why would a company want to manipulate transfer prices? In what conditions and for what reasons would such a manipulation lead to higher overall profits?

The main reasons for the manipulation of transfer prices are the following.

- To minimize of the tax liabilities for the company as a whole.
- To circumvent restrictions to the transfer of profits from host country(ies).
- To take advantage of expected appreciation or depreciation of currencies.
- To record low costs of components in a country/market that the company wants to penetrate through low prices. This is essentially a strategy of disguised dumping to gain competitive advantages over rivals.
- To record relatively low profits in countries where it is feared labour and its trade unions might demand wage increases if high profits were disclosed.

The most common – and best known - reason for the manipulation of transfer prices is the minimization of the company’s tax liability. A company with tax liabilities in many countries is likely to be faced with different fiscal regimes and therefore with different tax rates in different countries. If the company can disclose most of its profits in the country with the lowest tax rate, it will avoid the charge of higher tax rates on some of its profits. Such a strategy will minimize the overall tax liability of the company as a whole. This aim can, partly, be achieved by a strategy of transfer prices manipulation that leads to the recording of higher profits in the country with the lowest tax rate, and very low profits in countries with high tax rates\(^8\).

Companies that engage in international vertical integration strategies have large scope for the transfer of components across countries and therefore have large scope for manipulating transfer prices. Such a manipulation can occur also in the pricing of services transferred between different parts of the company. These can be factor services – like the services of a highly-skilled technical expert or manager – or product services.

The manipulation of transfer prices is not without problems for the company. First of all, the practice is illegal and no company would own to using such a strategy. However, for most services and components transferred internally to a company, no external market exists and therefore it is difficult for tax revenue officers to compare prices and thus gain evidence about possible manipulation\(^9\). Nonetheless, if the practice is discovered the company may have to pay large fines. Second, it is not as easy to implement as it appear at first sight. It may require some type of double accounting. Moreover, it may lead to conflicts between managers of different units.

There are important effects of this practice at the macro level as well as at the micro company level. The strategy leads to minimization of overall tax revenue for the company; the other side of this is that there is a transfer of surplus from the international public domain to the private domain. Essentially, in the world as a whole, less will go to the public sphere as

\(^7\) On transfer prices and their possible manipulation see Eden (2001).

\(^8\) One thing to keep in mind is that this issue is not one of home versus host country: the lowest tax regime country could be the home or a host country. The direction of possible transfer of profits depends on the tax rate of the countries not on whether they are host or homes or whether they are developed or developing countries.

\(^9\) OECD (2010) gives guidelines for companies and tax administrators on how to – respectively – set and monitor transfer prices.
tax revenues, and more will be kept in the private sphere of companies who pay, overall, a lower tax bill than due. Moreover, a transfer of surplus takes place between countries because of this practice. The countries with high tax rates will see their tax revenue siphoned off towards low tax rates countries. In the last analysis the practice leads to divergence between private and social benefits worldwide and to the redistribution of surplus between different countries.

If the strategy is used for market penetration reasons, there are issues of possible unfair competition and therefore effects on the market structure of the industry in which the company operates.

Last, but not least, the manipulation of transfer prices has effects on the volumes and structures of the balance of payments of the various countries involved in the transfers as the recorded values of the transactions are different from the value that should have been invoiced on the basis of arm’s length prices.

5. Summary and conclusions
Following an introduction to the transnational company, the chapter analyses the political and innovation contexts within which we have seen the evolution of the structure and pattern of TNCs and their activities. A discussion of the linkages between transnationality and finance follows.

The transnational companies are heavily involved in the financial sectors because: most finance companies operate transnationally and indeed the finance sector has been absorbing an increasing share of world FDI. Moreover, most transnationals – whether in the finance sector or not – are involved in financial operations via: portfolio investment; their mergers and acquisition deals; and via the manipulation of transfer prices.

References


