AN EVALUATION OF THE PROBLEMS OF MEASURING THE PROFIT PERFORMANCE OF MULTINATIONAL ENTERPRISES IN LESS DEVELOPED COUNTRIES — A CASE STUDY OF BANGLADESH

by Muhammad Zubaidur Rahman

A thesis submitted to the University of Manchester for the degree of Doctor of Philosophy in the Faculty of Economic and Social Studies

October 1982

Abstract

Multinational enterprises are powerful economic entities enjoying oligopolistic or monopolistic advantages in the less developed countries where they operate. Due to special market advantages multinational enterprises may be expected to show better profit performances than their local counterparts in host less developed countries. But available empirical evidence shows little difference between profit rates of multinationals and those of local firms in less developed countries. It is predicted that multinational enterprises in less developed countries report distorted profit performance in published accounts; this may explain divergences between expected and reported profits of multinationals. This prediction is supported by the fact that multinationals in less developed countries appear to have many incentives for understating reported profits. One major incentive seems to be the need to avoid political costs; it is believed that multinational enterprises reporting low profit performances are less exposed to political attacks. Political attacks may result in expropriation, nationalisation or tougher controls. The hypotheses and implications of the study are set out below:

Hypotheses: Multinational enterprises in less developed countries attempt to understate reported profits by manipulating accounting policies, and/or by manipulating transfer prices. The findings of this study do not lend support to the accounting policy manipulation hypothesis, but the empirical evidence supports the transfer price manipulation hypothesis.

Implications: This study, by analysing the international efforts for standardisation of accounting policies for multinational enterprises, identifies a need for accounting standards to help control transfer price manipulation by multinationals in less developed countries. It is argued that less

developed countries need to streamline and strengthen their administrative machinery and mechanisms, in controlling the activities of multinational enterprises, in order to make multinational investments benefit the economic progress of their countries.

Declaration

No portion of the work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institution of learning.

October 1982 M.Z. Rahman

Acknowledgement

I wrote this thesis, but a number of individuals and organisations contributed to shaping its final form in a variety of ways. It is difficult to express my sense of gratitude to all of them separately. I can mention only a few and keep all of them in mind with gratitude.

First of all I would like to express my thanks and gratitude to Dr. Robert W. Scapens. As supervisor of this thesis he has provided invaluable help, intellectual guidance and fostered the spirit of intellectual enquiry which I hope this study reflects. He gave constant encouragement, wise counsel and appropriate degrees of patience - when I needed them most - which I deeply appreciate.

From the conception to the completion of this study Tony Hope was very closely associated with it as my friend, philosopher and guide. It was he who suggested the general line of enquiry which eventually led to this study. Without doubt my great debt of gratitude is owed to him. It was through his thoughtful comments and penetrating criticisms I was able to complete writing of this thesis.

Apart from these two, I drew directly on the time and work of many others in the Department of Accounting and Business Finance at the University of Manchester. Among the faculty, these included Professor John Arnold, Mike Sherer, John Whitman, Dr. David Cooper (presently at the University of East Anglia), Dr. J. Cadle, and Vera Price. I am very grateful to all of them.

I must also acknowledge the help of a body of men who must remain unnamed. For the research data I have interviewed a host of individuals, many in the most senior positions in some ministries and departments of the government of Bangladesh,

and many in top positions in the private industrial enterprises in Bangladesh. These government officials and the men of business gave generously of their time to clarify issues, to suggest valid sources of ideas and information, and to explain their own problems. The research could not have been possible at its later stages without the help of these men, and I am grateful for their help and cooperation.

This note would remain incomplete if my humble gratitude is not expressed to all those authors and researchers whose work I freely consulted in conducting the study and in preparing the thesis.

Any errors which remain in this thesis are mine and mine only.

As a Commonwealth Scholar from Bangladesh, I received financial support for this study from the Association of Commonwealth Universities. I am indeed grateful to this institution.

A special note of acknowledgement is due to my wife, Nargis, who listened to and questioned my ideas, stimulated new thinking, actively participated in data collection during field work for this study in Bangladesh, and who gave encouragement and support through bad times as well as good.

M.Z. Rahman
Manchester
October 1982

Contents

Contents

Contents

Contents

Contents

LIST OF FIGURES

Contents

CHAPTER ONE

Introduction

1.1 BACKGROUND

The rapid growth and geographical spread of multinational enterprises in the past quarter of a century has evoked widespread public interest in their operations. Alternatively welcomed and spurned, praised and condemned, controlled and deemed uncontrollable, such enterprises have been at the centre of growing debates in both developed and less developed countries. One of the sharpest debates involves the impact of multinational enterprises on the economies of their host less developed countries. On one side, there are those who see multinationals as catalysts whose presence is vital for the rapid industrialisation and economic growth of less developed countries;[1] on the other side, there are those who see these economic institutions as an important aspect of the imperialist penetration of the less developed countries heightening their dependency and deepening the process of dependent development.[2]

In spite of growing controversy concerning the role of multinational enterprises they are often wooed by many less developed countries who vie for their capital and technology by offering tax incentives, subsidised industrial sites and preferential customs treatment for imports.[3] The governments of these countries try to make a trade-off between the national interests and the interests of the investing multinationals. But in practice such a trade-off may be difficult to determine and thus conflicts may grow between the host country

1. For example, see: G. Ranis, The Multinational Corporation as an Instrument of Development, Yale Economic Growth Center, Discussion Paper no. 123, September 1974.
2. For example, see: articles in H. Radice (ed.), International Firms and Modern Imperialism, Penguin Books, Middlesex (England), 1975.
3. For example, see: "Bangladesh Lures the Investor", Far Eastern Economic Review (Hong Kong), 23 November 1979, p.55; and "Bargaining on the Free Trade Zones", New Internationalist (London), No.85, March 1980, pp.12-15.

and the multinational investor(s). The following quote from Vernon (1977)[4] highlights the concern:

> ". . . One group of leaders in the developing countries tends to see the linkage ofthe national economy to foreign-owned enterprises as a betrayal of the national interests. Other groups tend to see such links as opportunities for national growth, provided the links are properly managed and carefully exploited. . . . The interests of governments and those of foreign-owned enterprises in developing countries are usually compatible in some degree; both sides, at any rate, usually think they will gain by a continuation of the relationship. But elements of conflict are always present, in the sense that one or another would like to acquire more of the available pie."

In order to create an environment such that multinational enterprises can contribute to the economic development process in less developed countries without causing any economic, social and political ills, different international and supranational organisations have in the last decade formulated various codes of conduct for controlling the activities of multinationals. The United Nations Commission on Transnational Corporations, the International Labour Organisation, the Organisation for Economic Cooperation and Development and the European Economic Community are among those engaged in devising international codes of conduct and guidelines for multinational enterprises. But it is difficult to predict that these codes of conduct will be universally accepted and given legal force. None of these codes are mandatory. Only national laws and practices can set real limits on multinationals and alter their relations with the host nation-states. In practice, a multinational's investment or operational behaviour in this or that country is ultimately determined by straight-forward bargaining with the government concerned. And in order to accomplish efficient negotiations with the potential multinational investors, the host countries need sufficient knowledge

4. Vernon, R., "The Power of Multinational Enterprises in Developing Countries", C.H. Madden (ed.), The Case for the Multinational Corporation, Praeger Publishers, New York, 1977, p.165.

of the role of these enterprises in their national economies. In the case of less developed countries this need is even more pressing.

1.2 THE PROBLEM

The measurement of the performance of multinationals compared with the performance of local enterprises seems to be an important step in assessing the role of the former enterprises in a national economy. The literature on foreign private investments in less developed countries has devoted a great deal of attention to the "performance" of foreign affiliates as concerns their use of technology, their balance-of-payments effects, productivity, profitability and so on. Yet there still remains a large grey area of semi-ignorance, in large part because of the inherent problems in making a meaningful assessment of the performance of multinationals in less developed countries. Identification of these problems can be of great help in both overcoming them and in making more understandable the "performance measurement" of multinational enterprises in less developed countries. These problem areas give rise to a great many possibilities for further research concerning operations of multinationals. But it may be also helpful to sort through this confusing plethora of possibilities and focus more clearly on a particular topic.

Any particular topic may appear divisive, because it can lead to endless debates on the "correct" choice. The present study attempts to evaluate the problems of measuring the profit performance of multinational enterprises in less developed countries. There may be arguments and counter arguments about choosing this particular topic. Such a debate has been deliberately avoided in the present study. It is hoped that whatever findings come out of the study that would throw some lights on the efficacy of published accounting reports of multinationals as the basis for their "performance measurement" in less developed countries. It needs to be mentioned here that published accounting reports are the

principal (perhaps the only) formal source of information about multinational enterprises available in host countries.

It is often predicted that multinational enterprises operating in less developed countries should be more profitable than their local counterparts in these host countries. Monopolistic or oligopolistic characteristics of multinationals, coupled with their high capital investment, advanced technology, innovatory management and international diversification of direct investments, support such predictions. But very limited empirical evidence is available to substantiate the hypothesis that multinational enterprises are more profitable than local enterprises in host less developed countries. The divergence of reported profits from expected profits of multinational enterprises operating in less developed countries gives rise to a possibility that the reported profits might be distorted. This possibility calls for an investigation into the potential sources of distortions in reported profit performances. The present study seeks to analyse some possible sources of distortions which pose problems for the measurement of performance of multinational enterprises in host less developed countries.

1.3 DEFINITION OF MULTINATIONAL ENTERPRISE

The definition of a multinational enterprise, or, alternatively, multinational corporation or transnational corporation, is subject to some debate.[5] Some consensus seems to exist that a multinational is a firm which exercises management control over enterprises operating in more than one national market. Exactly what constitute managerial control, however, is an issue over which there is some debate. There would be little disagreement that an enterprise headquartered in one country can hold managerial control over foreign branches or wholly owned subsidiaries. It may, however, be

5. Aharoni, Y., "On the Definition of Multinational Corporations", Quarterly Review of Economics and Business, Vol.11, No.3, Autumn 1971, pp.27-38.

argued that effective managerial control can be exercised by an enterprise over its foreign affiliates in which it has but a minority interest, or even over foreign firms in which it holds no equity but operates via a management contract or licensing of patents and trade marks.

For the purpose of the present study, a multinational is defined as an enterprise having equity interests in manufacturing enterprises in more than one country. This definition, adopted by the United Nations study (1973)[6], does not encompass the foreign owned financial institutions and trading concerns in a host country.

According to the definition of a multinational enterprise used in the present study, 20 multinational enterprises operate in Bangladesh. All these multinationals are studied for the purpose of an empirical examination of the hypotheses set out in the present study. Of the 20 multinationals in Bangladesh, 2 are wholly foreign owned subsidiaries, 2 have foreign ownership between 40 and 49 per cent, and the remaining 16 have foreign ownership ranging between 52 per cent and 76 per cent.

1.4 HYPOTHESES

The goal of this study is to investigate the potential loopholes in accounting reports of multinational enterprises operating in less developed countries. The number of hypotheses to be examined is limited. It is anticipated that the findings would generate new directions for further research. From the experience of past research work it is hypothesised that multinational enterprises in less developed countries may tend to distort their reported accounting numbers either by manipulating accounting policies or by manipulating transfer prices, or both. The economic incentives for such manipulations are analysed and the following two hypotheses are developed in chapters 6 and 7 of the present study:

6. United Nations, Multinational Corporations in World Development, UN Department for Economic and Social Affairs, New York, 1973.

Hypothesis 1 : Multinational enterprises in less developed countries manipulate accounting policies in order to understate reported profit performance.

Hypothesis 2 : Multinational enterprises in less developed countries manipulate transfer prices in order to understate reported profit performance

1.5 METHODOLOGY

The principal research method was the collection of data through a series of interviews with the finance executives of 20 multinational and 10 local enterprises in Bangladesh, and with high ranking officials in different Departments of the Government of Bangladesh. The 20 multinationals form the total population of multinational enterprises in Bangladesh, and only 10 local firms could be identified as the local counterparts of those multinationals.

For an empirical examination of the "Accounting Policy Manipulation" hypothesis, the computer programme DISCRIMINANT was used to make a discriminant analysis of the income effects of accounting policies used by multinationals and local firms in Bangladesh. The "Transfer Price Manipulation" hypothesis was more difficult to test empirically, largely because internalised transactions (leading to transfer pricing) constitute one of the most secretive operations of multinational enterprises. However, a limited amount of empirical evidence on transfer pricing was collected in Bangladesh. This information, coupled with the available empirical evidence in the literature, formed the basis for examination of the transfer price manipulation hypothesis in the present study.

1.6 AN OVERVIEW OF THE PRESENT STUDY

The following chapter extracts give an indication of the focus of the study:

Chapter 2: A salient characteristic of the structure of the post-World War II world economy is the tendency for the

basic economic unit (the corporation) to organise production on an international basis and this has given rise to the growth of multinational enterprises. Of the total foreign investment stock in the world, about one quarter is in less developed countries; whereas these countries have three-quarters of the world's population living on one quarter of the world's income. Many multinationals have total sales three to five times greater than the gross national products of the countries in which they operate.

Chapter 3: Multinational enterprises seem to be motivated to invest in foreign countries by the ability to take advantage of (i) market imperfections, and/or (ii) risk-diversification. Overall motivation seems to be fulfilment of the objective of maximising global interests, i.e. maximising global profits. It seems that the oligopolistic characteristics of multinationals help them in attaining higher profitability through direct investment in foreign countries.

Chapter 4: Theoretically the market share of corporations has an influence on profitability. A number of economic studies have found that those industrial enterprises which are responsible for high concentration have higher profitability - high concentration means that a few top (two, four or eight) firms have a majority share of the total market for a product. Empirical findings from available studies show that multinational enterprises in less developed countries tend to be highly concentrated and that in many less developed countries two or three multinationals dominate the markets for particular products. This evidence leads to the prediction that multinationals in less developed countries will have superior profitability than their local counterparts. Moreover, it may be predicted that because multinationals have world-wide production facilities and stronger economic and managerial resources than their local counterparts they are likely to be more profitable. However, the empirical findings from available studies indicate that there is hardly any difference between the profitability of multinationals and

their local counterparts in less developed countries. This suggests that there might be distortions in reported profit performances of such multinationals.

Chapter 5: Accounting reports act as an important source of information to the public about the performance of an enterprise. The enterprise management may distort reported profit performance either through manipulation of accounting policies or manipulation of accounting inputs, or through both. Manipulation of accounting policies involve choosing from among alternative accounting policies those policies that help to report profit at a desired level. Manipulation of accounting inputs involve inflating or deflating particular items of income or expense - but increases or decreases in such items must be supported by valid invoices or vouchers (i.e. "fiddling" of accounts does not fall under this purview). An example of accounting input manipulation might be "transfer price manipulation" by multinational enterprises. It follows, therefore, that if multinational enterprises in less developed countries attempt to distort reported profits, they might resort to accounting policy manipulation and/or transfer price manipulation.

Chapter 6: It is possible to report a firm's income in different ways, each determined according to generally accepted accounting principles. A number of empirical studies in the sixties and early seventies attempted to explain that the "income smoothing" objective of an enterprise may be an important motivation behind accounting policy choice. A recent series of articles has re-examined the theory of accounting policy choice, and suggested that there seem to be other economic reasons behind accounting policy choices; based on these studies, an attempt has been made to identify some potential factors that may motivate an enterprise to choose those accounting policies which understate reported profits. These particular factors (of which political cost appear to be predominant) seem to motivate multinational enterprises in less developed countries to choose income-reducing accounting policies.

Chapter 7: Over-pricing or under-pricing of goods and services transacted between the affiliates of a multinational enterprise may be used as an strategy for reporting distorted profit performances. An analysis of the factors influencing transfer pricing decisions suggests that multinational enterprises operating in less developed countries seem to have motivations for reporting lower profit performance through manipulation of transfer prices. These motivations arise from the objectives of maximising profits and/or minimising risks in less developed countries.

Chapter 8: Multinational enterprises operating in different industries in Bangladesh have been found to enjoy market power. In the pharmaceutical industry, oligopolistic advantages enjoyed by the eight multinationals might be expected to make them very profitable by comparison with local enterprises. In other production sectors, market dominance of single multinational enterprise could be expected to give each of these enterprises monopolistic advantages which should enable them to earn superior profits. But the available empirical evidence on profit performances of the multinationals and local enterprises appears to indicate that multinationals do not earn higher profits than their local counterparts. The difference between the reported and expected profits of multinational enterprises in Bangladesh helps advancement of the hypothesis that multinational enterprises in less developed countries might understate reported profits.

Chapter 9: In order to empirically examine whether or not the multinational enterprises in Bangladesh manipulate accounting policies, the income effects of the accounting policies used by multinational and local enterprises in Bangladesh were analysed. Four accounting policies, viz. stock valuation method, asset revaluation policy, depreciation method, and corporate tax provision policy, were considered for this analysis. Evidence shows that multinationals and locals can be classified into two groups on the basis of the income effects of the accounting policies used. But evidence

does not suggest that the accounting policies used by multinational enterprises have income-reducing effects any different from that of local enterprises. It thus seems that the empirical evidence does not lend support to the accounting policy manipulation hypothesis.

Chapter 10: Some empirical evidence from available studies on transfer price manipulations in less developed countries has been assembled. The findings of the Bangladesh case study has provided additional information on the transfer pricing practices of multinational enterprises operating in a less developed country. Based on the empirical evidence it does not seem unreasonable to suggest that, multinational enterprises in less developed countries, have the ability to, and probably do, understate reported profits by manipulating transfer prices.

Chapter 11: The implications of the findings of the present study are reflected through a proposal on the development of "Accounting Standards for Multinational Enterprises in Less Developed Countries." A normative analysis of the accounting standard setting process in less developed countries, with the aim of suggesting potential disclosure requirements for multinationals in less developed countries, leads to the conclusion that a "political process" would be helpful in setting accounting standards for multinationals. Further research is required to devise such accounting standards that can help control transfer price manipulation of multinational enterprises in host less developed countries.

Chapter 12: The study concludes with the recommendation that effective measures need to be taken by the policy makers in less developed countries, in order to control transfer price manipulation and to standardise the accounting practices of multinational enterprises. This may be expected to alleviate the problems of measuring the performance of multinational enterprises in less developed countries.

CHAPTER TWO

Growth of Multinational Enterprises

2.1 INTRODUCTION

> "Since the beginning of the Industrial Revolution there has been a tendency for the representative firm to increase in size from the 'workshop' to the 'factory' to the 'national corporation' to the 'multi-divisional corporation' and now to the 'multinational corporation'. This growth has been qualitative as well as quantitative. With each step, business enterprises acquired a more complex administrative structure to coordinate its activities and a larger brain to plan for its survival and growth."
>
> - Hymer (1972)[1]

The late nineteenth century and early twentieth century saw many of today's multinational enterprises establishing foreign affiliates,[2] but the golden age of multinationals began at the end of the Second World War. In the pre-1914 period, the majority of the capital movements across borders were in the form of portfolio investments. After the First World War, the world economic scene started changing. The Great Depression of the thirties brought a turning point in the pattern of international investments. During this time the general recession produced chronic problems for international capital flows. Exchange controls, competitive devaluations, tariff barriers, market-sharing and price-fixing cartels were all symptoms of the bad economic climate. The marketing of portfolio capital became very difficult due to the prevailing economic conditions. Consequently international portfolio investment suffered badly and the international investors from Europe and North America started shifting from portfolio investment to direct foreign investment. The real growth of foreign private investment began in the post-Second World War

---

1. Hymer, S., "The Multinational Corporation and the Law of Uneven Development", in J. Bhagwati (ed.), Economics and World Order from the 1970's to the 1990's, Macmillan, New York, 1972, pp. 113-114.
2. Stopford, J.M., J.H. Dunning, and K.O. Haberich, The World Directory of Multinational Enterprises; Macmillan, London, 1980, Part 1, p.xviii.

period. The mid-twentieth century also saw the emergence of multinational enterprises as a powerful economic institution in the world economy. More recently, Dunning (1974)[3] comments:

> "In every respect, multinational enterprises are among the most powerful economic institutions yet produced by the private enterprise system."

The economic power of multinational enterprises has attracted severe criticisms throughout the years of their growth. There was growing opposition to investment from abroad in Canada and Australia in the 1920s and 1930s. The same was true in Europe in the 1950s, when American inflows of private foreign investments were at their peak and European outflows were still negligible. Japan simply kept foreign investors out.[4] The attitudes in less developed countries toward multinational enterprises have ranged from cautious to prohibitive. Many less developed countries nationalised the assets of foreign companies in mining and public utility service sectors. However, the desire to industrialise in many less developed countries made a new form of international investment attractive to both multinational enterprises and host countries. The host countries wanted to acquire technological and management skills, while the multinationals wanted to protect their markets; this has led to multinationals' expansion into less developed countries.

A dynamic picture of how multinational enterprises have grown, has been drawn by Hymer (1972)[5] by substituting the word "multinational corporation" for "bourgeois" in the following quote from 'the Communist Manifesto':

> "The need of a constantly expanding market for its products chases the multinational corporation over the whole surface of the globe. It must nestle

---

3. Dunning, J.H., "The Distinctive Nature of the Multinational Enterprise", in J.H. Dunning (ed.), Economic Analysis and the Multinational Enterprise, George Allen & Unwin, London, 1974, p.13.
4. Billerbeck, K., and Y. Yasugi, Private Direct Investment in Developing Countries, World Bank Staff Working Paper No. 348, The World Bank, Washington, 1979, p.1.
5. Hymer (1972), op.cit., foot note (p.136).

everywhere, settle everywhere, establish connections everywhere. The multinational corporation has through its exploitation of the world-market given a cosmopolitan character to production and consumption in every country. To the great chagrin of reactionists, it has drawn from under the feet of industry the national ground on which it stood. All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life and death question for all civilized nations, by industries that no longer work up indigenous raw material, but raw material drawn from the remotest zones; industries whose products are consumed not only at home, but in every quarter of the globe. In place of the old wants, satisfied by the production of the country, we find new wants, requiring for their satisfaction the products of distant lands and climes. In place of the old local and national seclusion and self-sufficiency, we have intercourse in every direction, universal interdependence of nations. And as in material, so also in intellectual production. The intellectual creations of individual nations become common property. National one-sidedness and narrow-mindedness becomes more and more impossible, and from the numerous national and local literatures there arises a world literature."

"The multinational corporation, by the rapid improvement of all instruments of production, by the immensely facilitated means of communication, draws all even the most barbarian, nations into civilization. The cheap prices of its commodities are the heavy artillery with which it batters down all Chinese Walls, with which it forces the barbarians' intensely obstinate hatred of foreigners to capitulate. It compels all nations, on pain of extinction, to adopt the multinational mode of production, it compels them to introduce what it calls civilization into their midst, i.e., to become multinational themselves. In a word, it creates a world after its own image. . . ."

The above unique way of explaining multinationals' growth and their activities demonstrates the type of attacks these institutions had to sustain through the history of their growth. But in spite of the attacks and the criticisms, multinational enterprises have grown rapidly over the past quarter of a century; they have learnt how to adjust to changing circumstances and to grow.

In today's world, new forms of multinational investments have emerged in addition to the most usual form of direct

capital investment. Multinational enterprises, in the recent past, have been expanding their activities into less developed countries through these new forms of investments. These new forms of multinational investments are discussed in the following section.

2.2 NEW FORMS OF MULTINATIONAL INVESTMENTS

In recent years, the historical preference given by multinational enterprises to wholly owned subsidiaries is giving way to the new forms of associations in host countries, particularly in host less developed countries. When a multinational has a strong technological lead over the competition, these kinds of association tend to be preferred, since the parent company runs less risk of losing control over its process or products. But if the competition from other multinational enterprises is already strong and there is no technological lead to protect, the parent has greater latitude to envisage other, possibly more advantageous forms of control. In general, it appears that the new forms of multinational investments have advantages for both multinationals and host countries. The following are some of the commonly used new forms of multinational investments.

(a) Joint Ventures:

A joint venture normally implies the sharing of assets, risks and profits, and participation in ownership (i.e. equity) of a particular enterprise or investment project by more than one firm or economic "group". The latter may include private firms, public sector enterprises, or even states. The profit or loss sharing ratio in a joint venture project may be determined accoridng to each participant's financial contribution, or it may be based on other criteria, i.e. other forms of capital contribution, such as provision of technology, management know-how, international marketing facilities, etc.

A joint venture project ordinarily involves one multinational enterprise and one or more local collaborating

enterprise(s) in a host country. This is a modified version of direct investment by multinational enterprises.

(b) Turnkey Operations:

Under this arrangement a multinational firm enters into an agreement either with the host country government or with one or more private entrepreneurs to construct an entire project and make it available for operation by local personnel. Although the supplier's direct control over the project ceases after the start of operation, the multinational may continue to exert control indirectly through its technological superiority. Such an indirect control, in some cases, may be more crucial than direct control; and the multinational may continue to extract benefits from such projects in future.

(c) International Sub-Contracting:

This arrangement normally involves a "principal" multinational placing orders with a sub-contractor (normally a local firm) in another country to produce components or to assemble finished products with inputs provided by the principal. The final product is sold by the principal in the international market or in the home market of the multinational.

The growing importance of international sub-contracting is closely related to tariff regulations in the developed countries and to the rapid growth in recent years of so called "free export zones" or "free trade zones" in many less developed countries.

Under this arrangement the linkage between the multinational and the sub-contractor is direct; and the multinational has the advantage of reaping benefits towards its ultimate objective of increasing global interests.

(d) Licensing Agreements:

Under this kind of agreement a multinational (licensor) provides another firm (licensee) in a host country, with

access to a particular technology or set of technologies in return for value - an initial lump-sum fee (in some cases initial payment may not be required) and a percentage of annual sale proceeds or any amount of annual fixed payment in the form of royalties. There may be other arrangements tied to the licensing agreements - the licensee in most cases is bound by agreement to purchase raw materials from the licensor (the multinational group).

The technology to which the licensee is given access may include "know-how" (i.e. secret unpatented technology), trademarks, copyrights or patents, or a combination of these, and as is the case with most of the new forms of investment, may also call for the training of local personnel by the licensor/supplier of technological assistance.

(e) Management Contracts:

These call for the supplying multinational to manage a project or enterprise in a less developed host country. They usually also involve training of local personnel and the handing-over of authority to locals after a certain time. In some cases, especially in the Middle East, the host-country government uses independent experts to monitor the activities of the managing company. During the tenure of its term in management of an enterprise, the supplier of managerial expertise has ample opportunities of establishing short and long-term dependence of the enterprise concerned with the parent or subsidiaries of the multinational group.

(f) Trilateral Co-operation or Tripartite Industrial Co-operation.

Under this system at least three firms or organisations, one or more domiciled in a centrally planned economy, at least one in the OECD (an industrialised economy of Western Europe, North America, Australia or Japan) and one or more in the South (a less developed economy of Africa, Asia or Latin America) join forces to carry out common activities in a less developed host country. This kind of investment seems

to have less attraction to the western multinationals. There may, however, be fields of investment in a less developed country where direct multinational involvement is restricted (i.e. exploration of natural resources etc.) and the less developed country may, for ideological commitments, prefer not to let western multinationals directly intrude into her economy; under such circumstances tripartite industrial co-operation helps the multinational to enter into a new source of raw materials and to create a new market.

It is worth mentioning here that the new forms of multinational investments are more often practised in host less developed countries rather than in developed countries. One explanation of this tendency may be that the multinationals' involvement in the new forms is largely a defensive reaction in response to more nationalistic attitudes and threats of expropriation. A second explanation may be that it reflects strategy initiatives of firms which have perceived opportunities for increasing their leverage (achieving the same return with less initial capital investment) or want to get into sectors not previously open to foreign investors in a host country. A possible third explanation is that within the realm of non-price competition the emphasis, during the sixties, was on product differentiation; it has perhaps shifted in the seventies and the eighties towards process competition and hence cost reduction. New forms of investment in less developed countries may contribute to reducing the cost of production for final products of the multinational.

The new forms of multinational investments are relatively new phenomena in the field of the growth of multinational enterprises in the world economy. So far as we are aware, there are hardly any statistics on the magnitude of multinational involvements in the new forms of investments in the world economy. Therefore, in the following sections, all discussions are concerned with the direct capital investments of multinational enterprises.

2.3 STOCK OF FOREIGN INVESTMENTS BY MULTINATIONALS

Between 1971 and 1978, the stock of foreign direct investment by multinational enterprises originating from the developed market economies increased by about 120 per cent (table 2.1) - an annual average growth rate of about 12 per cent. During the same period a growth of 509 per cent was achieved by Japanese multinationals. Growth in foreign investment during the same period, by multinational enterprises from West Germany was 336 per cent, Switzerland 159 per cent, Sweden 150 per cent, Belgium 125 per cent, Canada 109 per cent, France 104 per cent, United States 103 per cent, United Kingdom 73 per cent, Netherlands 72 per cent, and Italy 10 per cent. Table 2.1 shows that the book value of the stock of direct foreign investment by multinational enterprises of the developed market economies in 1978 was $396.3 billions. The growth trend suggests that by the end of 1980, this figure might have risen to well over $400 billions.

In 1978, the U.S. was the leading home country accounting for 45.5 per cent of the total direct foreign investment stake - although its share has been falling since the early 1960s. Likewise the U.K.'s share has been falling since the early 1960s. The shares of West Germany and Japan have shown a rising tendency over the last decades. The shares of Italy and Netherlands have been falling, while the shares of Switzerland, France, Canada, Sweden, and Belgium-Luxembourg have been more or less unchanged.

In the late 1970s, multinational enterprises began to emerge from some of the more industrialised of the less developed countries. Brazil, India, South Korea, Hong Kong and Argentina are among the less developed countries which have sizeable outward direct investments.[6]

There are few published statistics regarding geographical distribution of the stock of investments by multinational enterprises. Table 2.4 below gives a picture of the total

6. Stopford et al. (1980), op.cit., p.xv.

Table 2.1

Stock of Direct Investment Abroad of Developed Market Economies, by Major Country. (US $ billions; percentage share in parenthesis)

Country of Origin	1971	1975	1976	1977	1978
United States	82.8 (49.3%)	124.1 (47.2%)	136.8 (46.1%)	149.8 (45.5%)	168.1 (45.5%)
United Kingdom	23.7 (14.1%)	30.4 (11.6%)	31.8 (10.7%)	36.8 (11.2%)	41.1 (11.1%)
West Germany	7.3 (4.3%)	16.0 (6.1%)	19.9 (6.7%)	24.8 (7.5%)	31.8 (8.6%)
Japan	4.4 (2.6%)	15.9 (6.0%)	19.4 (6.5%)	22.2 (6.7%)	26.8 (7.3%)
Switzerland	9.5 (5.7%)	17.6 (6.7%)	25.4 (8.6%)	25.4 (7.7%)	24.6 (6.7%)
Netherlands	13.8 (8.2%)	19.0 (7.2%)	20.3 (6.8%)	21.9 (6.7%)	23.7 (6.4%)
France	7.3 (4.3%)	11.1 (4.2%)	11.9 (4.0%)	13.1 (4.0%)	14.9 (4.0%)
Canada	6.5 (3.9%)	10.4 (4.0%)	11.4 (3.8%)	12.1 (3.7%)	13.6 (3.7%)
Sweden	2.4 (1.4%)	4.4 (1.7%)	5.0 (1.7%)	5.6 (1.7%)	6.0 (1.6%)
Belgium - Luxembourg	2.4 (1.4%)	3.6 (1.4%)	3.9 (1.3%)	4.8 (1.5%)	5.4 (1.5%)
Italy	3.0 (1.8%)	3.3 (1.3%)	2.9 (1.0%)	3.1 (0.9%)	3.3 (0.9%)
Total Above	163.1 (97.0%)	255.8 (97.3%)	288.7 (97.4%)	319.6 (97.1%)	359.3 (97.3%)
All Other (Estimate)	5.0 (3.0%)	7.2 (2.7%)	7.8 (2.6%)	9.5 (2.9%)	10.0 (2.7%)
Grand Total	168.1 (100.0%)	263.0 (100.0%)	296.5 (100.0%)	329.1 (100.0%)	369.3 (100.0%)

Source: Stopford, J.M.,J.H. Dunning, and K.O. Haberich (1980), op. cit., p. xv, originally compiled and estimated by United Nations Centre on Transnational Corporations, based on data provided by national governments and by private sources.

direct foreign investments of the developed market economies in the less developed countries. By using the statistics in table 2.1 and in table 2.4, an estimate is made in table 2.2, of the distribution of foreign direct investments between developed[7] and less developed[8] countries. Assuming that the stock of direct foreign investments from developed market economies (table 2.1) constitutes the total foreign investment stock of multinational enterprises in the world, and further assuming that the stock of direct investments by multinational enterprises originating from less developed countries was very insignificant during the years under consideration, the geographical distribution would look like that shown in table 2.2.

Table 2.2

Percentage Distribution of Multinational Enterprises' Investments between Developed and Less Developed Countries.

Regions	1971	1975	1976	1977	1978
Developed Countries	71.5	71.1	74.3	74.2	73.9
Less Developed Countries	28.5	28.9	25.7	25.8	26.1
Total	100	100	100	100	100

Table 2.2 suggests that the developed economies were host to about three-quarters of capital invested by foreign based enterprises, and the less developed countries to about one quarter. The share of less developed countries in the total stock of foreign direct investments fell from a peak of about

7. Developed Market Economies include 17 Development Assistance Committee Countries: USA, UK, West Germany, Japan, Switzerland, Netherlands, France, Canada, Sweden, Belgium, Italy, Australia, Austria, Denmark, Finland, New Zealand and Norway: these developed market economies are considered as the developed countries, in the present study.
8. Less developed countries include all countries in Africa except South Africa, all in America except the United States and Canada, all in Asia except Japan, all in Oceania except Australia and New Zealand, and certain countries in Europe - Cyprus, Gibraltar, Greece, Malta, Portugal, Spain, Turkey and Yugoslavia (OECD's list of 'developing countries').

32 per cent in 1967, mainly due to the expropriation of assets of foreign based multinationals in oil and other extractive industries, and the move to new forms of investments in less developed countries.

2.4 MULTINATIONAL ENTERPRISES IN LESS DEVELOPED COUNTRIES

Although the less developed countries are host to about one-quarter of total direct investments of multinational enterprises, the economic significance of this volume of investments in these countries seems no less than that in developed market economies. Since the developed market economies are the home countries of multinationals which operate on a world-wide basis, the fact that they are host to three-quarters of multinationals' foreign direct investments puts them in an advantageous position compared with the less developed countries. An important point for consideration in this respect is that the developed market economies produce about three-quarters of the total world Gross National Product (GNP), excluding the GNP of the non-market industrial economies. The remaining one-quarter of GNP is generated in all other countries including all the less developed countries (table 2.3).

Table 2.3
Gross National Product (GNP) of the World, 1978
(US $ billions)

	GNP including Non-market Industrial Economies	GNP Excluding Non-market Industrial Economies
Developed Market Economies[a]	5,621 (64%)	5,621 (75%)
Non-Market Industrial Economies[b]	1,326 (15%)	
Other Countries[c]	1,846 (21%)	1,846 (25%)
World Total	8,793 (100%)	7,467 (100%)

Source: 1980 World Bank Atlas, World Bank, Washington, D.C.

Notes : (a) Development Assistance Committee Countries.
(b) USSR, GDR, Bulgaria, Poland, Hungary, and Czechoslovakia.
(c) Include all the less developed countries of the world; 160 of the 183 countries and territories covered by 1980 World Bank Atlas.

The information contained in tables 2.2 and 2.3 above indicates that the volume of the stock of foreign investments in less developed countries has potentially real economic significance, when one considers that the less developed countries have three-quarters of the world's population living on one-fifth of the world's income.[9] The poor countries of the world, being the hosts of foreign investments from the developed countries appear to have justifiable cause for concern about the economic impact of these investments.

Table 2.4 below summarises the stock of direct foreign investments in less developed countries. It shows that upto the mid-1970s, 13 members of the Organisation of Petroleum Exporting Countries (OPEC) were host to more than 20 per cent of the total multinational investments (direct foreign investments) in less developed countries. After the mid-1970s a change took place in OPEC's share due mainly to the expropriation of foreign assets in the oil industry by many host governments, and due to the increased interest of multinationals in manufacturing activities in less developed countries. The UN (1978)[10] report reveals that the share of less developed countries in the reported stock of foreign investments has been increasing in the manufacturing and service sectors during the 1970s. Moreover, since the late sixties, the tax haven countries have been attracting a growing volume of multinational investments.[11] While the share of OPEC countries has fallen during the seventies, the share of tax haven countries has risen from 8.1 per cent in 1971 to 13.1 per cent in 1978.

---

9. For a discussion on poverty and the scarcity of resources in less developed countries, see: W. Brandt et al., North-South: A Programme for Survival, the Report of the Independent Commission on International Development Issues under the Chairmanship of Willy Brandt, Pan Books, London, 1980.
10. United Nations, Transnational Corporations in World Development: A Re-Examination, UN Economic and Social Council, E.78, II, A.5, 1978.
11. For a discussion on the advantages offered by tax haven countries to the foreign investors, see: E. Chambost (English Edition by T. Crawley), Using Tax Havens Successfully, Institute for International Research, London, 1978.

Table 2.4

Direct Foreign Investment Stock in Less Developed Countries from Developed Market Economies[a] (US $ billions)

Host Countries	1971	1975	1976	1977	1978
Total Stock	47.9(100%)	75.9(100%)	76.2(100%)	85.0(100%)	96.4(100%)
OPEC Countries[b]	11.6(24.2%)	15.6(20.6%)	12.1(15.9%)	13.5(15.9%)	14.9(15.4%)
Tax Havens[c]	3.9(8.1%)	8.9(11.7%)	9.5(12.5%)	10.5(12.4%)	12.6(13.1%)
All Other Less Developed Countries:	32.4(67.7%)	51.4(67.7%)	54.6(71.1%)	61.0(71.7%)	68.9(71.5%)
of which -					
Brazil	5.1	9.1	9.1	10.7	13.5
Mexico	2.5	4.8	4.7	5.1	6.0
India	1.7	2.4	2.5	2.5	2.5
Malaysia	0.9	2.3	2.4	2.7	2.9
Argentina	2.2	2.0	2.3	2.9	3.3
Singapore	0.4	1.7	1.3	1.5	1.7
Peru	0.8	1.7	1.8	1.9	2.2
Hongkong	0.6	1.3	1.5	1.7	2.1
Philippines	0.8	1.2	1.4	1.6	1.8
Trinidad and Tobago	1.0	1.2	1.2	1.3	1.3
Total above Ten Countries	16.0(33.4%)	27.7(36.5%)	28.2(37.0%)	31.9(37.5%)	37.3(38.7%)

Source: Computed from data published in: Organisation for Economic Co-operation and Development, Development Co-operation, OECD, Paris, various issues - 1973, 1977, 1978, 1979, 1980.

a. Developed Market Economies include all (17) Development Assistance Committee members of the OECD.
b. OPEC Countries: Algeria, Libya, Gabon, Nigeria, Indonesia, Iraq, Iran, Kuwait, Qatar, Oman, Saudi Arabia, United Arab Emirates, Ecuador, Venezuela.
c. Tax Haven Countries: Bahamas, Barbados, Bermuda, Cayman Islands, Netherlands Antilles, Panama; the list is from: UN (1978), op.cit.

About 70 per cent of the multinational enterprises' total foreign investments in less developed countries is hosted by over 100 countries outside the OPEC and tax haven countries. But foreign investments by multinationals are concentrated mainly in a few of these 100 less developed countries - 10 countries (Brazil, Mexico, India, Malaysia, Argentina, Singapore, Peru, Hong Kong, Phillipines, and Trinidad and Tobago) together held about 39 per cent of the total stock in 1978. The share of these 10 countries has been on the increase since 1971 when it was 33.4 per cent. As supporting evidence to the argument that multinational enterprises are attracted to the richer of the less developed countries, a relationship between per capita income of the host countries and the stock and the stock of foreign private investments in these countries, may be drawn. In 1978, about 50 per cent of the total stock of multinational investments in less developed countries was in non-OPEC, non-tax haven countries with per capita income of more than US$1000. In the same year, about 79 per cent of the total multinational investments in less developed countries was in the richer of this group of countries (OPEC, tax havens, and countries with per capita income over US$1000). The remaining 21 per cent of the total stock was mainly concentrated in countries with large markets and/or sources of raw materials.

2.5 MAGNITUDES OF MULTINATIONAL ENTERPRISES

In the 1970s, the sales of foreign-based affiliates of multinational enterprises increased at average rates higher than those reported for their consolidated sales world-wide.[12] Taking into account that the output of the affiliates of multinational enterprises has in many cases, increased faster than their equity investments, and that non-equity operations have become increasingly important during the 1970s, the rate of growth of multinational investments shown earlier may be an under-estimate of the actual expansion of the operations of multinational enterprises.

---

12. Vaitsos, C., "World Industrial Development and the Transnational Corporations: the Lima Target as Viewed by Economic Actors", Industry and Development, No.3 of UNIDO, 1979, pp.33-43.

The UN (1973)[13] report reveals that the firms which own and control income-generating assets in more than one country (the broad definition of multinational enterprises) accounted for one-fifth of the world's output (excluding centrally planned economies) by the end of 1971; and their production grew at the rate of 10 per cent per annum, nearly twice the growth rate of world output. Stopford et al. (1980)[14] show that in 1978, 430 major multinational enterprises accounting for 80 per cent of the world's stock of foreign direct investments had annual sale exceeding US$ 1 billion (the largest multinationals, Exxon and General Motors, had sales of over US$ 63 billions each). According to the same source, sales of the 430 multinationals grew at an annual average rate of about 12 per cent (at current market price) between 1974 and 1978.

While the gross national product (GNP) of countries and sales data of multinational enterprises are not directly comparable, they are indicators of relative economic proportions of these two types of economic entities. Considering all the nations of the world (both market economies and centrally planned economies) and multinational enterprises as individual economic entities, table 2.5 below shows a crude assessment of economic activities (GNP or sales), of the top 100 economic entities in the world in 1978. This in turn sheds some light on the magnitude of multinational enterprises in the world economy. Table 2.5 shows that of the top 100 economic entities in the world, 60 are nations and 40 are multinational enterprises.

Each of the top five multinational enterprises in 1978 had sales larger than the individual GNP of 80 per cent of all the nations of the world. In other words, 147 of all the countries in the world had individual GNP less than sales of each of the top five multinational enterprises in 1978.[15]

---

13. United Nations, Multinational Corporations in World Development, UN Economic and Social Council, E73, II, A.11, New York, 1973.
14. Stopford et al. (1980), op.cit., Part II, Annexure.
15. 1980 World Bank Atlas contained data on GNP of 183 countries and territories in the world for the year 1978.

Table 2.5

World's 100 largest Nations and Multinational Enterprises Ranked by 1978 GNP or Sales. (US$ millions)

Rank	Nation or Firm	GNP or Sale	Rank	Nation or Firm	GNP or Sale
1	United States	2,135,010	* 41	Mobil (USA)	34,736
2	USSR	967,820	42	Finland	34,020
3	Japan	884,500	43	Greece	32,430
4	West Germany	631,590	* 44	Texaco (USA)	28,607
5	France	473,030	45	Bulgaria	28,310
6	United Kingdom	319,480	* 46	Brit.Petroleum(UK)	27,407
7	Italy	260,940	47	Algeria	25,730
8	China	219,010	48	Philippines	24,410
9	Canada	203,980	49	Thailand	23,390
10	Brazil	180,020	* 50	Standard Oil of California (USA)	23,232
11	Spain	146,940	51	Colombia	22,990
12	Netherlands	128,270	* 52	National Iran Oil (Iran)	22,789
13	Poland	127,560			
14	India	117,520	53	Iraq	22,540
15	Australia	114,780	* 54	IBM (USA)	21,076
16	Belgium	95,450	55	Libya	19,820
17	East Germany	94,960	* 56	General Electric (USA)	19,653
18	Mexico	91,190			
19	Sweden	87,260	57	Kuwait	19,410
20	Switzerland	81,930	58	Portugal	19,000
21	Iran	77,328	* 59	Unilever(UK/Neth.)	18,893
22	Czechoslovakia	71,640	60	Pakistan	18,250
* 23	General Motors(USA)	63,221	61	Gulf Oil (USA)	18,069
* 24	Exxon (USA)	60,334	62	New Zealand	17,700
25	Austria	56,450	63	North Korea	17,040
26	Saudi Arabia	54,200	64	Egypt	16,890
27	Denmark	54,000	* 65	Chrysler (USA)	16,340
28	Turkey	53,890	66	Chile	15,770
29	Argentina	53,430	67	Hong Kong	15,400
30	Nigeria	48,100	68	Malaysia	15,270
31	South Korea	48,000	* 69	ITT (USA)	15,261
32	Yogoslavia	46,140	* 70	Philips (Neth.)	15,121
33	Indonesia	45,780	* 71	Standard Oil of Indiana (USA)	14,961
* 34	Royal Dutch/Shell (UK/Netherlands)	44,044	* 72	Siemens (W.Germany)	13,864
35	South Africa	43,760	73	Israel	13,760
* 36	Ford Motor (USA)	42,784	* 74	Volkswagen (W.Ger.)	13,332
37	Venezuela	39,880	75	Morocco	12,890
38	Norway	38,790	* 76	Toyota Motor(Japan)	12,768
39	Hungary	37,150	* 77	Renault (France)	12,715
40	Romania	36,190	* 78	ENI (Italy)	12,565
			* 79	Francaise des Petroles (France)	12,509
			80	Cuba	12,330

Table 2.5 : Continued . . . . . .

Rank	Nation or Firm	GNP or Sale	Rank	Nation or Firm	GNP or Sale
* 81	Atlantic Richfield (USA)	12,298	* 91	BASF (W.Ger.)	10,732
			* 92	Peugeot-Citroen(Fr.)	10,584
82	Ireland	12,280	* 93	Matsushita Elec.Ind (Japan)	10,020
83	United Arab Emirat.	12,180			
* 84	Daimler-Benz(W.Ger.)	12,090	* 94	Nissan Motor(Japan)	9,751
* 85	Hoechst (W.Ger.)	12,068	* 95	Western Electric (USA)	9,525
86	Peru	11,440	* 96	Nippon Steel(Japan)	9,521
* 87	Bayer (W.Ger.)	11,392	* 97	Continental Oil(USA)	9,455
* 88	Shell Oil (USA)	11,062	* 98	Mitsubishi Heavy Inds. (Japan)	9,200
* 89	U.S. Steel (USA)	11,049			
* 90	Nestle (Switzerland)	11,001	* 99	Thyssen (W.Ger.)	9,182
			*100	Hitachi (Japan)	9,153

Source: GNP of Nations at 1978 current market prices, compiled from 1980 World Bank Atlas (GNP of Iran taken from World Development Report 1980 of World Bank); Sales of Multinational Enterprises from Fortune, May 15, 1979.

Notes : (i) Names of Multinational Enterprises are marked with a star.

(ii) Admittedly, sales of corporations are not identical to GNP of countries, yet the yardsticks are representative of the relative scope of economic activities of the two economic entities.

(iii) World's 100 largest Nations and Multinational Enterprises Ranked by GNP or Sales; Ranges, 1978

Range of GNP or Sales	Number	
	Nations	Firms
More than US$ 2000 billions	1	-
US$ 500 billions to US$ 1000 billions	3	-
US$ 100 billions to US$ 499 billions	11	-
US$ 50 billions to US$ 99 billions	12	2
US$ 25 billions to US$ 49 billions	13	5
US$ 10 billions to US$ 24 billions	20	26
US$ 9 billions to US$ 9.9 billions	-	7
TOTALS	60	40

If size is the appropriate criterion, contemporary multinational enterprises can, if need be, rival nation states as economic entities. This possibility might have induced Kindleberger (1969)[16] to state that, "The nation-state is just about through as an economic unit." Many multinational enterprises have annual sales three to five times greater than the GNP of the countries in which they operate (table 2.5). The comparison of economic entities in table 2.5 includes only industrial corporations; had banks and other non-manufacturing enterprises been included, another dozen or more multinationals would have joined the world's 100 top economic entities. Though some observers have dismissed the relevance of comparison between sales of firms and GNP of countries, the ranking suggests the order of magnitude of multinational enterprises' control over resources and its consequent potential economic and political implications.

2.6 CONCLUSION

A salient characteristic of the structure of the post-War world economy, as implied by the foregoing discussion, is the tendency for the basic economic unit (corporation) to organise production on an international basis. In the past, markets and production were mainly within the boundaries of national states. But in today's world the situation has changed - the investment and planning horizons of the large enterprises (multinationals) now reach far beyond national frontiers into the remotest markets. The former American Under Secretary of State, George Ball (1967)[17] wrote:

> ". . . those who manage great enterprises have ceased to think in the classic pattern of producing goods for the home market and exporting the surplus overseas. Today they operate and think on a world scale. . . . They tend more and more to think in terms of a world economy."

---

16. Kindleberger, C.P., American Business Abroad, Yale University Press, New Haven, 1969, p.207.
17. Ball, G.W., "Multinational Corporations and Nation States", Atlantic Community Quarterly, Summer 1967, p.247.

The international operations of national enterprises have resulted in the emergence and growth of modern multinational enterprises. Foreign operations of multinational enterprises have expanded to such an extent that anyone who has travelled widely should have experienced that brand names like Coca-Cola, Lifebuoy Soap, Canon Camera, Kodak Film, Philips Radio, Raleigh Bicycle, Toyota Cars, GEC electric goods, 555 cigarettes, and many more are as familiar in the remotest corners of Asia, Africa and other continents, as in the developed countries of the world.

