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Why Brands Matter
Intangible assets and corporate rent-seeking

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1. Introduction

This paper is an attempt to explain the evidence of recent changes in the structures and practices of transnational corporations (TNCs),[1] with a view to stimulating further thinking. It sets out some of the changes that have occurred and gives a partial interpretation of what they mean for TNC strategies and the functioning of the world economy. After short sections describing how TNCs have rearranged their affairs from the previous period and the institutional context which gave rise to this, the paper contains two main parts. The first of these is a case study of European investments in Mexico since 2000, illustrating TNC operations in three sectors, the motor industry, brewing and banking. The next section outlines the roles in TNC management of incorporeal and intangible assets, economic rents and profits from sales, and considers the implications. This is followed by a very brief summary.

2. How TNCs have rearranged their affairs

Over the last 30 or 40 years there have been radical changes in the ways in which TNCs have been organised and operated. These arise from alterations in the legal and economic environment, many of which have themselves been the result of political lobbying by TNCs. Four main aspects of the current system should be emphasised:

- The disaggregation of production processes and their dispersal among various countries, with important parts (or even the whole) carried out by separate subsidiaries or affiliates or (under outsourcing) by other companies under licence and contract. This has led to the development of global value chains (GVCs). A value chain has been defined as the 'full range of activities that firms and workers do to bring a product from its conception to its end use and beyond.'[2]
- Headquarters retain direct control over 'knowledge' parts of the business – design, proprietary technology and what has become known since the late 1980s as 'intellectual property' (IP) – patents, copyrights, trade marks, image rights etc.
- Care in siting corporate offices, with the use of secrecy jurisdictions and tax havens, with international tax planning as a coordinating principle.
- Expansion not only organically but via mergers and acquisitions (M&A), often unsolicited – in effect, trading in companies themselves. TNCs buy independent firms but also subsidiaries of other TNCs to create business portfolios. Private equity funds exist to

[1] Also known as multinational enterprises (MNEs).

[2] OECD (2012), p. 7, citing Gereffi, G. and K. Fernandez-Stark (2011). 'Global Value Chain Analysis: A Primer,' Center on Globalization, Governance & Competitiveness (CGGC), Duke University, North Carolina, USA.

acquire portfolios of companies whose market values they aspire to increase for resale at a profit.

The complexity of the GVCs in some modern industries is seen in Fig. 1, an illustration of the companies and places involved in the manufacture of a modern airliner.

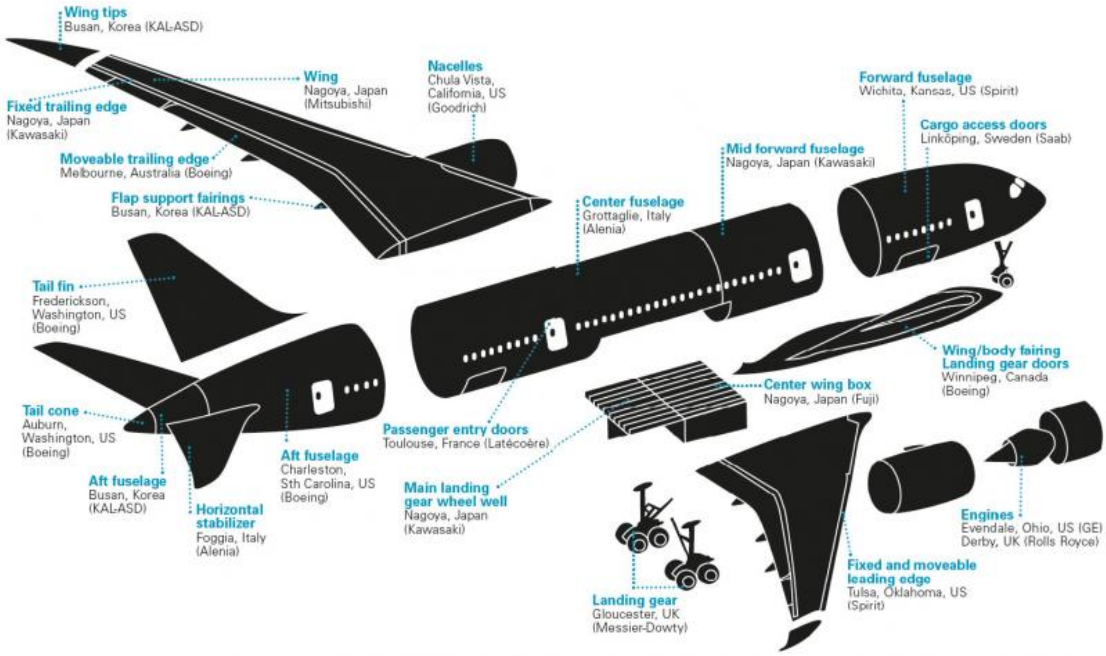

Fig. 1: Production sourcing of the Boeing Dreamliner 787 aircraft via a global value chain[3]

