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MNCS' FINANCIAL STRATEGIES IN TERMS OF HOST COUNTRIES INTEGRATION

У статті розглянуто стратегії управління фінансовими потоками транснаціональних корпорацій в умовах їх діяльності на територіях приймаючих країн, що знаходяться на певних стадіях регіональної інтеграції (розглянуто на прикладі інтеграції країн Перської затоки).

В статье анализируются различные стратегии управления финансовыми потоками транснациональных корпораций в условиях их деятельности на территориях принимающих стран, которые находятся на определённых стадиях региональной интеграции (рассмотрено на примере интеграции стран Персидского залива).

This paper is premised on the idea that financial management of an MNC depends on the economic conditions and regulations of home and host countries. The integration among host countries challenge the financial management of an MNC to adapt its intra-corporate finance to the terms of this kind of specific economic conditions. The main question revealed in the paper is how the conditions of regional integration union among host countries impact the financial management of the MNC. The issue is supported with an example of Gulf Cooperation Council Monetary Union (GCCMU).

Multinational Corporation, financial management, regional integration, tax planning, investment, dividends, cross-border liability, transfer pricing

Introduction

Problem identification. Multinational corporations (MNCs) are a key force in the global economy, although they have been studied quite differently over the years. For economists, multinational firms can contribute to global efficiency. This is because they are a way to avoid or minimize transaction costs. Replacing private negotiations among independent entities operating in many countries with hierarchical control and strict procedures for internal affairs leads to saving deadweight costs that are otherwise necessary to achieve the same economic goals. Sociologists have tended to emphasize the social embedding of markets along with the contingent and precarious nature of organizational forms (Gereffi 2003). Generalizing different approaches of MNC definition, the author considers an MNC to be a network of companies located in more than one country that has common governance and economic policy aimed at maximizing benefits for its owners.

Relations between the MNC and host country change along with the evolution of the MNC' strategies and the host country's political reforms. One factor affecting such relations is the participation of host country in regional integration initiatives that impact directly independence of domestic economic policies. Adhering to the opinion that the activities of an MNC depend on economic and legal conditions in home and host countries, the MNC financial management concerns such fields as: tax planning, cross-border investment and liability, dividend policy and transfer pricing.

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Analysis of latest researches and publications. The above-mentioned constituents of financial management of an MNC have been well investigated by economists and nowadays researches concern different practical aspects of an MNC's international financial strategies. For example, Buss et al. (2007), Rowe and Tanenbaum (2006) investigated tax planning of an MNC under different taxation systems. Aulakh and Mudambi (2005) examined how the efficiency of external capital markets across countries impacts financial flows between MNCs and their foreign subsidiaries. The MNCs' dividend policy and investment strategies were elaborated by Kose et al. (1991) and Desai et al. (2007). These investigations concern financial strategies of MNCs under variety of specific economic conditions in host countries. There is, however one circumstance not yet revealed – how the host-countries regulation impact MNC financial management in case of monetary integration of host countries. A question emerges if financial strategies of MNCs differ when host countries are members of a monetary union. Thus the objective of this paper is to recognize the potential impact of monetary integration on financial management of a MNC. The rest of the paper is organized as follows. Section II discusses elements of financial strategies of a MNC and points the areas of potential interference of economic conditions present under monetary integration. Section III presents Gulf Cooperation Council region, its history and the institutional design. Section IV concludes on prospects for MNCs operating in the Gulf Cooperation Council member states after full monetary integration in the region is reached.

Elements of MNCs' financial strategies and interference from monetary integration

Tax planning in MNC and available instruments

Problem of taxation is perceived as one of the most significant for financial management of MNCs. It can be argued that the aim of all business entities is to minimize tax obligations but only a highly internationalized enterprise is able to achieve this goal quite efficiently. Fiscal issues of base- and host countries impact expenses of the MNC because they are associated with costs of hedging the risks caused by varying approaches in different countries. There are several main aspects of taxation that impact the MNC's financial management most. The structure of taxation, i.e. the system of direct and indirect taxes and the procedures of paying taxes. This involves also the problem of tax avoidance. When referring to contemporary discussion among EMU countries one can recognize an emphasis placed on initiatives aimed at preventing tax competition. This policy results not only from different nominal tax rates but also from the side-provisions allowing for tax avoidance when meeting some additional requirements. Regional economic integration has its impact this way on MNCs' financial management because a successful union is supposed to equalize nominal tax rates and standardize investment-associated exempts. Another problem seems to be associated with the difference in regimes and treaties of avoiding double taxation. It could be a monetary integration associated issue if monetary union is not preceded by an economic union – where this problem is solved as one of the first, being a prerequisite for a free flow of factors of production.

To optimize taxation, MNCs use a variety of methods, which can be divided to organizational and economic ones. Organizational methods cover value chain design based on exporting goods and services by tolling. This means importing raw materials and highly processed elements to a custom-free territory, then processing/assembling the final goods and next exporting. In addition, relationships with local entities are designed in a specific way to avoid some undesired requirements. This is achieved by dealing with local companies on the basis of agency contracts, partnership, joint investments. This allows to achieve economic goals without establishing an incorporated company. A very effective way is to establish a representative office in the host country instead of a subsidiary. This allows in many cases for avoiding income taxes in this jurisdiction.

More advanced forms of this approach include establishing special subsidiaries and branches in low-tax jurisdictions or in offshore zones. Lack of financial supervision is an additional benefit of this method. When the tax to be avoided is of a different nature – and is paid out of wealth, then it is necessary to transfer assets to a special holding in low-tax jurisdiction or in offshore zones. Once again this proves inability of national fiscal authorities to prevent capital flight when fiscalism approaches high levels and affects accumulated wealth of citizens.