While multinational enterprises are neither stateless nor without a controlling nationality, they seem to consider the world as a whole as their hunting ground. Therefore, it may be expected that no sizeable or rapidly growing market would long be left unpenetrated by multinational enterprises. In planning for their overseas expansion of direct investment facilities, multinationals may be motivated by certain factors. An insight into these factors seems to be of importance in a study concerning multinational enterprises. Therefore, an attempt is made in the following chapter to discuss the potential motivations for foreign investments by multinational enterprises.

CHAPTER THREE

Motivations for Foreign Investments by Multinational Enterprises

3.1 INTRODUCTION

> "When a foreign investment opportunity is brought before management, the burden of proof that such an opportunity should be considered (let alone decided upon) is on the proposer. It is not enough to show that the expected value of profits is high. It must be proved that "it is worthwhile to go abroad"."
>
> - Aharoni (1966)[1]

The fundamental assumption relating to foreign investments by multinational enterprises is that enterprises that invest for direct production abroad are at a disadvantage compared to local enterprises because of their unfamiliarity with local market conditions and because they incur higher information costs than do their local counterparts.[2] The argument goes, therefore, that the foreign firms should have some motivations to invest abroad and that these motivations should be sufficiently great to offset the higher information costs of their alien status if they are to operate in foreign markets. These motivations seem to be of great importance in any investment decision of a multinational enterprise, in order to prove that the particular foreign investment would be "worthwhile".

The construction of a theory to capture the essential features of the motivations for foreign investments by multinational enterprises is a difficult task. Any such theory is likely to be a simplified abstraction of the complex interrelationships and decisions undertaken by multinationals.

---

1. Aharoni, Y., The Foreign Investment Decision Process, Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1966, p.42.
2. For this view, see: S.H. Hymer, The International Operations of National Firms: a Study of Direct Foreign Investment, MIT Press, Cambridge: Mass, 1976; and C.P. Kindleberger, American Business Abroad, Yale University Press, New Haven, 1969.

As an abstraction, the theory may not be expected to describe accurately and precisely every single detail of the foreign investment decision process of multinational enterprises. This may be the reason behind the advancement of several theoretical explanations of the motivations for foreign investments, in the existing literature.[3]

Given that the environment of multinational enterprises is a mixture of diversified cultural, political and economic elements, and that alternative motivating factors may induce foreign investment decisions of multinationals in different countries, any particular theory may not be sufficient to explain the real world conditions. Therefore, in the present chapter we attempt to discuss two theories that seem to have potential in explaining the motivations for foreign investments by multinational enterprises; these are: (i) the market imperfection theory, and (ii) the risk-diversification theory. However, broadly speaking, one may argue that in whatever way it is defined, the basic motivation behind foreign investment decision of a multinational enterprise may be the desire of maximising its global interests.

3.2 THE MARKET IMPERFECTION THEORY

Since the doctoral dissertation of Hymer in 1960,[4] several studies have suggested that direct investments of multinational enterprises can be best explained by the theory of industrial organisation. According to this theory, direct foreign investment is motivated by market imperfections that permit a multinational enterprise to exploit monopolistic advantages in foreign markets that it has acquired in its domestic environment. Based upon the work of Hymer,

---

3. For a comprehensive survey of the studies concerning the theory of foreign investment, till the early seventies, see: V.G. Stevens, "The Determinants of Investment", in J.H. Dunning (ed.), Economic Analysis and the Multinational Enterprise, George Allen & Unwin, London, 1974, pp.47-88; since new studies advocating alternative theories have been published, and these will be mentioned later.
4. Hymer, S.H., The International Operations of National Firms: a Study of Direct Investment, Ph.D. thesis, MIT, 1960.

Kindleberger (1969)[5] summarised this point as follows:

> "For direct investment to thrive there must be some imperfection in markets for goods or factors, including among the latter technology, or some interference in competition by government or by firms, which separates markets."

Kindleberger believed that a market imperfection must exist in order to have international production rather than exporting or licensing. The market imperfection may be caused by the monopolistic advantages, creating motivations for direct foreign investments by a multinational enterprise, and may be one or more of several types - for example:[6]

> "1. departures from perfect competition in goods markets including product differentiation, special marketing skills, retail price maintenance, administered pricing and so forth;
>
> 2. departures from perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, of differences in skills of managers organized into firms rather than hired in competitive markets;
>
> 3. internal and external economies of scale, the latter being taken advantage of by vertical integration;
>
> 4. government limitations on output or entry."

Caves (1971)[7] has suggested that one of the reasons the parent company establishes subsidiaries abroad is to produce a similar product and benefit from managerial and technical advantages acquired in the original development of that product. Selling in the host economy market offers further local advantages, even though the plant established in a host country is in many ways a replica of the parent company's plant in home country; examples are the oil, copper, and aluminium industries.

---

5. Kindleberger (1969), op.cit., p.13.
6. Ibid, p.14.
7. Caves, R.E., "International Corporations: The Industrial Economics of Foreign Investment", Economica, 38, February 1971, pp.1-27.

In line with the view of Caves, Galbraith (1973)[8] emphasises the organisational and motivational characteristics of oligopolistic modern corporations. Galbraith interpreted overseas investment essentially as the rational behaviour of big oligopolistic corporations nurtured in an advanced capitalistic economy like that of the United States. In a mature stage of capitalism, what he called 'a technostructure' comes into existence. The technostructure is a 'complex of scientists, engineers, and technicians' in the fields of management, marketing, and production, hired by a big corporation. It is a planning system built on 'collective intelligence' and on 'the authority of organization'.

Galbraith brought in the unique organisational form of the modern corporation as an additional factor to explain overseas investments. The existence of an oligopolistic market is simply a necessary but not a sufficient condition for direct investment to occur, he viewed; the firms in such a market should reach a mature stage of organisation to form a technostructure.

In addition to the above explanation of Galbraith as to the inducements for foreign investments by modern corporations, the 'product cycle' theory expounded by Vernon (1966, 1971)[9] offers another motivational explanation within the oligopolistic framework. The theory states essentially that multinational enterprises try to retain control over their innovations by establishing their own overseas production facilities whether wholly or jointly owned. According to this view, foreign investments in production facilities are essentially of a defensive nature; direct foreign investment is the alternative to export of a new product, and it helps to preserve for the multinational the fleeting advantage embodied in the innovation. The multinational enterprise is induced to

8. Galbraith, J.K., Economics and the Public Purposes, Houghton Mifflin Co., Boston, 1973.
9. Vernon, R., "International Investment and International Trade in the Product-life-cycle", Quarterly Journal of Economics, May 1966, pp.190-207; and Sovereignty at Bay, Basic Books, New York, 1971.

set up production facilities abroad as a defensive reaction to the threat of potential competition.

Johnson (1970)[10] argued that a firm internalises services like production, marketing or management techniques in order to exert monopoly market power in different countries through its overseas subsidiaries. Innovations and new know-how, either protectected through trade-marks, or kept secret within the multinational group, helps the organisations exploit world-wide imperfect markets. In a dynamic context, knowledge is an integral factor in the development and maintenance of world-wide oligopolies. Industries requiring a high degree of research and technical know-how, may tend to rely on the expansion of foreign subsidiaries to earn higher profits that could not otherwise be earned in the domestic markets.

Knickerbocker (1973)[11], studying the expansion of American enterprises abroad, argued that foreign subsidiaries are established by multinationals in response to initial direct investment by rival firms. It is assumed that the host-country market structure is characterised by oligopoly rather than perfect competition, leading to the implication that direct foreign investment can be explained by market imperfections. Together with the assumption of oligopoly is the hypothesis that American exports follow a product cycle in which product pioneering enterprises generate advantages in production of goods by innovations in manufacturing, marketing, management, and technology. These advantages are specific to the enterprise and thus it is in the interest of the enterprise to exploit its innovation not only in the domestic market but also by extending operations abroad through establishment of subsidiaries.

---

10. Johnson, H.G., "The Efficiency and Welfare Implications of the International Corporations", in C.P. Kindleberger (ed.), The International Corporation, MIT Press, Cambridge: Mass, 1970, pp.35-56.
11. Knickerbocker, F.T., Oligopolistic Reaction and Multinational Enterprise, Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1973.

The above discussion suggests that foreign investment takes place once the multinational enterprise has secured a firm-specific advantage. In ideal competitive conditions no single firm can, by assumption, have access to any sort of special advantage which is not equally available to other firms operating in the same economy. Therefore, it is essential that market imperfection created by the existence of a firm-specific advantage, should prevail in order to motivate a multinational enterprise to make overseas investments. A multinational enterprise can exploit the market imperfection by internalising its firm-specific advantages through establishment of production facilities in foreign countries. Therefore, the theory of internalisation as an explanation to foreign direct investments by multinational enterprises, as advanced by Buckley and Casson (1976)[12], and Dunning (1977)[13], is essentially an extension of the theory of market imperfection. The internalisation theory, which Dunning (1981)[14] developed as the "eclectic theory", places emphasis on the firm-specific advantages enjoyed by multinationals, and it implies that such advantages are best exploited via foreign production facilities rather than by either exporting or licensing.

A classic example of firm-specific advantage is the superiority of knowledge of one firm over that of others. It may be technological, managerial or marketing knowledge. The acquiring of knowledge involves an expenditure on research and development, or other outflows of funds which introduce innovations into the production or marketing process of a firm. Once a particular knowledge is acquired by incurring an expenditure, it can be used until it is obsolete. In other words, particular knowledge can be used concurrently by any number of users without the involvement of additional expenditures. Therefore, the pricing of knowledge is a difficult (may be impossible) task. In fact, the non-existence of an

12. Buckley, P., and M. Casson, The Future of the Multinational Enterprise, Macmillan, Basingstoke and London, 1976.
13. Dunning, J.H., "Trade, Location of Economic Activity and the MNE: A Search for an Electric Approach", in B.Ohlin et al. (eds.), The International Allocation of Economic Activity, Macmillan, London, 1977.
14. Dunning, J.H., International Production and the Multinational Enterprise, George Allen & Unwin, London, 1981.

open market for knowledge poses problems for its pricing. A firm can overcome the missing open market for knowledge by internalisation. The internal market of a firm permits the production of final products which use knowledge as an intermediate input, and the monopoly use of the knowledge-advantage permits the firm to appropriate a return for its initial expenditures for acquiring such a knowledge. While any firm with a monopoly in knowledge can extract benefits within a national economy, a multinational enterprise can extract maximum possible benefits from its knowledge-advantage by expanding its production facilities to foreign countries. In addition to the knowledge-advantage, other 'monopolistic advantages' as described by Kindleberger (1969)[15], may give rise to market imperfection and in turn may provide motivations for foreign investments by multinational enterprises.

3.3 THE RISK-DIVERSIFICATION THEORY

At a theoretical level, it can be hypothesised that a multinational enterprise should provide greater benefits to its shareholders than a comparable enterprise with no direct foreign investments. This is because of the benefits from international diversification of operations which enable the multinational enterprise to enjoy a more stable stream of profits over time. This hypothesis has its premise in the finance theory of portfolio selection. As direct foreign investments by a multinational enterprise help to diversify risks, the investors (existing and potential) may expect a more stable rate of return. If this expectation is impounded in the market price of shares of the enterprise, it will ceteris paribus raise its value. It is, therefore, believed by some researchers that, risk-diversification acts as an important motivation for foreign investments by multinational enterprises.

The theory of portfolio selection under conditions of uncertainty, as developed by Tobin (1958)[16]

15. Kindleberger (1969), op.cit.
16. Tobin, J., "Liquidity Preference as Behavior Towards Risk", The Review of Economic Studies, 25, February 1958, pp.65-86.

and Markowitz (1952,1959)[17], was first applied in an international context by Grubel (1968)[18]. He demonstrated that it was possible for individual asset holders to reduce risk by holding an efficiently diversified portfolio of international assets. His analysis considered financial capital flows, as did studies by Levy and Sarnat (1970)[19], Miller and Whiteman (1970)[20], and Grubel and Fadner (1971)[21]. It can be extended to the field of direct foreign investments by multinational enterprises, as attempted by Cohen (1972)[22], Severn (1974)[23], and Rugman (1974)[24]. This has given recognition to the theory of risk-diversification as an explanation of the motivations for foreign investments by multinational enterprises. An attempt is made below to make a normative analysis of the risk-diversification theory in the context of direct foreign investments.

A corporation can reduce its variance of earnings (surrogate of business risk) by product-diversification and/or plant-diversification within an economy. But such a risk reduction cannot exceed certain level because of the existence of those macro-economic parameters that affect all enterprises in a particular national economy. Examples of such macro-economic

17. Markowitz, H., "Portfolio Selection", Journal of Finance, March 1952, pp.77-91; and Portfolio Selection: Efficient Diversification of Investments, Wiley, New York, 1959.
18. Grubel, H.G., "Internationally Diversified Portfolios: Welfare Gains and Capital Flows", American Economic Review, 58, December 1968, pp.1299-1314.
19. Levy, H.,and M.Sarnat, "International Diversification of Investment Portfolios", American Economic Review, 60, September 1970, pp.668-692.
20. Miller, N.C.,and M.V.N. Whiteman, "A Mean-Variance Analysis of United States Long-term Portfolio Foreign Investment", Quarterly Journal of Economics, 84, May 1970, pp.175-192.
21. Grubel, H.G.,and K. Fadner, "The Interdependence of International Equity Markets", Journal of Finance, March 1971, pp.89-94.
22. Cohen, B.I., Foreign Investment by U.S. Corporations as a Way of Reducing Risk, Yale University Economic Growth Center (mimeo), Discussion Paper No. 151, September 1972.
23. Severn, A., "Investor Evaluation of Foreign and Domestic Risk", Journal of Finance, May 1974, pp.545-550.
24. Rugman, A.M., Foreign Operations and the Stability of U.S. Corporate Earnings: Risk Reduction by International Diversification, Ph.D. Dissertation, Simon Fraser University, USA, 1974.

parameters are: tax and tariff policies, import and export policies, investment policy, and other economic policies of the government; general economic conditions and general purchasing power of the people; foreign exchange reserves and exchange rates; the general political and investment climate; and suchlike. The corporate risk emerging from these macro-economic parameters is called systematic risk. Product-or plant-diversification within a particular national economy, therefore, are still subject to fluctuations in the economy. The way to increased stabilisation of profit is through diversification across national boundaries - in addition to the other types of diversification. Risk diversification through international plant diversification is possible if and only if the economies of the host countries and the home country of the multinational enterprise are less than perfectly positively correlated with economic fluctuations of the economies of each other.

According to portfolio theory, the concern of a multinational enterprise is with the distribution of the return on its total global investments (i.e. portfolio of investments). The characteristics of an individual investment project in a host country, are only important in terms of their effect on the distribution of the portfolio return.The **way** in which the return from a particular investment project in a host country can be **considered** in the context of the return from the portfolio of investments, is shown below:

(a) Expected Return:

$$E(R_p) = \sum_{i,j}^{n} X_{ip}E(R_i) + X_{jp}E(R_j)$$

Where: $E(R_p)$ = Expected return on a portfolio of investments in both home and host countries.

$E(R_i)$ = Expected return on investment "i" in home country.

$E(R_j)$ = Expected return on investment "j" in host country.

X_{ip}, X_{jp} = Proportionate weights in the portfolio (total) of investments of the projects "i" and "j" respectively.

(b) Risk of Return:

In a real world situation corporations are exposed to various uncontrollable risks, earlier defined as systematic risk. Due to the existence of such risks it may not be possible to attain the expected return on a portfolio computed according to the equation shown above. The possibility of divergence between expected and actual returns on a portfolio necessitates the computation of risk of return. The probability of attaining expected return and stabilising rate of return over time depends, among other things, to a great extent on the ability to diversify the risk of return.

The most commonly used measure of the risk of return on an investment is the extent to which actual returns are likely to diverge from the expected or predicted return. Taking variance as a measure of risk, the risk of return on a portfolio of investments in both the home and host countries may be computed as below:

Risk of return on investment only in home country -

$$\sigma^2(R) = E\left\{\left[R - E(R)\right]\right\}^2$$

Where:

$\sigma^2(R)$ = Variance or risk of return on investment in home country.

R = Actual return on investment in home country.

$E(R)$ = Expected return on investment in home country.

Risk of return on portfolio of investments in home and host countries ("i" for home-country investment and "j" for host-country investment) -

$$\sigma^2(R_p) = X^2_{ip} E\left[R_i - E(R_i)\right]^2 + X^2_{jp} E\left[R_j - E(R_j)\right]^2 + 2X_{ip}X_{jp} E\left\{\left[R_i - E(R_i)\right]\left[R_j - E(R_j)\right]\right\}$$

Where:

X^2_{ip} = Square of home-country investment's proportion in the portfolio of investments.

X^2_{jp} = Square of host-country investment's proportion in the portfolio of investments.

$E\left[R_i - E(R_i)\right]^2$ = Variance of returns on investment in home country.

$E\left[R_j - E(R_j)\right]^2$ = Variance of returns on investment in host country.

$\sigma^2(R_p)$ = Variance or risk of return of the portfolio of investments (i.e., total investment of the multinational enterprise).

$E\left\{\left[R_i - E(R_i)\right]\left[R_j - E(R_j)\right]\right\}$; this part of the above equation shows the pairwise covariance between the actual returns on investment in the home country and in the host country, i.e., between R_i and R_j. This covariance term measures the degree of covariation between returns on investment in the home country and in the host country. It is interesting to note that the co-efficient of correlation (r) between the returns on investment in the home country and in the host country has an immense influence on the risk of the portfolio of investments. When "r" is perfectly positive, there is maximum risk, and when "r" is perfectly negative,there is minimum risk.

It has been mentioned earlier that the return on investment of a firm in a particular economy is affected by the systematic risks arising out of economic fluctuations in that particular economy. As the corporation cannot control economic fluctuations to any great extent in the economy, the variance of return on investment continues to be a function of systematic risks (or economic fluctuations in the economy). Therefore, the degree of covariance between economic fluctuations in the home-country economy and in the host-country economy will influence the risk of return on the portfolio of investments.

In the real world, it is rare to observe perfect positive correlation between economic fluctuations in the economies of two or more countries. This phenomenon contributes to the

success of risk reduction attempts through international diversification of investments by multinational enterprises. Severn (1974)[25] stated that the foreign investments by U.S. firms attained greater benefits through risk diversification because the fluctuations of the economies of host countries and the U.S. were not perfectly positively correlated. After allowing for the influence of industry classification, size, and other factors, Rugman (1974)[26] demonstrated that foreign operations reduce the risk of a firm's profits.

3.4 THE MULTINATIONALS' VIEW : TWO STUDIES

In 1973, the American Institute of Certified Public Accountants (AICPA) Conference Board prepared a study report for the U.S. Department of Commerce to determine why multinational enterprises invested in foreign countries. The 76 firms surveyed, cited more than one reason, but the 10 reasons most often mentioned are shown in table 3.1 below:

Table 3.1
Reasons for Foreign Investment

Importance of reasons for foreign investments	Mentioned by number of companies
1. Maintain or increase market share locally	33
2. Unable to reach market from U.S. because of tariffs, transportation costs or nationalistic purchasing policies.	25
3. To meet competition	20
4. To meet local content requirements and host government pressure	18
5. Faster sales growth than in the U.S.	15
6. To obtain or use local raw materials or components	13
7. Low wage costs	13
8. Greater profit prospects abroad	11
9. To follow major customers	10
10. Inducements connected with host government investment promotion programs	8

Source: Forster, J.M. (ed.), "Tax Reform - Foreign Income", The Journal of Accountancy, November 1975, exhibit 1, p.40.

25. Severn (1974), op.cit., p.p.545.
26. Rugman (1974), op.cit., chapter 4.

The reasons for foreign investments by multinational enterprises shown in table 3.1, support the general oligopoly theories, in which growth is depicted as vital for the survival of the large oligopolies. Growth in this context is defined as an increasing share of the total potential market throghout the world.

The findings of the AICPA study summarised in table 3.1, seem to conform to the findings of another contemporary study by Reuber et al. (1973)[27] who surveyed 80 international firms with operations in less developed countries.

Reuber et al. classified foreign investments in less developed countries in three categories:

(a) Market-development investments - those with the distinguishing features: (i) that the output of the product is intended primarily for consumption in the host country, and (ii) that the investment is made primarily in response to underlying economic considerations such as the size of the local market and its long run potential, local production costs, and so on.
(b) Export oriented investments - those exporting over 10 per cent of the project's output. Such investments are usually made with the desire to develop secondary and more diversified sources of supply of low-cost products to be used either as inputs or for sale elsewhere.
(c) Government-initiated investments - those which occur mainly in response to government subsidies of one kind or another that on balance are sufficiently large to make the investment attractive to the investors, irrespective of underlying demand and cost conditions.

Of the 80 foreign investment projects in less developed countries studied by Reuber et al.[28], 32 were of the market development type, 26 of the export oriented type and 22 of the

27. Reuber, G.L., H.Crookell, M.Emerson, and G. Gallais-Hamonno, Private Foreign Investment in Development (a study sponsored by the Development Centre of the OECD), Clarendon Press, Oxford, 1973, chapter 4.
28. Ibid, table 4.1, p.72.

government initiated type.It was observed that market-development investments tended to be essentially defensive of markets built up by exporting, while export-oriented investments were often undertaken to defend existing global markets from low-priced international competition. In either case the corporate initiative usually reflected a direct threat to existing operations. With market-development investments the threat, often indirect, came from the observed tendency of the governments of many less developed countries to block or hinder imports as markets grew. With the export oriented type, the threat came more often from other multinational enterprises. With the government initiated type, the protection offered in domestic host-country markets were the most important determinants of investment.

3.5 MAXIMISATION OF GLOBAL INTERESTS

There may be different theories of foreign investments by multinational enterprises. Multinationals, when asked, may point out different reasons of foreign investments. But in the real world, it does not seem imprudent to think that the basic motivation for foreign investments by a multinational enterprise may be the desire to maximise its global interests. In other words, investing abroad in production facilities, may be a way to maximise returns to a multinational's stock of assets - both tangible and intangible; intangible assets, i.e. "knowledge" may be of great importance in this consideration. Such a maximisation strategy considers not only the present returns but also the future returns to total global investments of a multinational. Strategies to achieve both present and future returns may not be always compatible,because an investor may have to sacrifice short-term benefits to preserve the overall market position, to increase sales or to increase market share with the ultimate goal of increasing future returns. The complex planning for investment strategies of a multinational enterprise seem to consider both the present and future returns to global investments.[29] And this may be the

29. For a thorough review of literature about this issue, see: Stevens (1974), op.cit.

reason why the desire for maximisation of global interests seems to be an important explanation of the motivations for foreign investments by multinational enterprises.

Global interests or returns on global investments by a multinational enterprise do not correspond solely to profit figures in books of account. Vaitsos (1974)[30], for example, calculated the "effective profitability" on foreign operations as:

> "(1) before tax earnings of subsidiaries; plus
> (2) technical assistance payments, including royalties (assuming the technology's marginal cost to the parent equals zero); plus
> (3) capitalized know-how and fully depreciated machinery that is capitalized in the subsidiary; plus
> (4) parent margins on intrafirm sales to the subsidiary (this price-cost margin may be subdivided into components of the competitive international price level less the parent's marginal cost-subsidiary opportunity costs-and the parent's price above the international price level-an intrafirm monopoly rent); plus
> (5) interest payments of subsidiary on parent-held debt (divisible into the same components as in 4 above); plus finally
> (6) some less quantifiable benefit called "control", since full ownership of the subsidiary insures these returns for future periods."

Although a multinational enterprise may be expected to be motivated by the desire for maximisation of global interests through maximisation of the "effective profitability" on foreign investments, the underlying characteristics of the theories of foreign investments discussed earlier do not seem different from it. In other words, maximisation of global interests seems to be the underpinning of the available theories of foreign investments.

The market imperfection theory indicates that multinational enterprises possess various advantages over domestic firms in a host country, and these advantages in turn may help in attaining superior earnings. That is, the ultimate motivation appears to be the ability to earn superior profits. The risk-diversification theory indicates that multinational

30. Vaitsos, C.V., Intercountry Income Distribution and Transnational Enterprises, Clarendon Press, Oxford, 1974, pp.145-147.

enterprises attempt to reduce corporate risks in order to attain expected profits and stabilise profits over time. That is, the motivation for foreign investment is to insure profit performance of the global operations of a multinational enterprise. Similarly, the market-development strategy of a multinational indicated in the AICPA (1973) and Reuber et al. (1973), has its basis in the desire for increasing present and future "effective profitability" of the enterprise.

3.6 CONCLUSION

An attempt has been made in the present chapter to examine the motivations for foreign investments by multinational enterprises. A multinational enterprise, investing in a foreign country (host country), may be expected to have some disadvantages due to its alien status. But these disadvantages seem to be offset by certain advantages that in turn act as the motivations for foreign investments. These advantages stem from the ability of a multinational enterprise to exploit the imperfect markets throughout the world. In its attempts to exploit imperfect markets, a multinational enterprise may reduce corporate risks through diversification of products and plants throughout the world. All these efforts are in essence directed towards maximisation of global interests of the multinational enterprise. In other words, multinational enterprises seem to be motivated to invest in foreign countries by their desire for maximisation of global interests.

CHAPTER FOUR

Market Share, Profitability and Multinational Enterprises in Less Developed Countries

4.1 INTRODUCTION

> "It is now widely recognized that one of the main determinants of business profitability is market share. Under most circumstances, enterprises that have achieved a high share of the markets they serve are considerably more profitable than their smaller-share rivals. This connection between market share and profitability has been recognized by corporate executives and consultants, and it is clearly demonstrated in a project undertaken by the Marketing Science Institute on the Profit Impact of Market Strategies (PIMS). The PIMS project . . . is aimed at identifying and measuring the major determinants of return on investment (ROI) in individual business. Phase II of the project, completed in late 1973, reveals 37 key profit influences, of which one of the most important is market share."
>
> - Buzzell et al. (1975)[1]

Economic theory and available empirical evidence suggest that the more competitive the structure (the larger the number of competitors and the smaller their market shares), the greater the difficulty of exercising market power by any individual enterprise or by any small group of enterprises, to earn super normal profit.[2] In a market with very few enterprises accounting for the major share of market sales, there is the possibility that the market mechanism will be controlled by such enterprises with the objective of earning more than "normal" profit in that particular market. In a market with many enterprises, each having a small share, neither a single enterprise by its action alone nor a few enterprises by joint action can exert a significant influence over price and thus output will be carried to the point where each seller's marginal cost equals market price.

---

1. Buzzell, R.D., B.T. Gale, and R.G.M. Sultan, "Market Share - a Key to Profitability", Harvard Business Review, 53, January-February 1975, p.97.
2. See any standard Economics text book, for example: R.D. Lipsey, An Introduction to Positive Economics, Widenfield and Nicolson, London, 1979, ch.19; for an in-depth analysis, see: J.S. Bain, Industrial Organization, John Wiley and Sons, New York, 1968.

Based on the hypothesis that profitability has a positive relationship with market share of the enterprise(s), it can be argued that multinational enterprises in less developed countries earn higher profits than their domestic counterparts, because evidence shows[3] that the multinational enterprises in less developed countries are highly concentrated, i.e. these enterprises account for larger shares of markets. The present chapter is concerned with the argument that multinational enterprises in less developed countries are likely to earn higher profits than the domestic enterprises. But as the available empirical evidence does not support such an argument, the chapter concludes with the indication that there might be distortions in the reported profits of the multinationals in less developed countries; and suggests that this may be why theoretical premises do not tally with empirical findings.

4.2 MARKET SHARE AND PROFITABILITY: THE "PIMS" PROJECT

The Profit Impact of Market Strategies (PIMS) project[4] was based on the data from the pool of operating experience assembled in 1973. Financial and other information on 620 individual "businesses" for the three-year period 1970-1972, were supplied by 57 North American corporations. The market share of each business was defined as simply its dollar sales in a given sales volume. Return on investment (ROI) was measured by relating pre-tax operating profits to the sum of equity and long-term debt. Operating income was defined after deduction of allocated corporate overhead costs, but prior to any capital charges assigned by corporate offices.

The evidence on the relationship between market share and return on investment, produced by the PIMS project is shown in figure 4.1 below. Figure 4.1 shows average pre-tax ROI for groups of businesses in the PIMS project that had successively increasing shares of their markets. On the average, a difference of 10 percentage points in market share was accompanied by a difference of about 5 points in pre-tax ROI.

---

3. Discussed in section 4.4 of the present chapter.
4. Buzzell et al. (1975), op.cit.

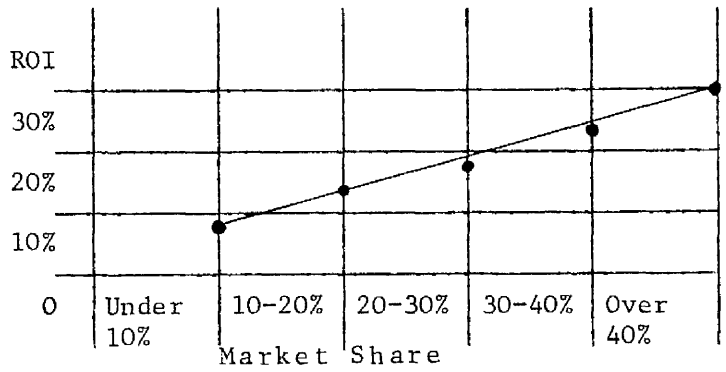

Figure 4.1 : Relationship Between Market Share and Pre-Tax ROI
Source : Reproduced from Buzzell et al.(1975),op.cit.

The evidence produced in figure 4.1 shows the differences in return on investment (ROI) between high-and low-market-share businesses. This evidence of the relationship itself, however, does not tell why there is a link between market share and profitability. Buzzell et al. showed three possible explanations to the relation between market share and profitability:[5]

> "Economies of Scale : The most obvious rationale for the high rate of return enjoyed by large-share businesses is that they have achieved economies of scale in procurement, manufacturing, marketing, and other cost components. A business with a 40% share of a given market is simply twice as big as one with 20% of the same market, and it will attain, to a much greater degree, more efficient methods of operation within a particular type of technology.
>
> Closely related to this explanation is the so-called "experience curve" phenomenon widely publicized by the Boston Consulting Group (BCG)[6] According to BCG, total unit costs of producing and distributing a product tend to decline by a more or less constant percentage with each doubling of a company's cumulative output. Since, in a given time period, businesses with large market shares generally also have larger cumulative sales than their smaller competitors, they would be expected to have lower costs and correspondingly higher profits.
>
> Market Power: Many economists, especially those involved in antitrust work, believe that economies of scale are of relatively little importance in most industries. These economists argue that if large-scale businesses earn higher profits than their smaller competitors,

5. Buzzell et al. (1975), op.cit., p.98.
6. Boston Consulting Group, Inc., Perspectives on Experience, Boston, 1968 and 1970.

it is a result of their greater market power: their size permits them to bargain more effectively, "administer" prices, and in the end, realize significantly higher prices for a particular product.

Quality of Management : The simplest of all explanations for the market-share/profitability relationship is that both share and ROI reflect a common underlying factor: the quality of management. Good managers (including perhaps, lucky ones!) are successful in achieving high shares of their respective markets; they are also skilful in controlling costs, getting maximum productivity from employees, and so on. Moreover, once a business achieves a leadership position - possibly by developing a new field - it is much easier for it to retain its lead than for others to catch up.

These explanations of why the market-share/profitability relationship exists are not mutually exclusive. To some degree, a large-share business may benefit from all three kinds of relative advantages . . ."

A simple explanation of the relationship between market share and profitability seems to be that an enterprise with higher market share possesses certain advantages over other enterprises with lower market share; in fact such advantages help in achieving higher market share and in turn higher profitability. These advantages are, in the industrial organisation literature, considered synonimous with the monopolistic or oligopolistic market power of an enterprise.[7]

4.3 MARKET CONCENTRATION AND PROFITABILITY

When a single enterprise accounts for the largest market share of a product, in comparison with any other enterprises in the same or similar product-market, and the dominance of the particular enterprise enables it to charge a higher price and produce a lower output than would a group of perfect competitors facing the same circumstances, that enterprise may be considered as having monopolistic market power. The monopolist thereby generates excess profits for itself. When a few enterprises, accounting for a larger share of a product-market, can more easily and effectively coordinate their actions, the more likely they are to achieve results similar to those of monopoly.[8]

7. Bain (1968), op.cit.,especially chapter 6.
8. Chamberlin, E.H., The Theory of Monopolistic Competition, Cambridge, Massachusetts, 1962.

The coordinated efforts of a few large enterprises to control a particular market and thereby to achieve the monopolistic advantages towards ensuring monopoly rent (super profit) for each of them, create a kind of market structure under which they are considered as having oligopolistic market power. The oligopolists act in collusion with one another and thus control the market. An often used measure of oligopolistic market power of the leading enterprises in a market is "market concentration". The concentration ratio is defined as the percent of total market sales of a product and its substitute made by some specified number of the largest enterprises in the market. The logic behind this measure is that if only a few enterprises account for most of the sales in the market they probably earn "super" profits.

A number of empirical studies - since 1950s, have attempted to find a relation between market concentration and enterprise profitability. Many of them have found such a relationship. The findings of the four most important of these studies are discussed below:

(1) Bain Study:

The first empirical study relating profit to concentration was published by Bain (1951)[9]. His sample was formed of 335 companies belonging to 42 industries. He used annual rates of return defined as the ratios of profit net of depreciation and after tax to the net worth at the beginning of the year, for the period 1936-40. He then averaged the rates of return by industry, using net worth of companies as a weighting factor. As a measure of concentration, Bain took the share of sales of the eight biggest firms, given, for each industry, by the 1935 Census of Manufacturers. Bain did not find a very good linear relationship between concentration and profit rates. However, he did find that industries with eight-firm concentration above 70 per cent tended to have relatively high average profit rates.

9. Bain, J.S., "Relation of Profit Rate to Industry Concentration: American Manufacturing, 1936-1940", Quarterly Journal of Economics, 65, August 1951, pp.293-324.

Consider:[10]

> "The positive conclusion that does emerge is that there is a rather distinct break in average profit rate showing at the 70 per cent concentration line and that there is a significant difference in the average of industry average profit rates above and below this line."

(2) Stigler Study:

Stigler's(1963)[11] study contains an analysis of the concentration-profits relation. This study was concerned with a sample of 99 three-digit American industries for various dates between 1938 and 1957. In accordance with Bain's hypothesis, Stigler first divided his sample into three classes. Industries with four-firm concentration ratios above 60 per cent were considered as "concentrated". Those with a national market and a concentration ratio smaller than 50 per cent or with a regional market and a concentration ratio below 20 per cent were called unconcentrated. The remaining industries were classified as ambiguous.

Stigler's basic data for profit rates at the three-digit industry level were as tabulated by the Internal Revenue Service. Since Census concentration ratios were not reported at the three-digit level, he computed weighted averages of the four-firm shipments concentration ratios for the four-or five-digit product classes within each three-digit industry. For those companies that did not publish balance-sheets, Stigler estimated rates of return taking into account special regulations for depreciation and including as profits parts of the salary of the owners of small companies. Stigler's methodology of aggregating data on rate of return and of estimating rates of return of small companies may make one skeptical about the meaningfulness of the regressions based on such data.

---

10. Bain (1951), op.cit., p.314. Brozen re-examined Bain's study introducing more data. Brozen's conclusion was that, Bain's sample was biased toward yielding higher profit rates in concentrated industries; see: Y. Brozen, "Bain's Concentration and Rates of Return Revisited", Journal of Law and Economics, October 1971.
11. Stigler, G.J., Capital and Rates of Returns in Manufacturing Industries, Princeton, New Jersey, 1963.

Stigler's results are shown in table 4.1 below. His conclusion was that the results were somewhat ambiguous. But on the whole, he considered the hypothesis of a positive relation between concentration and profit rate as not confirmed.

Table 4.1

The Concentration - Profits Relation

Period	Profit Rate In	
	Concentrated Industries (14)	Unconcentrated Industries (54)
1938 - 1941	6.51%	5.25%
1942 - 1944	6.23%	7.68%
1945 - 1947	7.30%	10.01%
1948 - 1950	9.11%	8.02%
1951 - 1954	6.33%	5.05%
1955 - 1957	7.05%	5.44%

Source: Stigler (1963), op.cit.

Kilpatrick (1968)[12] argued that Stigler's data adjustments led to a systematic bias. After correction of this bias, Kilpatrick found a significant positive relationship between profit rates and concentration.

(3) Collins and Preston Study:

The study by Collins and Preston (1968)[13] did not use profit rate as the dependent variable. Rather, it introduced a variable asserted to approximate Lerner's measure[14] of the degree of monopoly, that is:

$$\frac{\text{Price - Marginal Cost}}{\text{Price}}$$

In the Collins and Preston study, the margin 'M' was the difference between revenues and current costs expressed as a percentage of revenues. An advantage of 'M' was that it

12. Kilpatrick, R.W., "Stigler on the Relationship Between Industry Profit Rates and Market Concentration", Journal of Political Economy, May-June 1968.
13. Collins, N.R., and L.E. Preston, Concentration and Price-Cost Margins in Manufacturing Industries, Berkeley, California, 1968.
14. Lerner, A.P., "The Concept of Monopoly and the Measurement of Monopoly Power", Review of Economic Studies, June 1963.

could be calculated at the four-digit industry level.

Collins and Preston regressed the margin on four-firm concentration (C) for various groups of four-digit industries. In addition to concentration, they used two other independent variables: the capital-output ratio (K) and an index of geographic dispersion (G). The data all apply to the year 1958. Their regression for all 288 four-digit industries was as follows:

$$M = 14.6 + 0.122C - 0.015G + 0.011K,$$
$$R^2 = 0.13$$

The coefficient of C was statistically significant at the 1 per cent level. Collins and Preston concluded that their study confirmed the conclusions of previous studies that showed a statistically significant, but not always strong, association between concentration and profits.

(4) Hall and Weiss Study:

The Hall and Weiss (1967)[15] study used individual firms rather than industries as observations. They used both of the profit rate measures (returns on equity and assets) and employed firm size, output growth, and leverage, in addition to concentration, as explanatory variables. The sample of firms studied were selected from the Fortune Directories of 500 largest Industrial Corporations for the years 1956 to 1962. Each firm in each year was treated as a separate observation, and firms within the samples ranged in assets from $33 million to $11 billion.

An interesting technical aspect of the Hall and Weiss study was their correction for heteroscedasticity in their regressions. Because small firms had greater profit rate variances than large firms, the general linear regression assumption of homoscedasticity was not satisfied.

The corrected regressions in the Hall and Weiss study tended to confirm the usual weak, though statistically

15. Hall, M., and L. Weiss, "Firm Size and Profitability", Review of Economics and Statistics, 49, August 1967, pp. 319-331.

significant, positive association between concentration and profits. However, an equally important result was the finding that overall firm size also tended to result in high profit rates. This was interpreted by Hall and Weiss as an indication that capital requirement barriers to entry (measured by size of assets) were important.

An important contribution to the theory arising from the endorsement of the hypothesis that concentration and profit rates are positively correlated, is demonstrated in the following quote from Weiss (1969)[16]

> "Almost all of the 32 concentration-profits studies except Stigler's have yielded significant positive relationships for years of prosperity or recession, though they have depended on a wide variety of data and methods. I think that practically all observers are now convinced that there is something to the traditional hypothesis."

It is thus commonly accepted that concentration ratios are useful indices of market power and a positive relationship exists between these indices and profitability of corporations. Such a relationship exists because, as mentioned earlier, market concentration resulting from larger market share accounted for by a few large enterprises, has its origin in oligopolistic market power, and oligopolistic market power may be expected to yield superior profit performance.

4.4 CONCENTRATION AND MULTINATIONAL ENTERPRISES IN LESS DEVELOPED COUNTRIES

There are relatively few systematic studies which examine the degree of concentration of multinational enterprises in less developed economies. Most of the available studies in this regard have been conducted in the context of Latin American countries.

---

16. Weiss, L., "Quantitative Studies of Industrial Organisation: (a paper presented at the New York meeting of the Econometric Society, December 1969), reprinted in M.D. Intriligator (ed.), Frontiers in Quantitative Economics, North-Holland, Amsterdam, 1971.

Meller (1976)[17] showed measures of concentration for ten Latin American countries (excluding Brazil) and found that there existed a similar pattern of industrial concentration in Latin American countries' industries with the highest levels of concentration being in tobacco, rubber, basic metals, and manufacture of paper. Meller further showed that the Latin American countries with smaller market size had systematically higher levels of concentration than others. Most of the studies that found market concentration caused by the presence of multinational enterprises in different less developed countries, were forced to rely on poor data. Still it is hoped that the available empirical evidence will give useful indications of the market power of multinational enterprises in less developed countries.

(1) Mexico:

Newfarmer and Mueller (1975)[18] used data on a sample of 197 U.S. multinational enterprises to analyse the degree of foreign ownership in manufacturing industries in Mexico for the year 1972. They found that of the 100 largest firms, 61 were foreign (of which 39 were U.S.); of the 300 largest, 150 were foreign (97 U.S.). Foreign subsidiaries were on average much larger than local private firms, but smaller than public-sector enterprises. The U.S. firms accounted for 36 per cent, and other foreign firms for 16 per cent, of the assets of the top 300 firms; of the total GDP of Mexico, multinational enterprises accounted for 18 per cent in 1962 and 23 per cent in 1970 (U.S. firms for 15 per cent and 18 per cent respectively). Thus, multinational enterprises represented a large and growing force in Mexican manufacturing.

Newfarmer and Mueller, based on information from Fajnzylber and Tarrago (1975)[19], reported that in Mexico,

17. Meller, P., International Comparisons of Industrial Concentration in Latin America, National Bureau of Economic Research, New York, 1976.
18. Newfarmer, R.S., and W.F. Mueller, Multinational Corporations in Brazil and Mexico: Structural Sources of Economic and Non-Economic Power, U.S. Senate Subcommittee on Multinational Corporations, Washington, D.C., 1975, chapters 3,4.
19. Fajnzylber, F., and T.M. Tarrago, Las Empresas Transnacionales en la Industria Mexicana, CONACYT/CIDE, Mexico City, 1975.

in 114 industries the four largest plants produced 50 per cent or more of the sales in 1970. In 46 industries, the leading four plants produced 75 per cent or more of sales. The 114 highly concentrated industries accounted for 40 per cent of all manufacturing sales and 23 per cent of manufacturing employment. Multinationals often owned some or all of the leading plants. On the relation between concentration and multinational domination the report stated:[20]

> "Assessing the relation of MNCs (multinational corporations) to industrial concentration reveals a strong tendency for the most concentrated industries to be foreign dominated. For manufacturing as a whole, 61 per cent of MNC production was sold in markets where the largest four plants accounted for half or more of the markets' total sales. Mexican manufacturing enterprises, on the other hand, sold only 29 per cent of their products in such industries. The association between MNCs and concentrated industries proved strongest in consumer durable production. The association can be seen in another way. Of all manufacturing sales in highly concentrated industries (with four-plant concentration ratios of greater than 75 per cent), MNCs produced 71 per cent while Mexican enterprises produced 29 per cent."

Newfarmer and Mueller found that industries in Mexico were highly concentrated relative to the U.S., with over three-fourths of production coming from industries where one or more of the leading producers were multinationals. They also found 'a high correlation between the presence of MNCs in various markets and their overall concentration.'[21]

(2) Brazil:

Newfarmer and Mueller (1975)[22] also provided similar data on Brazil, where the U.S.-owned firms accounted for 36 per cent of foreign capital stock, and where, of the 500 largest non-financial corporations in 1972, 158 (U.S. firms 59) were multinationals. Multinational enterprises were found to be larger than domestic private firms but smaller than state owned firms.

As in Mexico, industry in Brazil was found to be highly concentrated. Newfarmer and Mueller found:[23]

---

20. Newfarmer and Mueller (1975), op.cit., p.61.
21. Ibid, p.62.
22. Ibid, chapters 5 and 6.
23. Ibid, p.114.

> "Of a total of 302 industries (analogous to U.S. four-digit SIC industries) in 1968, 176 had four-plant concentration ratios of greater than 50 per cent. Of these 176, 90 industries (representing 30 per cent of the total) had four-plant concentration ratios of greater than 75 per cent, and 86 industries (28 per cent of total) had ratios between 50 and 75 per cent."

In Brazil, in 1968, Newfarmer and Mueller found an average four-plant concentration ratio of 54 per cent in industries where at least three of the four leading plants belonged to multinational enterprises. These multinational dominated industries accounted for 26 per cent of the total industrial production. Analysing data on industrial structure in Brazil, Newfarmer and Mueller commented:[24]

> "These data would suggest that in those markets where the leaders are predominantly foreign, average concentration is higher than where the leaders are predominantly national."

(3) Argentina:

Sourrouille (1976)[25] has provided data on concentration and multinational enterprises in Argentina. His study found that foreign firms contributed some 30 per cent of total manufacturing output in 1970, far more than 20 years previously. Moreover,[26]

> "In 1970/73 two-thirds of the foreign industrial produce stemmed from sub-groups where they dominated over 75 per cent of the market . . . and 75 per cent came from sub-groups where they dominated over 50 per cent of the market."

The growth of multinational enterprises in Argentina was 60 per cent higher than average industrial growth in the country during 1970/73.

(4) Central America:

Willmore (1976)[27] calculated the degree of foreign dominance in the industries of Guatemala. Studying data

---

24. Newfarmer and Mueller (1975), op.cit., p.115
25. Sourrouille, J.V., The Impact of Transnational Enterprises on Employment and Income: the Case of Argentina, World Employment Working Paper No. 7 (mimeo), ILO, Geneva, 1976.
26. Ibid, p.27.
27. Willmore, L., "Direct Foreign Investment in Central American Manufacturing", World Development, June 1976, pp.499-517.

on 22 industries for the year 1971, Willmore found that, in those industries in which at least one of the leading three firms was foreign, the degree of concentration increased as foreign control of leading firms increased. He concluded that the entry of foreign firms raised the level of concentration.

(5) Pakistan:

Khilji (1975)[28] commented that for Pakistan, the multinational dominated industries were more concentrated than industries dominated by Pakistani firms; and this was supported in all cases by the different sources used and the different methods of computation employed. In Khilji's study, an industry was considered dominated by a firm, if that firm was the largest in the industry, as well as accounting for at least 20 per cent of the industry's sales.

Khilji found that the two-firm concentration ratio for Pakistan (West Pakistan in 1968), was 63 per cent in the multinational dominated industries and 41 per cent in the Pakistani-firms dominated industries, i.e. in industries where the leading firm was a multinational enterprise, the two largest firms accounted for 63 per cent of the total market sales; whilst the corresponding statistic for industries dominated by local firms was 41 per cent.

Scattered data of this sort are available for other less developed countries. Lall (1977)[29] found that 48 per cent of manufacturing output and 51 per cent of fixed assets in West Malaysia were foreign controlled in 1972; and that upto 77 per cent of manufacturing output and 88 per cent of manufactured exports were contributed by foreign controlled firms in Singapore in 1975. Zetlin (1974)[30] reported similar findings

28. Khilji, F., "Multinational Corporations and Restrictive Business Practices: The Case of Pakistan", Pakistan Development Review, Vol.14, No.4, Winter 1975, pp.416-436.
29. Lall, S., Transfer Pricing in Assembly Industries: A Preliminary Analysis of the Issues in Malaysia and Singapore, Commonwealth Secretariat (mimeo), London, 1977.
30. Zetlin, M., "Economic Concentration, Industrial Structure, National and Foreign Capital in Chile, 1966", International Industrial Organization Review, 1974, pp.195-205.

in Chile, where foreign enterprises dominated local enterprises. The Reserve Bank of India publishes periodic data on sales of foreign companies, but these have not been utilised to calculate concentration ratios; an observation of these data however, indicates that multinationals' dominance prevails in the Indian industries where those enterprises operate.

The general conclusion from the discussion above seems to confirm the 'a priori' expectation that multinational enterprises in less developed countries enjoy a dominant market power to enable themselves to earn superior profit performance. The high level of market concentration of multinational enterprises in a less developed country, which reflects oligopolistic market power, seems to stem from certain inherent characteristics of these enterprises which the local enterprises seem not to possess; to mention a few:

(i) Scale economies of production.

(ii) High research and development expenses in parent companies, the benefit of which can be enjoyed by the subsidiaries in different host countries.

(iii) Sophisticated and efficient marketing techniques (efficient and effective advertisement etc.).

(iv) Easy sources of finance within the host country as well as from foreign countries (parent company, other subsidiaries of the same group or the international money and capital markets).

(v) Management skills, etc.

The above characteristics of multinational enterprises in less developed countries may be expected to give them some superiority over local enterprises. Therefore, it is plausible that in less developed countries the entry of multinational enterprises would speed up the process of market concentration, and that the non-competitiveness of local enterprises would enable the multinationals to achieve a higher degree of market dominance.

Based on the arguments in the above sections, if one accepts that market share or concentration influences corporate profitability, and that multinational enterprises in

less developed countries account for a large market share and thus have a high degree of market concentration, it may not be imprudent to expect multinationals in less developed countries to earn higher profits than their local counterparts. High capital investment, advanced technology, innovatory management, and overall monopolistic or oligopolistic advantages of the multinationals in the economies of less developed countries support such predictions. However, the available literature on the operations of multinational enterprises in less developed countries provides little empirical evidence to support the claim that multinationals earn higher rates of return than their local counterparts.

4.5 COMPARATIVE PROFITABILITY OF MULTINATIONALS AND LOCAL FIRMS IN LESS DEVELOPED COUNTRIES

While some scattered data are available on the profitability of multinational enterprises in less developed countries, there are relatively few studies which try to statistically analyse and explain the comparative profitability of multinationals and local firms.