3. The institutional context

These developments did not occur by chance but as a result of a series of changes in national and international policies and institutions, occurring mostly since the 1980s but some of them finding their origins as early as in the 1950s. These are the main policy changes which set up the present-day world of globalisation and neo-liberalism:

1. The liberalisation of exchange rates in the 1970s and the ending of exchange controls in the 1980s, which led to the free movement of capital globally and, in due course, the financialisation of much of the world economy;[4]
2. International policy prescriptions by the International Monetary Fund and the World Bank, which led developing countries away from the previous model of Import-Substituting Industrialisation (ISI) to the doctrine of Export-Oriented Industrialisation (EOI), with foreign direct investment (FDI) represented as an essential element in it. Along with this, the promotion of export-processing zones (EPZs) following the model pioneered by Singapore and later taken up in China;
3. The gradual development since the 1950s of what are variously known as tax havens and secrecy jurisdictions, with associated regulatory changes in the core global economies;[5]
4. The continued reduction in import restrictions, especially for industrial goods, through the General Agreement on Tariffs and Trade (GATT) and the World Trade Organisation (WTO), the alignment of regulations under free-trade areas (FTAs) and

[3] Humphries (2014), citing Australian Department of Foreign Affairs and Trade, 'Trade At A Glance 2013' (at a weblink that is no longer available).

[4] Financialisation has been defined as a 'process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes' – Palley (2007), p. 2.

[5] Shaxson (2012) is an essential text for understanding tax havens and their role in corporate strategies.

the 'protection' of investments themselves under bilateral investment treaties (BITs) between countries;

5. The introduction of a global system of protection of IP under the Trade-Related Intellectual Property (TRIPS) Agreement at the WTO.

4. Case study: recent FDI in Mexico

While general trends in TNC management can be discerned, companies operate differently in different sectors. Good examples are found in the European investments in Mexico since its FTA with the European Unon (EU) came into force in 2000.[6] Between 2000 and 2014 the EU provided 38.7 per cent of the FDI coming into Mexico (and the USA and Canada 51.7 per cent).[7] Up to 2011, the total value of the EU's FDI was $101 billion, of which 38.4 per cent was in manufacturing and 27.8 per cent in financial services. It came in at the rate of $8.4 billion per year.[8] EU-based TNCs invested in three sectors in particular, and they provide good illustrations of ways in which corporate investment operates under current arrangements.

a) The motor industry

The manufacture of motor vehicles has become an important part of the Mexican economy since the inauguration of a common market with the USA and Canada under North America Free Trade Area (NAFTA) in 1994 and it is the sector where GVCs are the most prominent. Mexico has become the world's eighth largest car, truck, part and component producer and within that field, the sixth producer of heavy vehicles; in 2014 it also became the seventh producer of light vehicles, ahead of France and Spain. The industry accounts for 6 per cent of Mexico's GDP and 18 per cent of its manufacturing production,[9] and accounted for 21 per cent of incoming FDI in 2012. It has contributed to a huge expansion of Mexico's exports (and reduction of dependence on oil) under NAFTA, which transformed the manufacturing sector from serving domestic demand under the protection of high international tariffs to a new kind of dependent role within GVCs.

In general, GVCs have developed the most in more technologically advanced industries.[10] Car companies operate them in classical form, investing in new plant in Mexico for relatively cheap manufacturing and assembly for tariff-free trade with the lucrative markets of the USA and Canada under NAFTA. Ruíz calls Mexico 'the hub behind the automobile renaissance of North America,'[11] and Villareal and Fergusson describe how it has worked:

> 'NAFTA was instrumental in the integration of the North American auto industry, which experienced some of the most significant changes in trade following the agreement. U.S. auto parts producers may use inputs and components produced by another NAFTA partner to assemble parts, which are then shipped to another NAFTA country where they are assembled into a vehicle that is sold in any of the three NAFTA countries. NAFTA provisions consisted of a phased elimination of tariffs and the gradual removal of many non-tariff barriers to trade. It provided for uniform country of origin provisions, enhanced protection of intellectual property rights, adopted less restrictive government procurement practices, and eliminated performance requirements on investors from

[6] The legal texts of the FTA are European Commission (2000A, 2000B and 2001).
[7] Konrad (2015).
[8] Mexican Mission to the EU (2012), p. 2.
[9] See 'Automotive Industry in Mexico: A Key sector', www.automotivemeetings.com/mexico/index.php/en/automotive-industry-in-mexico (September 2015).
[10] Banga (2013), p. 32.
[11] Ruíz (2015), p. 7.

other NAFTA countries. NAFTA established the removal of Mexico's restrictive trade and investment policies and the elimination of U.S. tariffs on autos and auto parts.'[12]

Moreover, as reported by a consultancy firm: 'Because Mexico is a major auto manufacturer, 89 of the world's top 100 auto parts makers have production in the country. The companies are concentrated in five Mexican states, reducing transportation costs.'[13] European car companies turned Mexico into an important final-assembly point of their own. The German firms Volkswagen, BMW and Daimler-Benz were attracted by low production costs and the ability to export to the USA within NAFTA. They were also able to take advantage of Mexico's wider network of 10 FTAs with 45 countries and 32 BITs with 33 countries[14] to facilitate the import of vehicles or parts of vehicles from elsewhere and ensure that their investments were protected.

Ruíz cautions that in this process, 'in many cases, industries that had been emblematic for the country and had previously created many jobs, such as the textile, clothing and footwear industries, among others, began to decline.'[15] This has not led to particularly rapid economic growth in general or much overall growth in industrial employment, but has been associated with social and regional fragmentation. This is partly because the sector benefits from a geographical clustering effect, as the above-quoted consultancy report indicates.

b) <u>Brewing</u>

Outside the motor industry, most of the EU's investors bought into existing Mexican firms, creating relatively few new factories or jobs. An important sector is brewing, in which in 2013 Anheuser-Busch InBev, the world's largest beer company, with headquarters in Belgium, bought Grupo Modelo for $20 billion and with it, the successful *Corona* brand of beer. Globally, AB Inbev is second only to Nestlé among food and drinks corporations, and the 56th largest company of all. In 2010 the Dutch company, Heineken, bought Femsa Cerveza, Mexico's second-largest brewer, for around $7 billion. This company had 20,000 employees, and Mexico is reported to have become Heineken's largest profit producer.[16]

In the global beer market, a sector with simple and mature technology, the main impetus for GVCs lies in a system of global branding rather than the production circuit. Pilsener or lager beer is the dominant segment, with 90 per cent or more of global sales.[17] Easily managed, transported and replicated, pilsener is more suitable for large-scale commerce than the 'live' traditional beers of England and Belgium. It is a largely undifferentiated product but there are differences of taste between lagers, which leave consumer preferences open to subjective associations. In recent years the global beer market has become very concentrated. In 2016 AB InBev took over SABMiller, hitherto the world's second largest brewing company, raising its share of the world's beer sales to about 28 per cent.[18] The new company comprises what were before 2002 five separate brewing groups, with headquarters in Belgium, Brazil, the UK and the USA. Heineken is now the second largest firm.

To differentiate their products in consumers' minds, the brewing TNCs use brand marketing and extensive advertising. In the words of the *Financial Times*, 'The beer business is, in large part, marketing magic.'[19] The leading companies create hierarchies of brands, identified for

[12] Villareal and Fergusson (2014), pp. 15-16.
[13] Bloomberg (2013), citing a report from Boston Consulting Group.
[14] Pro México website (2017), 'Trade Agreements.'
[15] Ruíz (2015), p. 8.
[16] AP **(**2013)**,** Sellers (2014).
[17] 90.3 per cent of global sales by value and 92.9 per cent by volume in 2003, calculated from data at www.bevindustry.com/articles/83562-2004-beer-report (May 2017), which cites Euromonitor International. More recent data on this breakdown are hard to find.
[18] European Commission (2016B), *Wall Street Journal* (2015).
[19] *Financial Times* (2016).

different market areas, and Mexican and Mexico-related beers now provide three of the 12 'global' and 'international' brands' in the top tiers at AB Inbev and Heineken.[20] European beer drinkers might be surprised to learn of this, in what is to all appearances a distinctly European product. But Mexican production costs will be lower than in Northern markets. With the right corporate organisation, ownership of globally protected patents and trade marks, and free access to major distribution chains and good marketing techniques, the scene is set to promote beer produced there and brands which originated there. And if the Mexico image is appealing, it can be applied to brands which have no actual link with the country at all.