In a statistical analysis of the profit performance of multinational enterprises and non-multinational enterprises in India and Colombia, Lall and Streeten (1977)[31] gave a detailed account of the comparative profitability of multinationals and and local firms in less developed countries. This study compared the profitability of multinationals and other firms, and foreign-and-locally-controlled firms, for a sample of 109 manufacturing firms - 53 in India and 56 in Colombia, for the year 1968-69. After an analysis of variance, the study concluded that the declared profits of multinational enterprises and non-multinational enterprises "do not differ significantly from each other", in either of the less developed countries studied.

In Central America, two other studies produced results similar to that of Lall and Streeten.

---

31. Lall, S., and P. Streeten, Foreign Investment, Transnationals and Developing Countries, Macmillan, London, 1977, chapter 6.

Resenthal (1973)[32] reported:

> "Scant information available from Guatemala's income tax office and the Industrial Survey of 1968 suggests that, if anything, average rates of return on domestic industrial plants were higher than those for foreign plants. However, this very preliminary conclusion warrants further study, especially between competing plants within the same economic activity."

Willmore (1976)[33] compared a sample of 33 foreign and 33 matched local firms in Costa Rica for the fiscal year ending 30th September 1971. The study found that foreign firms were no more profitable than the local firms.

Mason (1973)[34] studied operating characteristics of 14 subsidiaries of U.S. based multinationals and 14 closely matched local firms in the Philippines. After performing the Wilcoxon test, the study rejected the hypothesis that the rates of return on total capital of the U.S. subsidiaries were more than those of the local firms.

Sharwani (1976)[35] estimated the extent of industrial concentration in the major manufacturing industries in Pakistan for the years 1967 to 1973, and analysed the effect of concentration on some standard behavioural aspects of oligopoly. An important result of this study was that rates of profits in industries dominated by multinationals were lower than that of the industries dominated by domestic enterprises. Sharwani's findings in fact implied that the multinational enterprises in Pakistan appeared less profitable than their domestic counterparts.

---

32. Resenthal, G., The Role of Private Foreign Investment in the Development of the Central American Common Market, (mimeo), 1973, p.126 (quoted in Willmore (1976), op.cit.).
33. Willmore (1976), op.cit.
34. Mason, R.H., "Some Observations on the Choice of Technology by Multinational Firms in Developing Countries", The Review of Economics and Statistics, 55, August 1973, pp.349-355.
35. Sharwani, K., "Some New Evidence on Concentration and Profitability in Pakistan's Large-Scale Manufacturing Industries", Pakistan Development Review, Autumn 1976, pp.272-289.

Newfarmer and Marsh (1981)[36] studied market structure and industrial performance in Brazil. Analysing data of over 150 multinational and Brazilian enterprises in the electrical industry for the years 1972 and 1974, the study found that Brazilian enterprises were comparatively more profitable than the multinational enterprises. The results of the study were as follows:

Table 4.2
Profitability of Multinational and Brazilian Firms, Various Measures, 1972 and 1974.

Profit Measure	Brazilian Firms	Multinationals
(1)After tax earnings on equity	20.6%	13.9%
(2)After tax earnings on sales	6.8%	5.5%
(3)After tax earnings on assets	9.6%	6.6%
(4)After tax earnings plus interest on assets	14.0%	10.7%
(5)Price-cost margins (Sales - Costs/Sales)	12.1%	12.7%

Newfarmer and Marsh ran regressions using all five measures of profitability. The fit of regression equations was substantially better in the sales and asset measures than in the equity measure. The R^2 of the equations for the profits/sales ranged from 0.40 to 0.48 compared with the range of 0.18 to 0.27 for the returns on equity. Nevertheless, the results were sufficiently consistent across all five measures. Looking at the better profit performance of the Brazilian firms compared to the multinational firms, Newfarmer and Marsh commented at the conclusion of their study that "...transfer pricing may cloud the results".

The above findings on the comparative profit performance of multinational and local enterprises contradict 'a priori'

36. Newfarmer, R.S., and L.C. Marsh, "Foreign Ownership, Market Structure and Industrial Performance, Brazil's Electrical Industry", Journal of Development Economics, February 1981, pp.47-75.

expectations that multinationals, because of their oligopolistic advantages, should produce better profit performance than their local counterparts in less developed countries. But if one believes that the profitability of the affiliates of multinational enterprises is determined in large part by the degree of competition in a market determined by the level of market concentration, and the relative market power of the individual firm, it becomes difficult to conceive that multinationals in less developed countries should not show better profit performance than their local counterparts. However, the divergence of reported profits from expected profit performance of multinationals in less developed countries gives rise to a possibility that the reported profits might be distorted. In this connection, Newfarmer and Mueller (1975)[37], studying the performance of multinational enterprises in Mexico and Brazil, stated:

> "... Earnings performance is difficult to assess accurately using the reported balance sheet and income account items. Earnings registered in affiliate accounts often do not reflect the true rates of return to invested equity. The first category of distortions arises in differing use and manipulation of standard accounting procedures common to all companies. For example, shifting accounting techniques for inventories, depreciation, research and development, and advertising can drastically affect earnings in a given year. Basically, the larger the firm, the more leeway there is for accounting manipulation. In the case of MNCs, a second category of distortion arises from the practice of transfer pricing...."

4.6 CONCLUSION

It has been argued in the present chapter that corporate profitability is positively related with market share - i.e. the multinational enterprises in less developed countries, being possessors of larger shares of product markets, may be expected to show higher profitability than their local counterparts. A number of economic studies have found that those industrial enterprises which are responsible for high market concentration, have higher profitability. Empirical findings from available studies show that the multinational

37. Newfarmer and Mueller (1975), op.cit., p.89.

enterprises in less developed countries tend to account for larger market shares and thereby create higher levels of market concentration, which in turn seems to give these enterprises monopolistic or oligopolistic market advantages to earn higher rates of return. In many less developed countries one or two multinationals dominate the markets of particular products. On the basis of the empirical evidence on high market share of multinational enterprises it was predicted that these enterprises should have superior profit performance than their local counterparts in less developed countries. Moreover, multinational enterprises having world-wide production facilities and stronger economic and managerial resources than their local counterparts in a host less developed country, may be predicted to have higher profitability.

The empirical findings from available studies indicate that there is hardly any difference between the profitability of multinationals and their local counterparts in less developed countries. This suggests that the reported profit performance of multinational enterprises in less developed countries might well be distorted. There may be various incentives for such distortions. The present study will examine some possible ways and means of, and incentives for, the possible distortions in reported profit performance of multinationals in less developed countries.

CHAPTER FIVE

Reporting Profit Performance : Problem Areas

5.1 INTRODUCTION

> "Ordinarily, the firm is not informationally open to the rest of the economy via direct observation. Rather, it is open primarily via the (accounting) information it communicates in its external reports, so that much of what the firm's economic environment 'knows' about the firm's operations depends upon how the firm describes them in its external reports. In fact, much of what the economy 'knows' about its own functioning (through its macro-economic accounts) also depends upon the firm's external reports. For this reason, appropriate financial disclosure as well as the accounting standards to which the financial reports shall conform is an important (social) requirement."
>
> - Prakash and Rappaport (1977)[1]

It needs no justification to state that accounting reports act as a bridge between the firm and the parties interested in the firm's operation and performance. However, the extent of dependence on the published accounting reports by interested parties (user groups) for their decision making is subject to qualifications. Different users may used published accounting data in different ways, or some users under certain conditions (e.g. in an efficient market[2]) may get little useful information from these published accounts. Still published accounting reports are viewed as the most formal source of information about the performance of a business enterprise. Probably this is why most of the economic studies on profit performance of enterprises are conducted on the basis of information published in accounting reports,[3] and the findings

---

1. Prakash, P., and A. Rappaport, "Information Inductance and its Significance for Accounting", Accounting, Organisations and Society, Vol.2, 1977, p.35.
2. See works undertaken on the Efficient Market Hypothesis, e.g. Ball, R., and P. Brown, "An Empirical Examination of Accounting Income Numbers", Journal of Accounting Research, 6, 1968, pp.159-177. Ball and Brown, and subsequently others suggested that that annual earnings numbers in published accounts provide relatively little unanticipated information to (efficient) market participants.
3. For example, all the studies on profit performance of multinationals, cited in chapter 4, used published accounts.

of such studies are determined ultimately by the reliability or weakness of these published data. Besides measuring and analysing profit performance, other measurements of enterprise performance are made using data in published corporate accounting reports; and these are also susceptible to the limitations of published accounting data.

5.2 POTENTIAL LOOPHOLES OF ACCOUNTING REPORTS

Although data published in accounting reports are used for various business performance measurements, the efficacy of all such measurements depends on the proximity of the reported enterprise performance to actual performance. It should be borne in mind that 'actual performance' is a vague term, since determining the actual requires a criterion to judge actuality; and in the accounting literature there seems to have been considerable controversy about such a criterion. There are different accounting treatments of a particular transaction, and there are arguments and counter arguments for and against each of thetreatments. The alternative treatments can produce quite different indications of enterprise performance. Therefore, instead of looking for an overriding criterion to judge actual enterprise performance, one needs to identify certain standard accounting treatments those would produce a rational (a proxy of actual) enterprise performance under given conditions.

Accounting treatments (which will hence forth be termed accounting policies) chosen by a particular enterprise can be checked against standard accounting policies in order to find out whether or not the particular enterprise has attempted to report business performance differently from what should have been rationally reported. If a tendency to deviate from the use of standard accounting policies is observed, it would indicate that the particular enterprise might have manipulated accounting policies to report a distorted profit performance. Accounting policy manipulation may result in reporting a profit performance more than or less than the

actual profit performance. The direction of profit distortions can be assessed only through further scrutiny involving a detailed investigation.

An enterprise which is contemplating reporting its business performance in an ambiguous way may also manipulate "accounting inputs" in addition to or irrespective of the manipulation of accounting policies. Accounting inputs, here, denote those accounting numbers which are used to prepare corporate financial statements. For example, if an enterprise inflates one or more major expenditure items such that no audit objection can be made against such a practice, its ultimate effect will be to reduce reported profit. Deflation of income item(s) also is likely to produce a reduced profit figure. Similarly profit figures could be increased by deflating expenditure items and/or inflating income items. Although the manipulation of accounting inputs involve inflation or deflation of the items of income or expenditure, e.g. purchases, sales, etc.; the increase or decrease of such items needs to be supported by valid invoices or vouchers. "Fiddling" of accounts does not fall under this purview.

The accounting input manipulation process may work more easily in those cases where the particular income or expenditure items are the direct results of transactions between enterprises having a proprietary relationship. When two related enterprises transact between themselves, over-charging or under-charging for the transaction by one enterprise may result in a profit decrease or a profit increase respectively in the other enterprise. However, the accounting input manipulation practice may be subject to inter alia taxation effects in both the enterprises. In the case of a transaction between two related enterprises the overall profits of the owners (owners of both the enterprises being the same) may be increased. In this way while the overall profits of a multinational enterprise can be increased, the profit performance of individual subsidiaries can be regulated by shifting profits from one subsidiary to another. But distortion of the

reported profit performance of an enterprise through accounting input manipulation may not be possible in cases where transactions take place only with the unrelated parties; in such cases profits will be shifted outside the organisation, thus effecting an overall loss for the organisation.

Multinational enterprises often transfer goods and services between related parties. The pricing of these 'intra-group' transactions is known as "transfer pricing". In multinational enterprises, the process of accounting input manipulation takes the shape of transfer price manipulation. The available literature indicates that multinational enterprises resort to transfer price manipulations.[4] Transfer pricing in a multinational enterprise is operated and coordinated so tightly that it may be very difficult (and some times impossible) to detect any manipulation with the help of generally practised audit procedures.

5.3 MULTINATIONAL ENTERPRISES IN LESS DEVELOPED COUNTRIES - MANIPULATIONS IN ACCOUNTS

It follows from the above that a multinational enterprise may, if it wishes, show a particular result in its accounting reports without going outside prescribed generally accepted accounting rules. Thus if the users of accounting reports do not have access to inside information, there is the possibility that they may not be able to properly assess the performance of a multinational enterprise. This possibility may be even greater in case of multinational enterprises in less developed countries mainly because of:

(i) the lack of accounting standards,[5] and

(ii) the shortcomings of government authorities to control transfer price manipulations.[6]

---

4. For a survey of literature on transfer price manipulations, see: chapter 10 of the present study.
5. For a discussion on the incentives for accounting policy manipulations and on the lack of accounting standards in less developed countries, see: chapter 6 of the present study.
6. For a discussion on transfer price manipulations and on the general weakness of control mechanism in less developed countries, see: chapter 7 of the present study.

The Economist magazine,[7] while evaluating the activities of multinational enterprises in less developed countries, commented:

> "It fiddles its accounts. It avoids or evades its taxes. It rigs intra-company transfer prices. . . . Nobody can control it. . . . Let it bloody well go home."

Such allegations against the multinational enterprises operating in less developed countries are common in the literature. If these allegations are correct, the external accounting reports of the multinational enterprises, particularly those operating in less developed countries, may not be a completely reliable guide to the assessment of real business performance. Therefore, the declared profits of the multinational enterprises in less developed countries can be of limited use in evaluating the performance of these enterprises. A comprehensive study is, therefore, necessary to examine whether or not allegations of the above kind are true. A possible starting point for such a study may be found in the "potential loopholes of accounting reports" discussed in the previous section of the present chapter. Two potential areas of accounting manipulation, viz. manipulation of accounting policies and manipulation of transfer prices, may be studied by the examination of hypotheses concerning accounts manipulations by multinationals operating in less developed countries.

5.4 HYPOTHESES OF THE PRESENT STUDY

The present study attempts to evaluate the problems of measuring the profit performance of multinational enterprises in less developed countries. The subject matter of the present study has been decided on the basis of an 'a priori' belief that multinational enterprises operating in less developed countries do not behave in the same manner so far as the reporting of profit performance is concerned, as the locally owned enterprises. The foundation of this 'a priori' belief lies in the empirical evidence on the divergence of the reported profit performance of the multinationals in

---

7. The Economist (London), January 24, 1976, p.68.

less developed countries from their expected profitability. In chapter 4 of the present study, it was suggested that the monopolistic or oligopolistic market advantages enjoyed by multinationals in less developed countries lead to the prediction that these enterprises should have better profit performance than their local counterparts. But the absence of any evidence in the literature on such a superior profitability of multinationals raises the possibility that multinationals in less developed countries might tend to distort reported profit performance through manipulation of their accounts. This possibility can be examined with the help of the following hypotheses:

Hypothesis 1: Multinational enterprises in less developed countries manipulate accounting policies in order to understate reported profit performance.

Hypothesis 2: Multinational enterprises in less developed countries manipulate transfer prices in order to understate reported profit performance.

5.5 CONCLUSION

It has been argued in the present chapter that possible manipulations in corporate accounts may present a distorted picture about the profit performance of an enterprise, and the external users of accounting reports may be misled by the published accounting numbers in their attempts to assess the performance of that particular enterprise. The possibility of accounts manipulation in multinational enterprises operating in less developed countries seems to pose problems to the measurement of their performance. Particularly, the measurement of comparative performance of the multinationals and of the local enterprises may be difficult. Therefore, it is important to understand whether or not multinational enterprises in less developed countries really resort to the possible ways and means of manipulation in order to distort their reported profits, and if so whether they resort to accounting policy manipulation and/or transfer price manipulation. The two hypotheses built in the present chapter, are developed further in the following two chapters.

CHAPTER SIX

Accounting Policy Manipulation Hypothesis

6.1 INTRODUCTION

In view of the increasing importance of accounting reports as a source of corporate information, policy makers in accounting have in recent years been seriously concerned with the standardisation of accounting policies. The terms 'accounting policies', 'accounting principles' and 'accounting techniques' have been used interchangeably in the accounting literature, and this practice is followed in the present study. These terms refer to the ways of treating accounting events (transactions) in the books of account. Generally accepted accounting principles allow alternative treatments of several types of accounting events. Lack of a specific standard policy for treating a particular transaction leads to measurement rules such that two companies in the same industry having identical economic histories may report quite different business performances.

It is now widely recognised in the accounting literature that profit performance of a company may be greatly influenced by the choice of alternative accounting policies. Chambers (1966)[1] calculated that it is possible to report a given firm's income as any one of 30 million figures, all determined according to generally accepted accounting principles. Even if Chamber's calculation is only partially correct, this dramatic view suggests that the generally accepted accounting principles allow enterprise management to choose particular accounting policies in order to report business performance at a desired level; i.e. reported profit may be distorted by the choice of appropriate accounting policies.

Theoretically, any enterprise could produce particular profit figures in its published accounting reports. But in practice, it seems unlikely that an enterprise management

1. Chambers, R.J., "A Matter of Principle", The Accounting Review, 41, July 1966, pp.443-457.

would produce specific profit figures without genuine economic reasons. An understanding of why an enterprise might be motivated to choose particular accounting policies to influence the level of its business performance is crucial to any study of accounting policy manipulation. In the present chapter, an attempt is made to develop a hypothesis concerning possible accounting policy manipulations by multinational enterprises in less developed countries, and this is done through an analysis of the economic incentives for accounting policy manipulation.

6.2 ECONOMIC INCENTIVES FOR ACCOUNTING POLICY CHOICE : Past Studies

Conventionally, corporate financial statements are regarded as the result of a two-stage process. Management prepares the financial statements and certified (public) accountants verify whether or not they have been prepared according to the generally accepted accounting rules. Management, therefore, within limits, selects the accounting policies. Why the management would prefer one particular accounting policy (policies) instead of an alternative policy (policies) in treating a particular accounting event? This question has been the subject-matter of research over a long period. Although it is difficult to say whether such research has produced conclusive results, a brief review of some conclusions which seem to be of importance to the problem considered in the present study, is given below.

Some studies conducted in the early sixties helped to develop a belief among some researchers that accounting policies are manipulated by enterprise management in order to "smooth" corporate income. "Income Smoothing" denotes reporting enterprise income (by manipulation of accounting policies) in such a way that year to year fluctuations in annual income numbers are not evident in the financial statements.

Jacobsen (1963)[2] investigated the internal records of 28

2. Jacobsen, L.E., "The Rise of Profit Deferral Notion", The Accounting Review, 38, April 1963, pp.285-292.

firms and concluded that 21 of the 28 accounting policy changes increased reported income. Lindhe (1963)[3] found that 317 of 450 large firms changed to the accelerated method of depreciation in the first year of their eligibility for tax purposes. Sorter et al. (1964)[4] sought to explain Lindhe's findings as other than deliberate income smoothing attempts. Archibald (1967)[5] continued the investigation of depreciation changes and found, inter alia, that 22 of the 55 firms which changed first to accelerated and then to straight-line depreciation had income decreases in the year of switch-back, and that most of the changes increased income. Sprouse (1967)[6] criticised Archibald's findings as an uncontrolled experiment. Bird (1969)[7] redigned the experiment and concluded that companies with decreasing income are more likely to effect accounting changes which increase income than are companies with increasing income.

Gordon (1964)[8] in a seminal article, first attempted to theorise "income smoothing" behaviour of enterprises as follows:

> "Proposition 1 : The criterion a corporate management uses in selecting among accounting principles is the maximisation of its utility or welfare. Whether or not a management should be so motivated is a value judgement that need not concern us here.
>
> Proposition 2 : The utility of a management increases with (1) its job security, with (2) the level and rate of

3. Lindhe, R., "Accelerated Depreciation for Income Tax Purposes - A Study of the Decision and Some Firms Who Made It", Journal of Accounting Research,1,Autumn 1963, pp.139-48.
4. Sorter, G.H., S. Becker, T.R. Archibald, and W. Beaver, "Corporate Personality Reflected in Accounting Decisions", Journal of Accounting Research,2,Autumn 1964, pp.183-196.
5. Archibald, T.R., "The Return to Straight-Line Depreciation: An Analysis of Change in Accounting Method", Empirical Research in Accounting : Selected Studies 1967, (Supplement to Journal of Accounting Research,5), pp. 164-183.
6. Sprouse, R.T., "Discussion of the Return to Straight-Line Depreciation", Empirical Research in Accounting : Selected Studies 1967 (Supplement to Journal of Accounting Research, 5) pp.184-186.
7. Bird, F.A., "Interperiod Comparability in Financial Reporting", Journal of Accountancy, June 1969, pp.51-56.
8. Gordon, M.J., "Postulates, Principles and Research in Accounting", The Accounting Review,39, April 1964, pp.44-52.

growth in the management's income, and with (3) the level and rate of growth in the corporation's size.

Proposition 3 : The achievement of the management goals stated in Proposition 2 is dependent in part, on the satisfaction of stockholders with the corporation's performance. That is, other things being equal, the happier the stockholders the greater the job security, income, etc. of the management. Further, these variables increase by diminishing marginal amounts with stockholder satisfaction. In other words, when stockholders are highly dissatisfied with a management, an increase in their satisfaction greatly increases the management's job security, etc., and hence its utility. On the other hand, when stockholders are highly pleased with a management, a further increase in their satisfaction by the same amount will not materially increase job security, income and corporate size. ...

Proposition 4 : Stockholder satisfaction with a corporation increases with the average rate of growth in the corporation's income. This proposition is as readily verified as Proposition 2.

Theorem : Given that the above four propositions are accepted or found to be true, it follows that a management should within the limits of its power, i.e. the latitude allowed by accounting rules, (1) smooth reported income, and (2) smooth the rate of growth in income. By smoothing the rate of growth in income we mean the following: If the rate of growth is high, accounting practices which reduce it should be adopted and vice versa."

Gordon, Horwitz and Meyers (1966)[9] attempted to test the empirical validity of the Gordon (1964) normative model. But they could not reach any consistent conclusion. Copeland (1968)[10], Cushing (1969)[11], Dasher and Malcom (1970)[12], Barefield and Comiskey (1972)[13], Ball and Watts (1972)[14],

9. Gordon, M.J., B.N. Horwitz, and P.T. Meyers, "Accounting Measurements and Normal Growth of the Firm", in R. Jaedicke, Y. Ijiri, and O. Nielson (eds.), Research in Accounting Measurement, American Accounting Association, 1966, pp. 221-231.
10. Copeland, R.M., "Income Smoothing", Empirical Research in Accounting: Selected Studies 1968 (Supplt. to JAR), 6, pp. 101-116.
11. Cushing, B.E., "An Empirical Study of Changes in Accounting Policy", Journal of Accounting Research, 7, Autumn 1969, pp. 196-203.
12. Dasher, B.E., and R.E. Malcom, A Note on Income Smoothing in the Chemical Industry", Journal of Accounting Research, 8, Autumn 1970, pp. 253-259.
13. Barefield, R.M., and E.E. Comiskey, "The Smoothing Hypothesis: An Alternative Test", The Accounting Review, April 1972, pp. 291-298.
14. Ball, R., and R. Watts, "Some Time Series Properties of Accounting Income", Journal of Finance, June 1972, pp. 663-682.

Beidleman (1973)[15], and Barnea, Ronen and Sadan (1975)[16], among others, have attempted to test empirically the Gordon model, or variants of it. Collectively, these studies are part of what is known as the "smoothing" literature in accounting. Problems with the specification of the empirical tests in the smoothing literature leave the Gordon model essentially unconfirmed. Also, certain aspects of the Gordon model contribute to its lack of confirmation. Essentially, Gordon assumed that shareholder satisfaction (and, presumably wealth) is solely a positive function of accounting income. This assumption avoids the conflict between shareholders and management by implying that an increase in stock prices always accompanies an increase in accounting income. The evidence developed by Ball (1972)[17], Sunder (1975)[18], and others suggest that investors are not collectively misled by changes in accounting methods. If this interpretation of the evidence is correct, then one may be faced with the perplexing problem of determining why the managers of enterprises should choose particular accounting policies to report a particular level of business performance.

A recent series of articles[19] has re-examined the theory of accounting policy choice first addressed by Gordon (1964). These articles have extended Gordon's theory by attempting to determine the economic incentives which might motivate enterprise management to prefer particular accounting policies.

15. Beidleman, C.R., "Income Smoothing: The Role of Management", The Accounting Review, October 1973, pp.653-667.
16. Barnea, A., J. Ronen, and S. Sadan, "The Implementation of Accounting Objectives - An Application to Extraordinary Items", The Accounting Review, January 1975, pp.58-68.
17. Ball, R., "Changes in Accounting Techniques and Stock Prices", Empirical Research in Accounting : Selected Studies 1972 (Supplement to Journal of Accounting Research, 10), pp.1-38.
18. Sunder, S., "Stock Price and Risk Related to Accounting Changes in Inventory Valuation", The Accounting Review, April 1975, pp.305-315.
19. (a) Watts, R., "Corporate Financial Statements: Product of Market and Political Process", Australian Journal of Management, April 1977, pp.53-77.
    (b) Watts, R., and J. Zimmerman, "Toward a Positive Theory of the Determination of Accounting Standards", The Accounting Review, January 1978, pp.112-134.
    (c) Hagerman, R.L., and M.E. Zmijewski, "Some Economic Determinants of Accounting Policy Choice", Journal of Accounting and Economics, 1 , 1979, pp.141-161.

In these articles, management's preferences concerning the set of accounting policies is exhibited through two economic phenomena. The first is the firms' lobbying activities for or against a proposed accounting standard. These activities are designed to influence the standard setting authorities to accept particular accounting policies as generally accepted accounting principles. The second is the choice of specific accounting policies in the preparation of financial statements. The question which arises in relation to these two economic phenomena is, what benefits do the management derive either for themselves or for the firm from such activities? In response to this question, the series of articles referred to above has attempted to develop a "positive theory of the determination and choice of accounting principles". This theory encompasses the economic incentives for accounting policy choice. An attempt is made below to describe these economic incentives through a brief review of this positive theory.

Watts and Zimmerman (1978)[20], hereafter W-Z, formally developed a "positive theory" encompassing the economic incentives open to managers in choosing accounting policies, and from it developed an empirically testable model. W-Z tested this model on managements' lobbying of the Financial Accounting Standards Board (FASB) in U.S.A. on the general price level accounting (GPLA) exposure draft. The W-Z theory is based on the premise that managements attempt to maximise their utility which is directly related to their compensation and hence wealth. Management compensation is increased by either increasing the value of management stock option plans and/or by increasing the incentive cash bonuses. Therefore, W-Z argued that the following factors would increase managements' wealth: (i) decreased or delayed tax payments, (ii) favourable government regulations, (iii) decreased political costs, e.g. threats of nationalisation, expropriation, anti-trust suits etc., (iv) decreased information production costs, and (v) increases in the income measure used as the base for the incentive bonus plans. Increased financial benefits for the firm from the

20. Watts and Zimmerman (1978), op.cit.

first four factors would, ceteris paribus, lead to higher stock prices, while the last factor would result in a direct increase in management compensation. Based on this logic, W-Z argued that management will lobby for and choose those accounting policies which decrease or defer tax payments, help secure favourable regulations, decrease political costs, decrease information production costs, and/or increase their cash bonuses.

The W-Z study assumed that reduction in reported profit through use of particular accounting policies can be well interpreted by the investors in a capital market; i.e. the capital market can see through the figures in accounting reports. Therefore, while accounting policy choice reduces reported profit, it helps to increase stock price instead of decreasing it, because the firm has benefitted by reduction of the various costs (political cost etc.) mentioned above. An accounting policy which has an income reducing effect in the financial statements, can reduce a firm's tax burdens or can delay tax payments (assuming that the same policy can be used for both accounting and tax purposes, e.g. LIFO method of inventory valuation or accelerated method of depreciation). If a firm is subject to government regulations (e.g. price control actions of the government), accounting policies which decrease reported profit would allow management to argue for price increases. Lower profit also reduces political costs because the firm is less likely to be subject to attacks by political activists on the allegation of economic exploitation; while firms with higher profits might be considered by political activists as exploiters, hence political costs could be high. Finally, if a company provides incentives to its management on the basis of reported profit, the management might be motivated to choose those accounting policies which increase reported profit. W-Z did not find any statistically significant empirical evidence in favour of the argument that management incentive plans are based on reported profit performance of the enterprises. The W-Z model predicted that large firms which experience reduced earnings due to changed accounting standards favour the change.

The study concluded:[21]

> "The single most important factor explaining managerial voting behavior on General Price Level Accounting is firm size (after controlling for the direction of change in earnings). The larger firms, ceteris paribus, are more likely to favour GPLA (if earnings decline). This finding is consistent with our government intervention argument since the larger firms are more likely to be subjected to government interference and, hence, have more to lose than smaller corporations."

While interpreting the results of W-Z study one need to be cautious about the fact that the methodology used in the study is not above criticism. Therefore, the findings are to be considered with due care. One possible limitation of the methodology may concern the W-Z proposition regarding management's utility function. W-Z contended that management wealth would be increased due to an increase in stock price; increased wealth would increase management utility. But in the real world, it may be very difficult to predict the factors responsible for maximisation of management utility - utility is a complicated aspect of human behaviour. Although this and other methodological limitations identified by critics may cast doubt on the W-Z findings, the arguments in their study gave an insight into the potential economic incentives for accounting policy choice. Particularly the arguments about political costs and government intervention seem to us to be In line with the arguments of W-Z, it seems logical to think that firms can affect their future cash flows by discouraging government actions and by reducing political costs through the manipulation of accounting policies to report lower profit performance. The ability of management to affect future cash flows may be helpful in raising the value of the firm and in keeping the shareholders happy; all these may in turn insure greater job security of the management.

Hagerman and Zmijewski (1979)[22], hereafter H-Z, also examined the positive theory addressed by W-Z. H-Z used probit analysis to determine if the choice of accounting policies for

---

21. Watts and Zimmerman (1978), op.cit., p.131
22. Hagerman and Zmijewski (1979), op.cit.

four accounting treatments (viz. depreciation allocation, inventory valuation, treatment of investment tax credit, and amortisation of past service costs) by 300 firms could be explained as a result of incentives provided by certain important variables. Based on the theory developed by Watts and Zimmerman (1978), H-Z argued that firms which are large, risky, capital intensive or have monopoly rents, have incentives to select accounting policies which reduce reported profit. The H-Z study, like that of W-Z, gives some suggestions for specific incentives which might motivate the management to choose particular accounting policies.

Although there may be limitations in both the W-Z and H-Z studies, they suggest some economic incentives for accounting policy choice, and may be helpful in understanding potential accounting policy manipulations by multinational enterprises in less developed countries. Drawing on the findings of Watts and Zimmerman (1978) and Hagerman and Zmijewski (1979), an attempt is made in the following section to identify some potential factors affecting the accounting policy choices of multinational enterprises in less developed countries.

6.3 POTENTIAL FACTORS AFFECTING ACCOUNTING POLICY CHOICE OF MULTINATIONAL ENTERPRISES IN LESS DEVELOPED COUNTRIES

As the objective of financial statements of multinational enterprises in less developed countries is mainly to provide information to the government agencies and to the public (who might be political pressure groups),[23] and as multinational enterprises prepare two sets of accounts - one set for the external users in a host country and the other set for sending to the parent company,[24] it seems likely that the economic factors that seem to give rise to political costs and/or government intervention would receive more consideration in determining accounting policies for the published accounts of these enterprises in a host country. Based on this reasoning, four potential factors affecting the accounting policy choices of multinationals in less developed countries are discussed below.

---

23. For a discussion on the objectives of financial statements of multinationals see: chapter 11 of the present study.
24. See the concluding part of chapter 9 of the present study.

(a) Size of the Enterprise:

The effects of large corporate entities on our society are overwhelming. Their economic role in the production of goods and services, the provision of employment, the raising of standard of living of the population, and the utilisation of invested resources is enormous. This crucial economic significance has led to a great deal of social control of these entities. This social control may be stimulated by political pressures. The political pressure groups in a country have the power to effect wealth transfers from the corporations to different beneficiaries (e.g. corporate employees, consumers, exchequer, etc.) in the national economy. Jensen and Meckling (1976)[25] and others have argued that corporations are subject to political attack. The political lobbying may take the form of arguing for social responsibility, more regulations, divesture or higher corporate taxes to name just a few. In less developed countries political pressure groups look particularly closely at the large corporations as one source of exploitation, and therefore, lobby for control of large business enterprises (e.g. pressure for nationalisation, expropriation, or legislative actions against expansion of business through takeover or merger, etc.). The cost of such political pressure imposed on the corporations is often assumed to be a function of business size because smaller companies are less visible and hence less subject to political wealth redistribution actions.

Several studies in the U.S.A. have documented the association between size of firms and anti-trust actions.[26] Extrapolating from this evidence, one may argue that if firm size matters in forming public opinion or in determining government actions against enterprises in a large economy like that of the U.S.A., it may be more important in small economies of the less developed countries where large firms are likely to be more visible.

---

25. Jensen, M., and W. Meckling, Can the Corporation Survive? Public Policy Working Paper Series, Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester, New York, 1976.
26. Siegfried, J.J., "The Determinants of Anti-trust Activity", Journal of Law and Economics, October 1975, pp.559-581.

In the United States, in a proposed anti-trust legislation, size per se was mentioned specially as a criterion for actions against corporations.[27] The argument of Professor Mencke (1976)[28] suggests that the magnitude of the political costs of business operation is highly dependent on firm size:

> "Nevertheless, precisely because the actions of large firms are so visible, the American public has always equated absolute size with monopoly power. The major oil companies are among the very largest and most visible companies doing business in the United States. Huge accounting profits, but not high profit rates, are an inevitable corollary of large absolute firm size. This makes these companies obvious targets for public criticism."

The large firms may employ a variety of tactics to minimise the costs of political pressures. Watts and Zimmerman (1978)[29] argued:

> "To counter these potential government intrusions, corporations employ a number of devices, such as social responsibility campaigns in the media, government lobbying and selection of accounting procedures to minimise reported earnings."

By avoiding the attention that "high" profits draw because of the public's association of high reported profits with monopoly rents, management can reduce the likelihood of political actions. An attempt to reduce political costs by reporting low profits may also help to reduce another potential cost imposed by labour unions through increased wage demands due to large reported profits. Thus large firms may have an incentive to choose accounting policies which reduce reported profits.

If firm-size is an important consideration for management's choice of particular accounting policies, then the management of multinational enterprises in less developed

---

27. See: the "Curse of Bigness", Barron's, June 30, 1969, pp.1 and 8; also a bill introduced into the U.S. Senate by Senator Bayh, U.S. Congress, Senate Subcommittee on Anti-trust and Monopoly, 1975, pp.5-13.
28. Professor Mencke of Tufts University, in the hearings on the bill introduced by Senator Bayh, U.S. Congress, Senate Subcommittee on Anti-trust and Monopoly, 1976, p.1893.
29. Watts and Zimmerman (1978), op.cit., p.115.

countries may be expected to choose such accounting policies that result in understatement of enterprise profits. This is because there is widespread evidence that the multinational enterprises operating in less developed countries are comparatively larger in size than their domestic counterparts; and this factor often attracts criticism from political pressure groups and members of the public.

On average, the size of multinationals in most less developed countries may be found to be two to four times larger than their domestic competitors. Lall and Streeten (1977)[30] provide comprehensive empirical evidence on the comparative size of multinationals and non-multinationals in Jamaica, Kenya, India, Iran, Colombia, and Malaysia. They chose for reasons of convenience, sales and two measures of assets to indicate comparative size of the multinational and non-multinational enterprises. Firstly, they demonstrated that the size of average sales by multinationals was over twice the size of non-multinationals, in all the country samples with the exception of Kenya and Iran. They suggested that two country samples (Kenya and Iran) containing 24 out of the total 159 firms in the study, were affected by the apparently fortuitous inclusion of a few exceptionally large non-multinational enterprises, and should not be taken to modify seriously the general findings of the other countries. The observations in the Lall and Streeten study on the comparative size of multinationals and non-multinationals are shown in table 6.1 :

Table 6.1

Average Size of Sample Firms' Sales, by Country, 1968-1969
(US $ million)

Firms	Jamaica	Kenya	India	Iran	Colombia	Malaysia
Multinationals	2.5	4.2	21.3	1.4	6.2	5.2
non-Multinationals	1.6	6.5	5.7	2.7	3.0	2.2

Source: Lall and Streeten (1977), op.cit., p.101

30. Lall, S., and P.P. Streeten, Foreign Investment, Transnationals and Developing Countries, Macmillan,London,1977.

in table 6.1, non-multinationals denote the domestic counterparts of multinational enterprises in the less developed countries studied. In the same study, Lall and Streeten demonstrated that the multinational enterprises in India and Colombia were larger than the non-multinational enterprises also in terms of asset-size; this is shown in table 6.2:

Table 6.2
Total Assets and Net Fixed Assets (Net Fixed Capital) of Indian and Colombian Sample Firms, 1968-1969 (US$ million)

Firms	Average Total Assets Per Firm		Average Net Fixed Assets Per Firm	
	India	Colombia	India	Colombia
Multinationals	15.1	6.6	4.5	1.4
Non-Multinationals	5.8	3.7	2.1	1.2

Source: Lall and Streeten (1977), op.cit., p.103

It appears from the available empirical evidence that, by using different measures of size, multinational enterprises in less developed countries appear to be larger than their domestic counterparts. Therefore, if large size influences an enterprise management in choosing profit-deflating accounting policies, multinationals in less developed countries may be expected to use such accounting policies that understate reported profits.

(b) Capital Intensity:

Capital intensive enterprises have a greater possibility of close observation by trade unions and political pressure groups, on the grounds that such enterprises provide limited employment opportunities by comparison with labour intensive enterprises. One recent example of such trade union observation may be found in the Times (London) industrial dispute in 1979, that led to the closure of the Times newspaper for about a year. The industrial dispute originated from the management decision to introduce modern capital intensive technology requiring fewer workers. It was thus observed that an

increase in capital intensity can create problems leading to high (political) costs for an enterprise. An enterprise with high capital intensive investments may attempt to avoid such costs by reporting lower profit performance.

In accounting practice it is unconventional to charge the opportunity cost of capital in the income statement. The allocation of depreciation charges may not, however, cover actual opportunity costs. As a result the net income of an enterprise may not reflect the opportunity cost of maintaining capital intensive technology. Therefore, on average, a capital intensive enterprise would theoretically produce higher profits than a labour intensive enterprise even through the economic income of the two enterprises may be the same. In such circumstances, the capital intensive enterprises may be subjected to political costs due to higher reported profits. Hagerman and Zmijewski (1979)[31] argued that capital intensive enterprises may have an incentive to reduce reported profit, in order to compensate for the opportunity cost of capital, by selecting appropriate accounting policies.

As for the question of capital intensity of multinational enterprises in less developed countries compared with their local counterparts, the findings of the available empirical studies are mixed and based on shaky data and methodology. The ideal procedure would be to compare matched sets of foreign and local firms, making similar products, with equal access to the relevant technology and facing identical market conditions. While existing studies do not live up to this ideal, most of them have contended themselves with comparing large and diverse groups of local and foreign firms. However, Cohen (1975)[32] and Mason (1973)[33] tried to compare matched pairs of

31. Hagerman and Zmijewski (1979), op.cit., p.143.
32. Cohen, B., Multinational Firms and Asian Exports, Yale University Press, New Haven, 1975.
33. Mason, R.H., "Some Observations on the Choice of Technology by Multinational Firms in Developing Countries", The Review of Economics and Statistics, August 1973, pp. 349-355.

foreign and local firms in some less developed countries, but both studies failed to find consistent patterns of capital intensity in their samples once industry differences were accounted for, and were unable to conclude whether or not multinationals use more capital intensive technology than local firms in the less developed countries.

Vaitsos (1976)[34] found that foreign firms are more capital intensive in Peru for all except the largest sizes. Fajnzylber (1975)[35] found in Mexico that foreign firms use 2.5 times more capital per employee on average than local firms. Jo (1976)[36] reported for South Korea that capital intensities vary markedly over industries with no consistent pattern emerging for multinationals, though on average multinationals are more capital intensive. Agarwal (1976)[37] found for thirty-four Indian industries that multinationals are more capital intensive than local firms. Solomon and Forsyth (1977)[38] found for Ghana that foreign firms are more capital intensive than local firms within given sectors. Gershenberg (1976)[39] argued that multinational enterprises use more capital intensive techniques than local firms in Uganda.

---

34. Vaitsos, C.V., Employment Problems and Transnational Enterprises in Developing Countries : Distortions and Inequality, World Employment Programme, Working Paper No. 11 (mimeo), ILO, Geneva, 1976.
35. Fajnzylber, F., "Las Empresas Transnacionales y el Sistema Industrial de Mexico" El Trimestre Economico, October-November 1975, quoted in S. Lall, "Transnationals, Domestic Enterprises, and Industrial Structure in Host LDCs: A Survey", Oxford Economic Papers, July 1978, pp.217-248.
36. Jo, Sung-Hwen, The Impact of Multinational Firms on Employment and Incomes : The Case Study of South Korea, World Employment Programme, Working Paper No.12 (mimeo), ILO, Geneva, 1976.
37. Agarwal, J.P., "Factor Proportions in Foreign and Domestic Firms in Indian Manufacturing", The Economic Journal, 86, September 1976, pp.589-594.
38. Solomon, R.F., and D.J.C. Forsyth, "Substitution of Labour for Capital in the Foreign Sector: Some Further Evidence", The Economic Journal, 87, September 1977, pp.283-289.
39. Gershenberg, I., The Performance of Multinational and Other Firms in Economically Less-Developed Countries: A Comparative Analysis of Ugandan Data, Institute of Development Studies, Nairobi, Uganda, Discussion Paper 234 (mimeo), 1976.

While some studies have found multinational enterprises to be more capital intensive than their local counterparts in less developed countries, some other studies produced contradictory results. Balasubramanyam (1973)[40] compared factor intensities of Indian Firms without foreign technology or capital with those of Indian firms with foreign licensing and those with foreign capital. He found, within given industries, that the Indian firms without foreign technology or capital and the firms with foreign capital are less capital intensive than the Indian firms with foreign licensing. Reidel (1975)[41] found for Taiwanese export-based industries that there is no consistent pattern of difference between the factor intensities of foreign and local firms within specific sectors. Lall and Streeten (1977)[42] did not find that multinationality makes a statistically significant difference to capital intensity for their aggregated sample of 109 Indian and Colombian firms, but that the industry grouping does.

The mixed findings of the studies on capital intensity restrict any comment on the comparative capital intensity of multinational and local firms in less developed countries. But none of the studies mentioned above has refuted the argument that multinational enterprises in less developed countries use highly capital intensive technology; although perhaps the degree of capital intensity is not significantly higher than the local firms. Moreover some studies have found multinational enterprises in some less developed countries more capital intensive than their local counterparts. The differing findings of the studies may be caused by the weaknesses of methodology used or by the lack of reliable data, or by the different characteristics of the firms in different countries at different points in time. However, one point that emerges from the findings of available studies is that the industrial sector in less developed countries is highly capital intensive.

---

40. Balasubramanyam, V.N., International Transfer of Technology to India, Praeger, New York, 1973.
41. Reidel, J., "The Nature and Determinants of Export-Oriented Direct Foreign Investment in a Developing Country: Case Study of Taiwan", Weltwirtschaftliches Archiv, 1975, pp.505-528.
42. Lall and Streeten (1977), op.cit.

Islam (1976)[43] in his study of capital intensity in industrial enterprises in Bangladesh, showed empirically that as a whole industrial enterprises in that country are highly capital intensive. That study revealed that capital intensity in industries of most less developed countries including Bangladesh is higher than that of in many developed countries. This indicates that multinational enterprises in less developed countries have high capital intensity, which may be more than or similar to the capital intensity of the local enterprises. In the real world, high capital intensity may not cost much in terms of "political cost" for the local enterprises as it would for the multinationals. This may be because the people in less developed countries often consider multinational enterprises as the foreign agents of economic exploitation.[44]

Based on the above discussion of the capital intensity of multinational enterprises in less developed countries, one may argue that the capital intensity hypothesis, forwarded by Hagerman and Zmijewski (1979)[45], in association with other factors (viz. large size etc.), may motivate the multinationals in less developed countries to understate reported profit performance through the choice of appropriate accounting policies.

(c) Market Power and Monopoly Rent:

Enterprises earning monopoly rents through the exercise of their market power (monopolistic or oligopolistic market power), may be expected to make every effort to protect this power. Reporting lower profits by choosing particular accounting policies may be of importance to an enterprise with market power for two reasons: first it might combat political attacks, and second, it might discourage the entry of

---

43. Islam, R., Factor Intensity and Labour Absorption in Manufacturing Industries: the Case of Bangladesh, Unpublished Ph.D. thesis, University of London, 1976.
44. Turner, L., Multinational Companies and the Third World, Allen Lane, 1973, gave an excellent analysis of this view; for further details see: N. Girvan, Corporate Imperialism: Conflict and Expropriation, Monthly Review Press, New York, 1976.
45. Hagerman and Zmijewski (1979), op.cit., p.143.

potential competitors into the same market. The strategy of understating reported profit performance to maintain market power may be as useful in less developed countries as in developed countries.

In the United States, reported profits have been used by the Justice Department to determine market power and by members of the public to suggest that certain companies be investigated for possible anti-trust violations.[46] Political pressure groups often consider high reported profits of an enterprise as the surrogate of market power. Under such circumstances, one may argue that enterprises earning monopoly rents would have an incentive to understate reported accounting earnings in order to avoid political pressures for more control, more taxes, anti-trust litigation, nationalisation, or expropriation.

Mansfield (1962)[47] showed empirically that the number of firms entering an industry is positively related to the accounting profit of that industry. If the firms in an industry are found to earn abnormal profits, potential competitors have an incentive to enter that industry, thereby reducing the profitability of existing firms in that industry. Since the existing firms would not like to encourage the entry of competitors by revealing profitable opportunities, they may be motivated to understate reported profits by selection of appropriate accounting policies.

Multinational enterprises in less developed countries are oligopolistic in character, and the common features of multinational enterprises like technology innovation, product innovation and differentiation, heavy advertisement and brand identification, are both the symptoms of, and reinforce this oligopolistic market power. Recent theories of foreign

---

46. Brozen, Y., "Significance of Profit Data for Anti-trust Policy", The Anti-trust Bulletin, Spring 1969, pp.119-139.
47. Mansfield, E., "Entry, Gibrat's Law, Innovation and the Growth of Firms", The American Economic Review, 52, December 1962, pp.1023-1051.

investment, and in particular of the growth of investment by multinational enterprises, have turned to explanations based on 'imperfections', oligopolistic interdependence, and the possession of monopolistic advantages. These theories, which may be broadly labelled 'oligopolistic' explanations of direct foreign investment, draw upon a variety of different fields of study to produce a much more realistic and comprehensive, if relatively unrigorous,view of the actual process of market power of multinational enterprises.[48]

In less developed countries, critics often allege that multinational enterprises, by restricting competition in the market, earn monopoly rents, and thus exploit the national economy. Such allegations may in extreme cases result in unbearable political costs (e.g. nationalisation, expropriation) for a multinational enterprise. In order to prevent this sort of political cost, a multinational enterprise may demonstrate in its financial statements that it is not earning any more profit than the local enterprises. Such a demonstration might make its critics believe that the multinational enterprise does not enjoy any special advantage (monopolistic or oligopolistic) over the national firms in the economy. This strategy of showing lower profits in financial statements may be accomplished by the multinational through the choice of particular accounting policies.

(d) Business Risk:

Hagerman and Zmijewski (1979)[49] argued that the firms with higher systematic risk would have a tendency to choose income deflating alternatives which deciding accounting policies. The principal assumption of this argument is that higher systematic risk produces a higher risk-premium. The argument was put forward as follows:

> "Accounting profits, to the extent they measure economic profits, consist of normal return to capital and any abnormal profits or losses. ... This means that unless the public and politicians make adjustments for risk,

48. See chapter 3, and chapter 4 of the present study.
49. Hagerman and Zmijewski (1979), op.cit., p.143.

> riskier firms will appear to make excessive profits and thus be subject to negative wealth transfers. ... Firms that have highly variable earnings will naturally, from time to time, appear to earn abnormal profits. This subjects such firms to political costs. Thus these firms have the incentive to reduce the mean of their reported earnings distributions by choosing income deflating accounting alternatives. ..."

The business risk argument was examined by Hagerman and Zmijewski using the beta coefficient of stock prices as the measure of systematic risk. The beta coefficient was computed using the market model which is consistent with the capital asset pricing model (CAPM) developed by Sharpe (1964)[50] and others. But in the case of a less developed country where the capital market is unorganised and the stock market is less active, and where the assumptions of CAPM do not hold good, it may not be possible to examine whether or not beta (the measure of systematic risk) influences accounting policy choice. Although other measures of risk, e.g. standard deviation or variance of return on capital can be used, they seem inapplicable for studying accounting policy choice because such measures are based on published accounting numbers which may be distorted by manipulation of the accounting policies.

Corporate risk or business risk usually has two components: (i) unsystematic risk, and (ii) systematic risk. Unsystematic risk arises out of uncertainties at the micro-level of the enterprise; while systematic risk arises out of the uncertainties at the macro-level of the economy within which the enterprise operates. It is assumed that the corporate management can minimise unsystematic risk since this kind of risk is the outcome of uncertainties within the enterprise; efforts to alleviate such uncertainties make unsystematic risk controllable. Finance theory tells corporate management that it can reduce unsystematic risk to zero. As systematic risk is the product of uncertainties at the macro economic level, it may not be controllable by an enterprise management.

---

50. Sharpe, W.F., "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk", Journal of Finance, September 1964, pp.425-442.

Therefore, when an enterprise is exposed to a high degree of uncertainty at the macro economic level, it may be expected to face higher business risk and in turn to earn a higher risk premium in the form of higher profits.