Why Mexico and why *Corona* then? Much of the answer lies in the U.S. market, where from the 1980s on the brand built up an image as a glamorous and exotic beer, reminding young men of their beach holidays south of the border. The clear glass bottle with the label printed directly on it makes *Corona* stand out everywhere, as does the habit of drinking it with a slice of lime in the bottle's neck. However, these are marks of product differentiation, not quality: beer bottles are usually dark because beer deteriorates quickly when exposed to light, and while the original purpose of the lime is not clear, one explanation is that it disguised the flavour, which indeed deteriorated under Mexican sunshine.

What matters is the brand name itself, in which a country of origin is understood or merely implied, together with associations that can be attached to it by marketing. In itself it is little more than a name: the actual place of manufacture is of little or no importance. Thus, the success of *Corona* prompted other TNCs to imitate it. In 1995 a French company, Fischer, launched *Desperados*, a beer mixed with tequila. Exploiting old stereotypes of Mexican banditry, it combines the easygoing tropical exotica attached to *Corona* with the virile *frisson* of outlawry; but the recipe, name and marketing strategy all came from France. In 1996 Fischer was acquired by Heineken. Since Heineken's purchase of Femsa Cerveza, it has been able to include the new subsidiary's *Sol* beer in its list of eight 'international brands.' However, according to the label, *Sol* beer sold in the U.K. is brewed and bottled in the Netherlands 'under supervision' of the Mexican subsidiary.

This is how GVCs can be set up and succeed for a mass-produced and largely undifferentiated product that uses a readily available technology. There is no proprietary technology protect, but there are brands. TNCs can deploy global economies of scale allied with worldwide marketing. What really matters is not the product as such but the IP associated with it, as long as the TNC can ensure it is fully protected in the countries where it operates. It is no accident that the global consolidation of the brewing industry followed so closely on the spread of trade agreements, or that at the heart of the process should be that most globalised of middle-income countries, Mexico. The profits derive from flexibility in production and brand differentiation, relying on economic rents from the ownership of patents and trade marks more than a surplus of income over production costs. This is all reinforced by the panoply of corporate protectionism: the global regime of IP rights instituted in the WTO, the free movement of investment capital (including the outright purchase of indigenous companies in countries throughout the world) and low transport costs. Brewing is a perfect example of this, further supported in Mexico by NAFTA and the FTA with the EU.

c) Banking

By the end of 2012 only two of Mexico's eight biggest banks were Mexican-owned, holding between them 23 per cent of those banks' assets. Despite NAFTA, the leading banks which came under EU ownership were worth nearly twice as much as those owned from the USA

[20] See AB-Inbev's website, www.ab-inbev.com/brands/brand-portfolio.html, and Heineken's website, www.theheinekencompany.com/brands.

and Canada.[21] Mexico's largest and fourth largest banks were subsidiaries of Spanish banks (BBVA and Santander respectively), the second was U.S.-owned (Citigroup), the fifth was British (HSBC), the seventh Canadian (Scotia Bank) and the eighth German (Deutsche Bank).

The banks' strategies follow a pre-globalisation pattern, in which a TNC secures operations and profits within the host economy. Foreign ownership has nevertheless affected the ways in which the banks operate. In a troubled period for international banks, their Mexican subsidiaries in some cases came to the rescue of their foreign parent companies; in others, incompetence or neglect compounded local problems. For example, BBVA Bancomer, the largest bank in Mexico, is consistently the biggest contributor to its Spanish parent's global profits, returning €2.1 billion of the group's €3.75 billion net profit in 2015.[22]

The takeovers themselves occurred shortly after a rapid period of change in Mexican banking:

> 'With the consolidation of Mexico's banking sector during the 1990s, credit policy and risk management procedures have become more homogeneous, and have explicitly turned away from the financing of smaller-scale businesses of all kinds. Banks in Mexico have complained to the World Bank about the lack of "creditworthy" clients, and credit is increasingly directed to larger corporations and government agencies.'[23]