A multinational enterprise, due to its alien status in a host country, and particularly due to potential "political Costs" arising out of the nationalistic attitude of the members of the public in a host less developed country, seems to be exposed to a greater degree of macro-level uncertainty than any other domestic enterprise. This in turn raises the extent of business risk of a multinational enterprise in comparison with a local enterprise in a host country, particularly in a host less developed country. Assuming that high business risk is positively related to high profits, it may be assumed that multinational enterprises in less developed countries would have an incentive to hide the high profits (i.e. high risk premium) by understatement of reported profits. In line with the "business risk" argument put forward by Hagerman and Zmijewski (1979)[51], it can be argued that the understatement of reported profits by multinationals might be done through choice of appropriate accounting policies.

6.4 CONCLUSION

The present chapter has attempted to suggest some economic reasons behind the choice of accounting policies by business enterprises. These economic reasons have been analysed in the context of multinational enterprises in less developed countries. In summary, in the present chapter it has been argued that multinational enterprises in less developed countries may have an incentive to choose those accounting policies which reduce reported profits. This incentive could be due to the greater probability that large size, capital intensity, and ability to earn monopoly rent and/or a high risk premium, would make these enterprises subject to political actions that would reduce their wealth.

---

51. Hagerman and Zmijewski (1979), op.cit., p.143.

In addition, it has also been argued that multinationals in a host country may be motivated to reduce reported profits by the choice of appropriate accounting policies in order to discourage entry of potential competitors (mainly competing multinationals) in the same market.

So far as is known no study, either normative or empirical, has yet examined whether or not multinational enterprises in less developed countries resort to the practice of profit distortions by accounting policy manipulation or accounting policy choice, in order to demonstrate lower profit performance than the local enterprises. Such an study is important for understanding the behaviour of multinationals in host less developed countries. It may also be helpful in operationalising national and international efforts to prepare codes of conduct for multinationals. The present chapter has attempted to advance the hypothesis that "multinational enterprises in less developed countries manipulate accounting policies in order to understate reported profit performance". This hypothesis will be examined in chapter 9 of the present study with reference to the multinational enterprises operating in a less developed country (Bangladesh).

CHAPTER SEVEN

Transfer Price Manipulation Hypothesis

7.1 INTRODUCTION

Transfer prices ordinarily denote monetary amounts (prices) assigned to exchanges of goods and services between different profit centres of an enterprise. Although most foreign affiliates of multinational enterprises are theoretically separate legal entities, in practice they are integral parts of one economic organisation. In the context of multinational enterprises, transfer prices are the prices that are charged on "internalised" trade and other flows of services between affiliated companies or subsidiaries of the same multinational enterprise.

In a multinational enterprise, many transactions can take place between the subsidiaries in different countries or between the parent and subsidiaries - sales of goods, the provision of services, the licensing of patents and know-how, the granting of loans and so on. The prices charged for such transactions may not follow the rules of tradiitonal pricing theory under prevailing market conditions. The essential difference is simply that in transactions in the open market or between unrelated firms, the buyers and sellers try to maximise their benefits at each other's expense; while in the case of transactions between affiliates of a multinational, the price may be merely an accounting device used by the parties to maximise the overall benefit to the total organisation (the multinational enterprise). As a result there is a possibility that transfer prices may diverge considerably from the prices which would have been agreed between unrelated firms engaged in the same or similar transactions under the same or similar conditions in the open market. This open market price is usually called an "arm's length price". When the transfer price is set higher than the arm's length price, then the good or service is considered to be over-priced; and when the transfer price is below the arm's length price, then the good or

service is considered to be under-priced. This over-pricing or under-pricing of the goods and services results in a flow of liquid assets across the boundaries of the countries where the multinationals' affiliates operate; such flows might be regarded as a secret transfer of funds, which could be used by a multinational enterprise to distort reported profit performance of any of its affiliated companies.

7.2 TRANSFER PRICING PROCESS

The transfer pricing process may occur in various types of international transactions within a multinational group. Some of the ways in which the transfer pricing process may lead to price manipulations are discussed below:

(a) Pricing of Goods:

Suppose subsidiary X of a multinational enterprise manufactures sub-assemblies which are shipped to subsidiary Y. If the product is under-priced by X, then there occurs a secret transfer of funds from X to Y. If the product is over-priced, then there is a secret transfer of funds from Y to X. Likewise, there may be transfer price manipulation in the case of the shipment of capital goods such as machinery and spares, and finished products, from one party to another within a multinational group.

(b) Fees and Royalties:

Managerial advice, allocated headquarters' overhead, and royalties on patents and trade marks, are very difficult to price in the open market. Hence they appear to be very suitable conduits through which to move funds from a subsidiary to the parent company, or between subsidiaries. Higher or lower charges for fees, royalties and headquarters' overheads may result in a flow of funds in either direction.

(c) Inter-subsidiary Loans:

The most prevalent form of inter-subsidiary loan is to speed-up or delay the invoicing of shipments between two related enterprises within a multinational group. This is

very simple because normal terms of payment usually differ between regions of the world. In addition, actual shipping schedules can be accelerated in one direction and decelerated in the other so that one subsidiary carries inventory for both. The cost and benefit of this action may be allocated between different subsidiaries. Moreover, trade credit, and long or medium term loans between subsidiaries may involve interest payments at higher or lower rates than the 'normal rate'. This would result in a flow of funds between subsidiaries. In addition to inter-subsidiary loans, loans may also take place between the parent and subsidiaries, which may result in transfer price manipulation and ultimately a net flow of funds either from parent to subsidiary or from subsidiary to parent.

The transfer pricing process may not always involve a simple transfer of goods between two affiliates. As a result of international differences in tax rates and due to various other factors,[1] a multinational enterprise may adopt a strategy of shipping goods from one subsidiary to another, or from the parent company to a subsidiary, via a third affiliate.[2] This third affiliate may not be engaged in any manufacturing activity, rather it may act as a 'transit camp' for merchandise; these trading affiliates are sometimes called shippers. This type of affiliate is usually established in a country with greater tax advantages and international money transfer facilities.

Suppose the parent company of a multinational in the U.K. wishes to over-price exports to a subsidiary in Bangladesh; this would ultimately increase the cost of production and decrease the reported profit of the Bangladesh subsidiary. This transfer pricing policy, however, would increase revenue and ultimately the tax burden of the parent company in the U.K.. But the parent company can show a lower revenue in the U.K. by transferring goods to Bangladesh via a third affiliate (say)

1. Discussed in detail in the following section.
2. For details see: the following section, sub-heading "Reducing Corporate Profit Taxes".

in Hong Kong.[3] Knowledge of this process was gathered in the course of personal interviews with top management personnel of a number of multinational enterprises in Bangladesh. This process can be shown as below:

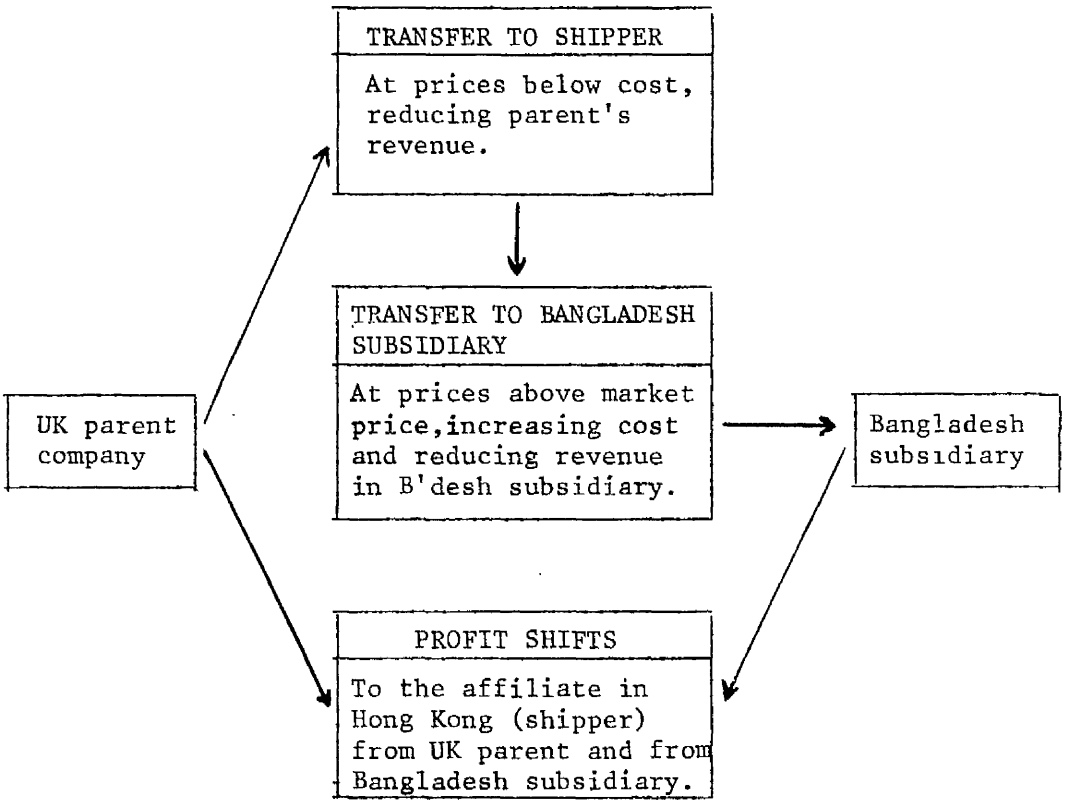

Figure 7.1 : Profit Shifts Through the Transfer Pricing Process

7.3 FACTORS INFLUENCING TRANSFER PRICING DECISION

Transfer pricing decisions in multinational enterprises may be influenced by various factors, the effects of which may determine an 'optimal' strategy for a multinational. The factors may be grouped under two broad headings: (i) those which help maximise global profit of the organisation, and (ii) those which help minimise current and potential risks of the multinational enterprise in a host country. An attempt is made below to discuss each of the important factors under these two broad headings.

3. Hong Kong provides various tax advantages and international money transfer facilities. There are a number of low tax and tax free countries in different parts of the world; many multinationals have set up subsidiaries in these countries to shelve profits from different sources world wide.

(A) Profit Maximising Factors

(a) Improving or Maintaining Competitive Position:

A multinational enterprise may attempt to improve its competitive position or to maintain an existing competitive position in the world market by using the transfer pricing mechanism. This may be achieved, for example, by under-pricing raw materials, intermediate products or services,or services transferred from one subsidiary to another, thereby enabling the receiving subsidiary to sell products at competitive prices either to increase its market share or to eliminate potential competitors. Low transfer prices would seem to be particularly common in vertically integrated industries, where competitive market position at the raw material and semi-processed material stages makes it possible to set transfer prices at levels which result in the bulk of the profit appearing at the processing and marketing stages. This may discourage new entrants at the processing level.

When a subsidiary of a multinational in a host country makes losses, profits earned in subsidiaries in other countries can be shifted to the loss making subsidiary through the transfer pricing mechanism. This process may help to sustain the loss making subsidiary and to maintain its market share. Alternatively when a subsidiary attains monopoly market power and can sell products at monopoly prices, goods and services from other subsidiaries can be shifted to that particular subsidiary at high transfer prices; this process may result in greater profitability for the multinational group, as high transfer prices will give high profits to the subsidiaries selling goods and services to the monopolist. The high cost of imports will not diminish the profitability of the monopolist because of its market power and its ability to raise market prices. Thus the overall profits of the multinational group may be increased.

In analysing its global competitive position, a multinational enterprise usually does not consider only the profitability of its sales and investments in both domestic and

foreign markets, but also the ways in which they affect each other. The interactions between profitabilities of the parent and a subsidiary, one subsidiary and another, and between the parent and all the subsidiaries, are likely to be considered in determining a global strategy for improving or maintaining a competitive position for the whole multinational enterprise. Figure 7.2 below demonstrates this pattern of interaction:

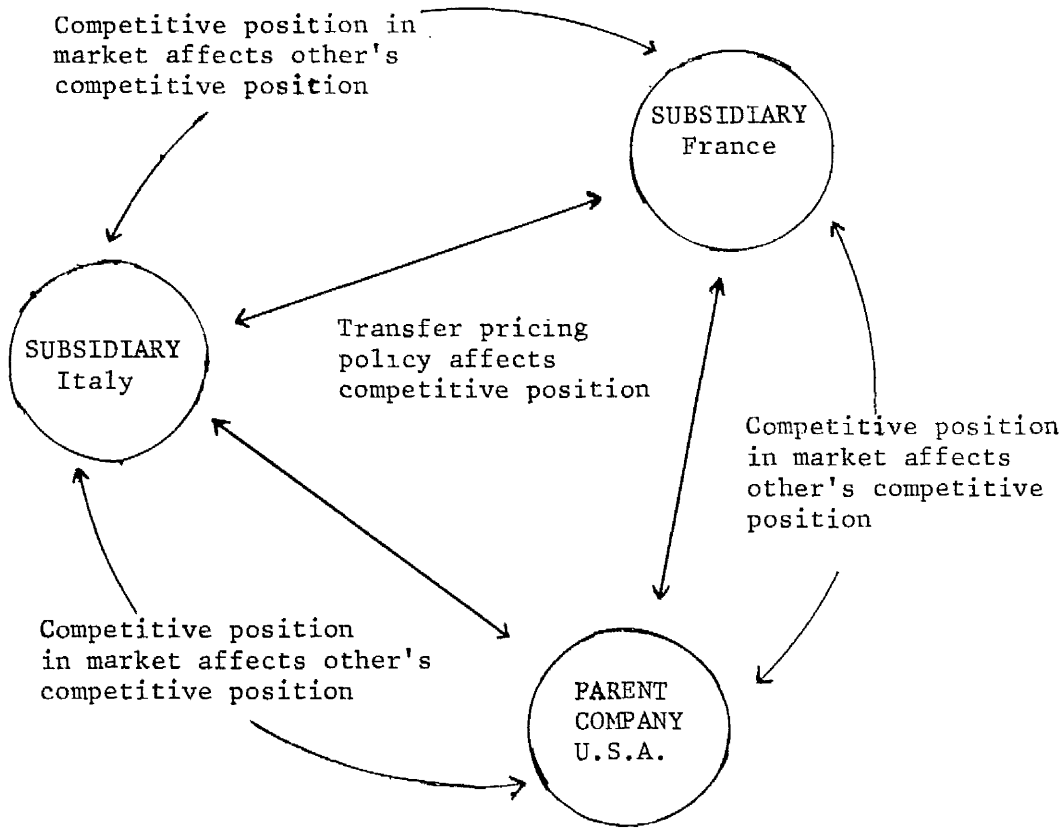

Figure 7.2 : Transfer Pricing and Competitive Position

(Note: The above diagram is from : J.S. Arpan and L.H. Radebaugh, International Accounting and Multinational Enterprises, Warren Gorham & Lamont, Boston, 1981, p.236.

As the transfer pricing policy of a multinational may affect its overall competitive position, policy decisions about transfer pricing are needed in individual cases, so that the potential impact on the existing and potential competitive position of the enterprise in the world market can be considered.

(b) Reducing Corporate Taxes:

Traditionally most of the discussion of transfer pricing deals with its impact on the overall burden of corporate taxes to the multinational enterprise. A common example is the use of transfer pricing by a multinational to shift profits out of high tax-rate countries to low tax-rate countries. The parent company can sell goods and services at lower than the arm's length price to a foreign subsidiary in a low tax-rate country and buy from that subsidiary at higher than arm's length price. The resultant loss in the parent's high tax-rate country will be balanced by the profits of the subsidiary in the low tax-rate country, and thus the multinational enterprise will achieve a reduction in its global tax burdens. A simple case of tax reduction through transfer pricing is depicted below:

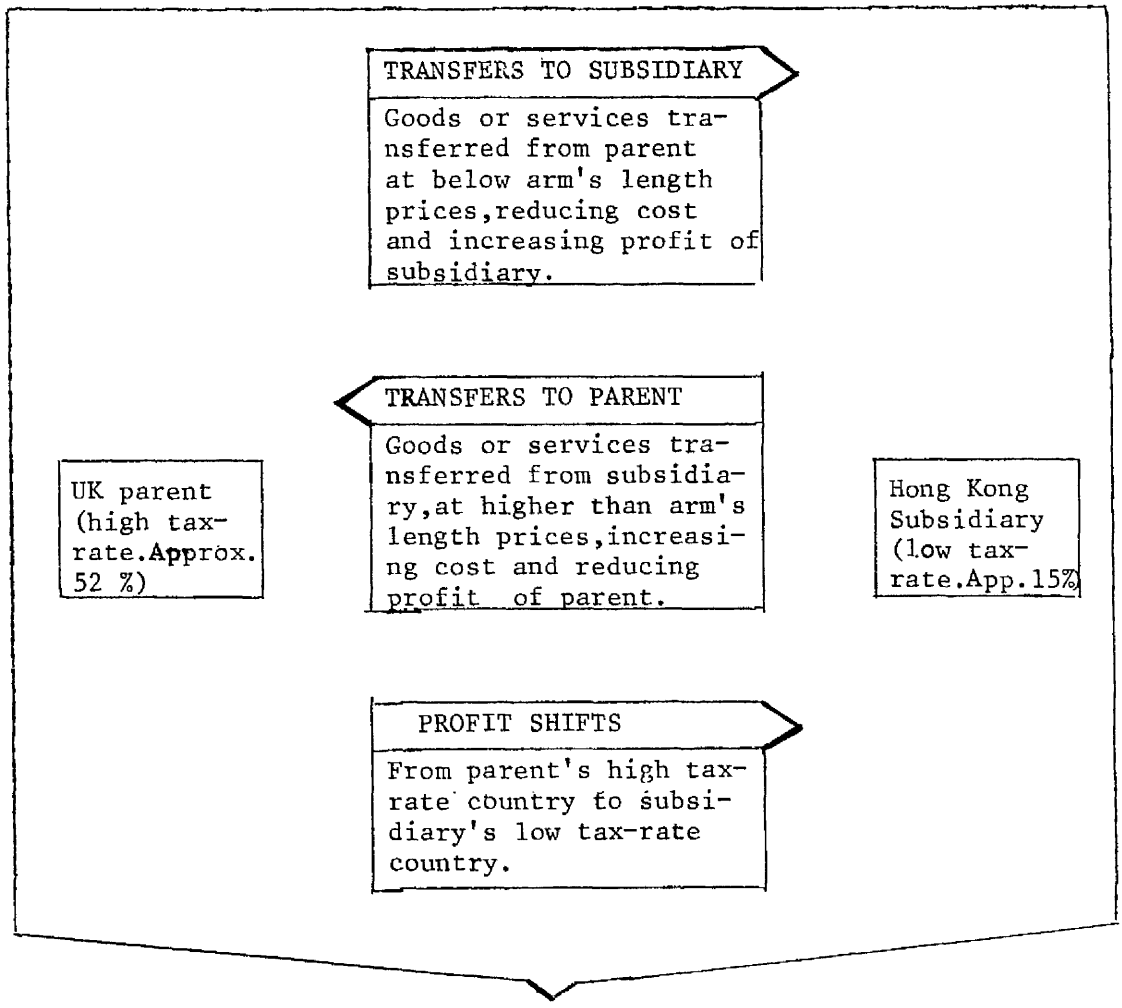

Figure 7.3: Transfer Pricing and Tax Reduction

How profits accruing to the multinational enterprise as a whole can be increased by setting high transfer prices to syphon profits from subsidiaries domiciled in high tax countries and low transfer prices to shift profits to low tax countries, may be exemplified by the following numerical example:

Example

Suppose a British multinational enterprise ABC Co. is involved in the car leasing business, and it has two subsidiaries - one in Japan and the other in Hong Kong. ABC Co. (Japan) purchases a fleet of used Toyota cars from XYZ Co. in Japan for, say £500 each. Then these used cars are resold by ABC Co. (Japan) to ABC Co. (Hong Kong) for £525 each, at a nominal profit of 5 per cent. The ABC Co. (Hong Kong) then resells these cars to the U.K. Parent company (ABC Co. in U.K.) for £1,500 each. The Hong Kong subsidiary makes a profit of £975 per car (a profit of 186 per cent). As the tax-rate on corporate profit is relatively low in Hong Kong (about 15 per cent), the tax burden for the high profit in the Hong Kong subsidiary is insignificant compared with the high tax-rate in U.K. or Japan. The parent company in the U.K. then leases the fleet of cars for a discounted sum close to its cost, thus minimising its taxable revenues, and makes necessary depreciation allowances for tax purposes. The transfer pricing mechanism has helped the multinational in minimising its global tax burden and thereby maximising the overall profits of the group.

A multinational enterprise, as seen in the above example, may establish an international trading affiliate as an intra-group trade intermediary in a so-called 'tax haven'. This facilitates tax reductions through transfer pricing. Profits may be accumulated by the multinational in a tax haven. Tax havens are usually located in relatively small countries or territories which have low tax rates and/or which frequently exempt from taxes either all or most income derived from foreign sources. These tax havens include:[4]

(i) The Bahamas, Bermuda, and the Cayman Islands, which have no taxes at all.

(ii) The British Virgin Islands, and Gibraltar, which have very low tax-rates.

(iii) Hong Kong, Liberia, and Panama, which tax locally generated income at low rates, but exempt income from foreign sources.

---

4. Choi, F.D.S., and G.G. Mueller, An Introduction to Multinational Accounting, Prentice-Hall, New Jersey, 1978, p.290.

(iv) Countries that allow special privileges that are suitable as tax havens for very limited purposes.

So long as profit can be transferred to a tax haven, the multinational can enjoy the benefit of tax deferrals. But when the parent company repatriates profit to the home country, the profit may be taxed by the home country government. Due to the avoidance of double taxation via aggrements between most national governments, the parent company is relieved from payment of tax on repatriated profit from subsidiaries, to the extent that tax has already been paid in the host country. This aspect of corporate profit taxation may be explained with the help of the following example:

Example:

Suppose a U.S. multinational enterprise "BMI Corp." derives all of its income from its subsidiary in Bangladesh. Net earnings before taxes are $100 million. Suppose BMI Corp. pays $30 million income tax in Bangladesh.

Assume the United States has a 50 per cent corporation tax-rate. The tax payers in the United States can credit corporate taxes paid in the host country.

The tax consequences of BMI Corp. in the United States will be as follows:

Earnings before tax		$ 100 mill.
Bangladesh tax		$(30)mill.
Pre-credit US tax (100 * .50)	= $50 mill.	
Credi for foreign tax	= $30 mill.	
Net US tax		$(20)mill.
Total taxes paid ($30mill. + $20 mill.)		=$ 50 mill.
Return after all taxes		=$ 50 mill.

The major home countries of multinationals, viz. the U.S.A., the U.K., the Federal Republic of Germany and Japan, have adopted the "foreign tax credit" mechanism. As dividends and income originating in the host country are held liable to tax in the home country when such incomes are effectively repatriated, the foreign tax credit mechanism, in itself, provides an incentive to retain profits in subsidiaries in low tax-rate countries. The tax saving by a multinational

enterprise may be considerably enhanced if incomes from high tax countries are remitted not to the parent company but to an affiliate in a tax haven, where the income is laid to rest in a tax-free climate, before being redeployed. Profits accumulated in tax havens may ultimately be used to invest in foreign countries which may help the multinational achieve tax and other benefits on account of capital expenditures.

Plasschaert (1979)[5] has pointed out some constraints on tax reductions through transfer pricing involving tax havens. First, some part of overseas profits (accumulated in tax havens) will eventually have to be channelled to the parent company, to sustain dividends to the parent's shareholders; at that point, the home country will tax the profits. Second, tax havens are excluded from benefits of double taxation agreements. And, finally, major countries have taken steps to thwart the use of tax haven 'convenience' subsidiaries. But it seems that these constraints have had only a limited effect on discouraging multinationals from using the transfer pricing mechanism to save world wide taxes. The growing tendency for multinationals to appoint international tax consultants suggests that the multinationals are in the search of many angles and tangles in tax laws in different countries to dodge the national and international efforts towards controlling tax savings through transfer pricing. Moreover, if profit transfers to tax havens can not save tax payments for ever (as suggested by Plasschaert), at least tax payments to the home country government can be deferred for a period of time; this can be used by the multinational as a means of combatting cash flow problems either in the parent company or in a subsidiary.

Vaitsos (1974)[6] argued that the question of tax payments is not limited purely to tax differentials. In practice, the parent company may over-price its exports to a subsidiary

5. Plasschaert, S., Transfer Pricing in Multinational Enterprises: A Clarification of Concepts and Issues, Centrum Voor Bedrijfseconomie En Bedrijfseconometrie, Universiteit Antwerpen - UFSIA, Working Paper 79-58, No.D/1979/2263/13, September 1979, pp.10-11.
6. Vaitsos, C.V., Intercountry Income Distribution and Transnational Enterprises, Clarendon Press, Oxford, 1974, p.115.

even if the tax rate is higher in the country of the parent company than in that of the subsidiary, because the profits thus shifted can be offset against 'taxable deductions' for certain fixed expenditures - such as research and development and management charges.

(c) Taking Advantages of Tariffs and Subsidies:

In addition to tax advantages, tariffs and export-subsidies in different countries, in less developed countries in particular, may influence the multinationals in determining transfer prices. Lall (1973)[7] has explained this in a lucid manner : (where A is the home country and B is the host country)

> "If tax-rates are higher in B than in A, and the parent MNE (=multinational enterprise) supplies imports to the subsidiary, it would pay the firm to over-price these transactions and move profits to A as long as the difference in effective tax rates exceeds the tariff in B on those imports. Similarly, if the subsidiary is exporting to the parent it would pay to under-price the transactions as long as the tax-rate differential plus the saving in import duty in A exceeded the export subsidy in B. If trade is taking place in both directions, the MNE may under-price imports into B to avoid duties and under-price its exports to A to take advantage of export subsidies in B and lower taxes in A. The extent to which profits can be moved around freely depends, of course, on the volume of intra-firm trade, the structure of the firm and the vigilance of the relevant authorities."

In practice, however, it would seem that customs duties are not viewed by multinational enterprises as especially important in their transfer pricing policies, because tariffs on raw materials and intermediate products - which constitute the bulk of intra-firm trade - tend to be low.[8]

(d) Hedging Against Exchange Rate Changes:

If the exchange rate of either the home country or the host country is expected to change and the multinational

---

7. Lall, S., "Transfer Pricing by Multinational Manufacturing Firms", Oxford Bulletin of Economics and Statistics, Vol.35, No.3, August 1973, p.176.
8. UNCTAD, Dominant Positions of Market Power of Transnational Corporations: Use of the Transfer Pricing Mechanism, United Nations Publication No.TD/B/C.2/167, New York, 1978, p.7.

enterprise cannot or will not speculate openly, it may use transfer prices to reinforce the normal leads and lags which minimise its obligations in the devaluing currency. The profitability of such speculation would depend on the amount of devaluation expected and the cost of using transfer prices in terms of additional taxes and tariffs. A simple example may illustrate this:

Example

Suppose, for example, that the U.S. parent has sold goods having a market price of £1 million, to its subsidiary in the U.K., price payable 3 months hence and that the exchange rate between sterling and the dollar, $2 = £1 now, is expected to change to $1.75 = £1 within the same span of time. Let us assume that the parent company, for shipment of goods to the U.K. subsidiary, imposes a transfer price of £1.2 million, without modifying the terms of payment. The U.S. parent company would receive £0.2 million or $0.35 million more, but the U.K. subsidiary would receive less goods to the extent of worth £0.2 million or $0.35 million. It follows that the "excess" price does not affect the overall current asset position of the multinational enterprise. But, when the "leading technique" (over-pricing to the extent of predicted future exchange-rate change) is successfully implemented, not only does the multinational avoid exchange risk, but also the transfer pricing mechanism allows it to extract more funds out of a weak currency for conversion into a strong one.

Leading or lagging is usually recognised by the monetary authorities as the most important route through which an enterprise can hedge against losses arising from exchange rate changes, although the phenomenon cannot easily be documented. Although different countries have imposed various restrictions on the terms of payments applied in international trade and payments, transfer pricing mechanisms resulting in leading or lagging still seem to be an important tool in the hands of multinational enterprises in hedging against exchange rate changes.

(e) Managing Cash Balances in Foreign Subsidiaries:

Multinational enterprises, for various reasons, may prefer to keep cash balances at a minimum level in particular subsidiaries especially in subsidiaries located in

less developed countries. The transfer pricing gambit may be of much use in this respect. The economies of most of the less developed countries suffer high inflation, which erodes the value of money. If a large cash balance is allowed to remain in these countries, there would be a cost for the enterprise as a whole because inflation would erode the value of the cash balance. Under such a circumstance, a multinational enterprise may attempt to shift cash from subsidiaries in high-inflation countries to subsidiaries in low-inflation countries by practising appropriate (appropriate for cash transfer) transfer prices.

A large number of less developed countries have very weak currencies. Even if these countries do not impose restrictions on the remittance of profits by foreign companies, practical problems due to lack of sufficient foreign exchange reserve create limitations on the transfer of money such countries. Anticipating a foreign exchange crisis in the host country, a multinational enterprise may resort to the transfer pricing mechanism to shift funds out of the weak-currency country.

In addition, the cash balances in foreign subsidiaries of multinational enterprises may be managed through the transfer pricing mechanism via different rates of interest in different host countries. An example of this is found in the following statement of an executive of a U.S. based multinational enterprise.[9]

> "One of our Danish subsidiaries had excess cash which it lent to another Danish subsidiary that was receiving goods from the Swedish subsidiary. The Danish company prepaid its account with the Swedish subsidiary, and this money financed the movement of Swedish products into the Finnish subsidiary. What did the manoeuvre accomplish? If Finland had been required to pay for the goods, it would have had to borrow at 15 per cent, the going Finnish rate. If the Swedish subsidiary had financed the sale, it would have had to borrow at about 9 per cent. But cash in Denmark was worth only 5 per cent to 6 per cent.Moreover,the Danish currency was weak in relation to the Swedish; by speeding up payments to Sweden we not only obtained cheaper credit, we hedged our position in Danish Kroner as well."

9. Interview reported in Financial Times,London,12 Sept. 1969.

(f) Adjusting Against Multiple Exchange Rates:

There are less developed countries where multiple exchange rates are applied on the official transfers of funds. This prevailed in Colombia before 1966, where the rate applicable to profit remittances tended to be unfavourable relative to the one applicable to imports of capital or intermediate goods.[10] These multiple exchange rates may induce a multinational enterprise to over-price imports for remittance of profits through the transfer pricing channel:

(g) Circumventing Quantitative Restrictions on Remittances:

In countries where strict exchange control regulations restrict repatriation of profits, and the multinational enterprise is not interested in reinvesting retained profits, the transfer pricing mechanism can play an effective role in remitting liquid assets and thereby limiting its declared profits. Kim and Miller (1979)[11], studying the practices of U.S. based multinational enterprises in world-wide transfer pricing, argued that profit repatriation restrictions and exchange controls in the host countries form very important inducements in transfer pricing decisions. In the words of Kim and Miller:[12]

> "Profit repatriation restrictions and exchange controls within the foreign subsidiary country received the highest ranking orders in an analysis of the variable statements. This is not surprising when it is seen that the two statements are, in fact, interrelated. Exchange controls imposed by many developing countries are often the means of implementing varied restrictions on profit repatriation by U.S. multinational firms. Furthermore, the high rank orders for these statements coincide with the impression obtained from personal interviews with company controllers and partners of several of the large accounting firms involved in these pricing practices. This result, then, is a dramatization of the well known fact that developing countries make major use of profit repatriation restrictions and/or exchange controls to prevent outflows of foreign capital. This may, of course, be an attempt to compensate for less sophisticated income tax regulations as compared to those in more developed countries."

---

10. Lall (1973), op.cit., p.177.
11. Kim, S.H., and S.W. Miller, "Constituents of the International Transfer Pricing Decision", The Columbia Journal of World Business, Spring 1979, pp.
12. Ibid, p.72.

(h) Exploiting Local Minority Shareholders:

The transfer pricing mechanism provides the multinational with a tool for exploiting the interests of local minority shareholders in a host country. The multinational, by over-pricing imports of capital assets and other inputs from related sources abroad, can shift profits in order to maximise global profits of the organisation, and thereby to deprive local shareholders of their share of such profits. As the local minority shareholders can exert little control in the management of the enterprise. the position of the multinational in this regard is always favourable to its own interest.

(i) Acting in Collusion With Local Collaborators:

In the case of a joint venture project where a multinational enterprise makes investment in collaboration with one or more local equity participants, the transfer pricing mechanism may be used by the multinational to remit profits out of the host country in the interests of both the parties (the multinational itself and the local collaborator(s)). This kind of collusion may be easy when the local collaborator(s) is (are) from the private sector of the economy.

It is rumoured that local private collaborators in a less developed country often encourage their foreign partners to remit funds through transfer pricing, a portion of this remitted fund being received by the host country collaborator(s) in hard currencies from the multinational. The local collaborator(s), it is presumed, enter(s) into such collusion with the multinational in order to accumulate secretly remitted profits in foreign countries which they can freely spend and/or resale on the 'black market'. This practice seems to exist in the case of those host countries which lay down strict requirements for local equity participation, and which have weak currencies.[13]

13. Although it is very difficult to produce evidence of this sort of collusive activity of the multinationals and their local collaborator(s), general statements about the existence of such a practice were made by some leading industrialists and competent government authorities in Bangladesh during the field work for the present study.

(B) Risk Minimising Factors

(a) Combatting Political and Social Pressures:

Multinational enterprises, especially those in less developed countries, may be motivated to use the transfer pricing mechanism to keep declared profits at a minimum; because high profits might induce trades unions to ask for a larger share of profits in the form of higher wages and bonuses and political activists might consider high profits as a surrogate for bourgeois exploitation or as the indicator of foreigners' exploitation of national resources. The allegation of 'exploitation' may cause tougher government restrictions on the operation of the multinational and on repatriation of profits. Moreover, if the social and political pressure groups are very powerful, highly profitable multinationals may be subjected to expropriatory actions by the host government.

Multinational enterprises, in order to safe-guard investments against political and social pressures, may resort to the transfer pricing gambit, to shift profits to safe places and thus to declare minimum levels of profits in a host country with high political and social pressures. For the long-term safety of multinational investments, transfer pricing may be used to syphon profits from enterprises in politically risky countries even without regard to tax-tariff or other short-term factors.

In practice, the political environment in a particular host country (especially if the country is a less developed country), may be one of the most important factors influencing the long-term strategy for transfer pricing. Volatility of the political conditions in many of the less developed countries seems to motivate multinational enterprises to make arrangements against existing and potential political risks - transfer pricing may be one of the best ways to reduce such risks.

(b) Arguing for Government Protection and Subsidies:

Multinational enterprises, when negotiating an investment with a host government, especially in a less developed

country, usually press for protection against imports and other competition. The host government, in order to encourage foreign investments may provide such protection. Moreover, various forms of subsidies and favourable fiscal measures may be enjoyed by a multinational on the grounds that it operates amidst many constraints in the host country.

If the host government discovers that a multinational enterprise is earning abnormal profits, it may refuse to provide any protection to the multinational. Furthermore, any subsidy and/or fiscal facilities already allowed in favour of the multinational may be curtailed by the government. If the level of protection is determined by the host government on the basis of the firm's cost of production plus some reasonable allowance for profit, the multinational can argue for increased protection and additional facilities by inflating its production cost through over-pricing intra-group imports. This would lead to an increase in overall profitability of the multinational. If the multinational enterprise understates reported profits for a number of years, it may provide a pretext for arguing with the host government for a higher level of protection and further concessions.

(c) Reducing the Impact of Price Controls:

Price control regulations, especially where limits are placed on the mark-ups on ex-factory or imported prices, may also provide an important influence on transfer pricing decisions of multinational enterprises. Price control authorities, in some countries, fix maximum prices of marketable products on the basis of cost plus a reasonable level of profit. Therefore, in order to reduce the impact of price controls on the profitability of the enterprise,a multinational can show a high cost of production by over-pricing imports of raw materials and intermediate products from sister organisations abroad. Empirical studies in India and Colombia have observed the evidence of over-pricing by multinational enterprises for imports of pharmaceutical products in these countries in order to circumvent price controls.[14]

14. UNCTAD (1978), op.cit., p.7.

The price control is an important risk against the profitable operation of multinational enterprises in a host country. Transfer pricing mechanism may play a vital role in reducing this risk.

(d) Discouraging Potential Competitors:

If a multinational enterprise enjoys the market power to earn above-normal profits, it may not like to see other potential competitors enter the same market to curb its market share. If the multinational reports a high rate of return in its financial statements, potential competitors, especially competing multinationals, might be attracted into the market. This could pose a great threat to the profitability of the existing multinational. To discourage entry of potential competitors, a multinational enterprise earning high profits through the exercise of a dominant position in the market may be motivated to show lower levels of profits in its financial statements. This may be accomplished through a transfer pricing gambit.

The above represent some general inducements to the use of the transfer pricing mechanism to manipulate reported profits in subsidiaries of multinational enterprises. There may be various other considerations for transmitting profits clandestinely (through transfer pricing) from one country to another. The inducements may vary from enterprise to enterprise as determined by the particular circumstances faced by each one.

Based on the discussion in the present section, table 7.2 below summarises various factors inducing transfer pricing decisions in a multinational enterprise. It appears from table 7.2 that different factors may induce a multinational to set a transfer price either above or below the arm's length price. It follows, therefore, that the factors inducing a transfer pricing decision may very well lead to transfer price manipulation. It should be noted here that the list of factors summarised in table 7.2 is not additive, and the list provides some simple predictions on transfer pricing behaviour of a multinational enterprise under given circumstances.

Table 7.1
Inducements for Transfer Price Manipulation and its Impact on Declared Profit Performance in a Subsidiary (where the parent company sells goods to a subsidiary)

Factors	Action taken by parent company	Profit impact in subsidiary
- Corporate tax:		
High corporate tax in host country	Over-pricing	Deflated profit
Low corporate tax in host country	Under-pricing	Inflated profit
- Customs duties:		
High customs duties in host country	Under-pricing	Inflated profit
Low customs duties in host country	Over-pricing	Deflated profit
- Inflation:		
High inflation in host country	Over-pricing	Deflated profit
Low inflation in host country	Under-pricing	Inflated profit
- Local equity participants in host country	Over-pricing	Deflated profit
- Exchange controls in host country	Over-pricing	Deflated profit
- Profit repatriation restrictions in host country	Over-pricing	Deflated profit
- Weak currency in host country	Over-pricing	Deflated profit
- Price control actions in host country	Over-pricing	Deflated profit
- Political attacks on charges of monopoly power in host country	Over-pricing	Deflated profit
- Possibility of new entrants into the host country market	Over-pricing	Deflated profit
- Many competitors in host country	Under-pricing	Inflated profit

7.4 EMPIRICAL STUDIES ON INDUCEMENTS FOR INTERNATIONAL TRANSFER PRICING DECISIONS IN MULTINATIONALS

The available empirical studies in the literature indicate that world-wide transfer pricing policy is an integral part of the overall long-term financial decision-making policy of a multinational enterprise.[15] A number of studies have attempted to identify the factors usually considered by multinational enterprises in deciding transfer prices. It is important to note that most of these studies were done by interviewing the executives of multinationals and/or by an analysis of the

15. For example, see: S.H. Kim, and S.W. Miller, "Constituents of the International Transfer Pricing Decision", the Columbia Journal of World Business, Spring 1979, pp.69-77.

replies to questionnaires mailed to the management of these enterprises. If a multinational enterprise practises a transfer pricing policy to shift funds from one subsidiary to another, then it seems doubtful that the management of that enterprise would disclose the actual determining factors of its transfer pricing decisions. This poses a great impediment to the studies on transfer pricing decisions. With this qualification in view, a brief discussion of some of these studies seems worthwhile.

Greene and Duerr (1970)[16] found that tax and customs considerations and desires of domestic divisional executives and local managers abroad have a profound influence on corporate policy in international transfer pricing. Their study was based on the responses from 130 senior executives of U.S. corporations having international operations. A number of respondents asserted that managers should, so far as possible, conduct all relations with foreign units with an eye to the "effect on the total corporation", or "the optimum consolidated profit".[17] This particular aspect of corporate management behaviour, concerning the relationship of a parent company with its subsidiaries abroad, indicates that a transfer pricing decision considers such economic and non-economic factors in both home and host countries as are likely to have major impact on the overall profitability of the multinational enterprise. Greene and Duerr recorded statements of some top corporate executives about the factors considered by their companies in reviewing the policies governing relations with overseas affiliates. The factors identified in these statements seem to form the major variables of consideration in a transfer pricing decision; because transfer pricing is the only corporate policy that is involved in the day to day dealings between affiliates of a multinational enterprise, and because transfer pricing policy seems to continuously govern the relations of a parent company with its overseas affiliates.

16. Greene, J., and M.G. Duerr, Intercompany Transactions in the Multinational Firm, The Conference Board: Managing International Business, No.6, New York, 1970, p.iv.
17. Greene and Duerr (1970), ibid., p. vi.

Greene and Duerr recorded the following statements by top U.S. corporate executives on the factors that induce the review of corporate policies regarding relations with foreign affiliates:[18]

"Any significant development in the U.S. or overseas involving exchange rates, substantial tariff changes, import or export restrictions, substantially different competition, and many other factors would prompt us to review our policies and practices for desirable changes."

(Vice president - instrument and controls company)

* * *

"Developments which cause us to review our policies and practices include, of course, the competitive situation, tax legislation both in the United States and abroad, governmental controls, e.g., the U.S. Foreign Direct Investment Regulations, and the strength or weakness of various currencies."

(Vice president - electronics manufacturer)

* * *

"The types of development in the U.S. or overseas markets which will prompt our company to review its policies and practices for desirable changes are:

1. Relative changes in prices resulting from varying rates of inflation or deflation.
2. Changes in tax practices.
3. Changes in duty rates.
4. Changes in political climate."

(President - machinery and equipment company)

* * *

"Developments necessitating review of past practices would be:

(a) Changes in competitive situation in foreign market.
(b) Changes in tax or restrictions on flow of funds or goods and services by U.S. or foreign governments.
(c) Changes in organization structure of parent company which affect foreign unit."

(Regional development manager - packaging firm)

* * *

"Changes in rulings by the U.S. internal Revenue Service as well as the Department of Commerce would cause us to review our policies. Of course, much of the present policy review has been made necessary by new rulings or new interpretations of the law from these governmental departments."

(Vice president - chemical products company)

18. Greene and Duerr (1970), op.cit., pp.52-53.

"Changes in market position of affiliated company, economic restrictions by host government, or assigned projects by parent company for research and development."

(Vice president - machinery and equipment company)

* * *

"A change in tax laws, or a completely new range of products or processes - having no historical pattern of transfer cost policies - would prompt our compahy to review seriously our present practices."

(Managing director - metals and products company)

The factors of consideration mentioned in the above statements were subsequently identified by different researchers as the major environmental variables influencing transfer pricing decisions of multinational enterprises.

Arpan (1972)[19] studied the environmental variables considered by multinational enterprises in taking decisions on international transfer prices. His study was based on correspondence and interviews with the executives of multinational subsidiaries in the United States, and with the partners of the "big eight" international accounting firms. Arpan found that the nature of competition and the differences in taxes were the two most important variables taken into account by multinational enterprises in formulating intracorporate prices; other variables considered were customs duties, export subsidies and tax credits, price controls, inflation, and devaluation.[20]

Tang and Chan (1979),[21] studying the environmental variables of international transfer pricing practices in the U.S. and Japanese multinationals, found that:

"overall profit was the single most important consideration for the American and the Japanese companies in formulating their international transfer pricing policies. But whereas profit was the key consideration,

---

19. Arpan, J.S., International Intracorporate Pricing, Non-American Systems and Views, Praeger, New York, 1972.
20. Ibid, p.70.
21. Tang, R.Y.W., and K.H. Chang, "Environmental Variables of International Transfer Pricing: A Japan-United States Comparison", Abacus, June 1979, pp.3-12.

> these companies also attached great importance to environmental variables such as the competitive position of foreign subsidiaries, restrictions on repatriation of profits, income taxes, and devaluation and revaluation of foreign currencies."[22]

This study was conducted on the basis of a mailed questionnaire survey. Therefore, the findings of this study, like those of others using the same methodology, need to be interpreted with caution. Because transfer pricing is a sensitive issue, it is difficult to expect that the responding corporate executives in the headquarters of multinationals would voluntarily disclose the actual environmental variables of transfer pricing in reply to a questionnaire mailed to them.

7.5 MOTIVATIONS FOR TRANSFER PRICE MANIPULATION IN LESS DEVELOPED COUNTRIES

It may be argued that multinational enterprises operating in less developed countries have the greatest inducements to manipulate transfer prices, and this may be expected to have an impact on the declared profitability of these enterprises. The inducements for transfer price manipulation in less developed countries would seem to motivate an over-pricing of intra-group imports of goods and services into subsidiaries located in these countries. While on the other hand, the same inducements might motivate an under-pricing of intra-group export of goods and services from such subsidiaries. An attempt is made below to briefly describe each of the important motivations for transfer price manipulation in less developed countries.

(a) High Corporate Tax:

Many less developed countries have high corporate tax-rates compared with the home countries of the multinational enterprises. This may motivate a multinational to over-price sales to its subsidiaries located in these high-tax countries.

Basic corporate tax-rates in the United States, United Kingdom, France and Germany range between 50 and 56

---

22. Tang and Chan (1979), op.cit., p.11.

per cent, and in Japan and Canada ranges between 40 and 46 per cent;[23] whereas in many less developed countries hosting multinational investments, basic corporate tax-rates appear somewhat higher. Moreover, in most of the less developed host countries, local and foreign companies are charged corporate profit taxes at different rates. Table 7.2 below shows corporate profit taxes in some less developed countries:

Table 7.2
Basic Corporate Tax-Rate in Selected (non-tax haven, non-oil producing) Less Developed Countries. (In Per cent)

Country	Basic Rates For Resident Companies	For Non-Resident Companies
Algeria	60	60
Argentina	33	45
Bangladesh	55	60
Brazil	30	47.5
Chile	52	52
India	45-55	70
Kenya	45	52.5
Pakistan	60	60
Peru	20-55	44-68.5
Sri Lanka	60	66
Tanzania	50	57.5
Trinidad and Tobago	50	50
Zaire	40	50
Zambia	45	45

Source: Lent, G.E., "Corporation Income Tax Structure in Developing Countries", IMF Staff Papers, No,3, November 1977, pp.722-755.

Tax-rates in most less developed countries are at least as high as the tax-rates in most of the developed countries. Therefore, over-pricing of exports to subsidiaries in less developed countries from either parents or tax havens, may be compatible with the strategy of optimising global tax-advantages. Rather this over-pricing may bring in additional overall benefits for the entire multinational enterprise.

23. Choi and Mueller (1978), op.cit., pp.285-286.

(b) Low Customs Duties:

Most less developed countries have low customs duties and other tariffs on imports of raw materials and intermediate goods.[24] Import duties on industrial inputs in these countries are kept low (some times very low) in order to boost the industrialisation process. This may provide an added motivation to a multinational enterprise to over-price intra-group imports into its subsidiary in a less developed country. This over-pricing may enable the multinational enterprise to gain tax and other benefits without incurring high costs for tariffs on imports.

(c) High Inflation:

High rates of inflation are common in many less developed countries. Such inflation erodes money value faster than in developed countries where inflation-controlling efforts are more effectively applied. The less developed countries, due to scarcity of resources and high demand for development expenditures, can not generally keep inflation at a tolerable level.

Between 1970 and 1979, the average annual rate of inflation was 10.8 per cent in low-income countries and 13.3 per cent in middle-income countries; whereas in industrial market economies, the home countries of most of the multinational enterprises in the world, the average annual rate of inflation during the same nine years was 9.4 per cent.[25] This suggests that multinational enterprises operating in host low-income and middle-income countries (i.e. less developed countries) may have an incentive to channel funds out of these countries through transfer price manipulations. Generally, multinational enterprises would prefer to keep cash balances in high-inflation host countries to a minimum. Thus it may be hypothesised that multinationals may be motivated to reduce reported profits in these countries through the transfer pricing mechanism.

24. Centre on Transnational Corporations, National Legislation and Regulations Relating to Transnational Corporations, United Nations, Sales No: E.78.II.A.3, 1978.
25. The World Bank, World Development Report 1981, The World Bank, Washington D.C., August 1981, pp.134-135.

(d) Weak Currency:

Most less developed countries have weak currencies. The weak currency of a host less developed country may induce a multinational enterprise in that country to shift funds to a strong-currency country through the transfer pricing gambit. Evidence of weak currencies in less developed countries may be found in the sharp fall of the market rates of their currencies over the years. The amount of U.S. dollars purchasable with one unit of currency of many less developed countries in 1980 was considerably lower than that of in 1972. The amount of U.S. dollar that could be bought with one unit of currency of Argentina at the end of 1980 was 99.75 per cent lower than that could be bought at the end of 1972. This fall in currency-value was of the order of 50.29 per cent for Bangladesh, 90.49 per cent for Brazil, 99.94 per cent for Chile, 55.24 per cent for Colombia, 35.52 per cent for Greece, 52.19 per cent for Jamaica, 88.66 per cent for Peru, and 62.78 per cent for Srilanka.[26]

A close look at the change in market rates for currencies of less developed countries reveals that the countries with slower economic development and with limited foreign exchange earnings from domestic exports have rapidly declining currencies. There is little incentive for multinational enterprises in these countries to reinvest retained profits and to maintain large cash flows within the economy. Consequently multinational enterprises may be motivated to shift funds from these countries to hard-currency countries. Although this may be attempted in various ways, transfer pricing manipulation is probably the most important channel.

(e) Political Risk:

During the period 1960-1974, for which systematic information is available, at least 875 foreign investors were

---

26. Calculated from: IMF, International Financial Statistics - Supplement on Exchange Rates, Supplementary Series No.1 International Monetary Fund, 1981, pp.18-19.

affected by the various forms of takeover that took place in 62 countries.[27] Almost all of these 62 countries belong to the group of less developed countries. Expropriation of foreign assets alone (not including renegotiation of contracts, creeping expropriation etc.) accounted for more than $10 billion over the period 1956-1972. Compensation was paid for only about 40 per cent of the total assets expropriated.[28]

In recent years, following the flood of literature on the operations of multinationals, politicians and the general public in third world countries have become aware of the undue benefits that can be extracted by these enterprises from their national economies. This has made the position of multinational enterprises in less developed countries more vulnerable.

The existence of political risk may induce a multinational enterprise to resort to practices which minimise such risk. Transfer pricing manipulation may be an important tool for withdrawing profits from and reporting lower profitability in a subsidiary located in a less developed country. This may discourage political activists from imposing political costs on that enterprise.

(f) Other Motivations:

Exchange controls, price controls and in many cases government pressure for inclusion of local equity participants is often found in many of the less developed countries. These factors may motivate multinational enterprises to shift profits out of these countries through transfer pricing mechanism. Moreover, multinationals enjoying monopolistic or oligopolistic advantages in a less developed country may be motivated to report lower profit performances through transfer price manipulations, in order to restrict the entry of potential competitors into the same market.

---

27. United Nations, Permanent Sovereignty Over Natural Resources, Report of the Economic and Social Council, UNO, A/9716, September 1974.
28. Williams, M.L., "The Extent and Significance of the Nationalization of Foreign Owned Assets in Developing Countries 1956-72", Oxford Economic Papers, July 1975, pp.260-273.

The above discussion of possible motivations for transfer price manipulation suggests that there is the possibility that the intra-group transfer of goods and services to multinational subsidiaries in less developed countries may be frequently over-priced, and the intra-group transfers from tjese subsidiaries may be frequently under-priced. It follows, therefore, that the reported profits of multinationals in less developed countries may be understated as a direct consequence of transfer price manipulations.

7.6 CONCLUSION

A normative study of the determinants of transfer pricing decisions of multinational enterprises indicates that there are reasons to hypothesise that multinational enterprises operating in less developed countries have motivations for manipulating transfer prices. There are various environmental variables influencing the pricing decision in an intra-group transaction. The environmental variables influencing such a pricing decision of goods or services either to or from a multinational subsidiary in a less developed country, seem to provide an incentive for manipulation. Such a price manipulation in an intra-group transaction may be predicted, in most cases, to result in understatement of the reported profit performance of the subsidiary.

The scope for transfer price manipulation is broadened by the increase in volume of intra-group transactions of a multinational enterprise. This may be why the transfer pricing issue has come to assume substantial importance in the literature on international trade, with a significant growth of intra-group international transactions in the last decade. Today a large proportion of international trade takes place between affiliated firms, at prices which are set by the multinationals themselves. These are administered prices, adjustable to suit the needs of the multinationals. There seems to be a possibility that these administered prices would be different from arm's length prices.

The following quote from a U.N. (1978)[29] report demonstrates that intra-group trade forms an important part of the international trade in the world. It further indicates that administered pricing is involved in the case of a large volume of international transactions, which may provide wider scope for transfer price manipulation.

> "approximately 40% of imports to the United States in 1974 were intra-firm transactions.... Roughly 50% of United States exports in 1970 were within transnational corporate systems....there are also data to indicate that 29% of Swedish exports in 1975, 30% of United Kingdom exports in 1973 (a rise from 26% in 1970) and 59% of Canadian exports in 1971 were on an intra-firm basis....these figures are based on sampling procedures and are, therefore, prone to error, but the errors are likely to be small in comparison to the magnitude of the base figures."

It emerges from the discussion in the present chapter that there is a possibility that multinational enterprises may endeavour to maximise their global interests through pricing decisions of their intra-group transactions. This possibility seems to be greater in case of multinationals operating in less developed countries. An analysis of the environmental variables in less developed countries indicates that a transfer pricing policy would be likely to be directed towards understatement of reported profit performance of a multinational subsidiary in one of these countries. In short, the present chapter has led to the advancement of the hypothesis that: "multinational enterprises in less developed countries manipulate transfer prices in order to understate reported profit performance". An empirical examination of this hypothesis is made in chapter 10 of the present study.

---

29. United Nations, Transnational Corporations in World Development: A Re-Examination, UN Economic and Social Council, E.78, II, A.5, 1978, p.4.

CHAPTER EIGHT

Multinational Enterprises in Bangladesh : An Overview

8.1 INTRODUCTION

Anyone who has travelled in Bangladesh is aware that Philips Radio, Lux Toilet Soap, Bata Shoes, Singer Sewing Machine, Capstan Cigarettes, Glaxo Baby Food, etc. are probably more popular in its towns and villages than in the home countries of the multinational enterprises that produce those products. Moreover, as in most less developed countries, most of the physicians and the general public in Bangladesh have a natural inclination to recommend and to use medicines of popular foreign brand names. All this is due to the business activities of multinational enterprises, and reflects the extent of the operations of multinationals in Bangladesh.

The stock of private foreign investment in Bangladesh was US$80 million at the end of 1978.[1] About one-sixth of this investment was in the manufacturing industries,[2] which represented about 2.5 per cent of the total investment in the manufacturing sector of Bangladesh. On the face of it, the extent of foreign control in the industrial sector of Bangladesh may appear to be very low by world standards, but relative to the economic conditions and small size of the private industrial sector in Bangladesh, the volume of foreign investment in that country is in fact significant.

Bangladesh is a country with a large population, great poverty and very limited natural resources. With a population of 90 million in an area of 56,000 square miles, she has one of the lowest per capita incomes in the world.

---

1. Organisation for Economic Co-Operation and Development, Development Co-Operation, OECD, Paris, 1980, p.165.
2. Private foreign investment in the manufacturing industrial sector denotes the total share of the private foreign investors in the total fixed assets of the manufacturing enterprises in Bangladesh.

Per capita income varies between US$90 and US$100 per annum. In addition to poor economic conditions, the investment climate in the Bangladesh economy has been seriously affected by political instability since the country was born in 1971. All these factors have contributed to the lag in the industrialisation process in Bangladesh. From this perspective, the relatively small volume of foreign private investment in Bangladesh can exert a substantial influence on the country's economy. This possibility raises the need for particular attention to be given to the operations of multinational enterprises in that country.

8.2 INDUSTRIAL SECTOR AND FOREIGN INVESTMENT POLICY

Bangladesh has a small industrial sector. Total contribution of the industrial sector to the gross domestic product (GDP) of Bangladesh was about 7.2 per cent in 1979-80. But the contribution of the modern industrial sector, i.e. large- and medium-scale industries, was about 4.1 per cent of the total GDP. The traditional industrial sector, i.e. small-scale and cottage industries, contributed about 3.1 per cent of the total GDP.[3] In 1979-80, the industrial sector provided employment for about 4.7 per cent of the total employed labour force in Bangladesh. Employment provided by the modern industrial sector was about 1.6 per cent and by the traditional industrial sector was about 3.1 per cent of the total employed labour force.[4] In spite of the smallness of the industrial sector in Bangladesh, most of the economic policies of that country over the last decade have been aimed at promoting the industrialisation process. Since the country achieved her political independence in 1971, successive governments have become increasingly aware of the responsibility to break the poverty circle inherited from the colonial days, and to induce growth and development. They pinned their aspirations for economic development on the industrial sector. Industry was expected to provide an accelerated growth in income which would lead to surpluses which in turn would further stimulate development.

3. 1980 Statistical Yearbook of Bangladesh, Bangladesh Bureau of Statistics, Govt. of Bangladesh, Dacca, 1981, p.394.
4. The Second Five Year Plan 1980-85, Planning Commission, Govt. of Bangladesh, Dacca, 1980, p.vi-4.

It was further expected that industrialisation, through product diversification, would lead to export promotion and import substitution. It has been hoped by succesive governments that industrial growth would bring social transformation, social equality, higher levels of employment, a more equitable distribution of income and a well balanced regional development. How far these hopes have been achieved is yet to be seen. But economists now argue that there is a pressing need for industrialisation leading to the economic progress in less developed countries like Bangladesh.[5]

PUBLIC AND PRIVATE OWNERSHIP IN THE INDUSTRIAL SECTOR

On December 16, 1971, when Bangladesh was liberated from the Pakistani occupation forces, the country had 36 per cent of all industrial assets under public ownership.[6] In March 1972 the government took over public ownership of all industrial units abandoned by Pakistanis with assets above 1.5 million takas,[7] and it nationalised all industrial units in three large-scale industries, i.e. cotton textiles (excepting handloom and specialised textiles), jute manufacturing and sugar manufacturing. As a result of the nationalisation and take over of abandoned industrial units, the public and private ownership of fixed assets in the industrial sector was 3,771 million takas (86 per cent) and 629 million takas (14 per cent) respectively, in March 1972.[8]

The first Industrial (Private) Investment Policy of Bangladesh, announced in July 1972, set various limits on private investment. This was due to the constitutional commitment of the government to gradually create a socialist economy in Bangladesh. But political changes in Bangladesh, resulting from the coups and counter coups in 1975, brought

5. For a useful summary of these arguments, see: L.J. White, Industrial Concentration and Economic Power in Pakistan, Princeton University Press, Princeton, 1974, pp.10-13.
6. Sobhan, R., "Nationalisation of Industries in Bangladesh: Background and Problems", in E.A.G. Robinson et al.(eds.), The Economic Development of Bangladesh Within a Socialist Framework, Macmillan, 1974, pp.181-200.
7. Taka = Unit of Bangladesh Currency.
8. Sobhan (1974), ibid.

substantial changes in its economic policies. Government policies towards private investment were considerably liberalised. A number of small industrial units under public ownership were disinvested, and the share of private ownership in the industrial sector gradually increased. This position is reflected in the statistics of the 1976-77 Census of Manufacturing Industries in Bangladesh.

Table 8.1
Statistics of Census of Manufacturing Industries in Bangladesh, 1976-77.

Ownership of Enterprises	Fixed Assets (Million Takas)	Gross Output (Million Takas)	Employment (Number)
(a) Public	5,096.88 (75.48%)	10,708.56 (55.26%)	275,675 (76.13%)
(b) Private	1,655.30 (24.52%)	8,669.51 (44.74%)	86,429 (23.87%)
	6,752.18 (100%)	19,378.07 (100%)	362,104 (100%)

Source: 1980 Statistical Year Book of Bangladesh, op.cit., pp.306-308.

As is evident in table 8.1 above, the share of private ownership in the industrial sector of Bangladesh showed a marked increase over the five year period from 1972 to 1977. In 1972 private ownership in industrial fixed assets was 14 per cent; this rose to about 25 per cent in 1977. Gross output of private enterprises, about 45 per cent of the total industrial output in 1976-77, reflects the important role played by these enterprises in the Bangladesh economy. Table 8.1 further shows that the productivity in private sector was very high compared with the productivity in public sector. In 1976-77, fixed assets of one million takas produced a gross output of 2.10 million takas in the public enterprises and 5.24 million takas in the private enterprises. In the same year, one employee produced a gross output of approximately 40 thousand takas in the public sector and of approximately 100 thousand takas in the private sector.

PRIVATE FOREIGN INVESTMENT POLICY

In the early years of the independence of Bangladesh, the attitude of the government towards domestic private enterprises determined in turn its policy towards direct foreign investment. While the nationalisation policy of the government in 1972 did not affect the operation of the 20 multinational enterprises operating in different areas of the industrial sector, government policy towards new direct foreign investment was relatively discouraging. In the first industrial policy statement of the government in 1972, direct foreign investment was allowed only in collaboration with the public sector corporations, and with a minority equity participation of up to 49 per cent. All acts of foreign collaboration, however, were to be approved by the government. Full freedom was guaranteed for the transfer of annual profits (after payment of taxes) and for the repatriation of capital spread over a number of years. A minimum dividend of 15 per cent, subject to the availability of profits, was also guaranteed. But the principal source of discouragement to potential private foreign investors was the threat of nationalisation. This threat was posed by the constitutional commitment of the government to transform the Bangladesh economy into a socialist one.

Political changes in Bangladesh during 1975, followed by liberal government policies towards private enterprises in the industrial sector, introduced new policies for attracting private foreign investment. From 1976 onwards, new industrial investment policies encouraged private foreign investment in both the public and private sectors, without any limit. The following specific measures were taken by the government in order to counter the fear of nationalisation and to attract foreign investment:

(i) In 1978, the Government announced that it did not have any intention to nationalise any industry at any future point in time. It was further announced that, should circumstances or any emergency necessitate nationalisation in any particular case, just and fair compensation would be paid in the currency of the country of origin of the foreign investor.

(ii) To give legal backing to the above commitment, the Bangladesh Parliament, in 1980, passed an Act named "Foreign Private Investment Promotion and Protection Act". This Act now guarantees that no foreign investment will be expropriated by the government; but if circumstance compels the government to expropriate any foreign entrepreneur's assets, just and fair compensation will be paid.

(iii) The Bangladesh government entered into an agreement with the U.S. government, under which the U.S. government guarantees investments by private U.S. investors in Bangladesh against any loss arising from: (a) problems in converting earnings in Bangladesh currency to U.S. dollars, and (b) expropriation in Bangladesh.

In addition, in pursuance of its policy of attracting private foreign investment, the government of Bangladesh allowed investments by foreign investors in certain areas previously reserved exclusively for the public sector; for example jute, textile, sugar, heavy electric, and heavy engineering. Moreover, in 1979, the government established an Export Processing Zone where foreign investors would be allowed to invest in export oriented industries, with no burden of tax and tariff, and with facilities for uncontrolled repatriation of profits and invested capital. But until the beginning of 1982, there was little response from foreign investors willing to invest in that zone. Still the government plans to set up two more Export Processing Zones in Bangladesh.

The following extract from the Second Five Year Plan of Bangladesh, launched in 1980, gives a precise account of the policy of the Bangladesh government towards private foreign investment during the plan period (1980-85)[9]:

"All industries in Bangladesh, except a hard-core of eight categories reserved for the government sector, are kept open for private investment by both local and foreign investors, and virtually without any ceilings on investment. Foreign private investments are allowed in collaboration with both government and local entrepreneurs. During the Second Five Year period, foreign equity participation will continue to be encouraged in those industries where raw materials are entirely local but technical know-how is not available

9. The Second Five Year Plan 1980-85, op.cit., p.IX-12.

locally, technology involved is complicated or capital intensive and the output is export-oriented. Foreign technical collaboration without equity participation will, however, be allowed in almost all types of industries. There is no rigidity about the extent of equity participation by foreign collaborators. Government policies comprising various monetary, fiscal and other incentives that are now allowed to induce foreign investment are quite liberal. In order to promote foreign private investment the Foreign Investment Promotion and Protection Act has already been passed by the Pariliament. It would provide further confidence to the potential foreign investors and remove apprehensions, if any, about non-business risk."

8.3 MULTINATIONAL ENTERPRISES IN BANGLADESH

In 1979, there were 20 multinational enterprises operating in different areas of the industrial sector of Bangladesh. Most of these enterprises were established during the 1960s. The home countries of these multinationals are as follows: 10 in U.K., 3 in U.S.A., 3 in Holland, 2 in Canada, 1 in Belgium, and 1 in West Germany. Of the 20 multinationals, 8 operate in the pharmaceutical industry, 3 in the chemical industry, 7 in the electric and engineering industry, 1 in shoe manufacturing and 1 in tobacco. Parent company's ownership in the equity of each of the subsidiaries ranges from 49 per cent to 76.33 per cent in the pharmaceutical industry, from 56 per cent to 60.75 per cent in the chemical industry, from 40 per cent to 100 per cent in the electric and engineering industry, 66 per cent in the tobacco industry and 100 per cent in the shoe manufacturing industry. Local ownership in each of the multinationals is principally held by the public sector. All but one of the multinationals in Bangladesh were established before 1971, when local equity participants were the (West) Pakistanis. After the independence of Bangladesh in 1971, the shares held by Pakistanis were taken over by the Bangladesh government. Thus the public sector emerged as an important equity participant in multinational operations in Bangladesh. Some of the multinationals that expanded their paid-up capital after 1971 sold shares to private Bangladeshi investors. However, private investors form a tiny portion of the local equity participation.[10]

10. For firm level data on shareholding pattern, see: Appendix-8A.

MARKET CONCENTRATION AND MARKET DOMINANCE

As in many other less developed countries, the multinational enterprises in Bangladesh dominate specific product markets. Such domination arises mainly from the high level of concentration in specific product markets where there is only one or a few multinationals. An attempt is made below to look at the market concentration resulting from the high market share of the multinationals in the total output of specific products in Bangladesh. Availability of the necessary data on the pharmaceutical industry allows a detailed discussion of this industry. However, discussions of other industries are included to the extent allowed by the availability of the necessary information.

(a) Pharmaceutical Industry:

Total sales of pharmaceutical products in Bangladesh in 1980 was about 1,250 million takas. Of this, about 150 million takas sales were from the direct import of medicines, and the remaining sales were from domestic production.[11] That is, the pharmaceutical industry in Bangladesh accounted for total sales of 1,100 million takas.

Of this total output of 1,100 million takas of pharmaceutical products in Bangladesh in 1980, 8 multinational enterprises accounted for output amounting to 890 million takas,[12] i.e. 81 per cent. Of the total pharmaceutical market in Bangladesh, the share of 8 multinationals was 71 per cent. According to an earlier estimate,[13] the same 8 multinational enterprises accounted for 66.35 per cent of the total sales of the domestic production of pharmaceutical products in Bangladesh in 1976.

---

11. Bichitra (a Bengali weekly published from Dacca, Bangladesh), 10th July 1981, p.22; estimates made by the "Progressive Pharmacists Group in Bangladesh".
12. Bichitra (1981), Ibid.
13. Report of the Expert Committee on Drugs & Pharmaceutical Capacity Utilization of the Pharmaceutical Factories of Bangladesh (1975-1976), Department of Industries (Chemical Directorate), Govt. of Bangladesh (mimeo), Dacca (Bangladesh), 1977, p.22.

A comparison of the market share of the 8 multinationals in the pharmaceutical industry in 1976 and in 1980 suggests that these firms have enjoyed oligopolistic market power which has enabled them to increase their share in the total production from 66.35 per cent to 81 per cent over a period of 5 years. This evidence on the market power of multinationals in the pharmaceutical industry of Bangladesh corresponds with evidence from other less developed countries.[14]

This oligopolistic power is further reflected by the fact that the top 4 firms in the pharmaceutical industry produced 43 per cent of the total domestic output in 1976 and the same 4 firms produced 52 per cent of the total domestic output in 1980. All of these 4 firms are multinationals. The largest multinational firm in the pharmaceutical industry produced about 16 per cent and about 18 per cent of the total domestic output in 1976 and 1980 respectively.

The retail prices of drugs produced by the multinationals and the retail prices of the comparable (of same generic name) drugs produced by local enterprises in Bangladesh give a picture of the oligopolistic character of multinationals in product pricing. In the Bangladesh market, there is evidence that the drugs produced by the multinational enterprises have considerably higher market prices than the comparable drugs produced by their counterparts. This is shown in table 8.2 below, for the market prices of 5 drugs. Although the market prices of only 5 drugs may not seem to be representative of the market prices of the drugs produced by the multinationals and the local firms in Bangladesh, observers have commented that the general pattern of drugs-pricing in that country is not very different from the evidence produced in table 8.2.[15]

---

14. Lall, S., "The International Pharmaceutical Industry and Less-Developed Countries", Oxford Bulletin of Economics and Statistics, August 1974, pp.143-172.
15. Bichitra (1981), op.cit., p.28; this was also stated by a top official of the Price Control Department in the Ministry of Commerce in Bangladesh, in an interview in connection with the present study.

Table 8.2
Comparative Retail Prices of Drugs in Bangladesh (1981) : Average Multinationals' vs. Average Locals'

Generic Names of the Drugs	Ave. Retail Price of the Produce of		Percent Higher Price in Multinationals
	Multinationals (Taka)	Locals (Taka)	
1) Tetracycline 250mg. (per capsules)	1.05	0.55	91
2) Metronidazole 200mg. (per tablet)	0.79	0.43	84
3) Diazepam (per tablet)	0.42	0.125	236
4) Paracetamol 500mg. (per tablet)	0.25	0.15	67
5) Aspirin 300mg. (per tablet)	0.11	0.06	83

Source: Calculated from data in Bichitra (1981), op.cit.,p.28

Table 8.2 was constructed as follows: each of the five drugs is produced by one or more multinational and one or more local firms in Bangladesh. For each of the drugs, the average retail price charged by the multinational(s) and by the local(s) was calculated. The higher price of the multinational(s) was calculated as a percentage of the price of the local(s).

Table 8.2 shows that for the 4 drugs examined, the multinationals' prices are 67 to 91 per cent higher than the locals' prices; and for one drug this percentage is much higher at 236 per cent. One interesting characteristic of drug buyers in Bangladesh is that they prefer to buy drugs produced by the foreign firms, even at a considerably high price, than to buy a comparable drug produced by local firms. But in terms of quality, the drugs produced by both types of firm are almost identical. The Bangladesh government's quality testing laboratory, and in a number of cases foreign independent sources, have confirmed this.[16]

16. Stated by Dr. H. Hye, Director General of the Directorate of Drug Administration, Govt. of Bangladesh, in an interview in connection with the present study.

The consumers' preference for high-price foreign producers' drugs may have been a contributory factor to the creation of the dominant market power of multinational pharmaceutical firms in Bangladesh.

Because of their market power these multinational pharmaceutical firms may be expected to earn high profits. But in practice, the management of these firms often complains about difficulties in earning any profit at all. A possible explanation of this paradox is stated in the following extract from a report published in The Asian Wall Stree Journal:[17]

> " . . . Eight multinationals run factories (in pharmaceutical industry) in Bangladesh. . . . The companies complain fervently, though not for quotation by name, of excessive government price controls and the extreme difficulty of making money.
>
> "it isn't profitable", says the manager of a company.... "We're just keeping our heads above water. We haven't paid a cent to our shareholders since we opened."
>
> Curiously this executive's company is contemplating a major expansion in Bangladesh. And about three other companies are said to be thinking about locating here... many in the country believe they can explain the anomaly. They say drug company profits are actually substantial, but are quietly transferred to parent companies in the form of payments for raw materials used in making finished drugs.
>
> "They buy from the parent company to give the parent profit quickly", says Matiul Islam, Secretary of the Ministry of Industries. "The important thing is to make a quick profit, which they do." A Western diplomat adds: They avoid complications and accusations of profiteering at the expense of the poor."
>
> "There is a grain of truth in it", concedes a drug-company manager. "Companies make raw materials for a profit. So they charge a price that gives them that profit." . . ."

This extract refers to the often made allegation that multinational pharmaceutical firms in Bangladesh exercise dominant market power to benefit their parent firms,and at the cost of the "poor" people of the country.Some evidence concerning these allegations will be discussed in chapter 10 of this thesis.

---

17. "Inexpensive Drugs for Bangladesh Put Multinationals on Antacids", The Asian Wall Street Journal, 28 February 1981.

(b) Chemical Industry:

The three multinational enterprises in Bangladesh that may be broadly classified as the chemical industry, produce diversified products. For the purpose of examining market concentration the product market of each of the three enterprises needs to be considered separately. Of these three enterprises, one produces soaps and detergents, one paints, and the other various chemical products for household use.

Total production of soaps and detergents in 1979 in Bangladesh was about 550 million takas.[18] The multinational enterprise operating in this area had production of 283 million takas.[19] This suggests a high concentration in the product market of soaps and detergents, caused by one multinational enterprise, since this enterprise alone produced about 51 per cent of the total domestic production. The second and the third largest producers of soaps and detergents in Bangladesh are in the public sector, and their shares in total domestic production in 1979 were about 20 per cent and about 8 per cent respectively. The remaining 21 per cent of the total production was accounted for by over 100 small producers. It follows from the above that a single multinational enterprise seems to possess a dominant market position in the soaps and detergents market of Bangladesh.

Data on the total country's production of paints and other chemicals for household use could not be collected; therefore, measurement of market concentration in the chemical industry had to be restricted to the soaps and detergents production sectors.

(c) Electric and Engineering Industry:

Multinational enterprises operating under this broad industrial grouping produce various kinds of products. An attempt is made below to estimate the concentration of the

18. Estimated from information in: Bangladesh Economic Survey 1980-81, Ministry of Finance, Govt. of Bangladesh, Dacca, 1981.
19. From Annual Accounts.

single multinational enterprise in the electric and engineering industry of Bangladesh.

The market for domestically produced radios, television and allied electric goods in Bangladesh is extremely concentrated. Only one firm is responsible for the high concentration, and that firm is a multinational. This enterprise engaged in the production (assembling) of radio, television and allied electric goods in Bangladesh, had output of 71 million takas in 1979.[20] In that year, total domestic output of these products was about 83 million takas.[21] Evidently, this single multinational had about 86 per cent market share, which made it responsible for the high concentration in the production of radio, television and allied goods in Bangladesh.

The market for domestically produced electric fans, electric motors and allied electric goods is moderately concentrated by a multinational enterprise. In 1979, this multinational had an output of 25 million takas against the total domestic production of about 75 million takas.[22] Any other single producer in this sector did not have market share over even 20 per cent.

The market for domestically produced electric bulbs is also highly concentrated. In 1979, total domestic output of this product was about 41 million takas.[23] One multinational enterprise in this sector had output of 30 million takas.[24] Thus, this firm accounted for about 73 per cent of the total domestic output of electric bulbs.

---

20. From Annual Accounts.
21. 1980 Statistical Yearbook of Bangladesh, op.cit., pp.319-320.
22. From Annual Accounts, and 1980 Statistical Yearbook of Bangladesh, op.cit.
23. From Annual Accounts.
24. 1980 Statistical Yearbook of Bangladesh, op.cit.

Other production sectors in the electric and engineering industry are also dominated by multinational enterprises. Lack of specific data on domestic output restricted estimation of market concentration in those production sectors. However, estimates based on scattered data from different sources reveals that one multinational enterprise producing industrial oxygen has a market share of more than half of the total domestic output, one multinational producing irrigation pumps has a market share of about one-third of the total domestic output, and the production sectors of sewing machines and cement roofing sheets are one hundred per cent concentrated by a multinational operating in each.

(d) Shoe Manufacturing:

The modern manufacturing sector of shoe industry in Bangladesh is dominated by a single multinational enterprise. In 1979, total output of shoes in Bangladesh was about 200 million takas.[25] One multinational enterprise had output of about 136 million takas,[26] i.e. 68 per cent of the total domestic output.

(e) Tobacco:

The tobacco industry in Bangladesh is also dominated by one multinational enterprise. The multinational enterprise operating in this industry had total output of 1,484 million takas in 1979.[27] In the same year, total output of the tobacco industry in Bangladesh was about 2000 million takas.[28] The share of the multinational thus stood at 74 per cent of the total domestic production.

It appears from the above figures that, generally speaking, single firm concentration or the market share of the top firm(s) in various markets within the industrial sector of Bangladesh, is fairly high. In these markets multinational enterprises dominate.

---

25. 1980 Statistical Yearbook of Bangladesh, op.cit.,pp.319-320.
26. From Annual Accounts.
27. From Annual Accounts.
28. 1980 Statistical Yearbook of Bangladesh, Ibid.

8.4 FINANCIAL STRUCTURE AND PROFIT PERFORMANCE : MULTINATIONAL ENTERPRISES vs. LOCAL ENTERPRISES

It is often argued that multinational enterprises in less developed countries have incentives for manipulating accounting numbers to distort the declared profits.[29] If this is correct, there seems to be little point in using accounting reports to analyse financial structure and profit performance of multinationals in less developed countries. Yet a general survey of multinational enterprises in Bangladesh without any reference to the comparative financial structure and profit performance of multinational and local firms would be incomplete. Therefore, an attempt is made below to look at the financial structure and profit performance of the multinational enterprises and of the local enterprises operating in different industries in Bangladesh. While all the 20 multinational enterprises in Bangladesh are included in the discussion, only 10 local enterprises are considered due to the lack of comparable sized local enterprises in the modern manufacturing sectors where the multinationals operate. The 10 local enterprises are the largest ones in their respective fields.

FINANCIAL STRUCTURE

The financial structures of multinational and local firms in different industry groups, as shown by their balance sheets for the five years from 1975 to 1979, are shown in table 8.3. Various components of Capital and Liabilities, and of Total Assets are shown in percentage terms for the average firm in multinational and local enterprise in each industry. The financial structure of multinationals and locals shown on an average basis for all industries demonstrates the general pattern of financing in multinationals and local enterprises in Bangladesh.

---

29. This argument may be found in most of the studies that were based on data from the published accounting reports; for example, see: S. Lall, and P. Streeten, Foreign Investment, Transnationals and Developing Countries, Macmillan, 1977, p.99.

Table 8.3
Financial Structure of Multinational and Local Firms in Bangladesh, Annual Average (1975-1979), (in per cent)

Industry & Type of Firm	Equity	Reserves & Retained Profits	Long-Term Loans	Short-Term Loans	Other Current Liabilities	TOTAL Capital & Liabilities	Net Fixed Assets	Current Assets	TOTAL Assets
Pharmaceutical									
Multinational[a]	14.44	17.66	4.11	24.46	39.33	100	25.30	74.70	100
Local[b]	9.10	16.72	23.25	12.88	38.05	100	11.00	89.00	100
Chemical									
Multinational[b]	25.19	21.08	0.25	10.31	43.17	100	14.00	86.00	100
Local[c]	3.55	3.61	7.46	66.73	18.65	100	6.65	93.35	100
Electric & Engineering									
Multinational[d]	25.57	17.00	2.43	9.00	46.00	100	25.00	75.00	100
Local[c]	15.63	6.55	25.07	31.10	21.65	100	29.35	70.65	100
Tobacco									
Multinational[e]	17.75	22.88	0.50	17.18	41.69	100	24.00	76.00	100
Local[e]	9.27	0.83	19.49	47.49	22.92	100	27.92	72.08	100
Miscellaneous[f]									
Multinational[e]	19.39	12.48	-	18.48	49.65	100	21.21	78.79	100
Local[c]	10.65	6.34	34.65	32.36	16.00	100	22.72	77.28	100
All Industries									
Average: All Multinationals	17.67	19.08	2.52	19.39	41.34	100	23.78	76.22	100
Average: All Locals	7.24	6.86	17.84	45.06	23.00	100	13.72	86.28	100

Notes: a = 8 firms average; b = 3 firms average; c= 2 firms average; d = 7 firms average; e = 1 firm; f = miscellaneous includes shoes, apparels and textile products.
Source: Appendix - 8B

As is evident from table 8.3 the financing pattern of multinationals and locals in Bangladesh is very different. Of the total capital and liabilities, long-term finance in multinationals is 39.27 per cent and in local firms is 31.94 per cent. Of this total long-term finance in multinationals, about 94 per cent is equity plus retained profits, and only 6 per cent is debt capital. But in case of the local firms, equity plus retained profits constitutes only 44 per cent of the long-term finance, while debt capital constitutes 56 per cent. This indicates that the local firms in Bangladesh are more highly geared than multinationals. It can be seen in table 8.3 that this pattern of financing prevails when an industry break-down is made. One interesting characteristic of the financial structure of the multinationals and of the locals is that both types of firm have almost similar current asset structures. In the multinationals, current liabilities worth 1 taka is backed by current assets worth 1.26 taka; and in the local enterprises, current liabilities worth 1 taka is backed by current assets worth 1.27 taka. A more or less similar pattern of asset structure of the multinationals and locals can be seen when an industry break-down is made.

PROFIT PERFORMANCE

It was shown earlier that multinational enterprises operating in different productive sectors of Bangladesh are highly concentrated and enjoy dominant market power. If profitability is in part a function of market dominance then it may be expected that the multinational enterprises in Bangladesh would show higher profitability than their local counterparts. But the accounting profits presented below suggests that this is not so.

It may be contended that profitability is a function of size of the enterprise. Table 8.4 shows the comparative size of multinational and local enterprises, both in terms of net fixed assets and in terms of total sales. This table demonstrates that the average multinational firm in

Table 8.4
Total Sales and Net Fixed Assets of Multinational and Local Firms in Bangladesh, Average Firm in Each Type, Average Annual (1975-1979), in Million Taka

Type of Firm	Average Annual Sales	Average Annual Net Fixed Assets
(1) Multinational Firms	114.9	14.2
(2) Local Firms	35.3	4.6

Source: Appendix - 8B, and Appendix - 8C

Bangladesh is more than three times larger than the average local firm, by both the measures of firm-size. Therefore, if profitability is a function of firm-size, then again it may be expected that the multinational enterprises in Bangladesh should show a higher profitability than their local counterparts.

The expectation of higher profitability in multinational enterprises is reinforced by the fact that these enterprises have higher productivity, both in terms of capital productivity and labour productivity. In Bangladesh, in one average year between 1975 and 1979, an average multinational firm produced total output of 8.1 million takas and an average local firm produced total output of 7.7 million takas by employing fixed assets of one million takas. Total production per employee was 0.31 million takas in the case of multinationals, whereas, in the case of locals it was 0.13 million takas. Evidently the productivity of assets and of labour in multinationals is higher than that of the local firms.[30]

Table 8.5 shows three measures of profitability for multinational and local enterprises operating in Bangladesh. These three measures give the impression that multinationals are less profitable than their local counterparts.

30 For detailed statistics, see: Appendix - 8B, and Appendix - 8C.

Table 8.5
Profitability of Multinational and Local Firms in Bangladesh, Average Firm in Each Type, Average Annual (1975-1979)

Profitability Measure	Multinational Firm	Local Firm
(1) Net Profit as Percentage of Net Worth (Equity plus Reserves & Retained Profits)	17.7	40.0
(2) Net Profit as Percentage of Total Assets	6.5	5.7
(3) Net Profit as Percentage of Total Sales	3.4	5.4

Source: Appendix - 8B, and Appendix - 8C

Table 8.5 was constructed using the reported accounting numbers of 20 multinational firms and their 10 local counterparts. It shows that net profit as a percentage of net worth of the average local firm was about 126 per cent higher than that of the average multinational firm; net profit as a percentage of total assets is, however, about 14 per cent higher in the average multinational firm than in that of average local firm; but net profit as percentage of total sales in the average multinational firm is about 59 per cent lower than that of the average local firm.

Of the three measures of profit, in table 8.5, the third one seems to be based on a more reliable denominator than the others. The sales figures in the annual accounts of the multinationals operating in Bangladesh seem to be less subject to the possibilities of manipulation. Because these enterprises make all their sales in the internal market the possibility of transfer price manipulations in intra-group exports is virtually non-existent. Total assets as a denominator seems less reliable because in an environment of high inflation the asset figures in corporate accounts do not

seem to reflect realistic values of assets; that is, the asset values may be understated in the books of accounts. This understatement of the values of assets in the books of accounts would result in higher rates of profit according to the second measure. The possibility of the overstatement of profit-rates under this measure seems greater in the case of multinationals than their local counterparts, because multinationals in Bangladesh are much larger than their local counterparts. The first measure of profit in table 8.5 also seems less reliable because an enterprise in Bangladesh, due to the absence of strict accounting standards, may manipulate its reserves figure thus making the denominator less reliable. However, it should be borne in mind that the reported profit figure used in each of the three measures of profit-rate, has the possibility of being manipulated. Therefore, the above discussion on the reliability of the denominators may appear to be meaningless. Although all the three measures of profit in table 8.5 may show distorted profit-rates, the third one may be treated as the "best among the worst".

The overall picture as shown in table 8.5, is that the reported profit performance of multinationals is no better than that of the local enterprises in Bangladesh; rather it appears to be other way round. This contradicts the "a priori" expectation about the profitability of the multinationals.

8.5 CONCLUSION

Multinational enterprises operating in different industries in Bangladesh were found to enjoy market power. In the pharmaceutical industry, market dominance of a few multinational enterprises might be expected to make them more profitable than their local counterparts. In other productive sectors, market dominance of a single multinational enterprise could be expected to give each of these enterprises monopolistic advantages which should enable them to earn

superior profits. But the empirical evidence on profit performance of the multinational and local enterprises appears to indicate that multinationals do not earn higher profits than their local counterparts.

The evidence of lower profit performance in multinationals relative to that of locals raises the questions about the declared profit performance of multinational enterprises. The difference between the reported and expected profits of multinational enterprises in Bangladesh seems to correspond to the findings in other less developed countries.[31] Such differences which give rise to suspicions concerning the reported profits of multinational enterprises in less developed countries, seems to reinforce the hypothesis that multinational enterprises in less developed countries may understate their reported profits. An empirical examination of this hypothesis will be undertaken in the following chapters using Bangladesh data.

---

31. See: chapter 4 of the present study.

CHAPTER NINE

Examination of the Accounting Policy Manipulation Hypothesis

9.1 INTRODUCTION

In this chapter an attempt has been made to examine empirically the "accounting policy manipulation hypothesis" developed in chapter 6. In the conclusion to that chapter the hypothesis was developed that "multinational enterprises in less developed countries manipulate accounting policies in order to understate reported profit performance". An empirical examination of this hypothesis could be achieved by analysing the "income effect" of the accounting policies used by multinational enterprises in comparison to the "income effect" of the accounting policies used by local enterprises in less developed countries.

The "income effect" of accounting policies denotes the impact of a particular accounting policy on reported profit. That is, if one alternative accounting treatment understates reported profit in relation to other alternative(s), then this particular accounting treatment (accounting policy) may be considered as having an "income reducing effect", and other accounting policies may be considered as having "no income reducing effect". For the purpose of the present study, this arbitrary classification criterion has been applied to identify which of the accounting policies used by an enterprise fall under the "income reducing" category, and which fall under the "non-income reducing" category. This method has been applied in the present chapter to find out the income effect of accounting policies used by multinational and local enterprises in selected areas of accounting treatments.

An empirical study of the accounting policy manipulation hypothesis would be more meaningful if a number of less developed countries could be examined. But resources, time, and other constraints have restricted the present study to one

less developed country. It is hoped that this single-country study will provide some insights and give direction for further research in the area.

9.2 SELECTION OF THE VARIABLES AND THE DATA

To examine whether or not enterprises attempt to understate reported profit performance by manipulation of accounting policies, it is necessary to identify which accounting policies are most likely to be used. Corporate behaviour in terms of choosing particular accounting policies may be different in different countries. Such differences may be due to existing customs in a particular country and/or may be due to standards set by the accounting profession or by the government authorities in that country. Therefore identification of accounting policies that are more likely to be used may not follow the same rule in all countries - in particular differences may exist between developed and less developed countries.

The accounting policies examined in the present study were limited to four sets of accounting alternatives. These four were chosen because, in the context of Bangladesh, their effect on reported profit is relatively unambiguous and the choice of method could be easily discovered from the annual accounts of the enterprises. This later condition, though essential, could bias the results against finding a relationship between the types of enterprises studied, i.e. multinational enterprises and local enterprises, and the choice among accounting alternatives, because firms wishing to manipulate accounting profits may prefer not to disclose the methods they use for this purpose. This possibility need to be kept in mind while interpreting the results.

The four accounting policies selected for the purpose of the present study, are: stock valuation method, asset revaluation policy, depreciation computation method, and the method of corporate tax provision. These policies, and their income effect under alternative accounting treatments,

are briefly reviewed below.

(a) Stock Valuation:

It is an accepted fact that over-or under-valuation of stock can produce a material effect on the calculation of profit. Generally accepted accounting principles allow valuation of stock on the basis of various measurement rules which can produce quite different figures for the value of the total stock of an enterprise. Consequently different profit figures may be reported.

In accounting for stock, the assumptions that are made as to the cost of the units used for production or sale (and consequently, the cost of the units remaining in closing stock) are important to the stock valuation process. There are various cost-flow assumptions. The three normally used, are:

(i) First In First Out (FIFO)
(ii) Last In First Out (LIFO)
(iii) Average Cost

Taking FIFO as the norm, and considering it as having a non-income reducing effect, LIFO and Average Cost assumptions of cost-flow in stock valuation will fall under the income reducing category. Or differently, if it is arbitrarily considered that the "cost of goods sole" figure arrived at by using FIFO is the norm, then the "cost of goods sole" figure in the Income Statement will be higher than the norm, under either LIFO or Average Cost. Consequently, under both the LIFO and the Average Cost, reported profit will be lower than what would have been under the FIFO assumption. Accordingly the income effect of each of the three alternative stock valuation policies may be summarised, for the purpose of the present study, as below:

(i) FIFO : non-income reducing effect
(ii) LIFO : income reducing effect
(iii) Average Cost : income reducing effect

In many countries the LIFO method is not allowed by tax law and is, therefore, not customarily used for stock valuation. In Bangladesh, due to tax law, the LIFO method is not used by any enterprise included in this study. Therefore, in the present study, the income effect of only two stock valuation methods have been considered; and the values attached to each of these methods for statistical analysis are as follows:

(i) FIFO (non-income reducing effect) = 0
(ii) Average Cost (income reducing effect) = -1

It should be mentioned here that none of the enterprises included in the present study switched from one method to the other during the five year period covered (1975-1979). Therefore, the income effect due to switching from one method to another need not be considered.

(b) Asset Revaluation:

Generally accepted accounting practices in Bangladesh allows the revaluation of assets of an enterprise. Revaluations may be carried out annually or at longer periodic intervals. Through asset revaluation the depreciation base can be changed. This provides scope for income manipulation. Asset revaluation in line with inflation raises depreciation charges in the Income Statement and thereby reduces reported profit figures below the non-revaluation level.

In the following diagram, a hypothetical case is shown where a company purchases an asset for £10,000 in 1976 and revalues it annually from the end of 1977, according to an annual index of price level changes. Straight-line depreciation calculated on the revalued amounts is shown by the line PQ; and that PR line shows annual depreciation using the straight-line method without revaluations. Whatever depreciation method is used, revaluation in a period of inflation will produce lower profit figures.

Figure 9.1: Depreciation Charges Under Asset Revaluation Policy

(i) Estimated Life : 5 years
(ii) Annual Depreciation Without Revaluation : £2,000
(iii) Rate of Inflation:
1977 - 10%
1978 - 15%
1979 - 15%
1980 - 12%
(iv) Annual Depreciation on Revaluation:
1976 - £2,000
1977 - £2,200
1978 - £2,530
1979 - £2,909
1980 - £3,258

The above diagram represents the simple case of a single asset firm. Normally, asset acquisitions take place from year to year, and thus, the scope for reporting lower profit performances through revaluations continues to be an useful mechanism for reducing reported profits.

In the present study, the annual accounts of the enterprises were studied for the five year period (1975-1979) to identify whether or not these enterprises followed any asset revaluation policy. In terms of income effect, two categories of enterprises were identified - those following an asset revaluation policy, and those not following an asset revaluation policy. Values have been attached to each of these policies for statistical analysis, by arbitrarily assuming that the absence of an asset revaluation policy is aimed at

not understating reported profits; i.e. this policy has been considered as the norm. And the presence of an asset revaluation policy has been considered as being aimed at an understatement of reported profits. Thus we have:

(i) Assets not revalued (non-income reducing effect) = 0
(ii) Assets revalued (income reducing effect) = -1

(c) Depreciation:

Generally accepted accounting practice in Bangladesh allows alternative methods of depreciation calculation. The two methods of depreciation calculation most widely used in Bangladesh, are (i) Straight-Line Method, and (ii) Accelerated Method. For the purpose of the present study, only these two methods have been considered.

Under the accelerated method, the depreciation charge is higher than the depreciation charge under the straight-line method in the initial years of the life of an asset. Although throughout the life of the asset both methods allocate the same total amount, the accelerated method helps to defer profits in the initial years of an asset's life. Therefore, in the accounting literature it is normally considered that the accelerated method has an income reducing effect in relation to the straight-line method.[1] For the purpose of the present study, considering the income effect of the straight-line method as the norm, accelerated method has been considered as having an income reducing effect. For statistical analysis, we have:

(i) Straight-line method (non-income reducing effect) = 0
(ii) Accelerated method (income reducing effect) = -1

(d) Corporate Tax Provision:

In addition to current trading liabilities, an enterprise needs to account for obligations which are not currently

1. For example, see: R. Barefield and E. Comisky, "Depreciation Policy and the Behaviour of Corporate Profits", Journal of Accounting Research, 9, 1971, pp.351-358.

enforceable as money payments. For these it is necessary to make provision in annual accounts. One of the most common types of provision is for corporate tax. The liability to such taxes arises as the profits are made, and thus proper provision needs to be made in the annual accounts. Although assessment by the tax-authority normally takes place some considerable time after the accounts are prepared, enterprises in Bangladesh have to pay advance corporate tax annually on the basis of a provisional self-assessment. As the taxation authority subsequently may disallow certain expenses, actual tax levied for a particular year may exceed the advance corporate tax provisionally calculated and paid by the enterprise. Thus, provisions for corporate tax are normally required for additional tax liabilities. The management of an enterprise may attempt to report a lower net profit by making a high provision for corporate tax.

In the present study an attempt has been made to identify enterprises that appear to use corporate tax provision to understate reported profits. This would be easy if the annual tax bill could be compared with the annual provision of corporate tax in each particular enterprise. In the absence of information about the annual tax bill of each particular enterprise, a surrogate of the annual tax bill has been used. On the basis of discussions with the Accountants and Finance Managers (Finance Directors) of the enterprises studied, and on the basis of estimates given by the tax officials in Bangladesh, the annual tax bill of an enterprise normally does not exceed by more than 25 per cent the advance corporate tax assessed and paid by the enterprises themselves. Therefore, in order to find a suitable surrogate for the annual tax bill, the average annual tax payment during the five year period (1975-1979) has been increased by 25 per cent in each particular case. And this surrogate of the annual tax bill has been compared with the annual average corporate tax provision during the same five year period. It has been decided for the purpose of the present study that any enterprise having an annual average corporate tax provision more than the surrogate of the annual tax bill is the type of enterprise that uses

its corporate tax provision as a means of understating reported profits. Accordingly, we have:

(i) Annual average corporate tax provision not exceeding the surrogate of the annual average tax bill (non-income reducing effect) = 0

(ii) Annual average corporate tax provision exceeding the surrogate of the annual average tax bill (income reducing effect) = -1

The income effect of policy choice in each of the four accounting areas has been assumed to be independent of the choice made in the other three areas. This may not be the case in practice. Management may be guided by an overall income disclosure policy.[2] This study however assumes that each of the four accounting policies are independently chosen by management; and leaves a consideration of the broader framework of income disclosure policy for future research.

Based on the above discussion, the independent variables, and their attached value labels are summarised below:

Income Effect	Stock Valuation (STV)	Asset Revaluation (ARV)	Depreciation (DEP)	Corporate Tax Prov. (CTP)
Non-income reducing effect	0	0	0	0
Income reducing effect	-1	-1	-1	-1

The dependent variables used in the present study for application of statistical techniques, are the types of enterprises; that is, (i) multinational enterprises, and (ii) local enterprises.

The total number of enterprises examined in the present study are 30, of which 20 are multinational and 10 are local firms. The number of firms studied may seem very small, but the 20 multinationals constitute the whole population of

2. Zmijewski, M.E., and R.L. Hagerman, "An Income Strategy Approach to the Positive Theory of Accounting Standard Setting/Choice", Journal of Accounting and Economics, 3, 1981, pp.129-149.

multinational enterprises in Bangladesh. Although comparable local enterprises are not available in Bangladesh, the 10 top local enterprises were selected from amongst the local enterprises in industries where those 20 multinationals operate. More than 10 local enterprises could not be studied because all others would be too small by comparison to the multinationals; and in Bangladesh, small-size enterprises do not produce accounting reports in a systematic manner. Therefore, it is hoped that the small number of sample companies will not cause any bias in the results due to sampling error.

Table 9.1
Accounting Policy Choice by Sample Firms

Income Effect	STV	ARV	DEP	CTP	Total
Not reducing effect	9	23	20	18	70
Reducing effect	21	7	10	12	50
TOTAL	30	30	30	30	120

Table 9.1 shows the accounting policy choice by the sample firms, analysed by the income effect of these policies. It appears that the non-income reducing policies are more used by the sample firms than the income reducing policies. Statistical analysis is, however, necessary to find out whether or not multinational enterprises make more use of the income reducing policies than the local enterprises. This statistical analysis, the means of an empirical examination of the "accounting policy manipulation hypothesis", presented below:

9.3 STATISTICAL METHOD

After a consideration of the nature of data and the purpose of the study, discriminant analysis was chosen as the method of statistical analysis. Although not as popular as regression analysis, discriminant analysis has been utilised in a variety of disciplines since its first application in the 1930's.[3] During its early years this statistical method was

3. Fisher, R.A., "The Use of Multiple Measurements in Taxonomic Problems", Annals of Eugenics, No.7, September 1936, pp.179-188.

used mainly in the biological and behavioural sciences. More recently this method had been applied successfully in conducting research in business disciplines.[4]

The objective of discriminant analysis is to statistically distinguish between two or more groups of cases. These "groups" are defined by the particular research situation. In the present study, discriminant analysis determines the degree to which an individual enterprise's profile of scores on a set of measures (i.e. the income effect of each of the accounting policies) corresponds to or resembles the typical profiles of each of the discrete types (i.e. the multinational and local enterprises).

The mathematical details of discriminant analysis can be found in any standard text on "Multivariate Analysis".[5] Essentially, there is a simple "scoring" system that assigns a "score" or value to each enterprise. This score is a weighted average of the numerical values labelled to the independent variables. On the basis of this score, each enterprise is assigned to the "most likely" group or type of enterprise. However, the classification procedure in discriminant analysis takes into account the probability of each enterprise's membership in each of the groups. Discriminant analysis has the advantage of considering an entire profile of characteristics (independent variables) common to the relevant enterprises, as well as the interaction of these properties. A univariate study, on the other hand, can only consider the measurements used for group assignments one at a time.