However, several of the new owners have exercised insufficient oversight, showing few scruples over who their subsidiaries lent to. Under foreign ownership lending practices deteriorated further, with especially damaging effects on small businesses, including farms. In the most notorious case, HSBC, Britain's largest bank, purchased Banco Internacional S.A. in November 2002. According to a U.S. Senate inquiry in 2012, HSBC Mexico (HBMX) opened a branch office in the Cayman Islands which was

> '…a shell operation with no physical presence in the Caymans, and … managed by HBMX personnel in Mexico City who allow Cayman accounts to be opened by any HBMX branch across Mexico … In September 2008, HBMX reported … over 60,000 Cayman accounts for nearly 50,000 customers, with total assets approaching $2.1 billion.'[24]

Concurrently, there were exceptionally large movements of U.S. dollars in cash from HBMX into HSBC's U.S. operation, which raised concerns about the '"high level of ML [money laundering] risk" involved.' The Senate report stated that 'within Mexico, HBMX "led the market in cash repatriation in 2007 and 2008," with "$3.2 billion repatriated in 2007 and $4.2 billion repatriated in 2008."'[25] Following this investigation, in December 2012 the HSBC group paid a $1.9 billion fine for a series of money-laundering offences, the biggest being the one identified in Mexico.[26]

The *New York Times* also reported that Citigroup had experienced 'widespread problems with controls and oversight across its Mexican unit' (Banamex, Mexico's second largest bank), where there was a $400 million fraud.[27]

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In Mexico one form of manufacturing economy has been replaced with another, and many export industries have moved a long way from the earlier model of low-skill *maquiladora* plants near the U.S. border. Nevertheless, as the European Commission pointed out, 'In

[21] Author's calculation, from figures in a list of the 20 largest banks in Mexico ranked by total assets (in 2012) at Banksdaily.com website (August 2015).
[22] See BBVA website.
[23] Audley *et al* (2004), p. 79.
[24] U.S. Senate (2012), pp. 91 and 92.
[25] U.S. Senate (2012), pp. 107 and 108.
[26] *The Guardian* (2012).
[27] *New York Times* (2014).

2014, over 80% of Mexican exports continue to have the US market as the final destination (USD 318.9 billion), followed by the EU as a distant second with 5.1%.'[28] Manufactures have been described as 'still the backbone of NAFTA, one of the major factors that led to the productive transformation of Mexico.' But the economic breadth of this transformation is small: 'Just five export sectors accounted for 49% of exports: motor vehicles, motor vehicle parts, oil and gas, computer equipment and audio and video equipment.' Meanwhile, 'oil and gas exports are still very important, representing around 11% of Mexican exports to the United States.'[29] The way this happened after Mexico's rapid economic liberalisation in the early 1990s was foreseen by Sanderson and Hayes in 1990:

> 'The relaxation of licensing regulations and the substantial drop in tariffs [in the 1980s] has already had a profound effect on foreign subsidiaries. Foreign-owned companies … have been freed from the necessity of producing all essential parts and end-products internally [in Mexico] and can now rationalize their manufacturing organizations and focus their efforts on the things they can produce most efficiently in Mexico.'[30]

However, the Transnational Institute is scathing about the impact on Mexico's industrial networks:

> 'In the export of manufactured goods that are not made in maquiladoras…, Mexican material inputs have fallen from 90% in 1982 to around 30% in 2008. The maquilas, which account for 45% of exports, only buy 3% of their consumables in the country. The export sector has disconnected from the rest of the national economy and has not been, as was hoped, an important motor for accelerating the overall growth of the economy. The effects on employment were dramatic, even before the recession brought by the current crisis. In the manufacturing sector, at the end of 2008 there was 10% less employment than 15 years previously.'[31]

The modern TNCs supplanted formerly integrated operations with GVCs and carefully calibrated international tax structures, in which Mexico plays a subordinate and dependent part. Among the consequences for Mexico have been a severe loss of sovereignty as TNCs play one host country off against another within a value chain, and a curious form of partial *deindustrialisation* born of industrial modernisation and restructuring. The former import-substitution industries have either adapted or gone, to be replaced in some cases by more advanced manufacturing processes, often including final assembly, as part of GVCs. In these sectors, Mexico provides an export springboard to U.S. markets with relatively skilled but much cheaper labour and a favourable location due to transport costs. In brewing, Mexican products were incorporated in GVCs when their producers were bought up by market-leading TNCs, to take advantage of their branding and marketing potential. Even in the financial sector, Mexico is now subject to a new form of dependency due to the foreign ownership of its biggest banks. All of this is protected by the large array of trade and investment treaties that Mexico has reached with other countries.

5. The roles of incorporeal and intangible assets, rents and profits from sales

According to the conventional view, firms make profits from the surplus of their sales prices over total costs. However, with disaggregated GVCs, tax havens and FTAs in place, the possibilities open to TNCs have changed and with them, their financial stance. Both capital and goods have become more mobile, enabling firms to rapidly take advantage of changing conditions. Since physical assets and workers are largely immobile, this has led to a rearticulation of production processes in more complicated forms. In this situation, the TNC's profits come to derive from financial transfers such as interest on loans and what has

[28] European Commission (2016A), p. 7.
[29] Ruíz (2015), p. 3.
[30] Sanderson and Hayes (1990), p. 6 of 8.
[31] Arroyo Picard *et al* (2009), p. 42.

been called 'the intangible component of value creation' which consists of 'IP rights, brands, business services, risks.'[32] Income can be earned from any of those 'intangible' elements, and by any of these three routes:

1. Separate companies completely 'at arm's length' from the owner of the asset (such as when a publisher sells a foreign publisher the right to translate a book and publish it in its own language).
2. Separate companies with which the firm has other relationships under outsourcing arrangements (for example, a licence to produce the firm's products or undertake some part of the production process as part of the TNC's value chain); those relationships can entail detailed control over many aspects of the licensee's operations.
3. Companies within the TNC's group, where the arrangement will be similar to outsourcing – with the parent company's income derived from intangibles in addition to profits from production – but the firm is wholly or partly owned by the TNC.

Under any of these headings, the TNC can earn income from interest on loans and other financial structures as well as fees from intangible assets. Beyond the flexibility and fleetness of foot which this gives TNCs, these mechanisms can also be used as a semi-covert way to transfer funds from one jurisdiction to another. Money can be lent by a firm registered in one country to a corporate affiliate in another, with the interest rates and repayment terms manipulated to regulate the amount of money that would end up in either place. Similar tactics are used with licence fees on patents, trade marks and other forms of IP, both within a corporate group and in relation to outsourcing contractors, with a view to ensuring that as much as possible of the profit accrues where the TNC most wants it. (According to accountancy practice, an 'intangible' asset is by definition non-monetary, including IP, goodwill and brands;[33] I use the term 'incorporeal' where I have both intangibles and monetary or financial assets in mind.)

These international mechanisms are referred to as 'transfer pricing.' Large corporations find them convenient because it is usually hard to specify unequivocally how much ought to be paid for a given transfer, and the value of the transfer can therefore be manipulated. Sikka and Willmott explain the accounting problem as follows:

> 'Corporations need to develop processes for allocating costs and overheads and design strategies for estimating transfer prices for goods and services. Since costs and overhead allocation mechanisms are highly subjective, corporations enjoy considerable discretion in allocating them to particular products/services and geographical jurisdictions.'[34]

Shaxson explains one of the main goals of what he calls 'a common offshore trick known as *transfer pricing*, or *transfer mispricing*': 'By artificially adjusting the price for the internal transfer, multinationals can shift *profits* into a low-tax haven and *costs* into high-tax countries where they can be deducted against tax.'[35] This is supported by the existence of the tax haven, defined by Shaxson as a 'place that seeks to attract business by offering politically stable facilities to help people or entities get around the rules, laws and regulations of jurisdictions elsewhere.'[36]

The importance of this development over recent decades is hard to exaggerate. Even some corporate headquarters have been moved from one country to another in order to reduce

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32 UNCTAD (2015), p. 25.
33 Deloitte website.
34 Sikka and Willmott (2010), p. 1.
35 Shaxson, (2012), pp. 11-12. Emphases in the original.
36 Shaxson, (2012), p. 8.

the incidence of tax. The development of tax havens and transfer pricing is also bound up with that of the euroloan markets since the 1960s – offshore banking which was first established specifically to evade a U.S. tax rule. Sikka and Willmott put it all in context:

> 'A former Senior Fellow of the Brookings Institution has argued that "transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe"… It has become a major growth area for international accountancy firms which market "creative and practical solutions for . . . transfer pricing needs."'[37]

This gives rise to the central importance in TNCs' strategies of international *tax planning*, which the U.N. Conference on Trade and Development (UNCTAD) explains thus:

> 'MNEs employ a wide range of tax avoidance levers, enabled by tax rate differentials between jurisdictions, legislative mismatches and tax treaties. MNE tax planning involves complex multi-layered corporate structures. From an investment perspective, two archetypal categories stand out: (i) intangibles-based transfer pricing schemes and (ii) financing schemes.'[38]

UNCTAD emphasises the importance of intangibles-based schemes:

> 'The essence of these schemes is to transfer profit to low tax jurisdictions via transfer pricing manipulation on intangibles (and associated royalties and licensing fees), generating a divergence between where value is created and where taxes are paid. The higher the intangible component of value creation (IP rights, brands, business services, risks), the higher the profit shifting opportunities. With the very high share of profits of large MNEs based on "what they know" rather than "what they make" the relevance of this type of scheme is clear.'[39]

The influence of tax planning can be seen in the case of Mexico. The European countries that invested the most in Mexico between 2000 and 2014 were Spain, with $51 billion, the Netherlands with $49 billion and the United Kingdom with $16 billion. Germany's direct investments were no more than $9 billion over this period although it emerged as Mexico's most important trading partner within the EU, and its firms now employ over 120,000 people in the country. Up to 2010, these four countries supplied 92 per cent of the EU's investments.[40] The Netherlands' high place in the list, as a relatively small country, is explained by its role as a corporate 'hub' country, through which TNCs can advantageously channel foreign investments. According to a company which specialises in this area, 'The Netherlands offer an excellent business climate and is [*sic*] used by many multinationals as a gateway… Through the beneficial holding company regime multinationals are still able to make use of the beneficial tax features of the Dutch tax system.'[41]

Tax guidelines have been developed[42] with the aim of ensuring that the pricing of any intra-firm transfers is the same as if the transaction was made 'at arm's length' on the market. But these are difficult to enforce, for three reasons: it is often difficult for tax authorities to find out what has actually been paid; regulation is complicated by the very fact that these 'transactions' cross international legal boundaries; and the non-market, intra-firm nature of the transactions makes it difficult to determine what an appropriate arm's-length market value would be. Even when they are between separate companies and therefore nominally at arm's length, as in outsourced production arrangements, the dominant power of the TNC will often lead to different terms from those that would be available on the open market.

The importance of this depends on the extent of intra-firm transactions in international trade, but there is not data on enough countries to make a proper assessment of it either.

[37] Sikka and Willmott (2010), pp. 1-2.
[38] UNCTAD, pp. 3-4.
[39] UNCTAD, p. 25.
[40] Arroyo Picard (2011), Table 3, p. 82, and p. 79.
[41] Vidend Consultancy website, www.taxhub.nl/ (July 2016).
[42] In Article 9 of the OECD's Model Tax Convention. See OECD (2014), pp. 29-30.

However, partial data cited by the OECD indicate that in 2007 'in Sweden the share of intra-firm exports in total manufacturing exports is 51%, the share is respectively 18% in the United States and 10% in Japan.' Data on intra-firm trade in services are even less widely collected but:

> 'The share of intra-firm exports in private US services exports was 26% in 2008, while the respective share for intra-firm imports was 22%... In Canada, intra-firm transactions accounted for 42% of exports and for 54% of imports of commercial services in 2003.'[43]

Intangible assets have therefore assumed great importance in TNC strategies. Every company and every sector is different, but a general view of those strategies can be described as follows. I will start with the general goals that seem to be implied by TNC behaviour, then relate how these are translated into principles of action, and then the actual methods that are deployed. It is intended as a general guide and does not pretend to be either universally applicable or exhaustive.

<u>General goals</u>:

1. What is politely called discretion and what critics call opacity or secretiveness;
2. Minimise global tax payments to increase retained profits;
3. Maximum freedom of manoeuvre, including the avoidance of government controls wherever possible and avoiding risks of unfavourable regulatory restrictions and any limits on profit-earning power; ensure financial flexibility and continued ownership (fear of expropriation or nationalisation);
4. Minimise the degree of control that any *one* government can exert.