---

4. For a list of marketing studies using discriminant analysis see: M.R. Crask and W.D. Perreault, "Validation of Discriminant Analysis in Marketing Research", Journal of Marketing Research, February 1977, p.60; and for a list of studies in corporate failure using discriminant analysis see: R.W. Scapens et al., Explaining Corporate Failure: A Catestrophe Theory Approach, Working Paper 8005, Department of Accounting and Business Finance, University of Manchester, 1979, p.7.
5. See, for example: W.W. Cooley and P.R. Lohnes, Multivariate Data Analysis, John Wiley & Sons, New York, 1971; T.W. Anderson, An Introduction to Multivariate Statistical Analysis, John Wiley & Sons, New York, 1958; M.M.Tatsuoka, Multivariate Analysis: Techniques for Educational and Psychological Research, John Wiley & Sons, New York, 1971.

Another advantage of discriminant analysis is that it reduces the number of dimensions from the number of different independent variables to (g - 1) dimension(s), where g equals the number of original 'a priori' groups.[6] The present study is concerned with two groups. Therefore, the analysis is transformed into its simplest form: one dimension. The discriminant function of the form $Z = V_1X_1 + V_2X_2 + \ldots + V_nX_n$ transforms individual variable values to a single discriminant score or Z value which is then used to classify the enterprises;

where $V_1, V_2, \ldots V_n$ = discriminant coefficients, and
$X_1, X_2, \ldots X_n$ = independent variables.

The discriminant analysis computes the discriminant coefficients, V_j, while the independent variables X_j are the actual values; where, $j = 1,2, \ldots n$.

When using a set of accounting policies to determine whether or not the income effect of the chosen accounting policies distinguish multinationals from local enterprises, there is reason to believe that the income effects of some of the accounting policies may have a high degree of correlation or collinearity with each other. While discriminant analysis takes care of this in assessing the predictive ability of the independent variables, it also has the advantage of yielding a model with a relatively small number of variables which have the potential of conveying a great deal of information. This information may indicate differences between groups - however, in the present study the concern is about whether or not these differences are meaningful. Discriminant analysis provides statistical tests for measuring the success with which the discriminating variables actually discriminate when combined into the discriminant function. In addition, the weighting coefficients of the discriminating variables serve to identify those variables which contribute most to the discrimination along the respective dimension (function).

---

6. The maximum number of discriminant functions to be derived is either one less than the number of groups or equal to the number of discriminating variables, whichever is smaller.

Perhaps the primary advantage of discriminant analysis in dealing with classification problems is the potential of analysing the entire variable profile of an individual (enterprise) simultaneously, rather than sequentially examining its individual characteristics. Moreover, the stepwise method of discriminant analysis identifies any independent variables that do not have discriminating power, and examines only the remaining variables.

The last but not least, advantage of discriminant analysis stems from the fact that this statistical method is useful in attacking problems where the dependent variable appears in qualitative form. In the present study, discriminant analysis is used to examine whether or not multinational enterprises in Bangladesh use income reducing accounting policies in contrast with local enterprises - the dependent variables are the types of enterprises.

At this stage, mention needs to be made about the sample size. The rule in discriminant analysis, as depicted by Tatsuoka (1970)[7], is that:

> "Total sample size should be at least two or (preferably) three times the number of variables used. . . . In fact, to be realistic, there are good reasons to insist that the size of the smallest group be no less than the number of variables used."

In the present study, this condition is satisfied. The number of variables used is 4 (4 accounting policy choices) and the total number of samples is 30 (where the smallest group, i.e. local enterprises, has 10 members, two and half times the total number of variables). Another important requirement is that the total number of variables should not be less than the total number of groups.[8] This latter requirement has also been fulfilled in the present study, because the number of groups is two and the number of variables is four.

---

7. Tatsuoka, M.M., Discriminant Analysis: The Study of Group Differences, Institute for Personality and Ability Testing, Champaign, Illinois, 1970, p.38.
8. Tatsuoka (1970), ibid.

The Discriminant Analysis Computer Programme (DISCRIMINANT) available in the SPSS,[9] has been used to perform the statistical analysis. The results are discussed in the following section.

9.4 INTERPRETATION OF RESULTS

This section is divided into three parts. In the first part, the results obtained by running the SPSS Discriminant Analysis Programme using the DIRECT method are interpreted. In the second part, the results of the STEPWISE method are interpreted. And in the third part, a summary of the findings is used to examine the accounting policy manipulation hypothesis.

DIRECT METHOD

In this method, all the independent variables are entered into the analysis concurrently. The discriminant function is taken directly from the entire set of independent variables, regardless of their individual discriminating power.

The classification results achieved by the discriminant analysis are presented below in tabular form. Actual group membership is equivalent to the 'a priori' groupings - the model attempts to classify correctly these firms. Strictly, at this stage the model is explanatory. Only when new companies are introduced will the model become truly predictive.

Table 9.2
Classification Results : Direct Method

Actual Group	Number of Cases	Predicted Group Membership	
		Multinationals	Locals
Multinationals	20	18 (90%)	2 (10%)
Locals	10	1 (10%)	9 (90%)
PERCENT OF GROUPED CASES CORRECTLY CLASSIFIED: 90.00			

9. Klecka, W.R., "Discriminant Analysis", in N.H. Nei et al. (eds.), Statistical Package for the Social Sciences (SPSS), McGraw-Hill, New York, 1975, pp.434-467.

The discriminant analysis model has correctly identified 90 per cent of the multinational enterprises, and in the case of local enterprises 90 per cent has also been correctly identified. Thus in each case 10 per cent misclassification has taken place. The 90 per cent correct classification of grouped clases is analogous to the coefficient of determination (R^2) in regression analysis, which measures the percentage of the variation of the dependent variable explained by the independent variable. The above results indicate that multinational and local enterprises in Bangladesh can be classified into their groups through an evaluation of the income effect of their accounting policies. The results, therefore, seem encouraging as far as the explanatory power of the discriminant function model is concerned. But potential limitations of the results should be kept in mind and need for further analysis should not be ignored.

In the present test only one discriminant function has been derived. In other cases more than one discriminant function may be derived, and a judgement is then needed as to which of the derived functions is/are important in terms of discriminating ability. Two useful aides in judging the importance of a discriminant function are, "canonical correlation" and "Wilks' lambda". Both of these statistics are produced by SPSS. The canonical correlation indicates how closely the function and the "group variable" are related, i.e., it measures the function's ability to discriminate among the groups. The Wilks' lambda is an inverse measure of the discriminating power in the original variables which have not yet been removed by the discriminant function - the larger the lambda, the less information remains. Lambda can be transformed into a chi-square statistic for a simple test of statistical significance.

The discriminant function derived by the direct method, has a canonical correlation of .7697262. This suggests that the function has reasonable discriminating ability. The Wilks' lambda of .4075216, with a corresponding chi-square of 23.339 which is significant at the .0001 level, indicates that the

discriminant function has made a high degree of separation between the groups, and there seems to be little probability that the prediction of the enterprise group membership has been made by chance.

Referring back to table 9.2, the direct method of discriminant analysis has predicted group membership of the enterprises on the basis of each one's characteristics explained by the income effects of its accounting policies. Each enterprise has been subjected to a test to see whether or not the income effect of its accounting policies helps to predict its group membership. The Z scores or discriminant scores of the enterprises were considered for this test. The mean discriminant score of the enterprises originally belonging to each group is the group centroid of that group. The group centroid of multinational enterprises was -.82369, and of local enterprises was 1.64738. The difference between these group centroids measures the "normal distance" between them; and the mid-point of this distance draws the dividing line between the derived Z scores. The following procedure is involved in the classification process:

If $Z > Z_{crit}$, classify the enterprise as belonging to local group.

If $Z < Z_{crit}$, classify the enterprise as belonging to multinational group

The Z_{crit} or critical value for the discriminant scores, or the point of division between centroids of the two groups, was .82369. Any enterprise having a Z score less than this critical value is predicted to be a multinational and any enterprise having Z score more than this critical value is predicted to be a local enterprise. In figure 9.1, a histogram of the Z scores of both the groups has been drawn with symbols (1) for multinational enterprises and (2) for local enterprises. The group centroids are indicated along the horizontal line. A thick vertical line is drawn at the mid-point between the two group centroids; this line separates the predicted multinational group (left side) from the predicted local group (right side). It is shown on the histogram that two actual multinational enterprises have fallen

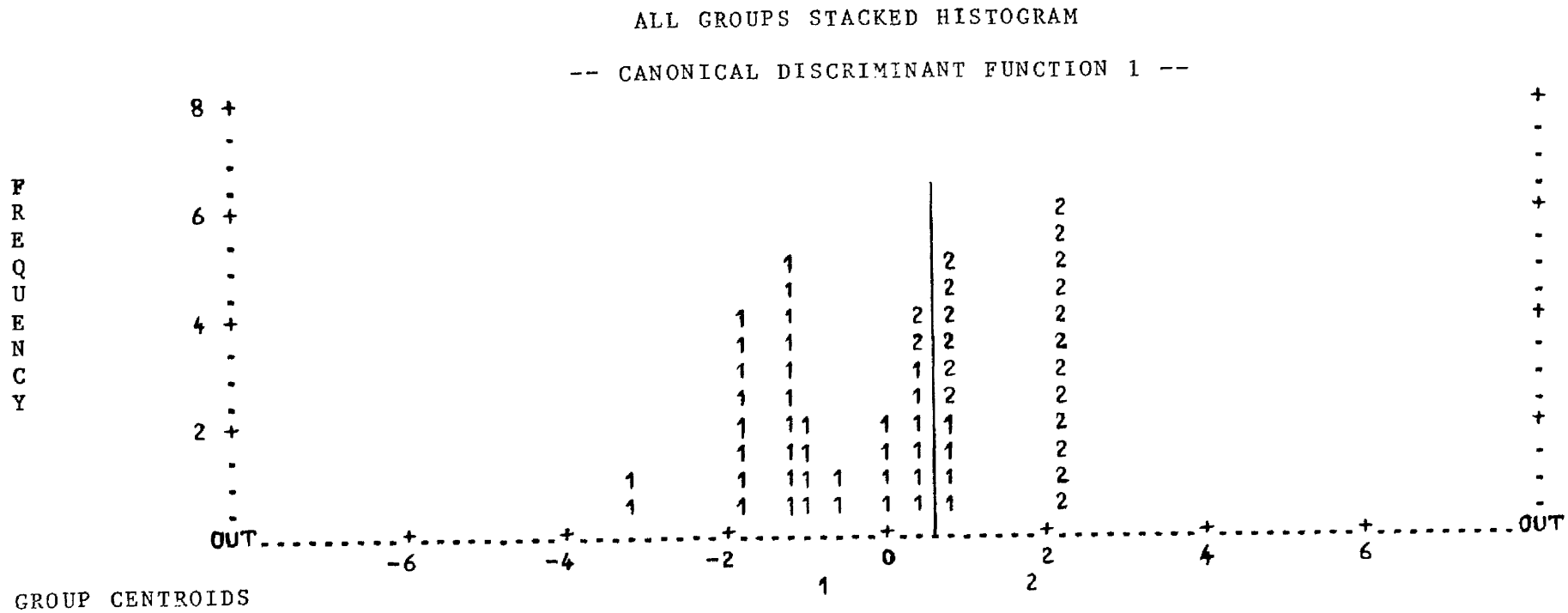

Figure 9.2 : Histogram Showing Classification of Enterprises into Two Groups, Direct Method

Notes: (i) Symbols Used: (1) multinational enterprise, and (2) local enterprise
(ii) Two numbers of each symbol = one frequency
(iii) The thick vertical line = line of separation between predicted multinationals (left), and predicted locals (right)

on the right side and one actual local enterprise has fallen on the left side of the line of separation. This means that the Z scores of two multinationals are more than Z_{crit}, and Z score of one local enterprise is less than the Z_{crit}.

Perhaps the most important statistics produced by the discriminant analysis are the weights associated with each of the discriminating variables (independent variables) in the discriminant function. These weights are called "standardised discriminant function coefficients". When signs are ignored, each coefficient represents the relative contribution of its associated variable to that function. The signs merely denotes whether the variable is making a positive or negative contribution. The intrepretation is analogous to the interpretation of beta weights in multiple regression. "By positive contribution is meant the direction descriptive of the group having the higher mean score on the linear combination".[10] Of the 4 variables used in the direct method, 3 have positive contributions and 1 has negative contribution (table 9.3).

Table 9.3
Relative Importance of the Discriminating Variables

Variables	Standardised Discriminant Function Coefficient	Relative Importance
Stock Valuation (STV)	.24970	10 %
Asset Revaluation (ARV)	.53459	21 %
Depreciation (DEP)	-.85202	34 %
Corporate Tax Prov.(CTP)	.89357	35 %

Of the four discriminating variables, STV appears to have the least discriminating power, whereas CTP has the highest discriminating power. But DEP's contribution to discrimination is fairly high, and its discriminating power is close to CTP's.

10. Tatsuoka (1970), op.cit., p.4.

The contribution of ARV in the discrimination analysis is reasonable. In order to interpret the statistics on relative importance of each of the discriminating variables, it is necessary to make reference to the group means of the variables (table 9.4).

Table 9.4
Group Means of the Discriminating Variables

Groups	STV	ARV	DEP	CTP
Multinationals	-.70000	-.30000	-.20000	-.60000
Locals	-.70000	0.00000	-.60000	0.00000

Recalling the value labels for each of the accounting policies, (-1) for income reducing effect and (0) for non-income reducing effect, the group means can be used to interpret the statistics on relative importance of the discriminating variables, as follows:

STV: Both the groups have the same mean value of the income effect (income reducing effect) of stock valuation policy. Therefore a positive sign of the standardised discriminant function coefficient does not indicate the direction of discrimination between the groups. In fact, the use of an income reducing stock valuation policy is no different in multinationals than in local enterprises. This fact has reduced the discriminating power of STV, which is only 10 per cent; it therefore seems that STV may be ignored as a discriminating variable.[11]

ARV: The multinationals make use of income reducing ARV to some extent, while none of the local enterprises do so. The multinational group has a higher mean value. Therefore, the positive sign of the standardised discriminant function coefficient indicates that the multinational group is discriminated from the local group as far as the use of an income reducing asset revaluation policy is concerned. In other words, the use of income reducing

11. See: Stepwise Method in the following section.

ARV in an enterprise has helped to predict it as belonging to the multinational group. But it seems that the 21 per cent degree of relative importance and a mean value of only (-.30000)of ARV are not sufficient to claim that the multinationals in general use ARV as a tool for reducing reported profits.

DEP: Both groups use income reducing depreciation methods, but the use of such a method is more prevalent in case of the local enterprises than in the case of the multinational enterprises. The multinational group has a lower mean value of DEP. The negative sign of the standardised discriminant function coefficient indicates that the local group is being discriminated from the multinational group as far as the use of an income reducing depreciation method is concerned. In other words, the use of income reducing DEP in an enterprise has helped to predict it as belonging to the local group. The DEP has a fairly high contribution to discrimination (34%), but the multinational group has a lower mean value; therefore, when compared with the local group it seems that multinationals in general may not use DEP as a tool for reducing reported profits.

CTP: The multinationals make use of income reducing CTP while none of the local enterprises do so. The multinational group has a higher mean value. Therefore, the positive sign of the standardised discriminant function coefficient indicates that the multinational group is discriminated from the local group as far as the use of an income reducing corporate tax provision is concerned. In other words, the use of income reducing CTP in an enterprise has helped to predict it as belonging to the multinational group. The CTP has the highest contribution to discrimination (35%), and the multinational group has the highest mean value of income reducing CTP (-.60000). Still it is difficult to suggest that multinationals use income reducing CTP to understate reported profits. This is mainly due to the fact that the multinationals

are of very large size compared with the local enterprises studied; and the large firms may have a tendency to allocate higher amounts for unforseen tax charges, than the small-size local firms.

The results of the direct method of discriminant analysis, discussed above, do not seem to lend support to the accounting policy manipulation hypothesis. Before any final discussion about these results, the results obtained by use of the stepwise method are given below.

STEPWISE METHOD

An alternative to the direct method is the stepwise selection method. Independent variables are selected for entry into the analysis on the basis of their discriminating power. In many instances, the full set of independent variables contains excess information about group differences, or perhaps some of the variables may not be very useful in discriminating among the groups. By sequentially selecting the "next best" discriminator at each step, a reduced set of variables can be found which could be as good as, and some times even better than, the full set. There are five stepwise selection criteria available in SPSS and of these, RAO has been used for the present research, because RAO is based on a criterion of Rao's V, a generalised distance measure, which is mostly used in research of the present kind.[12] Here the variable selected is the one which contributes to the largest increase in V when added to the previous variables; this results in the greatest overall separation of groups.

The stepwise method correctly classified (table 9.5) a lower percentage of cases than the direct method. But the results under the stepwise method are still interesting because none of the local enterprises have been misclassified. It seems that the typical use of accounting policies in local enterprises has been captured by the discriminant analysis. While 25 per cent misclassification of multinationals is two half times the misclassification under the direct method,

12. Klecka (1975), op.cit.

10 per cent misclassification of local enterprises under direct method has been avoided in present analysis.

Table 9.5
Classification Results : Stepwise Method

Actual Group	Number of Cases	Predicted Group Membership	
		Multinationals	Locals
Multinationals	20	15 (75%)	5 (25%)
Locals	10	0	10 (100%)

PERCENT OF GROUPED CASES CORRECTLY CLASSIFIED: 83.33

The discriminant function under the stepwise method has a canonical correlation of .7622681, which is slightly lower than that under the direct method; but there is still reasonable discriminating ability. The Wilks' lambda of .4189474 is slightly higher than the Wilks' lambda under the direct method; the corresponding chi-square of 23.055 is significant at zero level in the present case. These statistics indicate that the discriminant function under the stepwise method provides a high degree of separation between the groups.

Group centroids of the multinational and local enterprises are -.80451 and 1.60902 respectively. The critical value of discriminant scores is .80451. This critical value is slightly lower than the critical value under the direct method; and this has resulted in the new pattern of classification. The histogram in figure 9.2 shows that the predicted locals on the right hand side of the line of separation (thick line) include 5 actual multinationals, three of which were correctly classified under the direct method. However, all locals are on the right hand side of the line of separation.

The stepwise method reveals that the stock valuation policy (STV) does not have sufficient discriminating power to be considered as a discriminating variable.

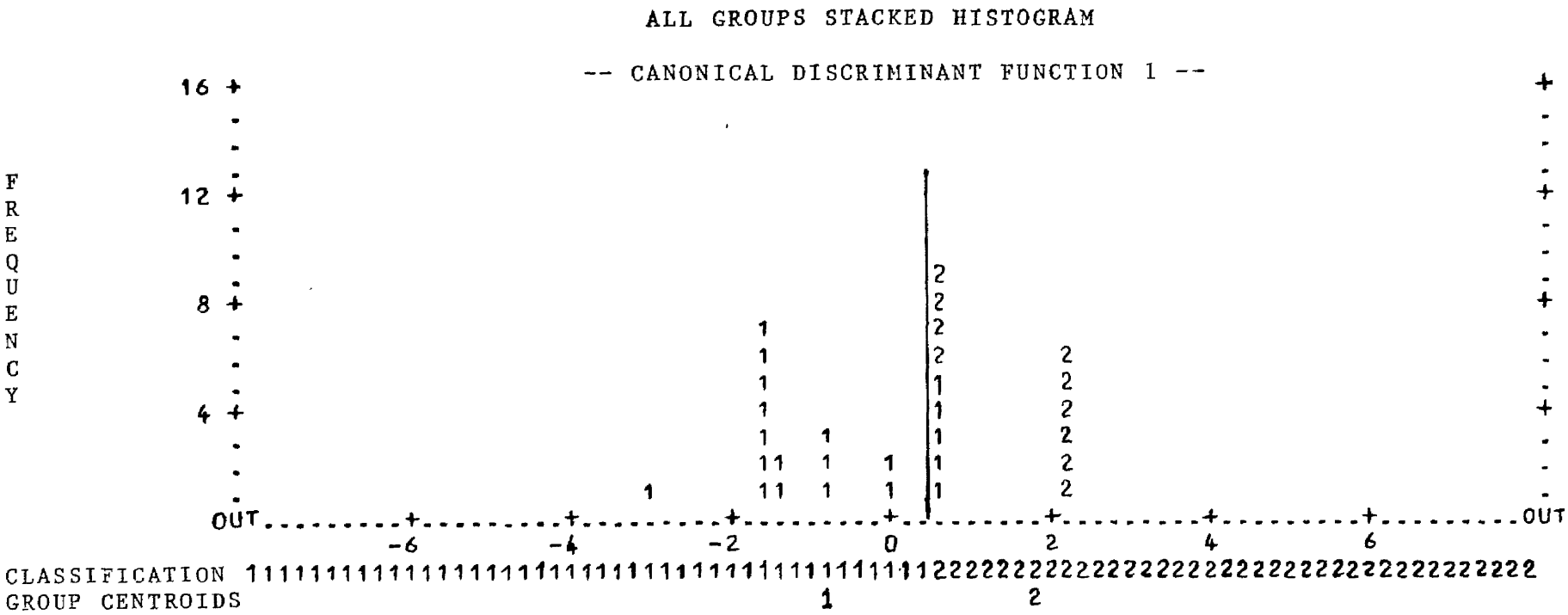

Figure 9.3 : Histogram Showing Classification of Enterprises into Two Groups, Under Stepwise Method

Notes: (i)Symbols Used: (1) multinational enterprise, and (2) local enterprise
(ii)One of each symbol = one frequency
(iii)The thick vertical line = line of separation between predicted multinationals (left) and predicted locals (right).

Table 9.6
Relative Importance of the Discriminating Variables

Variables	Standardised Discriminant Function Coefficient	Relative Importance
Asset Revaluation (ARV)	.56447	25 %
Depreciation (DEP)	-.74304	34 %
Corporate Tax Prov.(CTP)	.90516	41 %

The discriminant function contains three variables - ARV, DEP, and CTP. Table 9.6 shows the relative importance of each of these three discriminating variables. As in the case of the direct method, DEP makes a contribution of 34 per cent to the discrimination process, and a negative standardised discriminant function coefficient denotes that the use of income reducing DEP in an enterprise has helped its identification as a local firm. That is, the income effect of DEP in local firms is towards the direction of "income reduction", while in the case of multinationals this is not so. As in the case of the direct method, ARV in the present analysis appears to have income reducing effects in the case of multinationals in contrast with locals; but its low relative importance (25%) restricts the claim that multinationals use it as a tool for reducing reported profits. As in the previous analysis, CTP has the highest contribution to discrimination (41%) and it is only in this case that multinationals appear to use an income reducing policy in general. This evidence alone may not be sufficient to claim that multinationals use income reducing CTP to deliberately understate reported profits.

SUMMARY

Although the multinational enterprises and the local enterprises in Bangladesh can be classified into two groups on the basis of the income effect of chosen accounting policies, evidence does not suggest that multinationals in general use income reducing accounting policies in a deliberate

attempt to understate reported profits. In other words, the empirical evidence does not seem to lend support to the accounting policy manipulation hypothesis. However, the findings of the study reveals that the multinationals and local firms in Bangladesh use more or less dissimilar accounting policies.

9.5 ACCOUNTING POLICY DECISIONS : SUBSIDIARY INDEPENDENCE OR PARENT COMPANY INTERFERENCE

If a multinational enterprise pursues the policy of regulating the reported profit performance of its affiliated companies in different host countries, through manipulation of accounting policies, then it may be expected that the parent company will interfere with the accounting policy decisions of each of these affiliates. Interference from the parent company may be in the form of general guidelines on accounting policies, or in the form of specific policy prescriptions for particular subsidiaries. In both these cases, a subsidiary management loses complete independence regarding accounting policy decisions. If the management of a subsidiary does not have independence in deciding its accounting policies, there may be a possibility that the accounting policies used by the particular subsidiary would be different from those commonly used by the local enterprises in the host country. Under such a circumstance, it could be predicted that the subsidiary management would be in a position to distort the reported profit performance of the enterprise through accounting policy manipulation.

The findings of the present Bangladesh case study may be explained in the way that the enterprises in Bangladesh, whether multinationals or locals, follow accounting policies customarily used in that country. The experience gathered through the field work in Bangladesh suggests that the customary use of accounting policies is greatly influenced by the requirements of tax laws. This suggests that the management of the affiliates of multinationals in Bangladesh might enjoy independence in accounting policy decisions.

That accounting policies used by multinational enterprises in Bangladesh are not imposed by the parent companies, and are decided by the subsidiary-management according to the statutory requirements of the host government, was confirmed by the finance executives of 17 of the 20 multinationals in personal interviews during the field work in Bangladesh. The interviewees of the remaining 3 multinationals said that they decide accounting policies with due respect to both the instructions from the parent company and the statutory requirements of the host government.

As the annual accounting report prepared by a multinational enterprise for use of the host government and of the general public is based on the accounting policies customarily used in Bangladesh, a different set of accounts prepared according to the method prescribed by the parent company is sent by each of the 20 multinationals in Bangladesh to their parent companies. The finance executives of all the 20 multinationals in Bangladesh confirmed this in interviews. This information that the external accounting reports prepared by multinationals in Bangladesh are not used by the parent companies either for performance evaluation or for management decisions, might suggest that the accounting numbers in these reports could be distorted in order to misinform the external users regarding enterprise performance. But the empirical evidence in the present study does not make any strong suggestion about existence of accounting policy manipulation in multinationals in Bangladesh. It is, therefore, predicted that if multinationals do not manipulate accounting policies to distort accounting numbers, they might resort to other devices (e.g. transfer price manipulation) for this purpose. This prediction is made on the basis that multinational enterprises in less developed countries seem to have greater incentives for distortion of accounting numbers.

9.6 CONCLUSION

An empirical examination of the accounting policy manipulation hypothesis in the present chapter reveals that

multinational enterprises in Bangladesh do not tend to use particular accounting policies in order to understate reported profit performance. It indicates, therefore, that if a multinational enterprise in a less developed country distorts its reported profit performance, it may do so through the manipulation of accounting inputs (e.g. income or expense items) rather than through manipulation of the accounting policies. The present study indicates that the accounting policies used by both multinational and local enterprises in Bangladesh are those customarily used in that country. But the accounting policies used by the multinationals and local firms do not appear to be similar.

On the basis of empirical evidence from the Bangladesh case study, the accounting policy manipulation hypothesis seems to be unfounded. However, it is very difficult to completely reject this hypothesis on the basis of the evidence from this single-country case study. In order to make any generalised comment on the behaviour of multinational enterprises in less developed countries as to their accounting policy choice, further research in this area is necessary.

CHAPTER TEN

Examination of the Transfer Price Manipulation Hypothesis

10.1 INTRODUCTION

Focusing attention on the motivations for transfer price manipulations by multinational enterprises, the hypothesis was advanced in chapter 7, that "multinational enterprises in less developed countries manipulate transfer prices in order to understate the reported profit performance". An attempt is made in the present chapter to examine this hypothesis in order to observe whether or not empirical evidence lends supports to it.

Transfer price manipulations by multinational enterprises result in the clandestine transfer of funds from one country to another. Uncontrolled manipulation of transfer prices may affect the balance of payments position of the country from which funds are shifted. Therefore, if multinational enterprises manipulate transfer prices, they are likely to do so secretly. It is thus very difficult, and sometimes impossible, to assess how far multinationals actually do manipulate intra-group prices (i.e. transfer prices) to transfer income across national boundaries.

Due to the problems inherent in assessing transfer price manipulations, empirical research is scanty in this field. Most of the evidence on transfer price manipulations was found either by government authorities, or by researchers working in collaboration with government authorities. As access to confidential government documents and/or access to the books of accounts and invoices of multinational enterprises are important requirements for conducting a proper study on transfer price manipulations, it is very difficult for individual researchers to conduct studies in this subject without the co-operation of government authorities; cooperation from multinationals can hardly be expected. The data on transfer pricing

in Bangladesh that has been used in the present study was collected with the cooperation of government authorities in that country. The multinationals, as expected, refused to furnish any quantitative information on transfer prices.

Multinational enterprises throughout the world are very secretive about transfer pricing. With the proliferation of multinational enterprises in last quarter of a century, governments in both home and host countries of multinationals have become seriously concerned about this "secret" transfer of resources. In the last decade many actions have been taken by different national governments and also by international and regional organisations to control transfer price manipulations. But practical problems have set limits to the effective operationalisation of these actions. The following section looks into these problems.

10.2 GOVERNMENT CONTROL AND TRANSFER PRICING

The extent to which multinational enterprises can over-or-under-price imports and exports within the group depends upon the vigour with which controls are applied by the government authorities in host and home countries. Host government's control is especially important in this context. In view of this, multinational enterprises operating in less developed countries are thought to have wider scope for transfer price manipulations, because government control in these countries seem to be less efficient and less effective than in developed countries.

The main problem frequently faced by the government authorities in controlling transfer price manipulations is the lack of information on arm's length prices. Suppose a computer manufacturer ships a crate of parts for assembly by a foreign subsidiary. How much is it worth? A pharmaceutical company sends unique chemical compounds to a foreign subsidiary that packages them into finished drugs. What is the appropriate market price of the compounds, especially if they are the product of expensive research? Perhaps no one can answer these

questions with precision. The problem of finding arm's length prices of transactions between related parties in a multinational group provides wide scope for transfer price manipulations. It has been suggested in The Wall Street Journal,[1] that if multinationals want to manipulate transfer prices, it would be hard for anybody to prevent them. Some of the executives interviewed by The Wall Street Journal admitted that transfer pricing is used as an useful tool for allocating fixed expenses among subsidiaries, and for shifting profit from one subsidiary to another; this can be done by tacitly avoiding government controls.

It is generally held that there are three reasons which explain the difficulty of detecting transfer price manipulations: (i) it is frequently impossible to say what constitutes appropriate prices for goods and services transacted between affiliates of a multinational enterprise; (ii) many of the services, such as technological and managerial know-how, have no discernible market price; and (iii) to supervise and control transfer pricing practices thoroughly, the government authorities require a high degree of expertise, a great volume of information, large size of staff, and the necessary legislation that few, if any, government authorities is able to muster. Thus, even in developed countries, where administrative machinery is likely to be more highly developed, it is doubtful whether government authorities can identify and control all profit transfers through transfer price manipulations. The position of less developed countries, where administrative machinery is less developed, is likely to be much more exposed.

Although various governmental bodies may have interests in the transfer pricing issue, such interests may not be in harmony. The customs authority in a country is generally not concerned with import prices being higher than they should be,

1. "Profit Probes: Investigations Beset Multinational Firms with Stress on Pricing", The Wall Street Journal, December 19, 1974, p.1.

since these result in higher revenue as customs duty. The tax authority and the foreign exchange control authority, on the other hand, are likely to be concerned since such prices lead to lower profits and therefore lower tax revenue, and a higher than necessary outflow of foreign exchange. The contrary situation exists where import prices are artificially low; the customs authority is likely to react, but not the tax or foreign exchange control authorities. This problem may not be acute in developed countries due to developed and well coordinated administrative machinery. But in less developed countries this problem seems to pose a great hindrance to government control of transfer pricing.[2]

Recognising that multinational enterprises may manipulate transfer prices, international and regional organisations like the United Nations, Organisation for Economic Cooperation and Development, European Economic Community and several others have designed various guidelines and regulations for the control of transfer prices.[3] But these actions have not yielded results, mainly because the transfer pricing issue is likely to elicit different responses from the two governments involved in any intra-group transaction. While authorities in the importing country could well be disturbed by over-pricing the imports of a particular good or service, authorities in the exporting country usually welcome higher export receipts. such a situation entails actual or potential conflict of interest between countries involved in particular intra-group transactions, and is perhaps a major reason why international regulatory actions have had little impact on the control of transfer pricing.

---

2. In Bangladesh study, this was found to be an important factor hindering proper monitoring and control of transfer pricing. In fact, the customs authority in that country had never detected a case of over-pricing, whereas the tax authority suggested that over-pricing of imports often takes place.
3. For a review of international regulations, see: T.L. Brewer, "International Regulation of Restrictive Business Practices", Journal of World Trade Law, Vol.16, No.2, March: April 1982, pp.108-118.

Although the transfer pricing issue seems to elicit different responses from different countries, it is a great headache for almost all the home and host countries of multinational enterprises, particularly because multinationals may transfer profits from high-tax countries to low-tax countries, or to tax havens. Every tax authority is, therefore, constantly looking for devices that can help to control transfer price manipulations. The following report in a London daily newspaper highlights the concern:

The Times, February 26, 1981, p.19

INSPECTORS STUDY ABUSE OF TAX HAVENS

Paris, Feb.25 - Tax inspectors from more than 20 countries have met here for three days, under the Organisation for Economic Cooperation and Development, to discuss the increasing abuse of tax havens by multinational companies.

The talks focused on the way the multinationals set up subsidiaries in countries where taxes are low.

There is nothing illegal in corporations attempting to maximise their profits by minimizing tax obligations.

But the suspicions of tax authorities have been aroused by the consistently higher sales, and profits of some corporate subsidiaries operating in tax havens and low-tax countries, compared with the lower earnings that the same companies report in high-tax areas of operations.

What this often implies is that the companies have been engaging in internal transactions intended to disguise their true tax liabilities.

Transfer pricing is quite easy to disguise and hard to prove. "What is really difficult is in getting the evidence and obtaining convictions", One participant at the meeting said.

Tax officials credit American corporations with pioneering the use and abuse of tax havens in the 1960s. But now countries such as Sweden and The Netherlands have become increasingly interested in detecting the more sophisticated techniques by which companies there hide their true earnings.

> Multinational companies are estimated to have sheltered thousands of millions of dollars from United States tax authorities through imaginative transfer pricing practices.

In spite of the problems involved in the investigation of transfer price manipulations, government agencies in some developed countries have attempted to undertake such investigations and have detected substantial divergences in transfer prices from arm's length prices. These cases, briefly discussed in the following section, provide some empirical evidence of transfer price manipulations by multinational enterprises.

10.3 CASES OF TRANSFER PRICE MANIPULATIONS

(a) United Kingdom:

The most publicised case in the United Kingdom involving manipulation of transfer prices was the investigation undertaken by the Monopolies Commission into the supply of tranquilisers (librium and valium), in the United Kingdom market.[4] The principal supplier of the products in question was Roche Products, the United Kingdom subsidiary of the Hoffmann-la-Roche group (home country: Switzerland). The economic condition that permitted the group to manipulate transfer prices, was identified by the Commission as follows:[5]

> "The Hoffmann-la-Roche group has virtually a monopoly position, being derived from its success in product innovation and from patents on the active ingredients of both medicines. This patent monopoly is reinforced ... by the effect of established brand names in a market where there is a low degree of price competition and price sensitivity."

Distortions in transfer pricing occurred principally in two different areas: (i) the over-charging of prices on "tied" inputs supplied by the parent company, and (ii) excessive charges to the United Kingdom subsidiary for central and

4. United Kingdom Monopolies Commission, Chlordiazepoxide and Diazepam, HMSO, London, 1973.
5. Ibid, p.50.

head office expenses. Indirect profit transfers from 1966 to 1972 from the United Kingdom subsidiary to the parent company by the above means was estimated at £22 millions in contrast to a declared profit of only £3 millions.

It was found that the prices of the active ingredients provided by the parent company to the United Kingdom subsidiary were substantially higher than those quoted on the international market: the prices for these ingredients, if purchased from independent sources in Italy, would have been £9 and £20 per kg. compared with those charged to the Roche subsidiary by its parent of £370 and £922.

Furthermore, based on its own cost estimates, the commission determined that the rate of return on capital was far above the rates for the United Kingdom manufacturing industry. Accordingly, it requested the U.K. subsidiary of the Roche group to reduce the price of librium by 40 per cent and that of valium by 25 per cent of the market prices prevailing in 1970.

The subsidiaries of Hoffmann-la-Roche in Australia, the Netherlands and New Zealand were subsequently asked, by the governments of these countries, to reduce the market prices of librium and valium in these markets.

(b) Federal Republic of Germany:

The Federal Cartel Office (FCO) initiated proceedings in 1973 when it became aware of likely abusive prices charged by Hoffmann-la-Roche (Roche Grenzach) for valium and librium in the Federal Republic of Germany.[6] It ordered Hoffmann-la-Roche to cut its market prices by 35 and 40 per cent respectively for valium and librium on the ground that it had abused its dominant market position by charging excessive prices. It noted that in a number of other European countries the prices charged for these products were considerably lower than those in the Federal Republic. The reasons alleged by

6. Bundeskartellamt G. Beschlussabteilung, 36-432190 -T-37/73.

the German subsidiary of Hoffmann-la-Roche for these differences were considered invalid. The transfer prices charged by the parent were found to be ninety times the Italian competitive price in respect of valium, and fourty-seven times in respect of librium. The company appealed to the Court of Appeal (Kammergericht) but the Court confirmed, in 1976, the decision of the FCO.

Following price increases for gasoline, diesel oil and light fuel oil, the FCO also investigated major oil companies' transfer prices. However, in its investigations it encountered difficulties in obtaining information on transfer prices for crude oil and other charges. All except one of the companies involved claimed that they could not provide the required information since it was held by group headquarters located in other countries. Consequently, a proceeding was initiated against British Petroleum's subsidiary in the Federal Republic with a view to prohibiting it from charging prices in excess of those valid at a certain date. The FCO order of immediate enforcement of this decision was subsequently reversed by the Court of Appeal. In its decision, the Court agreed that in the light of the considerable profit increase of the parent company:

> "there was a suspicion that this enterprise had improved its profits as a result of the increase in the product prices; however, it said that the reasons given to prove the abuse were not conclusive. The Court, however, confirmed the possibility of conducting investigations into whether foreign affiliates of the company had caused an abuse affecting the domestic market by charging excessive crude oil prices and directed a request for information to the foreign affiliate, . . ."[7]

In the above case, although the FCO could detect through its experience of profit performance of subsidiaries in the Federal Republic and of their parents abroad, that excessive transfer prices were charged for imports from the parents, actions could not be taken for lack of appropriate information.[8]

7. Organisation for Economic Cooperation and Development, Annual Reports on Competition Policy in OECD Member Countries, OECD, Paris, 1975/No. 2, p.53.
8. Organisation for Economic Cooperation and Development, Restrictive Business Practices of Multinational Enterprises: Report of the Committee of Experts on Restrictive Business Practices, OECD, Paris, 1975, p.23.

(c) United States of America:

The U.S. Treasury Department (1973)[9] published data on a sizeable reallocation of taxable foreign-source income of multinational enterprises headquartered in U.S.A., for the year 1968-69, on the basis of arm's length pricing rules. A total of 871 cases were considered, and allocations were made in more than half of them. These allocations were made by the Internal Revenue Service according to the provisions of section 482 of the U.S. Internal Revenue Code. Section 482 authorises the Internal Revenue Service to allocate income or expenses among related companies when it is necessary to prevent tax evasion or to reflect clearly the income of each company.

The Internal Revenue Service detected large deviations in transfer prices from arm's length prices and in case of particular multinationals these were subjected to reallocation of taxable income. The total estimated deviation was about US$ 662 million. This estimated magnitude of deviation from arm's length prices in intra-group transactions lends some support to the hypothesis that multinationals tend to fix transfer prices at levels different from arm's length prices (i.e. they manipulate transfer prices).

Although the above scattered cases of transfer price manipulations do not provide conclusive evidence about transfer pricing practice in multinational enterprises, they give an important indication of the issue concerned. It is evident from investigation procedures in the above cases that developed countries have administrative mechanisms to control, to some extent, the abuse of transfer pricing; nevertheless, multinationals did not spare opportunities to manipulate transfer prices. In less developed countries, where the administrative machinery and mechanism for the control of transfer pricing is less organised, multinational enterprises may have

9. U.S. Treasury Department, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (mimeo), Washington D.C., January 8, 1973.

greater opportunities for transfer price manipulations. The limited number of studies on transfer price manipulations by multinational enterprises in less developed countries briefly discussed in the following section, supports this view.

10.4 EMPIRICAL STUDIES ON TRANSFER PRICE MANIPULATIONS

The available literature on multinational enterprises contains very limited quantitative information on transfer price manipulations. An attempt is made in the present section to assemble the information which is available in order to examine whether or not empirical evidence lends support to the transfer price manipulation hypothesis stated in chapter 7 of the present study.

(a) Vaitsos (1974)[10]

Vaitsos examined transfer pricing policies of multinational enterprises operating in Latin America. His survey of the motives for foreign investment emphasised oligopoly theory and market imperfection. His work provided an insight into the distortions which result from over-pricing of the products imported by multinationals from intra-group sources into host less developed countries.

Vaitsos found that in Colombia, on average, multinational enterprises over-priced imports as follows:[11]

Table 10.1
Over-pricing of Intra-Group Imports in Colombia (1968)

Industry	Estimated Over-pricing (average)
Pharmaceuticals ..	155 per cent
Chemicals ..	25.5 per cent
Rubber ..	40 per cent
Electronics ..	16 to 60 per cent

10. Vaitsos, C.V., Intercountry Income Distribution and Transnational Enterprises, Clarendon Press, Oxford, 1974.
11. Ibid, p.47.

Vaitsos was able to collect data on transfer pricing and on arm's length prices for particular products in 1968. His study mainly used data from Colombia, but with some supporting data from Ecuador, Chile, and Peru.

Overpricing in Vaitsos's study was defined as the difference between the FOB price paid by the purchasing multinational and the average of FOB prices for a particular product quoted in different markets around the world, divided by the latter. It was alleged that transfer price manipulations took place in two ways - exports being under-priced when sales were made by Latin American subsidiaries to their parent firms in the U.S.A., and imports being over-priced when sales were made from the parents to the subsidiaries. Vaitsos reported:[12]

> "Preliminary research in Colombia, still in progress, has given an indication of significant underpricing of exports by foreign subsidiaries to their parents in the timber, fish-processing, and precious metals industries. Similarly, foreign industrialists with an interest in entering the fishing industry in Peru have expressed their preference of breaking even, in their operations in Peru, while making their profits 'in the marketing end abroad'."

Vaitsos argued that the multinational enterprises investigated in his study, apparently used transfer pricing as a mechanism for reporting lower profit performance.[13] He further argued that monopoly profits earned by subsidiaries of multinationals could not be captured by the government since declared profits at the subsidiary level were understated. Vaitsos reported that in Colombia in 1968 declared returns were only 6.7 per cent on the investment of multinationals in the pharmaceutical industry, while he calculated the effective profit rate to be 136.3 per cent. The effective profit rate for the electronic industry was 50 to 80 per cent, whereas a foreign subsidiary in that industry reported a "loss" of 18 per cent in 1967. He also found that in the rubber industry, the effective rate of return on investment

12. Vaitsos (1974), op.cit., p.51.
13. Ibid, p.50.

of the subsidiary was 43 per cent in 1968, whereas the reported profit was 16 per cent. In the words of Vaitsos:[14]

> "...defining as effective returns to the parent corporation the sum of reported profits at the subsidiary, royalty payments, and intermediate products overpricing, and excluding interest payments on interaffiliate loans, the following data can be inferred from our sample representing almost half of the Colombian pharmaceutical industry: reported profits constitute 3.4 per cent of the effective returns, royalties 14 per cent and overpricing 82.6 per cent."

Vaitsos also found the following distortions in transfer prices in other Latin American countries:[15] In Chile, of the 50 products examined, over-pricing on average exceeded 100 per cent; and in Ecuador 6 products had an average over-pricing of about 200 per cent and 7 other products an average of 75 per cent. In Peru, prices of imports of 22 foreign subsidiaries in the pharmaceutical industry indicated over-pricing ranging from 5 per cent to 300 per cent.

The study by Vaitsos is not free from methodological limitations. He did not address the issue of whether it was appropriate to use official or market-determined foreign exchange rates when calculating international costs and prices. Nor did he consider in any detail the complex issues of multinational tax policy and double taxation agreements. The investigation into the transfer pricing issue in Vaitsos's study involved processing vast amounts of data, collected from different parts of the world, to estimate the arm's length prices. With such a vast task, some methodological limitations are likely. Therefore, even if Vaitsos's study suffers from some methodological limitations, his findings seem to lend support to the transfer price manipulation hypothesis.

---

14. Vaitsos (1974), op.cit., p.62.
15. Ibid, pp. 49-50.

(b) Lall (1973)[16]

Lall studied transfer pricing practices in 11 pharmaceutical, 1 rubber, and 2 electrical, subsidiaries in Colombia, for the period 1966-70: 12 were wholly-owned by foreign firms and 2 had foreign majority holdings (51 to 99 percent foreign ownership). Primary data were collected by the Import Control Board and the Planning Office of the Government of Colombia.

Lall found that the weighted average of over-pricing ranged from 33 per cent to over 300 per cent for the imports investigated in the pharmaceutical sector, and from 24 per cent to 81 per cent in the other sectors.

Lall adjusted for the over-pricing of imports of each of the 14 firms in order to estimate rates of return on net worth. The estimated rate of return was substantially higher than the declared rate of return of the 11 pharmaceutical firms. In the other three cases differences were found, but they were not so dramatic.

Lall's findings are summarised in table 10.2. He estimated that subsidiaries of multinationals in the pharmaceutical industry understated their profits, by manipulations of transfer prices (over-pricing of imports), by an average of 58.7 per cent of net worth. If Lall's estimates are not grossly incorrect, his evidence supports the hypothesis that multinational enterprises in a less developed country tend to manipulate transfer prices in order to understate reported profit performance. However, Lall concluded:[17]

> "It is impossible to generalise from a sample of such a small size and with such variability. Clearly, different foreign firms have different attitudes to transfer-pricing as opposed to declaring profits openly. The inducements to use transfer-pricing in Colombia are obvious enough: there are quantitative

16. Lall, S., "Transfer-Pricing by Multinational Manufacturing Firms", Oxford Bulletin of Economics and Statistics, Vol.35, No.3, 1973, pp.173-195.
17. Ibid, pp.187-188.

limits on profit remittances abroad as well as price controls on pharmaceutical and rubber products; duties on imports of intermediate products are quite low, especially in pharmaceuticals (a nominal 1-2 per cent); there is considerable suspicion of foreign enterprises and restriction on their activities; and some of the foreign firms are exceptionally profitable. Colombia seems to have been almost a laboratory case for the exercise of transfer-pricing. Many other less-developed host countries are in a similar situation, but have not started to react to it effectively."

Table 10.2
Extent of Profit Understatement by Transfer Price Manipulations in Colombia (1969-1970)

Industries and Foreign Affiliates	Understated Profit* (Percentage of net worth)
Pharmaceutical	
Firm : 1 ..	79.6
Firm : 2 ..	10.0
Firm : 3 ..	19.6
Firm : 4 ..	19.9
Firm : 5 ..	59.3
Firm : 6 ..	63.9
Firm : 7 ..	8.8
Firm : 8 ..	33.1
Firm : 9 ..	229.8
Firm : 10 ..	89.6
Firm : 11 ..	32.0
Rubber	
Firm : 12 ..	10.2
Electric	
Firm : 13 ..	1.3
Firm : 14 ..	5.9

* Understated Profit = Profits on Over-pricing Total Imports (imputed) as Percentage of Net Worth.

Source: Lall (1973), op.cit.

(c) Kopits (1976)[18]

Kopits attempted to estimate indirectly the extent of transfer price manipulations in intra-group transfers of intangibles in multinationals. He investigated the royalties remitted by manufacturing subsidiaries in different countries to the U.S. parents as payment for the transfer of intangibles (patents, know-how, or trademarks). He formulated a model in which royalties are a function of subsidiary sales, the excess foreign tax credit generated by subsidiary dividends from high-tax host countries, and foreign exchange restrictions. In that study, royalty payments from 14 subsidiaries in host developed countries, and from 9 subsidiaries in host less developed countries, were considered.

Through the use of weighted least-squares regressions on cross-sectional data for 1968, broken down by host country and industry, Kopits found that royalty payments to U.S. parents was on an average higher than arm's length prices, by 33 per cent in case of subsidiaries in developed countries, and by 14.7 per cent in case of the subsidiaries in less developed countries. He found that the larger the excess of the host country's tax rate (income plus dividend withholding taxes) over the home rate, the greater was the firm's propensity to inflate subsidiary royalties (if deductible in the host country) and to reduce dividends. Kopits further found that royalty payments were associated with technological intensity. A possible explanation of the lower royalty payments and lower transfer price manipulations in less developed countries is that multinationals in low-income countries sell goods which embody cheaper and less advanced technology.[19] Another reason may be that in many less developed countries royalty payments for a particular patent or trademark are not allowed beyond a fixed time period (7 or 10 years).[20] However, Kopits's findings

18. Kopits, G.F., "Intra-Firm Royalties Crossing Frontiers and Transfer-Pricing Behavior", Economic Journal, 86, December 1976, pp.791-805.
19. Kopits (1976), ibid, p.796.
20. For details, see: Centre on Transnational Corporations, National Legislation and Regulations Relating to Transnational Corporations, UNO, No. ST/CTC/6, 1978.

indicate that multinational enterprises in less developed countries do manipulate transfer prices of intangibles within the scope allowed.

Although Kopits's estimates of transfer price manipulations can be traced unambiguously to the tax factor, they cannot be checked against actual prices - a shortcoming of the study. However, Kopits contended that his study made some progress in ascertaining the extent of tax-induced transfer pricing practices, but he admitted that more empirical research in this area was needed.

(d) Other Studies:

Other studies have also found empirical evidence of transfer price manipulations by multinational enterprises in less developed countries. These studies are outlined below:

(i) Subrahmanian and Pillai (1976),[21] studying intra-firm trade of firms with multinational connections in the Indian dyestuff industry, observed that about two-thirds of total imports in 1973-74 were from related foreign sources. They found that firms with multinational connections paid substantially higher prices for imports, in comparison to import prices paid by the domestic firms. The extent of over-pricing in firms with multinational connections, in respect of imports of five items, was found to be between 124 per cent and 328 per cent. The study suggested that the firms with multinational connections in the Indian dyestuff industry had a tendency to manipulate transfer prices in order to shift funds from India to foreign related enterprises.

(ii) A study sponsored by UNCTAD and conducted by Lall (1975)[22] found considerable over-pricing of imports by multinational firms in the pharmaceutical industry in Iran.

---

21. Subrahmanian, K.K., and P.M. Pillai, "Implications of Technology Transfer in Export-led Growth Strategy", Economic and Political Weekly (Bombay, India), 30 October 1976, pp.1729-1735.
22. Lall, S., Major Issues in Transfer of Technology to Developing Countries: A Case Study of the Pharmaceutical Industry, UNCTAD, Geneva, No.TD/B/C.6/4, 1975, para 42.

In Iran, in the late 1960s, 38 per cent of the 72 cases examined involved over-pricing of intermediate drug chemicals of up to 199 per cent, another 50 per cent of the cases involved over-pricing of the order of 200 to 999 per cent, and in 6 per cent of the cases over-pricing was higher than 1000 per cent.

(iii) Business Asia (1977)[23] reported that in the philippines, claims have been made that multinational drug corporations were making upto 1000 per cent profit by over-pricing imports from related sources.

(iv) Submissions to the United States Senate hearings,[24] also indicated instances of over-pricing of imports by multinational enterprises in the drug industries in India, Pakistan and Brazil.

(v) UNCTAD (1978)[25] reported that according to an official estimate in Chile, average over-pricing of imports by Pfizer (a pharmaceutical multinational headquartered in the U.S.A.), in 1971, was 214.5 per cent. Table 10.3 shows the extent of

Table 10.3
Extent of Over-pricing by Pfizer Laboratory of Chile on Imported Selected Drugs in 1971.

Product	Extent of Over-pricing
Tiotixene ..	505.40 per cent
Terramicine ..	322.22 per cent
Sigmamicine (capsules) ..	282.22 per cent
Sigmamicine (IM) ..	383.33 per cent
Terramicine, unprocessed ..	45.45 per cent

Source: UNCTAD (1978), op.cit., p.22

23. Business Asia (Hong Kong), Vol. IX, No.4, 28 January 1977, p.27.
24. United States Congress, Senate Sub-Committee, Competitive Problems in the Drug Industry, U.S. Government Printing Office, Washington D.C., pp.73330-31.
25. UNCTAD, Dominant Positions of Market Power of Transnational Corporations: Use of the Transfer Pricing Mechanism, UN Publication No. TD/B/C.2/167, New York, 1978, p.22.

over-pricing by Pfizer in imports of five products from related sources. The extent of over-pricing was estimated in relation to prices of these products quoted on the international market.

(vi) Vernon (1971),[26] in his seminal work on multinational enterprises, pointed out that the transfer pricing practice in the automobile industry was found to be a mechanism for understating profits of foreign assembly plants of U.S. enterprises. Vernon mentioned that plants in the United States that produce components for assembly overseas tended to charge the assembling subsidiary the full wholesale price for "completely knocked down" kits of components. And when any item was deleted from a complete kit before shipment, such as a bumper or a headlight, the price of the kit was generally reduced only by the marginal cost of the deleted item.

The above review of the literature on investigations into transfer price manipulations in less developed countries seeks to show empirically that multinationals manipulate transfer prices, but in different magnitudes in different industries and different countries. The findings of the studies discussed above, seem to lend support to the transfer price manipulation hypothesis. Without such supporting evidence arguments about the potential abuse of transfer pricing by multinational enterprises in less developed countries could simply be dismissed as unfounded or propagandist.

10.5 INTRA-GROUP TRANSACTIONS AND SCOPE FOR TRANSFER PRICE MANIPULATIONS

If a multinational enterprise conducts all its transactions with unrelated enterprises, then there will be no transfer pricing and the question of transfer price manipulation will not arise. In other words, the prerequisite of a transfer price manipulation is the existence of an intra-group

26. Vernon, R., Sovereignty at Bay: The Multinational Spread of U.S. Enterprises, Basic Books, New York, 1971, p.138.

transfer of goods or services between two affiliates of a multinational enterprise. It follows, therefore, that the volume of intra-group transactions of a multinational enterprise does influence the scope for transfer price manipulation. As the prices for intra-group transfers of goods or services are administered by a multinational itself, these may be adjusted to suit the needs of the organisation, and these may be different from open market prices. A discussion on the volume of intra-group transactions in international trade is thus important to an understanding of the possible scale of transfer price manipulations by multinational enterprises. In the context of less developed countries, such a discussion seems even more important.

An attempt is made below to assemble available information on the extent of intra-group transfers of goods in multinational enterprises. Most of the empirical data on intra-group transfers available in the existing literature, are in relation to U.S.-based multinationals. Data for non-U.S. multinationals are relatively scarce.

According to one estimate, about one quarter of all international trade may be identified as intra-group transactions made by multinational enterprises. In 1980, intra-group exports and imports was estimated at $500 billion; about 36 per cent of this being accounted for by U.S.-based multinational enterprises.[27]

The U.S. Department of Commerce (1981)[28], surveying U.S.-based multinational trade with foreign affiliates (affiliates in which U.S. enterprises had 10 per cent or more ownership), found that U.S. parent companies sold $32.4 billion worth of exports to their foreign affiliates in 1977,

27. "Multinationals and World Trade", Multinational Business, (a publication of the Economist Intelligence Unit, London), No.4, 1981, p.16.
28. U.S. Department of Commerce, "1977 Benchmark Survey of US Direct Investment Abroad", Survey of Current Business, April 1981, pp.29-37.

equivalent to 26.7 per cent of that year's total exports from the U.S.A.. During the same year, imports worth 32.6 billion into the U.S.A. came from foreign affiliates to their U.S. parents.

Howenstine (1981)[29] found that during 1977 the affiliates of foreign multinationals operating in the U.S.A. exported goods amounting to $11.3 billion to their parent firms, and these affiliates imported from their parent firms goods amounting to $28.7 billion. Data for 1978 and 1979 on the U.S. affiliates of foreign multinationals reveal that intra-group trade has an important position in the total exports and imports of multinational enterprises (table 10.4).

If it is assumed that the proportion of U.S. exports represented by sales of U.S. parents to their overseas affiliates, and proportion of U.S. imports represented by purchases by U.S. parents from their overseas affiliates, remained unchanged over the period from 1977 to 1979, then intra-group exports from and imports into the U.S.A., 1977 through 1979, may be estimated by combining U.S. multinationals' and U.S. affiliates' intra-group imports into and exports from the United States (table 10.5).

The information contained in tables 10.4 and 10.5, indicate the potential scope for transfer price manipulations in multinational enterprises. As the United States accounted for 12 per cent of total world exports and 14 per cent of total world imports in 1977,[30] the U.S. data give an incomplete picture of the extent of intra-group trade by multinational enterprises. But even with this incomplete picture, it is possible to visualise the extent of intra-group transactions in multinational enterprises.

---

29. Howenstine, N.G., "Selected Data on the Operations of US Affiliates of Foreign Companies, 1978 and 1979", Survey of Current Business, May 1981, pp.35-54.
30. Multinational Business (1981), op.cit., p.21.

Table 10.4
Trade Flows of U.S. Affiliates of Foreign Companies ($ billion; percentage of total U.S. exports or imports in parentheses)

EXPORTS

	Sales to foreign parent	Sales to other foreigners	Total
1977	11.3 (9.3)	12.7 (10.5)	24.0 (19.8)
1978	16.1 (11.2)	15.1 (10.5)	31.2 (21.7)
1979	21.4 (11.8)	21.6 (11.9)	43.0 (23.7)

IMPORTS

	Purchases from Foreign parent	Purchases from other foreigners	Total
1977	28.7 (19.4)	12.7 (8.6)	41.4 (28.0)
1978	36.9 (21.5)	16.8 (9.8)	53.7 (31.2)
1979	42.2 (20.5)	17.1 (8.3)	59.4 (28.8)

Source: Howenstine (1981), op.cit.

Table 10.5
Estimated Intra-Group Exports from and Imports into the U.S.A. as Percentage of Total Exports and Imports

Year	Intra-Group Exports as percentage of total U.S. Exports	Intra-Group Imports as percentage of total U.S. Imports
1977	36.1	41.4
1978	37.9	43.5
1979	38.5	42.5

Source: Calculated from: U.S. Department of Commerce, Survey of Current Business (April 1981, and May 1981); and Howenstine (1981), op.cit.

Note (Table 10.5) : Figures in table 10.5 are most conservative estimates, and are understated to some extent. The intra-group exports and imports as percentages of total U.S. exports and imports respectively, are understated to the extent that exports and imports

of U.S. affiliates of foreign multinationals, sold to and bought from related sources other than the parents (i.e. sister affiliates abroad), are not captured in these estimates. These uncaptured exports and imports in the above estimates are included in sales to and purchases from other foreign companies in table 10.4.

A study by Dunning and Pearce (1981)[31] has provided enterprise level data on the proportion of intralgroup exports in the total exports of the parent companies in the largest industrial firms in the world. Dunning and Pearce considered 866 of the largest industrial firms in the world, and for 523 firms they were able to collect specific ratios relating, for example, overseas production to total group sales. For a smaller sub-sample of 329 firms, they were able to calculate the percentage of total parent company exports which went to affiliated companies abroad. The overall result of this sub-sample of 329 firms (which accounted for 49 per cent of the sales of all 866 firms) was that about one third of parent company exports was sent to affiliates overseas. The results by country are shown in table 10.6.

From the data in table 10.6 it appears that multinationals from different countries have different proportions of intra-group exports. These country differences may be due to sample firms from different countries belonging to different industries, or may be due to multinationals of different countries behaving differently in their intra-group buying and selling activities, or may be both. However, data on the industry-wise distribution of internal export ratios of the sample firms in Dunning and Pearce study, show that the high (except aerospace) and medium research intensity industries engage in more intra-group trade than less research intensity industries.[32]

---

31. Dunning, J.H., and R.D. Pearce, The World's Largest Industrial Enterprises, Gower Publishing Company, Hampshire (England), 1981.
32. Ibid, p.132.

Table 10.6
Internal Export Ratio[a] for the World's Largest Industrial Firms by Country, 1977

Country	Ratio (%)
U.S.A. ..	45.5
Canada ..	39.3
Sweden ..	36.1
Germany (West) ..	34.6
France ..	32.2
U.K. ..	29.6
Japan ..	17.0

a. Internal exports ratio = parent company exports to affiliates as % of total parent company exports.

Source: Dunning and Pearce (1981), op.cit., p.132.

The evidence of intra-group trade, shown above, does not specifically indicate the extent of intra-group exports from and imports into less developed countries. Such information could be of great importance for the present study. But empirical evidence in this respect is virtually absent in the available literature. However, in the present study, it is observed that the proportion of intra-group imports in total imports of the subsidiaries of multinational enterprises in Bangladesh is very high.

Besides international trade in goods, international trade in technology provides multinational enterprises with ample scope for transfer price manipulations. International trade in technology has grown so fast in recent years that it has exceeded by a wide margin the rate of growth of the stock foreign investment in the world. In 1965 payments for international trade in technology was around $2,700 million and it reached over $11,000 million in 1975, a growth of 307 per cent over a decade. The majority of the payments for trade in technology involved intra-group transfers.[33]

33. United Nations, Transnational Corporations in World Development: A Re-Examination, United Nations Economic and Social Council, No. E/C.10/38, New York, 1978, p.70.

The United States, the principal exporter of technology in the world, accounts for a substantial portion of the total intra-group transactions in technology. Chudnovsky (1981)[34] found that the U.S.A. obtained $5.6 billion in 1978 in receipt of royalties, licence fees and management fees: $4.6 billion, or 82 per cent of the net flows were accounted for by intra-group transactions. Chudnovsky found that, in 1978, of the total U.S. receipts for technology exports to Latin American countries and to other less developed countries, 81 per cent and 88 per cent respectively was accounted for by intra-group transactions.[35]

The above discussion seeks to explain that intra-group transfers form the bulk of international transactions of multinational enterprises. It suggests that the extent of intra-group transfers of goods and services provides considerable scope for manipulations of transfer prices - thus an increase in intra-group transactions of multinational enterprises may provide increased scope for transfer price manipulations. This possibility may be even more in case of the multinational enterprises operating in less developed countries, due to the lack of an effective mechanism for controlling transfer price manipulations in these host countries.[36]

10.6 TRANSFER PRICE MANIPULATION : CASE STUDY OF BANGLADESH

In a peripheral economy like Bangladesh, transfer price manipulation may adversely affect the balance of payments position, thereby retarding economic development and giving rise to economic problems. Therefore, the evidence on transfer pricing practice in Bangladesh is especially important for the policy makers of that country. But no empirical evidence exists on the transfer pricing practices of multinationals in Bangladesh; this may be due to the problems of

---

34. Chudnovsky, D., "Pricing of Intra-Firm Technological Transaction", in R. Murray (ed.), Multinationals Beyond the Market: Intra-Firm Trade and the Control of Transfer Pricing, Harvester Press, Brighton (sussex),1981,pp.119-132.
35. Ibid, p.121.
36. For a note on the lack of transfer price control mechanism in less developed countries,see: T.L.Brewer (1982),op.cit.

investigating transfer pricing practices mentioned at the outset of the present chapter. In spite of these many problems, an attempt is made below to present some evidence on the intra-group transfers and transfer pricing practices of the multinational manufacturing enterprises in Bangladesh. Although substantial amounts of data could not be obtained, the limited amount which was collected in Bangladesh provides a useful basis for understanding the transfer pricing practices of the multinationals. Most importantly, the findings from Bangladesh seem to lend support to the hypothesis that multinational enterprises in a less developed country tend to manipulate transfer prices for the purpose of understating reported profits.

To collect data for the present study, field work was undertaken in Bangladesh during the last part of 1980 and ealy 1981. The Finance Directors (or Finance Managers) of all 20 multinationals in Bangladesh,[37] and senior officials in different government departments, were personally interviewed. Although the top finance executives in multinational enterprises were not willing to provide any quantitative information about their transfer pricing practices, their views in this connection gave some important indications as to the possibility of over-pricing of intra-group imports of their firms.[38] It is worth noting that no multinational in Bangladesh exports goods or services; therefore, the question of transfer pricing for their exports did not arise.

The first step in data collection on transfer pricing practices in Bangladesh, was to ascertain the extent of intra-group imports into each of the 20 multinationals under consideration. This required considerable rigorous work in different government departments.

Every importer in Bangladesh needs to obtain an import licence from the Office of the Chief Controller of Imports and Exports. Information on annual imports of each of the

37. There are 20 manufacturing multinationals in Bangladesh.
38. These views are summarised at the end of this section.

firms was collected from this source. Next, an attempt was made to collect information on intra-group imports from documents of the Customs Authority. Almost all the imports of industrial raw materials in Bangladesh are made through Chittagong Port. The Customs Office in Chittagong preserves invoices of all the imports through that port. Access was obtained to these documents, which facilitated an estimate of intra-group imports of each of the firms under consideration. Because of time and resource constraints, only a limited number of invoices of each firm could be examined. For each firm, the invoices for imports during the six months period from July 1979 to December 1979, were selected, and the volume of imports from the parent company and from known related sources were extracted. Known related sources denote those sources of imports other than the parent company that could be identified as members of the multinational group in question. In this process some related sources of imports may have escaped consideration because of problems of identification. Consequently some volume of intra-group imports may not have been included in the estimates of intra-group imports of the multinational enterprises in Bangladesh. Therefore, the findings of the present study as to the extent of intra-group imports of each of the multinationals may have been understated to some extent. However, the Director General of Drug Administration who keeps information on all imports of the pharmaceutical firms in Bangladesh provided valuable information; this information were helpful in adjusting original estimates of intra-group imports of the pharmaceutical multinationals in Bangladesh. Final estimates of intra-group imports are given in table 10.7.

The multinational firms operating in different industries in Bangladesh are highly import-based. The proportion of total imports to total inputs in a year, on average, in 8 multinationals in the pharmaceutical industry is about 78 per cent, in 3 multinationals in the chemicals industry is about 74 per cent, in 7 multinationals in the electric and engineering industry is about 70 per cent, and in two multinationals in the shoes and tobacco industries is about 50 per cent.

Table 10.7

Intra-Group Imports by Multinational Enterprises in Bangladesh (1979 - 1980)

Industries and Firms	Intra-Group Imports as Percentage of Total Purchases	Intra-Group Imports as Percentage of Total Imports
Pharmaceuticals		
Firm : 1	52	69
Firm : 2	46	70
Firm : 3	56	74
Firm : 4	54	72
Firm : 5	58	75
Firm : 6	65	82
Firm : 7	50	67
Firm : 8	57	75
AVERAGE	55	73
Chemicals		
Firm : 9	59	75
Firm : 10	44	63
Firm : 11	45	60
AVERAGE	49	66
Electric and Engineering		
Firm : 12	62	78
Firm : 13	53	69
Firm : 14	39	60
Firm : 15	70	70
Firm : 16	47	65
Firm : 17	33	55
Firm : 18	54	75
AVERAGE	51	67
Others (Shoes and Tobacco)		
Firm : 19	28	55
Firm : 20	27	60
All Firms Average	50	68

Using the estimates of intra-group imports, and combining them with data on total purchases figures in annual accounts and total import figures obtained from the Office of the Chief Controller of Imports and Exports, table 10.7 was constructed.[39] It is evident from table 10.7 that high-import industries had a relatively high proportion of intra-group imports during the year 1979-80. In the pharmaceutical industry, average intra-group imports of the multinationals was 73 per cent of total imports and 55 per cent of total purchases of inputs during a year. Average intra-group imports as a percentage of total imports of the multinationals was 66% in the chemicals industry, 67% in the electric and engineering industry, and 55% to 60% in the shoes and tobacco industries. Average intra-group imports as a percentage of total purchases of inputs of multinationals was 49% in the chemical industry, 51% in the electric and engineering industry, and 27% to 28% in the shoes and tobacco industries.

For all the multinational firms, average intra-group imports was estimated to be 68 per cent of total imports. This high proportion of intra-group imports seems to provide a great scope for transfer price manipulation. The average proportion of intra-group imports in total purchases of all the multinationals was 50 per cent. This gives further indication that multinationals in Bangladesh have scope for distorting reported profits to a considerable extent by manipulation of the transfer prices of the related imports.

The final step in the data collection was to obtain information on the transfer prices and arm's length prices of selected imported items in 1980. Due to the problems involved in collection of information on arm's length prices from the international market, a methodology was devised to find a surrogate of arm's length price for each of the imported items considered. Due to various constraints, only ten items in the pharmaceuticals industry could be considered.

39. The names of the firms are kept anonymous for maintaining the ethics of confidentiality about the study-samples.

These ten items were imported by both multinationals and local firms from different sources in different parts of the world. Information on import prices and sources of imports by each of the importers was provided by the Directorate of Drug Administration in Bangladesh. Pharmaceutical firms are required to submit to the Directorate of Drug Administration detailed information about all imports. If such information is incorrect, the importers have the chance of losing their import licence. Therefore, the source of information on import prices of the ten items under consideration seemed reliable.

The information obtained was analysed as follows: suppose an item was imported by two multinationals from related overseas sources (the related source could be the parent company or an affiliate of the multinational group), and three other firms, perhaps all locals or locals and multinationals, imported the same item from unrelated overseas sources. The average import price per unit of the item in three firms who imported from unrelated sources was considered as an arm's length price of the item. This price was then compared with the average import price per unit of the imports by the multinationals from related sources. An estimate of the over-pricing of intra-group imports (or manipulation of transfer prices) was made as below:

$$= \frac{\text{(Average Import Price from Related Sources)} - \text{(Average Import Price from Unrelated Sources)}}{\text{(Average Import Price from Unrelated Sources)}} \times 100$$

In table 10.8, import prices of the goods means CIF (Cost, Insurance and Freight) prices at the Chittagong port in Bangladesh. Therefore, price variations from different sources might be accounted for to some extent by variations in freight and insurance. But details of import prices and sources of imports given in Appendix - 10 A, shows that in many cases prices of intra-group imports into Bangladesh from relatively nearer countries were considerably higher than the prices of imports from unrelated sources in more distant countries. It would however be prudent to allow for

Table 10.8
Over-pricing of Intra-Group Imports in Bangladesh: Pharmaceutical Industry (1980)

Imported Items of Pharmaceutical Inputs	Average Price per Kg. for Related Source Imports	Average Price per Kg. for Unrelated Source Imports	Over-pricing of Related Source Imports
	(Taka)*	(Taka)*	(In Per Cent)
1) Tetracycline	1,067	444	140
2) Oxy-Tetracycline	1,280	600	113
3) Ampicillin Trihydrate	2,479	1,393	78
4) Streptomycin	1,900	752	153
5) Trimethoprim	9,000	1,243	624
6) Diethyl Carbamazin Citrate	1,680	648	159
7) Gelatine Capsules	80	37	116
8) Sorbitol	19	9	111
9) Lactose Anhydrous	51	19	168
10) Levamisole	4,061	1,081	276

Note: Details of import prices of the items in different firms are given in Appendix - 10 A.

* Taka = Unit of Bangladesh currency.

the possibility of price differentials due to different freight and insurance costs when interpreting the results in table 10.8. From that table it can be calculated that average prices of all the ten items for inputs from related sources was 194 per cent higher than the prices of similar imports from unrelated sources. This evidence of over-pricing suggests transfer price manipulation by multinational enterprises in Bangladesh. Even if some adjustment is made for possible differences in freight and insurance costs, the extent of over-pricing would still be more than 150 per cent. This finding corresponds with the findings of Vaitsos (1974)[40] who found 155 per cent over-pricing of imports of pharmaceutical

40. Vaitsos (1974), op.cit.

inputs by multinational enterprises in Colombia. From the evidence on over-pricing of only ten items in intra-group imports of multinationals in the pharmaceutical industry in Bangladesh, it may not be prudent to make any generalised comment about transfer price manipulations by multinationals in less developed countries. But it adds to the empirical evidence on transfer price manipulations already available from other countries.

From table 10.7, it can be seen that multinationals in the pharmaceutical industry in Bangladesh import about 55 per cent of their total yearly purchases from their related overseas sources. From the evidence in table 10.8, if it is assumed that average over-pricing of imports from related sources in a multinational firm in pharmaceutical industry in Bangladesh is between 100 and 150 per cent, then it can be appreciated how much funds can be shifted out of the country via transfer pricing. This process of shifting funds out of the country could contribute to the understatement of profits of the multinationals in Bangladesh.

During the field work for the present study, an attempt was made to gather personal views of the top finance executives of multinationals in Bangladesh, on the transfer pricing issue. When asked questions about possible manipulations in the transfer pricing of imports, the personal interviews of the finance executives reflected mixed reactions. These reactions may be summarised as follows:

1) The views of some of the finance executives were of this kind: "We believe the intra-group suppliers of our imports over-price products in comparison with prices prevailing in the international market, but we do not have any say in this matter. It is forbidden in our company to challenge the transfer prices charged either by the parent company or by any other related supplier abroad. We have to carry out orders from the Managing Director; may be he is under pressure from the parent company. When deciding about any particular import, if the parent company or any of our foreign related sources can supply it, we have to import it from that source irrespective of the price charged for such import. We have to keep quiet about transfer prices, in order to save our jobs."

2) Some of the interviewees put forward their views in the following way: "The products of our plant in Bangladesh, are the results of huge research and development expenses in our parent company. Therefore, we are under obligations to buy our inputs from the parent company and/or from other related foreign suppliers.[41] We believe our related foreign suppliers do not charge more than the cost of production. If the transfer prices appear to be higher than open market prices, then that must be due to the fact that research and development expenses in our parent company are very high. If our related suppliers try to recover high research and development expenses through transfer pricing, there is nothing illegal about it, and it cannot be called manipulation."

3) The Finance Manager of an affiliate of a U.S.-based multinational pharmaceutical company said, "We are aware of the fact that transfer prices for our internal imports are higher than the international market prices; but we have no objection to this. Because we are here to enable our parent company to maximise overall profits of the company - the transfer pricing mechanism is one of the ways of attaining maximum global profits. So long as our parent company is happy, we are happy, because it ensures our job security."

4) About half of the twenty interviewees flatly denied the allegation that intra-group imports are over-priced. These finance executives said, "We believe that the suppliers of our intra-group imports do not charge us more than the prices prevailing in the international market; the question of transfer price manipulation is irrelevant."

The above statements by the finance executives of multinational enterprises in Bangladesh, although not giving any empirical evidence on the transfer pricing issue, nevertheless provide some personal views of corporate management as to the possibility of transfer price manipulations. The views of the finance executives who refuted the allegation of transfer price manipulation do not necessarily provide any evidence that transfer price manipulation does not take place, since one would not normally expect the management of multinationals to be forthcoming on this issue. The personal views of those finance executives who indicated that over-pricing of

---

41. There may not be contractual obligations in all cases. Perhaps, in many cases, obligations arise from the need to satisfy the parent company in order to ensure job security of the subsidiary management.

intra-group imports happens in practice appear to be compatible with the empirical evidence on transfer price manipulations in pharmaceutical multinationals. The indication about possible transfer price manipulation, given by the statements of the finance executives of about half of the total multinationals in Bangladesh, combined with the available empirical evidence seems to lend support to the transfer price manipulation hypothesis.

10.7 CONCLUSION

In the present chapter, some empirical evidence from available studies on transfer price manipulations have been assembled. The findings of the Bangladesh case study have provided some additional information on the transfer pricing practices of multinational enterprises operating in less developed countries. Empirical examination of the transfer price manipulation hypothesis, in the present chapter, seems to lend support to the hypothesis that multinational enterprises in less developed countries tend to shift profits outside the host countries by transfer price manipulations, and this contributes to the understatement of their profits in these countries.

Although it has been said above that multinational enterprises in less developed countries seem to practise transfer price manipulation, further empirical studies covering many less developed countries and involving substantial numbers of samples need to be undertaken, in order to come to any generalised conclusion about this issue. However, based on the empirical evidence discussed in this chapter, it does not seem unreasonable to suggest that multinational enterprises in less developed countries have the ability to distort reported profit performances by use of the transfer pricing mechanism. Perhaps it is only in recent years that the use of transfer price manipulations has become increasingly evident. This may be why the U.N. General Assembly in 1978 decided to convene, under the auspices of UNCTAD,

a United Nations Conference on Restrictive Business Practices to negotiate a set of principles and rules for the control of restrictive business practices having adverse effects on international trade, particularly that of less developed countries, and the economic development of these countries. The Conference met in November/December 1979 and in subsequent meetings in following years, attempts have been made to recommend principles, particularly to control "pricing policies in transactions between affiliated enterprises which over-charge or under-charge for products or services purchased or supplied as compared with prices for similar or comparable transactions."[42]

42. Greenhill, C.R., and E.O. Herbolzheimer, "International Transfer Pricing: The Restrictive Business Practices Approach", Journal of World Trade Law, Vol.14, No.3, May/June 1980, pp.232-241.

CHAPTER ELEVEN

Accounting Standards and Multinational Enterprises in Less Developed Countries

11.1 INTRODUCTION

The preceding chapters make it clear that multinational enterprises are significant economic entities in less developed countries. An important requirement of a less developed country in its dealings with multinational enterprises is a knowledge of their overall characteristics and performance. This knowledge is a prerequisite for evaluating alternative investment proposals, and is essential for monitoring the overall operations of multinationals once they are established in the host country. A thorough analysis of the operations of multinational enterprises and their economic impact in the host country is, however, hampered by the lack of usuable information on many aspects of their activities. Although published accounting reports provide an important source of information about multinational enterprises, inadequate disclosure of information restricts the efficacy of performance evaluation. This problem is deepened by the lack of accounting standards and disclosure requirements in many less developed countries.

From the above perspective, the present chapter attempts to address accounting standard setting issues in less developed countries. The term "accounting standard" may be used in a variety of ways but here it is used broadly to mean a set of policies on accounting treatment and information disclosure to be followed by multinationals in their published accounting reports in host countries. The assumption is that operationalisation of accounting standards for multinational enterprises would help meaningful interpretation of their published accounting reports and would also make financial statements of different multinationals reasonably comparable one with another. It is further assumed that compliance with such

accounting standards would ultimately help policy makers in a less developed country in their attempts to take different policy decisions concerning multinational enterprises.

During the 1970s, much effort was devoted to setting accounting standards for multinational enterprises on an international level. Various organisations have published or are preparing pronouncements aimed at a greater standardisation of accounting practices of multinational enterprises throughout the world. These include the United Nations Commission on Transnational Corporations (UN), the Organisation for Economic Cooperation and Development (OECD), the European Economic Community (EEC), and the International Accounting Standards Committee (IASC). These international initiatives for standardisation of accounting practices have basically addressed the problem with a view to harmonisation of accounting practices in different business enterprises in different countries. The UN proposals[1] on more extensive disclosure by large multinationals is directed toward a wide range of users but appears to be influenced nevertheless by the information needs of individual home and host countries, particularly of host less developed countries. The OECD guidelines[2], in contrast to the UN proposals (which cover individual subsidiary as well as group accounts), are limited to group accounts and incorporate disclosure requirements which are more general in nature. The IASC standards and the EEC directives are concerned with international harmonisation of accounting and reporting, rather than introduction of specific accounting standards for multinational enterprises. However, the present study is concerned with accounting standards for multinational enterprises from the host country perspective. Assuming the presence of accounting standards

1. Centre on Transnational Corporations, International Standards of Accounting and Reporting for Transnational Corporations, United Nations, New York, 1977.
2. Organisation for Economic Cooperation and Development, International Investment and Multinational Enterprises, OECD, Paris, 1976, revised 1979.

in developed countries, and their deficiency in many less developed countries, the present study considers only the host less developed countries. The study starts with a general discussion on standard setting.

11.2 USERS NEEDS AND ACCOUNTING STANDARDS

In the accounting literature, there seems to be little controversy about the fact that any attempt at accounting standard setting should be preceded by a clear identification of the needs of the external users of accounting reports. Of the potential users of accounting reports, existing and potential investors, creditors, government, trade union organisations, and interested members of the public are often considered as the main user groups.[3] The different users are likely to need different accounting information from the corporate accounts. But the provision of sufficient information in corporate accounting reports to satisfy the needs of all user groups may involve huge information production costs which enterprises may be unable or unwilling to bear. Also the needs of different user groups may conflict. This possibility may have induced some accounting researchers and certain policy makers to advocate "general purpose" accounting reports - i.e. reports that are designed to serve the information needs of the dominant user group (normally assumed to be the corporate investors), while simultaneously serving reasonably well the information needs of other users.[4] Many proposed accounting methods appear to be aimed at helping the decision making of the corporate investors.[5] But in the real world,

3. Carsberg, B., A. Hope, and R.W. Scapens, "The Objective of Published Accounting Reports", Accounting and Business Research, Summer 1974, pp.162-173.
4. Carsberg, B., J. Arnold, and A. Hope, "Predictive Value: A Criterion for Choice of Accounting Methods", in W.T. Baxter and S. Davidson (eds.), Studies in Accounting, Institute of Chartered Accountants in England and Wales, London, 1977, pp.403-423.
5. For example, see: Carsberg et al. (1977), ibid; J. Arnold and A. Hope, "Reporting Business Performance", Accounting and Business Research, Spring 1975, pp.96-105; and L. Revsine, Replacement Cost Accounting, Prentice Hall, New Jersey, 1973.

the use and users of financial statements go well beyond the confines of the securities market.[6]

There are various alternative assumptions which may be made within the normal scope of financial accounting about the identity of user groups and the nature of their information needs. On the basis of the findings of an empirical study by Carsberg, Hope, and Scapens (1974)[7], the potential user groups of accounting reports may be listed as below:

(1) Shareholders - to be informed of the state of affairs of their investments, and of the potential future earnings.
(2) Potential Investors - to be informed of the financial status of the enterprise in order to examine whether or not investment in the enterprise in question would be 'worthwhile'.
(3) Creditors (existing and potential) - to be informed of the creditworthiness of the enterprise.
(4) Trade Union Organisations - to be informed of the financial ability of the enterprise to increase employee benefits such as increased wages, bonuses, etc.; and to assess whether or not the employees are being exploited by the owners of the enterprise.
(5) Interested Members of the Public or Representatives of Society - to gather information to judge whether activities of the enterprise are consistent with national objectives.
(6) Government - to assess taxable income; to enforce statutory controls such as price control, import restrictions, protection for specified industries, foreign exchange control, etc.; and to guide public policy decisions regarding the corporate sector of the economy.

In the context of the corporate ownership structure and general economic system in developed market economies, identification of corporate investors as the dominant user group may not be far from reality. But in the context of

6. Accounting Standards Committee, Setting Accounting Standards, Report and Recommendations by the Accounting Standards Committee, London, January 1981, p.4.
7. Carsberg, Hope, and Scapens (1974), op.cit.

less developed countries where stock market activities are limited due to the nature of corporate ownership structure, and where the countries' policy makers need to monitor and control the activities of business enterprises in order to devise and implement various public policies for attaining economic development, government seems to rank first in the list of users of corporate accounting reports. This ranking is predicted from the following analysis of corporate ownership structure and the important role of corporate accounting reports in aiding government actions concerned with economic development, in less developed countries.

CORPORATE SECTOR

The corporate sector in many less developed countries comprises primarily of public enterprises and multinational enterprises. This corporate ownership structure is important in determining the dominant user group of accounting reports in these countries.

(a) Public Enterprises - In the past quarter of a century, the governments of many less developed countries have pinned their hopes for industrial development on public sector enterprises. This has resulted in the emergence of national governments as the major corporate investors in their own countries. Table 11.1 indicates that in the early seventies the contribution of the public sector in the national economies of a number of less developed countries was significant. A natural consequence of a large public sector investment is that private investors are not involved in the investment decisions of a large number of enterprises. In other words, the use of published accounting information in aiding the investment decisions of private investors may not extend similarly to the investment decisions of public sector enterprises.

(b) Multinational Enterprises - The private sector of many less developed countries is dominated by multinational enterprises (i.e. most of the large entities in the private

Table 11.1
The Pattern of Capital Accumulation in Some Less Developed Countries, in early 1970
(Per cent of Gross Fixed Capital Formation (GFCF))

Country	Public Sector	Private Sector	Total GFCF
Bangladesh	87	13	100
Brazil	52	48	100
India	43	57	100
Kenya	38	62	100
Mexico	48	52	100
Nigeria	42	58	100
Peru	43	57	100
Tanzania	44	56	100

Source: FitzGerald, E.V.K., Public Sector Investment Planning for Developing Countries, Macmillan, London, 1978, p.xv.

sector of many less developed countries are multinational enterprises).[8] The wholly owned subsidiaries of multinationals in less developed countries do not offer shares on the stock markets of the host countries. When subsidiaries are not wholly owned, the majority shares are usually held either by the parent company or by a member of the multinational group abroad. Generally only a handful of local entrepreneurs are collaborators with the multinational enterprises. This group of local investors do not appear to engage in frequent transactions of shares on the stock market.[9] Moreover, in a less developed country like Bangladesh, with a dominant public sector, the government holds a significant portion of the local ownership in joint-ventures with multinational enterprises. Thus the insignificant portion of the shares of multinationals that are quoted on the local stock market

8. See: chapter 8 of the present study; and S. Lall and P. Streeten, Transnationals and Developing Countries, Macmillan, London, 1977.
9. This statement is based on information from different literatures on the operations of multinational enterprises in Pakistan and India; experience on corporate ownership pattern in Bangladesh supports this view.

does not provide much scope for continuous decisions as to buying, holding or selling of shares.[10] Under such circumstances, the role of accounting reports in investment decisions seems to be limited.

ECONOMIC DEVELOPMENT NEEDS

The governments of less developed countries often intervene more directly in their economies than do governments of most developed nations. These countries often have explicit, carefully directed programs of government activity, usually with the dual purpose of increasing economic development and promoting economic stability.[11] The economic development programs of a government need to be based on well informed decision making. Government needs information on the factors of production, and capital markets; about alternative economic activities; about the efficiency of different economic units; and about the costs and benefits of its own programs as well as about many other factors. An important part of the government's information input is available from standardised corporate accounting reports.[12] In fact, corporate accounting reports constitute the single most important source of information about the economic activity of a nation.[13] The contribution which accounting reports can make to economic development programs of governments in less developed countries have been summarised by Scott (1970)[14] as follows:

> "Accounting information from private companies is needed by development oriented governments for two broad purposes, both of which are extremely important for economic development. The first purpose is to provide an

---

10. This statement is based on the findings of the present Bangladesh study, see: Appendix - 8A.
11. Baldwin, R.E., Economic Development and Growth, John Wiley & Sons, New York, 1966, pp.80-81.
12. Enthoven, A.J.H., "Standardized Accountancy and Economic Development", Finance and Development, Vol. 10, No.1, March 1973, pp.28-31.
13. Morgenstern, O., On the Accuracy of Economic Observations, Princeton University Press, Princeton, 1963, p.70.
14. Scott, G.M., Accounting and Economic Development, Graduate School of Business Administration, University of Washington, Seattle, 1970, pp.30-31.

> equitable basis for taxation and at the same time ensure governments enough revenues to effectively prosecute their development programs. . . .
>
> The second broad purpose to be considered here is to provide governments with information to assist in controlling the direction and stability of their economies, and also for controlling and assisting the various elements within the economies so that all are working harmoniously and effectively toward common goals. This may be stated in more detail as the need, by government, for company accounting information for
>
> (1) controlling and regulating private enterprises;
> (2) controlling economic cycles;
> (3) deciding the need for infrastructure expenditures and for government enterprises;
> (4) reporting of national income and other economic data;
> (5) aggregating and disseminating business information to the general public and business communities (perhaps even contrary to the desires of firms from which the information was collected): and
> (6) measuring opportunity losses from idle capacity in the economies."

It follows, therefore, that corporate accounting reports in a less developed country can play a significant role in measuring economic activities, and in the design of development plans and policies. However, the credibility of corporate accounting reports in providing information towards the economic development needs of the government depends to a great extent on the degree of uniformity in the treatment of accounting events, and on adequate disclosures in accounting reports. Briefly, the need for standardisation of corporate accounting practice is well recognised; the benefits are sounder economic and fiscal policies, and better planning and control.

From the discussion in the present section it appears that, of the major users of accounting reports in a less developed country the government is very important. Therefore, in any accounting standard setting effort in a less developed country, national policy considerations need to assume paramount importance. In other words, in identifying

accounting objectives, macro economic objectives should dominate over the micro objectives. An example of the dominance of macro objectives over the micro objectives may be found in the French Plan Comptable.[15] Accounting standards in France are directed mainly towards satisfying national economic needs. Knowledge of the macro accounting objectives stated in the French Plan Comptable, may be helpful in identifying accounting objectives and in developing accounting standards in less developed countries. The stated objectives of the French Plan Comptable are to:

(1) promote more reliable national economic and fiscal policies;
(2) assist in eliminating fiscal inequalities;
(3) minimise social misunderstandings by informing the public of the true distribution of national wealth;
(4) provide data for the study of market trends;
(5) improve healthy competition;
(6) aid in the development of more equitable taxation;
(7) provide shareholders, suppliers, and bankers with an opportunity to exercise their judgement more satisfactorily;
(8) provide clear and prompt view of financial results; and
(9) permit analysis and comparison of manufacturing costs.

On the basis of the above discussion it can be argued that a greater degree of standardisation in corporate accounting would be of particular benefit to the less developed economies. Such standardisation should be compatible with the information needs for macro economic development. Because of limited natural, financial, and skilled human resources in less developed countries, governments in these countries may involve themselves, through planning and control systems,

15. AICPA, Professional Accounting in 25 Countries, AICPA, New York, 1964, chapter 12.

in all socioeconomic activities. Standardised corporate accounting reports can be of much help to governments in attaining their goals of economic development.

11.3 ACCOUNTING STANDARDS FOR MULTINATIONALS

The previous discussion suggests that the information needs of the dominant user of accounting reports in a less developed country, i.e. the information needs of government, may be fulfilled to a reasonable extent if accounting numbers convey undistorted information on the performance of the enterprises operating in the economy. If multinational enterprises do not engage in intra-group transfers of goods and services, it can be expected that a uniform set of standard accounting policies for all enterprises in the economy would be helpful in providing standard corporate information and thus contribute to the requirements of the user group(s). Such a circumstance would make a case for setting similar accounting standards for both the local and multinational enterprises in less developed countries. But in the real world, multinational enterprises frequently engage in intra-group transactions and this gives rise to the possibility of transfer price manipulations with their attendant effect on the accounting reports.[16] This makes comparability with the accounting reports of local enterprises a difficult target. This indicates that particular accounting standards may be necessary for multinationals, in order to minimise the possibility of performance distortion through transfer price manipulation.

The present study found that there is considerable diversity in the use of accounting policies between multinational and local enterprises in Bangladesh.[17] The users of Bangladeshi accounting reports who attempt to assess the relative performance of industrial enterprises in the economy, or to compare performance between multinational and local

16. See: chapter 7 and chapter 10 of the present study.
17. See: chapter 9 of the present study.

enterprises in the economy, are likely to face problems due to the lack of uniformity in the accounting policies used by different enterprises. There seems to be a need for uniform standards of accounting policies in all enterprises operating in the economy. This suggests that uniform accounting allocation and measurement rules ought to be prescribed for both local and multinational enterprises. This would enhance comparability of the financial statements of both types of enterprises. In addition, multinational enterprises may be required to comply with some additional disclosure requirements regarding intra-group transactions.

INFORMATION ON INTRA-GROUP TRANSACTIONS

Intra-group transactions frequently account for a substantial proportion of the total transactions of a multinational enterprise. Potential abuse of the transfer pricing mechanism calls for ways and means to control such manipulation. Unless transfer price manipulation can be checked, the accounting reports of multinational enterprises could be distorted, thereby distorting their performance. As discussed elsewhere, it is very difficult and some times impossible to control transfer price manipulation. Still, attempts need to be made by a host country government to monitor and control such manipulations. One such attempt might be to require multinational enterprises to furnish certain information in corporate reports on intra-group transactions. The possibility of detection of transfer price manipulation, from the information on intra-group transactions in corporate reports, may impose some transfer pricing restraints on multinationals.

The following disclosure requirements (expressed in local currency) may be included in any accounting standards for multinational enterprises in a less developed host country. Compliance with these dislosure requirements in the preparation of corporate accounting reports by multinationals, may be expected to make the financial statements more meaningful and usable.

Information Disclosure Requirements

(a) Exports of goods.
(b) Exports of goods to related parties (intra-group).
(c) Exports of services.
(d) Exports of services to related parties.
(e) Imports of goods.
(f) Imports of goods from related parties.
(g) Royalty payments and the criterion of calculating royalty charges.
(h) Management fees and other overhead charges payable to the parent company or to any other related firm(s) overseas, and the basis of calculating overhead charges by the subsidiary.
(i) Interest payable on foreign loans from unrelated sources.
(j) Interest payable on foreign loans from related sources.
(k) Interest receivable on foreign loans extended to unrelated parties.
(l) Interest receivable on foreign loans extended to related parties.
(m) Foreign loans received from unrelated sources, rates of interests and terms of payment.
(n) Foreign loans received from related sources, rates of interests and terms of payment.
(o) Foreign loans extended to unrelated parties, rates of interests and terms of payment.
(p) Foreign loans extended to related parties, rates of interests and terms of payment.
(q) New inward foreign direct investment.
(r) New outward foreign direct investment.
(s) Dividends payable abroad.
(t) Dividends receivable from abroad.

In addition to the above information, a multinational enterprise might be required to furnish information about the method of fixing transfer prices of intra-group imports and exports.

Multinational enterprises in a host country will no doubt possess all the information listed above. Therefore, they can furnish all such additional information without any significant additional costs. It should be mentioned at this point that multinational enterprises normally prepare two sets of accounts - one set is published for external users in the host country and the other set is for the information needs of the parent company.[18] Detailed accounting is compiled for the preparation of the accounting reports to be sent to the parent company. This accounting information could be used by the multinational to comply with the additional information disclosure requirements, at an insignificant additional information production cost.

11.4 WHO SHOULD SET ACCOUNTING STANDARDS

Accounting standards for multinational enterprises in a host less developed country can be effectively implemented, if these are prepared by the government and are imposed on the multinationals through legislation. But in practice, there may be problems in doing so. Such problems arise mainly from the world-wide economic power of the multinationals that operate in less developed countries. For example, some (or all) of the following events may occur:

(a) The economically powerful multinational enterprises operating in a host less developed country may jointly move to influence the government to refrain from setting such standards that could affect their interests.

(b) The multinationals in a host less developed country have the financial ability to hire pressure groups in the country to join with them in moves to combat government initiatives towards setting strict accounting standards and disclosure requirements.

(c) Many less developed countries receive aid from international organisations like the World Bank, IMF,

---

18. See: chapter 9 of the present study.

OECD, etc.. Multinational enterprises originating from developed market economies may attempt to exert pressure on sympathisers holding top positions in those organisations, and so put pressure on the government of a host less developed country not to set accounting standards detrimental to the interests of these enterprises.

(d) In recent years, many less developed countries have been trying to attract multinational investments in their countries by offering various forms of incentives. These countries believe that multinational investments will help in the process of industrial developments. Under such circumstances, a host less developed country may not find it beneficial to set such accounting standards that might make multinational enterprises disinterested in investing in that country.

In addition to the above hurdles the lack of adequate administrative machinery to set and operationalise appropriate accounting standards may impede the standard setting process. The last, but not the least, problem of accounting standard setting in these countries seems to be the absence of a well organised and well developed accounting profession. This may be the most important reason for the lack of accounting standards in many less developed countries.

To overcome the problems mentioned above, it seems that a political approach is inevitable. In the United States, "a political solution in the creation of the SEC was seen as the only way of achieving harmonization at an acceptable level of disclosure."[19] In a less developed country, politically conscious individuals may start a campaign through the media and various other channels to create pressure on the

19. Gray, S.J., J.C. Shaw, and L.B. McSweeney, "Accounting Standards and Multinational Corporations", Journal of International Business Studies, Spring/Summer 1981,p.130.

government for setting up a national body responsible for accounting standard setting. This national body may consist of representatives from government, the accounting profession, academics, political personalities, chambers of commerce and industry, and other interested members of public. Such a national body may begin to initiate debates at a national level about different accounting issues. In this way a continuous process of accounting standard setting may emerge, which may amount to a built-in control system restricting the government from giving in to pressures from national and international interest-groups against accounting standards.

The above efforts may be supplemented by such international efforts as those of the UN and IASC. The UN guidelines on accounting standards for multinationals can be used as the starting point in any standard setting effort in a less developed country. If most of the less developed countries do the same, the possibility of international harmonisation would be greater than at present. The UN guidelines on minimum disclosure requirements in a host country can be used by the government of a less developed country as a basis for arguments against any pressure groups who might try to foil any initiative on accounting standardisation for multinational enterprises. The IASC, instead of prescribing standards from the top, can work as a consultant and guide in standard setting at the national level in less developed countries. As individual country standards would be formulated under the guidance and under the broad framework of IASC, an important step would be taken towards the international harmonisation of accounting practices. This proposed function of the IASC could perhaps help alleviate the major problems that are currently faced in gaining acceptance for IASC standards in different countries. Some of these problems, perhaps equally applicable for both developed and less developed countries, have been pointed out by Sir Henry Benson, former President of the Institute of Chartered Accountants in England and Wales, as follows:[20]

---

20. Benson, Sir H., "The Story of International Accounting Standards", Accountancy, July 1976, pp.34-39.

> "Some of the members of the IASC have not arranged compliance with the new Standards by their individual members sufficiently firm, and sometimes not at all... There are various reasons for this. Some countries take the view that they cannot require compliance locally until they are satisfied that the Standards are internationally acceptable. Some see local legislation as an obstacle to the introduction of international Standards. Some accounting bodies do not have the power to discipline over their members, and cannot therefore impose compliance with either national or international Standards. Some countries have not yet overcome stubborn local resistance from the business community. But all these impediments must be broken down, and there should be no delay in starting this process."

11.5 CONCLUSION

It has been argued in the present chapter that any effort at setting standards for accounting practices should be based on the information needs of users in the country concerned. Therefore, accounting standards deemed suitable in developed countries may not be useful or appropriate in less developed countries. As many of the less developed countries have deficiencies in respect of standardised accounting practices, further empirical research is necessary to identify user needs and appropriate accounting standards for these countries. However, the present chapter has identified government as the dominant user group and macro economic information needs as the important accounting objective in less developed countries.

Although various international efforts (UN, OECD, etc.) have been made at prescribing accounting standards or accounting disclosure requirements for multinational enterprises, all these efforts do not seem compatible with the user needs in less developed countries. Excepting that of the UN, other efforts do not cover the less developed host countries. The international efforts are in the form of "guidelines" as opposed to "requirements". "Mechanisms for reviewing and enforcing compliance (with accounting standards) can operate only at the national level - applicable to corporations

within the jurisdiction of national states and exercised by local regulatory, legislative, and judicial agencies."[21] It has been proposed in the present chapter that a political process of accounting standard setting can help development of accounting standards and disclosure requirements in a less developed country.

The main problem faced by less developed countries in handling multinational enterprises, seems to be the potential distortion of corporate performance through transfer price manipulation. The principal objective of setting accounting standards for multinationals need to be to devise such disclosure requirements that can help to develop a mechanism for controlling transfer price manipulation. In this regard, some potential disclosure requirements have been mentioned in the present chapter. Further research in this area can help to prepare a list of disclosure requirements; the UN Centre on Transnational Corporations can play an important role in this respect.