<u>Principles of action</u>:

1. Avoid the ownership of physical (especially fixed) assets and the employment of people as far as possible. Make these someone else's responsibility, such as a local contractor to own and run a factory;
2. With the benefit of low tariffs and cheap international transport, break up production processes to ensure that each stage is done in the cheapest location for it and prevent any government from having influence over more than one or a few of the stages (divide and rule);
3. Keep firm central control over what are now the TNC's core functions: strategy, group finance, research and development, design and IP resources;
4. Use gaps between jurisdictions, such as those arising where an investment or contract is made in another country or a process is carried out between countries, as income-earning opportunities. Design the international structure to enable the transfer of profits away from commercial or productive sites into secure and (as far as possible) non-transparent low-tax jurisdictions.

<u>Three central methods</u>:

1. Tax planning plus the manipulation of international transfers of funds. This involves, among other things, the invoice prices for goods or services shipped between jurisdictions ('transfer prices');
2. Maximising the international payments derived from mobile and intangible assets, including IP assets that assert ownership of elements of knowledge or creativity;
3. Financing by loans, whose interest rates and other terms can be manipulated to achieve the desirable international transfers.

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[43] Lanz and Miroudot (2011), pp. 13-16.

Since intangible assets are a TNC's property, the income derived from them is actually a form of *rent*. Production costs (such as research and development or the design of trade marks) are one-off sunk costs which do not generally recur after the asset is created, and any charges are for the *use* of the asset, not its acquisition. Institutions have not developed to facilitate the actual resale and secondary trade in intangibles. This is because their main purpose remains that of generating fees within the value chain itself, rather than a capital gain. In general therefore, these practices make other TNCs somewhat resemble financial businesses, whose income also derives from the creation, ownership, acquisition and deployment of incorporeal assets (mainly loans). Income from intangibles can come from two sources: (rarely) the surplus of any eventual sale price over the acquisition or production costs (if any) of the intangible asset, and (commonly) fees or other income resulting from its use. This is comparable with the loan assets of banks. Unlike loans, however, IP assets only become material after they are officially registered (or at least this status has been applied for, in the case of patents, or publicly affirmed, for copyrights under EU law).

The increasing resemblance of industrial and other TNCs' sources of profit and, therefore, forms of behaviour to those found in the financial sector helps to explain more direct forms of financialisation, such as the excursions into shadow banking by firms like GE and AIG, and the increased emphasis on the buying and selling of companies. Companies can themselves be regarded as intangible assets and are in effect tradeable in financial centres in like manner to shares, bonds and commodities, with specialised agencies in the forms of private equity funds and the M&A departments of investment banks.

The system is held up institutionally by a series of legal supports that have developed under various international auspices. This is not the place for more than a brief account, but the creation of the WTO in 1995 marked a big step forward in this direction as it added to the tariff provisions of the 47-year-old GATT new agreements on IP and other matters, as well as a legally binding disputes procedure. The WTO also authorises FTAs. There are also treaties between pairs of countries on mutual taxation and the protection of cross-border investments, allowing firms to appeal to external arbitration when they consider a government has discriminated against them, under the Investor-State Dispute Settlement (ISDS) system.

International treaties in the areas of trade, tax and investment exist in these areas:

- <u>Tax</u>:

Bilateral Tax Treaties / Double Taxation Agreements

- <u>Investment Protection</u>:

Bilateral Investment Treaties (BITs), using ISDS mechanisms

- <u>Trade, protection of intangibles and related matters</u>:

WTO: about 60 agreements, annexes, decisions and understandings;
Free/Regional Trade Agreements (FTAs, RTAs), old-style: Free Trade;
Free/Regional Trade Agreements (FTAs, RTAs), new-style: with deregulation and investment protection added (e.g. CETA, TPP, TTIP).

6. Summary

Very briefly, the situation can be summed up as follows:

- TNCs increasingly look for a basis in the ownership of intangibles, rather than physical assets;
- They earn economic rents from this ownership, more than profits from production;

- This is part of a general desire to be as mobile as possible, taking advantage of low tax possibilities;
- Central parts of the institutional structure are deliberately hidden from accountability in tax havens, also known as secrecy jurisdictions.
- This has all been facilitated and supported by a series of regulatory and legal changes affecting the international economy during the neo-liberal era.

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