---

21. Gray, Shaw, and McSweeney (1981), op.cit., p.130.

CHAPTER TWELVE

Conclusions

12.1 GENERAL REMARKS PERTAINING TO THE HYPOTHESES

This study is essentially an exploratory survey aimed at locating the loopholes through which multinational enterprises might distort their reported profit performances in less developed countries. Concepts of market imperfection (for example, those relating to oligopolistic behaviour), together with such dynamic features as international plant diversification leading to risk-diversification, were used to hypothesise that multinationals in less developed countries would have the ability to earn superior profits to those of their local counterparts. But the empirical evidence suggests that reported profit rates of multinationals and of local firms in less developed countries are not significantly different. This led to an investigation of potential accounting manipulation by multinationals.

Hypothesis One stated that multinational enterprises in less developed countries might choose such accounting policies as would understate declared profits. The findings of this research, based on the empirical evidence from Bangladesh, does not lend support to this hypothesis. However, multinationals and local firms in Bangladesh appeared to use dissimilar accounting policies. This latter finding suggests the need for standardisation of accounting policies in less developed countries like Bangladesh. This suggestion has been used in chapter 11 of this study to recommend the need for accounting standards for multinational enterprises in less developed countries.

Hypothesis Two stated that multinational enterprises in less developed countries might manipulate transfer prices to understate declared profits. The findings of available studies and of the present Bangladesh case study lend support to this

hypothesis. It follows therefore that the transfer price manipulation issue poses crucial problems for the measurement of performance of multinationals on the basis of published accounting reports. From the analysis in the present study, it would seem that most of the criticisms found in the literature against the operations of multinational enterprises in less developed countries are strongly associated with the manipulation of transfer prices. Because transfer price manipulation provides ample opportunities to a multinational enterprise to understate reported profit performance in a host country, it has been suggested that accounting standard setting efforts in less developed countries should be particularly concerned with devising such standards so that restraints on transfer price manipulation can be imposed (chapter 11).

The problem of inadequate data has been repeatedly evident throughout this study. While this lack would seem to operate as an obstacle to in-depth analyses of the loopholes of accounting reports prepared by multinationals in host less developed countries, the available data do seem to provide a reasonable basis for a general and exploratory treatment of the subject matter, such as the one attempted in the present study. However, more rigorous empirical research is necessary to shed more light on the problems of measuring performance of multinational enterprises in less developed countries.

12.1 POLICY RECOMMENDATIONS

The major implication of the present study pertains to the finding of "transfer price manipulation hypothesis". Although several studies earlier found transfer price manipulation by multinational enterprises operating in less developed countries, the present study researched the issue from an accountant's view point. And the finding in this regard has been incorporated in an argument for additional disclosure requirements in published accounting reports of multinational enterprises in less developed countries (chapter 11).

The present study found considerations relating to the public policies under which multinational enterprises operate in less developed countries to be of relevance. This was so because public policies regarding the control of operations of multinational enterprises were found to be inadequate in many less developed countries, and in Bangladesh in particular. This is mainly because the governments of these countries consider multinational enterprises as the vehicle for industrial development, and thus think that control measures against multinationals would create disincentives for potential multinational investors. From the experience of the motivations for foreign investments by multinational enterprises, analysed in chapter 3 of the present study, it appears that these enterprises are searching for new markets throughout the world; if one multinational delays in penetrating a potential market another competing multinational will come forward to capture that market. Under such circumstances, appropriate public policies controlling the operations of multinationals may not matter much in terms of incentives or disincentives for the potential multinational investors, "Because they have adapted to the world as it is", opined Karl Mayer, Business Planning Director of ITT.[1] Mayer went on to say, "If the legislators don't like the results, they may change the ground rules. Well-managed multinationals will simply adapt to the new ground rules and continue to do a good job of reallocating resources in a new optimum manner." However, further research in this regard may help to find out whether or not control measures do restrict entry of multinationals into less developed countries. For the time being, hypothesising that strict public policies to control operations of multinationals would not seriously affect the investment climate for multinationals in less developed countries, it can be argued that adequate and effective control mechanisms are essential for making multinational investments beneficial to the economic development of the host less developed countries.

---

1. Dun's Review, July 1976, p.56.

In the context of a less developed host country, the control measures for multinational enterprises need immediate and careful consideration. For example, most of the developed countries have imposed legal controls on the transfer pricing practice of multinational enterprises.[2] The less developed countries are lagging far behind in this respect. As mentioned elsewhere, less developed countries have many constraints on formulating and operationalising controls on transfer price manipulation. It can be argued however that the following measures may be an important step towards the ultimate goal of controlling transfer price manipulation by multinationals in less developed countries.

(1) Appropriate training of officials in relevant government departments such that they are equipped with adequate knowledge to deal with transfer pricing issues.
(2) Specific legislation empowering the taxation authority to investigate potential transfer price manipulation and to reallocate the income of multinational enterprises.
(3) Government policy towards establishing greater cooperation between customs authorities, taxation authorities, and exchange control authorities in a host country, to operationalise a continuous process of investigating transfer price manipulation in every case of intra-group imports of multinationals.
(4) Entering into agreements with appropriate government departments of the home countries of the multinationals (developed countries) to arrange to receive information on the market prices of intra-group imports of multinationals.

---

2. Section 482 of the U.S. Internal Revenue Code authorises Internal Revenue Service to allocate income or expenses among related companies when it is necessary to prevent tax evasion or to reflect clearly the income of each company. Many other countries, including Canada, France, Italy, and Britain have legislation resembling Section 482. For a description of how the British government investigate transfer pricing practices of multinationals, see: "U.K. Tax Authorities Zero in on Multinationals", Business Europe, 18 June 1976.

(5) Making all multinationals submit detailed information on all of their imports to the Ministry of Industries or to any specified government department. Such information should include, among other things, the source of import of each particular item, import price per unit of measure of each particular item, total import of each of the items in each consignment, etc.. If a similar item is imported by different firms at different prices, a case for investigating possible price manipulation may be started.

(6) In the extreme case, to create a "transfer price task force" to deal with transfer pricing issues.

The above list is not exhaustive. Further research is required to identify plicy measures suitable for particular less developed countries.

12.3 DIRECTION FOR FURTHER RESEARCH

Given the world-wide activities of multinational enterprises, further research is necessary to identify the actions that can be taken at national and international levels to minimise special disadvantages that accrue to less developed countries as a result of the present legal and institutional framework governing the activities of multinational enterprises in the area of accounting disclosures and transfer pricing practices.

Appendix - 8 A
Multinational Enterprises in Bangladesh (As of End 1979)

Name of the Company and Year of Establishment	Parent Company	Share in Equity In %		
		Foreign	Local (Govt.)	Local (Private)
1	2	3	4	5
1 Squibb of Bangladesh Ltd. (1966)	E.R. Squibb & Sons Inc. (USA)	70.00	30.00	-
2 ICI Bangladesh Manufacturers Ltd. (1968)	ICI Limited (UK)	70.00	28.88	1.12
3 Hoechst Pharmaceuticals Co. Ltd. (1968)	Hoechst A.G. (W.Germany)	52.00	48.00	-
4 Pfizer Laboratories (BD) Ltd. (1968)	Pfizer Inc. (USA)	76.33	18.26	5.41
5 Organon (BD) Ltd. (1965)	AKZO Pharma BV (Holland)	60.00	25.00	15.00
6 Bangladesh Pharmaceutical Industr. (1962)	May & Baker (UK)	60.00	40.00	-
7 Glaxo Bangladesh Limited (1967)	Glaxo Holding Limited (UK)	69.52	0.19	30.29
8 Fisons (BD) Ltd. (1966)	Fisons Limited (UK)	49.00	51.00	-
9 Lever Brothers (BD) Ltd. (1961)	Unilever Ltd. (UK)	60.75	39.25	-
10 Robinsons Bangladesh Ltd. (1961)	Reckitt & Colman Limited (UK)	56.00	36.00	8.00
11 Berger Paints (BD) Ltd. (1970)	Berger, Jenson & Nicholson Ltd. (UK)	57.67	42.33	-
12 Bangladesh Lamps Ltd. (1961)	NV Philips (Holland)	60.00	40.00	-

Continued .....

Appendix - 8A

Continuation: Multinational Enterprises in Bangladesh

Name of the Company and Year of Establishment	Parent Company	Share in Equity in %		
		Foreign	Local (Govt.)	Local (Private)
13 Bangladesh Electrical Indust. Ltd. (1959)	NV Philips (Holland)	60.00	40.00	-
14 GEC Manufacturing Ltd. (1948)	GEC Limited (UK)	60.00	40.00	-
15 Asbestos Cement Indust. (BD) Ltd. (1965)	Eteroute Mer S.A. (Belgium)	40.00	60.00	-
16 Bangladesh Oxygen Limited (1973)	BOC International Limited (UK)	60.00	39.49	0.51
17 KSB Pumps Co. (BD) Ltd. (1961)	Canadian Kay-Pump Limited (Canada)	76.00	24.00	-
18 Singer Sewing Machine Co. (1961)	Singer Sewing Machine Co. (USA)	100.00	-	-
19 Bata Shoe Company (BD) Ltd. (1962)	Bata Industries Ltd. (Canada)	100.00	-	-
20 Bangladesh Tobacco Company (Early sixties)	British American Tobacco Co. Ltd. (UK)	66.00	32.60	1.40

Appendix - 8B

Financial Structure of Multinational and Local Firms in Bangladesh, Annual Average (1975-1979)

(In Thousand Takas)[a]

Industry & Type of Firm	Equity	Reserves & Retained Profits	Long-Term Loans	Short-Term Loans	Other Current Liabil.	TOTAL Capital & Liabil.	Net Fixed Assets	Current Assets	TOTAL Assets
Pharmaceutical									
Multinational[b]	10,965	13,417	3,122	18,583	29,872	75,959	19,218	56,741	75,959
Local[c]	2,195	4,033	5,610	3,108	9,178	24,124	2,644	21,480	24,124
Chemical									
Multinational[c]	9,183	7,685	89	3,758	15,737	36,452	5,111	31,341	36,452
Local[d]	2,682	2,725	5,632	50,385	14,086	75,510	5,022	70,488	75,510
Electric & Engineering									
Multinational[e]	4,864	3,233	463	1,713	8,739	19,012	4,771	14,241	19,012
Local[d]	1,500	628	2,406	2,984	2,077	9,595	2,816	6,779	9,595
Tobacco									
Multinational[f]	54,000	69,584	1,522	52,250	126,786	304,142	72,982	231,160	304,142
Local[f]	2,880	257	6,054	14,748	7,120	31,059	8,672	22,387	31,059
Miscellaneous[g]									
Multinational[f]	6,903	4,443	-	6,579	17,683	35,608	7,553	28,055	35,608
Local[d]	3,120	1,858	10,153	9,489	4,682	29,302	6,656	22,646	29,302
All Industries									
Average: All Multinationals	10,511	11,352	1,500	11,538	24,592	59,493	14,150	45,343	59,493
Average: All Locals	2,407	2,278	5,927	14,979	7,634	33,225	4,560	28,665	33,225

Notes: a = Taka is the unit of Bangladesh currency; b = 8 firms average; c = 3 firms average; d = 2 firms average; e = 7 firms average; f = 1 firm; g = miscellaneous includes shoes, apparels and textile products.

Source: Prepared from the Annual Accounts of the Enterprises.

Appendix - 8 C

Additional Statistics : Multinational and Local Enterprises in Bangladesh, Annual Average (1975-1979)

Industry & Type of Firm	Turnover (000 Taka)[a]	Net Profit (000 Taka)[a]	Total Employees (Number)
Pharmaceutical			
Multinational (8 firms average)	62,245	3,671	269
Local (3 firms average)	27,739	2,400	263
Chemical			
Multinational (3 firms average)	84,357	5,016	195
Local (2 firms average)	89,276	5,813	445
Electric & Engineering			
Multinational (7 firms average)	25,966	1,233	162
Local (2 firms average)	6,751	510	45
Tobacco			
Multinational (One firm)	1,282,991	20,334	2,828
Local (One firm)	50,459	208	280
Miscellaneous[b]			
Multinational (One firm)	82,932	4,149	672
Local (2 firms average)	13,592	445	291
All Industries			
Average: All Multinationals	114,936	3,877	369
Average: All Locals	35,291	1,894	263

Notes: a. Taka = Unit of Bangladesh Currency
b. Miscellaneous includes shoes, apparels and textile products.

Source: Statistics on Total Employees, from the Ministry of Labour and Social Welfare, Government of the People's Republic of Bangladesh (Unpublished), Other statistics from Annual Accounts of the enterprises.

Appendix : 10 A

Details of Import Prices of Ten Items of Pharmaceutical Inputs in Bangladesh (1980)

Item	Importing Firm	Source of Import	Import Price (CIF) Per Kg.
			(Taka)
1)Tetracycline	(1)Multinational Firm	Parent (U.S.A.)	960
	(2)Multinational Firm	Related (Ireland)	1,440
	(3)Multinational Firm	Parent (U.S.A.)	800
	(4)Local Firm	Unrelated (China)	444
	(5)Local Firm	Unrelated (Italy)	473
2)Oxy-Tetracycline	(1)Multinational Firm	Parent (U.S.A.)	1,280
	(2)Multinational Firm	Unrelated (Yogoslavia)	581
	(3)Local Firm	Unrelated (Yogoslavia)	590
	(4)Local Firm	Unrelated (W.Germany)	610
3)Ampicillin Trihydrate	(1)Multinational Firm	Related (Singapore)	2,479
	(2)Local Firm	Unrelated (Italy)	1,359
	(3)Local Firm	Unrelated (Italy)	1,428
	(4)Local Firm	Unrelated (W.Germany)	1,465
4)Streptomycin	(1)Multinational Firm	Parent (U.K.)	1,900
	(2)Multinational Firm	Unrelated (U.S.A.)	752
5)Trimethoprim	(1)Multinational Firm	Related (U.K.)	9,000
	(2)Local Firm	Unrelated (W.Germany)	1,700
	(3)Local Firm	Unrelated (W.Germany)	1,149
	(4)Local Firm	Unrelated (Switzerland)	880

Item	Importing Firm	Source of Import	Import Price (CIF) Per Kg.
			(Taka)
6)Diethyl Carbamazin Citrate	(1)Multinational Firm	Parent (U.S.A.)	1,680
	(2)Multinational Firm	Unrelated (U.K.)	648
7)Gelatine Capsules	(1)Multinational Firm	Parent (U.K.)	80
	(2)Multinational Firm	Unrelated (U.K.)	37
8)Sorbitol	(1)Multinational Firm	Parent (Holland)	19
	(2)Multinational Firm	Unrelated (France)	8
	(3)Multinational Firm	Unrelated (Italy)	10
9)Lactose Anhydrous	(1)Multinational Firm	Parent (U.S.A.)	51
	(2)Multinational Firm	Unrelated (Italy)	20
	(3)Local Firm	Unrelated (Italy)	18
10)Levamisole	(1)Multinational Firm	Parent (U.K.)	5,700
	(2)Multinational Firm	Related (Belgium)	2,422
	(3)Local Firm	Unrelated (W.Germany)	1,081

SOURCE: Directorate of Drug Administration, Government of The People's Republic of Bangladesh.

Bibliography

Agarwal, J.P., "Factor Proportions in Foreign and Domestic Firms in Indian Manufacturing", The Economic Journal, 86, September 1976, pp.589-594.

Aharoni, Y., The Foreign Investment Decision Process, Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1966.

_____, "On the Definition of Multinational Corporations", Quarterly Review of Economics and Business, Vol.11, No.3, Autumn 1971, pp.27-38.

AICPA, Professional Accounting in 25 Countries, AICPA, New York, 1964.

Anderson, T.W., An Introduction to Multivariate Statistical Analysis, John Wiley & Sons, New York, 1958.

Archibald, T.R., "The Return to Straight-Line Depreciation: An Analysis of a Change in Accounting Method", Empirical Research in Accounting: Selected Studies 1967 (Suppl. to Journal of Accounting Research,5) pp.164-183.

Arnold, R.J., and L.B. Fletcher, "Concentration and the Determinants of Profitability of Large Food-Processing Firms", Quarterly Review of Economics and Business, Vol.12, No.2, Summer 1972, pp.19-32.

Arpan, J.S., International Intracorporate Pricing: Non-American Systems and Views , Praeger, New York, 1972.

_____ and L.H. Radebaugh, International Accounting and Multinational Enterprises, Warren,Gorham & Lamont, Boston,1981.

Arsdell, S.C.V., "Criteria for Determining Materiality", Journal of Accountancy, October 1975, pp.72-78.

ASC, Setting Accounting Standards, Report and Recommendation by the Accounting Standards Committee, London, January 1981.

Bain, J.S., "Relation of Profit Rate to Industry Concentration: American Manufacturing, 1936-1940", Quarterly Journal of Economics, 65, August 1951, pp.293-324.

____, Industrial Organization, John Wiley & Sons,New York,1968.

Balasubramanyam, V.N., International Transfer of Technology to India, Praeger, New York, 1973.

Baldwin, R.E., Economic Development and Growth, John Wiley & Sons, New York, 1966.

Ball, G.W., "Multinational Corporations and Nation States". Atlantic Community Quarterly, Summer 1967.

Ball, R., "Changes in Accounting Techniques and Stock Prices", Empirical Research in Accounting: Selected Studies 1972, (Suppl. to Journal of Accounting Research,10), pp.1-38.

___, and R. Watts, "Some Time Series Properties of Accounting Income", Journal of Finance, June 1972, pp.663-682.

___, and P. Brown, "An Empirical Examination of Accounting Income Numbers", Journal of Accounting Research, 6, 1968, pp.159-177.

Barefield, R., and E. Comisky, "Depreciation Policy and the Behaviour of Corporate Profits", Journal of Accounting Research, 9 , 1971, pp.351-358.

____ and ____, "The Smoothing Hypothesis: An Alternative Test", The Accounting Review, April 1972, pp.291-298.

Barnea, A., J. Ronen, and S. Sadan, "The Implementation of Accounting Objectives-An Application to Extraordinary Items", The Accounting Review, January 1975, pp.58-68.

Barnet, R.J., and R. Muller, Global Reach: The Power of Multinational Corporations, Simon and Schuster,New York,1974.

Barret, E.M., "Case of the Tangled Transfer Price", Harvard Business Review, May-June 1977, pp. 20-28, and 32, 36, 176, 178.

Barton, A.D., "Company Income Tax and Interperiod Allocation" Abacus, Vol.6, No.1, September 1970, pp.3-24.

Baylis, A.W., "Income Tax Allocation - A Defence", Abacus, Vol.7, No.2, December 1971, pp.161-172.

Behrman, J.N., "Actors and Factors on Foreign Direct Investment", World Development, August 1974, pp.1-14.

Beidleman, C.R., "Income Smoothing: The Role of Management", The Accounting Review, Vol.XLVIII, No.4, October 1973, pp.653-667.

Benson, Sir H., "The Story of International Accounting Standards", Accountancy, July 1976, pp.34-39.

Bhagwati, J. Illegal Transactions in International Trade: Theory and Measurement, North-Holland, Amsterdam, 1974.

Bierman, H. Jr., "Inventory Valuation: The Use of Market Prices", The Accounting Review, October 1967.

Billerbeck, K., and Y. Yasugi, Private Direct Investment in Developing Countries, World Bank Staff Working Paper No. 348, The World Bank, Washington D.C., 1979.

Bird, F.A., "Interperiod Comparability in Financial Reporting", Journal of Accountancy, June 1969, pp.51-56.

Brandt, W., et al., North-South: A Programme for Survival, the Report of the Independent Commission on International Development Issues under the Chairmanship of Willy Brandt, Pan Books, London, 1980.

Brewer, T.L., "International Regulation of Restrictive Business Practices", Journal of World Trade Law, Vol.16, No.2, March:April 1982, pp.108-118.

Brigham, E.F., "The Effects of Alternative Depreciation Policies on Reported Profits", The Accounting Review, January 1968, pp.46-61.

Brozen, Y., "Significance of Profit Data for Anti-trust Policy", The Anti-trust Bulletin, Spring 1969, pp.119-139.

Buckley, P.J., and M. Casson, The Future of Multinational Enterprise, Macmillan, London, 1976.

_____, J.H. Dunning and R.D. Pearce, "The Influence of Firm Size, Nationality, and Degree of Multinationality on the Growth and Profitability of the World's Largest Firms, 1962-1972", Weltwirtschaftliches Archiv, Vol.114, No.2, 1978, pp.243-257.

_____, and R.D. Pearce, "Overseas Production and Exporting by the World's Largest Enterprises: A Study in Sourcing Policy", Journal of International Business Studies, Vol.XII, No.2, Fall 1982, pp.9-32.

Buzzell, R.D., B.T. Gale, and R.G.M. Sultan, "Market Share-a Key to Profitability", Harvard Business Review, 53 , January-February 1975,pp.97-106.

Calvet, A.L., "A Synthesis of Foreign Direct Investment Theories and Theories of the Multinational Firm", Journal of International Business Studies, Vol.12, No.1, Spring/Summer 1981, pp.43-59.

Carley, W.M., "International Concerns Use Variety of Means to Cut U.S. Tax Bills", Wall Street Journal, 16 October 1972, p.1.

_____, "Profit Probes: Investigation Beset Multinational Firms With Stress on Pricing", Wall Street Journal, 19 December 1974, p.1.

Carsberg, B., A. Hope, and R.W. Scapens, "The Objective of Published Accounting Reports", Accounting and Business Research, Summer 1974, pp.162-173.

_____, J. Arnold, and A. Hope, "Predictive Value: A Criterion for Choice of Accounting Methods", in W.T. Baxter and S. Davidson (eds.), Studies in Accounting, Institute of Chartered Accountants in England and Wales, London 1977, pp.403-423.

Casanegra de Jantscher, M., "Tax Havens Explained", Finance and Development, March 1976, pp.31-34.

Caves, R.E., "International Corporations: the Industrial Economics of Foreign Investment", Economica, 38, February 1971, pp.1-27.

_____, "Causes of Direct Investment: Foreign Firms' Shares in Canadian and United Kingdom Manufacturing Industries", Review of Economics and Statistics, August 1974, pp.279-293.

_____, "Multinational Firms, Competition, and Productivity in Host Country Markets", Economica, 41, May 1974,pp.176-93.

Cerf, A.R., "Inflation, Inventory Valuation Methods and Business Cycles", Accounting Research, VII, October 1956, pp.279-285.

Chambers,R.J., "A Matter of Principle", The Accounting Review, 41, July 1966, pp.443-457.

_____, "Tax Allocations and Financial Reporting", Abacus, Vol.4, No.2, December 1968, pp.99-123.

Chamberlin, E.H., The Theory of Monopolistic Competition, Harvard University Press, Cambridge (Mass), 1962.

Chambost, E. (English Edition by T. Crawley), Using Tax Havens Successfully, Institute for International Research, London, 1978.

Choi, F.D.S., and G.G. Mueller, An Introduction to Multinational Accounting, Prentice-Hall, 1978.

Chudnovsky, D., "Pricing of Intra-Firm Technological Transaction", in R. Murray (ed.), Multinationals Beyond the Market: Intra-Firm Trade and the Control of Transfer Pricing, Harvester Press, Brighton (England), 1981, pp.119-132.

Cohen, B.I., Foreign Investment by U.S. Corporations as a Way of Reducing Risk, Yale University Economic Growth Center (mimeo), Discussion Paper No.151, September 1972.

_____, Multinational Firms and Asian Exports, Yale University Press, New Haven, 1975.

Collins, N.R., and L.E. Preston, Concentration and Price-Cost Margins in Manufacturing Industries, Berkeley, California, 1968.

Connor, J.M., The Market Power of Multinationals: A Quantitative Analysis of U.S. Corporations in Brazil and Mexico, Praeger, New York, 1977.

_____, and W.F. Mueller, Market Power and Profitability of Multinational Corporations in Brazil and Mexico, Report to the Senate Subcommittee on Multinational Corporations, Government Printing Office, Washington D.C., 1977.

Cooley, W.W., and P.R. Lohnes, Multivariate Data Analysis, John Wiley & Sons, New York, 1971.

Copeland, R.M., "Income Smoothing" Empirical Research in Accounting: Selected Studies 1968 (Suppl. to Journal of Accounting Research,6), pp.101-116.

Crask, M.R., and W.D. Perreault, "Validation of Discriminant Analysis in Marketing Research", Journal of Marketing Research, February 1977, 60-68.

Cushing, B.E., "An Empirical Study of Changes in Accounting Policy", Journal of Accounting Research, 7, Autumn, 1969, pp.196-203.

Dasher, B.E., and R.E. Malcom, "A Note on Income Smoothing in the Chemical Industry", Journal of Accounting Research, 8, Autumn 1970, pp.253-259.

Domer, E., "The Case for Accelerated Depreciation", Quarterly Journal of Economics, Vol.67, 1953, pp.493-519.

Dunning, J.H., "The Distinctive Nature of the Multinational Enterprise", in J.H. Dunning (ed.), Economic Analysis and the Multinational Enterprise, George Allen and Unwin, London, 1974.

_____, "Trade, Location of Economic Activity and the MNE: A Search for an Electric Approach", in B. Ohlin et al. (eds,) The International Allocation of Economic Activity, Macmillan, London, 1977.

_____, "Towards an Electric Theory of International Production: Some Empirical Tests", Journal of International Business Studies, Vol.XI, No.1, Spring/Summer 1980,pp.9-31.

_____, International Production and the Multinational Enterprise, George Allen & Unwin, London, 1981.

_____, and R.D. Pearce, The World's Largest Industrial Enterprises, Gower Publishing Company, Hampshire (England), 1981.

Economist Intelligence Unit, "Multinationals and World Trade", Multinational Business, No.4, 1981.

Eichner, A.S., The Magacorp and Oligopoly, Cambridge University Press, Cambridge, 1976.

Enthoven, A.J.H., "Standardized Accountancy and Economic Development", Finance and Development, Vol.10, No.1, March 1973, pp.28-31.

_____, Accountancy and Economic Development Policy, North Holland, 1973.

_____, "Social and Political Impact of Multinationals on Third World Countries (and Its Accounting Implications)", Plenary Session Paper, 60th Annual Meeting, American Accounting Association, Richardson, Texas: University of Texas at Dallas, 1976, 36pp., (monograph).

Evans, P.B., "Foreign Investment and Industrial Trnsformation: A Brazilian Case Study", Journal of Economic Development, 3 , 1976, pp.119-139.

_____, "Direct Investment and Industrial Concentration", Journal of Development Studies, 13:4, July 1977, 373-386.

Fajnzylber, F., and T.M. Tarrago, Las Empresas Transnacionales en la Industria Mexicana, CONACYT/CIDE, Mexico City, 1975.

Fisher, R.A., "The Use of Multiple Measurements in Taxonomic Problems", Annals of Eugenics, No.7, September 1936, pp.179-188.

Franko, L.G., "Who Manages Multinational Enterprises?", Columbia Journal of World Business, Summer 1973, pp.30-42.

Frankel, M., "Home Versus Foreign Investment: A Case Against Capital Export", Kyklos, 18, 1965, pp.411-432.

Frishkoff,P., "Some Recent Trends in Accounting Changes", Journal of Accounting Research,8, Spring 1970, pp.141-144.

Galbraith, J.K., The New Industrial State, Houghton Mifflin, Boston, 1967.

_____, Economics and the Public Purposes, Houghton Mifflin, Boston, 1973.

_____, "The Defence of the Multinational Company", Harvard Business Review, March-April 1978, pp.83-92.

Gershenberg, I., The Performance of Multinational and Other Firms in Economically Less-Developed Countries: A Comparative Analysis of Ugandan Data, Institute of Development Studies, Nairobi, Uganda, Discussion Paper 234, (mimeo), 1976.

Gordon, M.J., "Postulates, Principles and Research in Accounting", The Accounting Review,39, April 1964, pp.44-52.

_____, B.N., and P.T. Meyers, "Accounting Measurements and Normal Growth of the Firm", in R. Jaedicke, Y. Ijiri, and O. Nielson (eds.), Research in Accounting Measurement, American Accounting Association, 1966, pp.221-231.

Gray, P., "Inventory of Generally Accepted Accounting Principles in the United States of America", The Accounting Review, January 1965, pp.21-30.

Gray, S.J., J.C. Shaw, and L.B. McSweeney, "Accounting Standards and Multinational Corporations", Journal of International Business Studies, Vol.12, No.1, Spring/Summer 1981, pp.29-42.

Greene, J., and M.G. Duerr, Intercompany Transactions in the Multinational Firm, The Conference Board: Managing International Business, No.6, New York, 1970.

Greenhill, C.R., and E.O. Herbolzheimer, "International Transfer Pricing: The Restrictive Business Practices Approach", Journal of World Trade Law, Vol.14, No.3, May/June 1980, pp.232-242.

Grubel, H.G., "Internationally Diversified Portfolios: Welfare Gains and Capital Flows", American Economic Review, 58, December 1968, pp.1299-1314.

_____, and K. Fadner, "The Interdependence of International Equity Markets", Journal of Finance, March 1971, pp.89-94.

Hagerman, R.L., and M.E. Zmijewski, "Some Economic Determinants of Accounting Policy Choice", Journal of Accounting and Economics, 1, 1979, pp.141-161.

Hall, M., and L. Weiss, "Firm Size and Profitability", Review of Economics and Statistics, 49, August 1967, pp.319-331.

Helleiner, G.K., "The Role of Multinational Corporations in the Less Developed Countries, Trade In Technology", World Development, April 1975, pp.161-189.

Hirsch, S., Location of Industry and International Competitiveness, Oxford University Press, London, 1967.

Hirschleifer, J., "On the Economics of Transfer Pricing", Journal of Business, July 1956.

Hood, N., and S. Young, The Economics of Multinational Enterprise, Longman, London, 1979.

Hopewood, A.G., "An Empirical Study of the Role of Accounting Data in Performance Evaluation", Empirical Research in Accounting: Selected Studies 1972 (Suppl. to Journal of Accounting Research,10), 1972.

Horst, T., American Investments Abroad and Domestic Market Power, Brookings Institution, Washington D.C., 1975.

____, "American Taxation of Multinational Firms", American Economic Review, June 1977, pp.376-389.

Howenstine, N.G., "Selected Data on the Operations of US Affiliates of Foreign Companies, 1978 and 1979", Survey of Current Business, May 1981, pp.35-54.

Hymer, S. H., and R. Rowthorn, "Multinational Corporations and International Oligopoly: The Non-American Challenge", in C.P. Kindleberger (ed.), The International Corporation, MIT Press, Cambridge (Mass), 1970, pp.57-91.

Hymer, S.H., "The Multinational Corporation and the Law of Uneven Development", in J. Bhagwati (ed.), Economics and World Order from the 1970's to the 1990's, Macmillan, New York, 1972, pp.113-140.

____, The International Operations of National Firms: a Study of Direct foreign Investment, MIT Press, Cambridge (Mass), 1976.

____, The Multinational Corporation: A Radical Approach (Papers by S.H. Hymer, edited by R.B. Cohen et al.), Cambridge University Press, Cambridge, 1979.

Ijiri, Y., R.K. Jaedicke and K.E. Knight, "The Effects of Accounting Alternatives on Management Decision", Research in Accounting Measurement, Collected Papers, American Accounting Association, 1966, pp.186-199.

Islam, N., Development Planning in Bangladesh : A Study in Political Economy, University Press, Dacca (Bangladesh), 1979.

Islam, R., Factor Intensity and Labour Absorption in Manufacturing Industries: the Case of Bangladesh, Unpublished Ph.D. Thesis, University of London, 1976.

Jacobsen, L.E., "The Rise of Profit Deferral Notion", The Accounting Review, 38, April 1963, pp.285-292.

Jain, S., and Y. Puri, "Role of Multinational Corporations in Developing Countries: Policy Makers Views", Management International Review, Vol.21, No.2, 1981, pp.57-66.

Jensen, M., and W. Meckling, Can the Corporation Survive? Public Policy Working Paper Series, Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester,New York, 1976.

Jo, Sung-Hwen, The Impact of Multinational Firms on Employment and Incomes: The Case Study of South Korea, World Employment Programme, Working Paper No.12 (mimeo), ILO, Geneva, 1976.

Johnson, H.G., "The Efficiency and Welfare Implications of the International Corporations", in C.P. Kindleberger (ed.), The International Corporation, MIT Press, Cambridge (Mass), 1970, pp.35-56.

Kapoor, A., and P.D. Grud (eds.), The Multinational Enterprises in Transition: Selected Readings and Essays, Darwin Press, Princeton, 1972.

Katrak, H., "Multi-National Monopolies and Monopoly Regulation", Oxford Economic Papers, Vol.32, No.3, November 1980, pp.453-466.

Khilji, F., "Multinational Corporations and Restrictive Business Practices: The Case of Pakistan", Pakistan Development Review, Vol.14, No.4,Winter 1975, pp.416-436.

Kilpatrick, R.W., "Stigler on the Relationship Between Industry Profit Rates and Market Concentration", Journal of Political Economy, May-June 1968, pp. 479-488.

Kim, S.H., and S.W. Miller, "Constituents of the International Transfer Pricing Decision", Columbia Journal of World Business, Spring 1979, pp.69-77.

Kindleberger, C.P., American Business Abroad, Yale University Press, New Haven, 1969.

Klecka, W.R., "Discriminant Analysis", in N.H. Nei et al. (eds.), Statistical Package for the Social Sciences (SPSS), McGraw-Hill, New York, 1975, pp.434-467.

Knickerbocker, F.T., Oligopolistic Reaction and Multinational Enterprise, Division of Research, Graduate School of Business Administration, Harvard University, Boston,1973.

Kohlhagen,S.W., "Host Country Policies and MNCs - The Pattern of Foreign Investment in South East Asia", Columbia Journal of World Business, Spring 1977, pp.49-58.

Kopits, G.F., "Intra-Firm Royalties Crossing Frontiers and Transfer-Pricing Behavior", Economic Journal, 86, December 1976, pp.791-805.

Lall, S., "Transfer Pricing By Multinational Manufacturing Firms", Oxford Bulletin of Economics and Statistics, Vol.35, No.3, August 1973, pp.173-195.

____, "The International Pharmaceutical Industry and Less-Developed Countries", Oxford Bulletin of Economics and Statistics, August 1974, pp.143-172.

____, "Financial and Profit Performance of MNCs in Developing Countries: Some Evidence from an Indian and Colombian Sample", World Development, Vol.4, No.9, 1976, pp.713-724.

____, and P. Streeten, Foreign Investment, Transnationals and Developing Countries, Macmillan, 1977

____, Major Issues in Transfer of Technology to Developing Countries: A Case Study of the Pharmaceutical Industry, UNCTAD, Geneva, No.TD/B.6/4, 1975.

____, "Transnationals, Domestic Enterprises and Industrial Structure in Host LDCs: A Survey", Oxford Economic Papers, Vol.30 No.2, July 1978, pp.217-248.

____, The Multinational Corporation : Nine Essays, Macmillan, 1980.

Leftwich, R.B., "U.S. Multinational Companies' Profitability, Financial Leverage and Effective Tax Rates", Survey of Current Business, May 1974, pp.27-34.

Lent, G.E., "Corporation Income Tax Structure in Developing Countries", IMF Staff Papers, No.3, November 1977,pp.722-755.

Lerner, A.P., "The Concept of Monopoly and the Measurement of Monopoly Power", Review of Economic Studies, June 1963.

Levy, H., and M. Sarnat, "International Diversification of Investment Portfolios", American Economic Review, 60, September 1970, pp.668-692.

Lim, L.Y.C., and P.E. Fong, "Vertical Linkages and Multinational Enterprises in Developing Countries", World Development, Vol.10, No.7, July 1982, pp.585-595.

Lindhe, R., "Accelerated Depreciation for Income Tax Purposes - A Study of the Decision and Some Firms Who Made It", Journal of Accounting Research,1, Autumn 1963, pp.139-148.

Lipsey, R.D., An Introduction to Positive Economics, Widenfield and Nicolson, London 1979.

Mansfield, E., "Entry, Gibrat's Law, Innovation and the Growth Firms", American Economic Review, 52, December 1962, pp.1023-1051.

Markowitz, H., "Portfolio Selection", Journal of Finance, March 1952, pp.77-91.

_____, Portfolio Selection: Efficient Diversification of Investments, John Wiley & Sons, New York, 1959.

Mason, R.H., "Some Observations on the Choice of Technology by Multinational Firms in Developing Countries", Review of Economics and Statistics, 55, August 1973, pp.349-355.

Mautz, R.K., "Conglomerate Reporting and Data Reliability", Financial Executives, September 1967, pp.25-35.

Meller, P., International Comparison of Industrial Concentration in Latin America, National Bureau of Economic Research, New York, 1976.

Miller, N.C., and M.V.N. whiteman, "A Mean-Variance Analysis of United States Long-term Portfolio Foreign Investment", Quarterly Journal of Economics, 84, May 1970, pp.175-192.

Morgenstern, O., On the Accuracy of Economic Observations, Princeton University Press, Princeton, 1963, p.70.

Nagy, R.J., "Transfer Price Accounting for MNCs", Management Accounting (NAA), 7 January 1978, pp.34-38.

Newfarmer, R.S., and W.F. Mueller, Multinational Corporations in Brazil and Mexico: Structural Sources of Economic and Non-Economic Power, U.S. Senate Subcommittee on Multinational Corporations, Washington D.C., 1975.

Newfarmer, R., Transnational Conglomerates and the Economics of Dependent Development: A Case Study of International Electrical Oligopoly and Brazil's Electrical Industry, Jai Press, Greenwich (Connecticut), 1980.

_____, and Marsh, "Foreign Ownership, Market Structure and Industrial Performance, Brazil's Electrical Industry", Journal of Development Economics,February 1981, pp.47-75.

Nickels, L., Transfer Pricing in Multinational Firms, Almqvist & Wiksell International, Stockholm, 1975.

Nisser, C., and D. Wallace, "National Treatment for Multinational Enterprises - Will the OECD Governments Meet the Challenge?" Columbia Journal of World Business, Fall 1978.

Ozawa, T., "International Investment and Industrial Structure: New Theoretical Implications from the Japanese Experience", Oxford Economic Papers, Vol.31, No.1, 1979, pp.72-89.

Parry, T.G., The Multinational Enterprise: International Investment and Host-Country Impacts, Jai Press, Greenwich (Connecticut), 1980.

Plasschaert, S., Transfer Pricing and Multinational Corporation: An Overview of Concepts, Mechanisms and Regulations, European Centre for Study and Information on Multinational Corporations (ECSIM), 1979.

Prakash, P., and A. Rappaport, "Information Inductance and its Significance for Accounting", Accounting, Organisations and Society, Vol.2, 1977.

Radice, H. (ed.), International Firms and Modern Imperialism, Penguin Books, Middlesex (England), 1975.

Ranis, G., The Multinational Corporation as an Instrument of Development, Yale Economic Growth Center, Discussion Paper no.123, September 1974.

Reidel, J., "The Nature and Determinants of Export Oriented Direct Foreign Investment in a Developing Country: Case Study of Taiwan", Weltwirtschaftliches Archiv, 1975, pp.505-528.

Reuber, G.L., H. Crookell, M. Emerson, and G. Gallais-Hamonno. Private Foreign Investment in Development, Clarendon Press, Oxford, 1973.

Rugman, A.M., International Diversification and the Multinational Enterprise, Lexington Books, Lexington (Mass), 1979.

_____, Multinationals in Canada: Theory, Performance, and Economic Impact, Martinus Nijhoff Publishing, Boston, 1980.

Scapens, R.W. et al., Explaining Corporate Failure: A Catestrophe Theory Approach, Working Paper 8005, Department of Accounting and Business Finance, University of Manchester, 1979.

Schwamm, H., and D. Germidis, Codes of Conduct for Multinational Companies: Issues and Positions, ECSIM Publications, Saxon House, England 1977.

Scott, G.M., Accounting and Economic Observations, Princeton University Press, Princeton, 1963.

_____, "Financial Control in Multinational Enterprises - The New Challenge to Accountants", International Journal of Accounting, Spring 1971, pp.55-68.

Severn, A., "Investor Evaluation of Foreign and Domestic Risk", Journal of Finance, May 1974, pp.545-550.

Sharpe, W.F., "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk", Journal of Finance, September 1964, pp.425-442.

Sharwani, K., "Some New Evidence on Concentration and Profitability in Pakistan's Large-Scale Manufacturing Industries", Pakistan Development Review, Autumn 1976, pp.272-289.

Shulman, J., "When the Price is Wrong - By Design", Columbia Journal of World Business, May-June 1967, pp.69-76.

Siegfried, J.J., "The Determinants of Anti-trust Activity", Journal of Law and Economics, October 1975, pp.559-581.

Simpson, R.H., "An Empirical Study of Possible Income Manipulation", The Accounting Review, 44, October 1969, pp.806-817.

Sobhan, R., "Nationalisation of Industries in Bangladesh: Background and Problems", in E.A.G. Robinson et al. (eds.) The Economic Development of Bangladesh Within a Socialist Framework, Macmillan, 1974, pp.181-200.

_____, "Bangladesh and the World Economic System: The Crisis of External Dependence", Development and Change, Vol.12, No.3, July 1981, pp.327-347.

_____, and M. Ahmad, Public Enterprise in an Intermediate Regime: A Study in the Political Economy of Bangladesh, The Bangladesh Institute of Development Studies, Dacca, 1981.

Solomon, R.F., and D.J.C. Forsyth, "Substitution of Labour for Capital in the Foreign Sector: Some Further Evidence", Economic Journal, 87, September 1977, pp.283-289.

_____, and K.P.D. Ingham, "Discriminating Between MNC Subsidiaries and Indigenous Companies: A Comparative Analysis of the British Mechanical Engineering Industry", Oxford Bulletin of Economics and Statistics, May 1977, pp.127-138.

Sorter, G.H., S. Becker, T.R. Archibald, and W. Beaver, "Corporate Personality Reflected in Accounting Decisions", Journal of Accounting Research,2, Autumn 1963, pp.139-148.

Sourrouille, J.V., The Impact of Transnational Enterprises on Employment and Income: the Case of Argentina, World Employment Working Paper No. 7 (mimeo), ILO, Geneva, 1976.

Sprouse, R.T., "Discussion of the Return to Straight-Line Depreciation", Empirical Research in Accounting: Selected Studies 1967 (Suppl. to Journal of Accounting Research, 5), pp.184-186.

Stevens, V.G., "The Determinants of Investment", in J.H. Dunning (ed.), Economic Analysis and the Multinational Enterprise, George Allen & Unwin, London, 1974, pp.47-88.

Stewart, J.C., "Multinational Companies and Transfer Pricing", Journal of Business Finance and Accounting, Vol.4, No.3, Autumn 1977.

Stigler, G.J., Capital and Rates of Returns in Manufacturing Industries, Princeton, New Jersey, 1963.

Stopford, J.M., J.H. Dunning, and K.O. Haberich, The World Directory of Multinational Enterprises; Macmillan, London, 1980.

Streeten, P., "Policies Towards Multinationals", World Development, June 1975, pp.393-397.

Subrahmanian, K.K., and P.M. Pillai, "Implications of Technology Transfer in Export-led Growth Strategy", Economic and Political Weekly (Bombay, India), 30 October 1976, pp.1729-1735.

Tang, R.Y.W., and K.H. Chang, "Environmental Variables of International Transfer Pricing: A Japan-United States Comparison", Abacus, June 1979, pp.3-12.

Tatsuoka, M.M., Discriminant Analysis: The Study of Group Differences, Institute for Personality and Ability Testing, Champaign, Illinois, 1970.

Thomas, A.L., "Transfer Prices of the Multinational Firm: When Will They Be Arbitrary?", Abacus, June 1971.

Tobin, J., "Liquidity Preference as Behavior Towards Risk", Review of Economic Studies, 25, February 1958, pp.65-86.

Tomlison, W.C., The Joint Venture Process in International Business: India and Pakistan, MIT Press, 1970.

Torre, J. de la, "Foreign Investment and Economic Development: Conflict and Negotiation", Journal of International Business Studies, Vol.XII, No.2, Fall 1982, pp.9-32.

Turner, L., Multinational Companies and the Third World, Allen Lane, London, 1973.

Vaitsos, C.V., Intercountry Income Distribution and Transnational Enterprises, Clarendon Press, Oxford, 1974.

_____, Employment Problems and Transnational Enterprises in Developing Countries : Distortions and Inequality, World Employment Programme, Working Paper No.11 (mimeo), ILO, Geneva, 1976.

_____, "World Industrial Development and the Transnational Corporations: the Lima Target as Viewed by Economic Actors", Industry and Development, No.3 of UNIDO, 1979, pp.33-43.

Vernon, R., Sovereignty at Bay : The Multinational Spread of U.S. Enterprises, Basic Books, New York, 1971.

_____, Storm Over the Multinationals: the Real Issues, Macmillan, London and Basingstoke, 1977.

_____, "The Power of Multinational Enterprises in Developing Countries", in C.H. Madden (ed.), The Case for the Multinational Corporation, Praeger Publishers, New York, 1977, pp.151-183.

Verlage, H., Transfer Pricing for Multinational Enterprise, Rotterdam University Press, 1975.

Watts, R., "Corporate Financial Statements: Product of Market and Political Process", Australian Journal of Management, April 1977, pp.53-77.

_____, and J. Zimmerman, "Toward a Positive Theory of the Determination of Accounting Standards", The Accounting Review, January 1978, pp.112-134.

Weiss, L., "Quantitative Studies of Industrial Organisation: (a paper presented at the New York meeting of the Econometric Society, December 1969), reprinted in M.D. Intriligator (ed,), Frontiers in Quantitative Economics, North-Holland, Amsterdam, 1971.

White, G., "Discretionary Accounting Decisions and Income Normalization", Journal of Accounting Research, 8, 1970, pp.260-275.

White, L.J., Industrial Concentration and Economic Power in Pakistan , Princeton University Press, Princeton, 1974.

Williams, M.L., "The Extent and Significance of the Nationalization of Foreign Owned Assets in Developing Countries 1956-72", Oxford Economic Papers, July 1975, pp.260-273.

Willmore, L., "Direct Foreign Investment in Central American Manufacturing", World Development, June 1976, pp.499-517.
Zetlin, M., "Economic Concentration, Industrial Structure, National and Foreign Capital in Chile, 1966", International Industrial Organization Review, 1974, pp.195-205.
Zmijewski, M.E., and R.L. Hagerman, "An Income Strategy Approach to the Positive Theory of Accounting Standard Setting/Choice", Journal of Accounting and Economics,3, 1981, pp.129-149.

UNITED NATIONS PUBLICATIONS

Multinational Corporations in World Development, UN Department for Economic and Social Affairs, New York, 1973.
Transnational Corporations in World Development: A Re-Examination, UN Economic and Social Council, E.78, II, A.5, 1978.
National Legislations and Regulations Relating to Transnational Corporations, UN Centre on Transnational Corporations, No. ST/CTC/6, 1978.
Permanent Sovereignty Over Natural Resources, Report of the Economic and Social Council, September 1974.
International Standards of Accounting and Reporting for Transnational Corporations, UN Centre on Transnational Corporations, 1977.
Dominant Positions of Market Power of Transnational Corporations: Use of the Transfer Pricing Mechanism, UNCTAD, No. TD/B/C.2/167, New York, 1978.

OECD PUBLICATIONS

Annual Reports on Competition Policy in OECD Member Countries, OECD,Paris, 1975, No.2.
Restrictive Business Practices of Multinational Enterprises: Report of the Committee of Experts on Restrictive Business Practices, OECD, Paris, 1975.
International Investment and Multinational Enterprises, OECD, Paris, 1976, revised 1979.
Development Co-Operation,(various issues between 1970 and 1980).

UNITED STATES GOVERNMENT PUBLICATIONS

Summary Study of International Cases Involving Section 482 of the Internal Revenue Code, U.S. Treasury Department.
Competitive Problems in the Drug Industry, U.S. Congress Senate Sub-Committee Proceedings, pp.73330-31.
"1977 Benchmark Survey of US Direct Investment Abroad", Survey of Current Business, U.S. Department of Commerce, April 1981, pp.29-37.

BANGLADESH GOVERNMENT PUBLICATIONS

The First Five Year Plan 1973-78, Planning Commission, Dacca, 1973.

The Companies Act, 1913 (VII of 1913), Indian Companies Act of 1913 as adopted in Bangladesh, Ministry of Law and Parliamentary Affairs, Dacca, 1975.

The Two Year Plan 1978-80, Planning Commission, Dacca, 1978.

Investment Policy, 1978, Ministry of Industries, Dacca, 1978.

Memorandum for the Bangladesh Aid Group, 1978-79, Ministry of Planning (Planning Commission), Dacca, April 1978.

Final Report of the Taxation Enquiry Commission, Ministry of Finance (Internal Resources Division), Dacca, April 1979.

The Macro-Model for the Second Five Year Plan: Some Preliminary Results, Background Papers of the Second Five Year Plan of Bangladesh (volumes: i, ii, iii), Perspective Planning and National Income Section of the General Economics and Evaluation Division, Planning Commission, Dacca, June 1980.

The Second Five Year Plan 1980-85, Planning Commission, Dacca, 1980.

Report of the Expert Committee on Drugs & Pharmaceutical Capacity Utilization of the Pharmaceutical Factories of Bangladesh (1975-1976), Department of Industries (Chemical Directorate), Dacca, 1977.

1979 Statistical Yearbook of Bangladesh, Bangladesh Bureau of Statistics, Dacca, 1980

1980 Statistical Yearbook of Bangladesh, Bangladesh Bureau of Statistics, Dacca, 1981.