All of these methods seem to be operational for a corporation doing business in a monetary union. Despite this form of economic integration does not involve explicit fiscal coordination, it may include fiscal convergence and for sure – unification of domestic tax systems in order to integrate the union. A first conclusion is that when monetary integration starts – we can observe a formal unification of tax systems and an implicit coordination of some fiscal issues. It means that a MNC operating in a region affected by this form of economic integration will be subject to significant changes in the tax environment and the previously used organizational methods for tax avoidance might become outdated and require redesigning.

The other group, the economic methods of tax optimization by MNCs include a very well recognized, but still questionable transfer pricing. These are artificially structured payments between affiliated companies that result in moving value added from one tax jurisdiction to another. The literature on this topic is vast and offers many creative examples. When transfer pricing is based on some artificial fixed exchange rate a monetary integration disintegrates the basis for this method by introducing a common currency. Otherwise, this form of economic integration seems not to harm pricing for transferring profits to country of management's choice. When profits are transferred to a tax haven the economic benefits are distributed to owners of a MNCs via dividends and other forms of income from financial companies incorporated in low-tax jurisdictions.

Transfer pricing in a monetary union

Pricing of intercompany transactions can have a significant effect on the company's overall effective tax rate. Careful transfer pricing planning reduces the effective tax rate by generating deductions or attributing profits to jurisdictions of management's choice. This can be a more efficient, less costly and faster alternative for achieving savings than a complicated business restructuring.

Appropriate transfer pricing is critical in both the commissionaire (Figure 1) and LRD structures (Figure 2) in order for most of the profit to be shifted to the Salesco, since it incurs most of the risk.

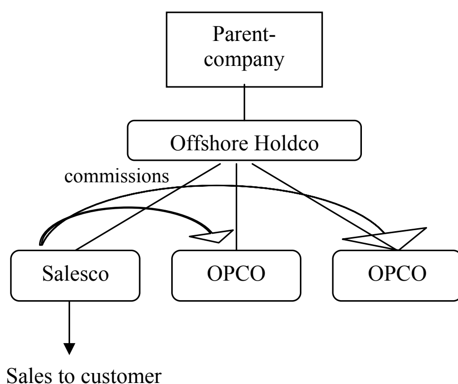

Figure 1

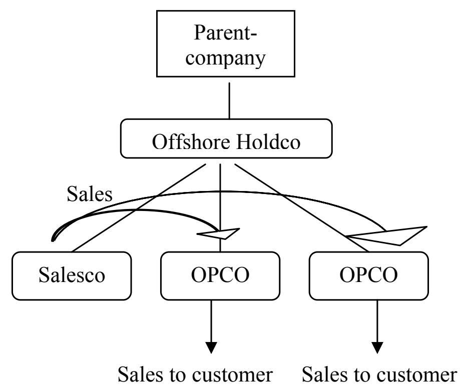

Figure 2

In a commissionaire structure, because ownership of the goods remains with Salesco, it automatically bears the risk in respect to, and carries the investment in, the goods. Thus, the only element of overall profit which remains with OPCo is the commission for its sales activities.

The key to the LRD structure is to limit many of the business risks that are commonly found in an entity which owns the product and resells it, so that more profit pops up in Salesco. To that end, it is critical to examine each element of business risk to determine how to shift the risk of loss. If transfer pricing is done correctly, the taxable profit left in the Salesco should be substantially the same in both the commissionaire structure and the LRD structure. Thus, in practice, the choice between the LRD or the commissionaire structure may have less to do with income tax planning and more to do with day-to-day practical implementation issues. Transaction-based taxes such as customs and VAT may also arise and should be factored into the decision. The ability to handle customs matters, in practice, often influences the choice between a commissionaire structure and an LRD structure. The issues extend far beyond the area of tax, and whether the customer has the expertise or desire actually to import the goods can be a determining factor in which structure to use. In many industries, the commissionaire structure may not be practical if the customer is not willing to handle customs matters. In the LRD structure, since the OPCo takes title to the product, it can perform import's services or hire agents to perform such services and, for this reason, is often more appealing when customs issues are involved. Monetary integration influence on transfer pricing and the structure to be used for this purpose is significant because of two reasons. First, when monetary union is preceded by a customs and economic unions – there are no customs matters to be dealt with by counterparts in the transaction. Therefore one of the incentives disappears. Second, in a monetary union national tax structures are very often converging for both direct and indirect taxes. This way another incentive and reason for transferring prices within a monetary union is removed.

When a company transfers profits outside a monetary union, the primary advantage of either the commissionaire or the LRD structure is that a significant portion of profits is taxed in the hands of the Salesco rather than the OPCos. This, in turn, depends on the Salesco being subject to a relatively low rate of taxation (outside a monetary union). The choice of jurisdiction for the Salesco is therefore very important. In addition to a low tax rate, other factors must be considered. It is important that the Salesco not have a taxable presence in the OPCo's jurisdiction. This will generally require that the Salesco be formed in a jurisdiction with a strong treaty network so that it can take advantage of treaty protection. Generally, under most tax treaties, a greater level of activity is required to have a taxable presence; therefore, a tax treaty will allow Salesco to avoid such a presence under circumstances where it might not be avoidable without a treaty. In addition, repatriation of profits from the OPCos and Salescos must be considered, as well as maintaining tax efficiency on exit. As with the OPCo structure, usually a top-tier holding company will be used to hold the stock of the Salesco and the OPCos (and the IPCo if a separate IPCo is used). This will generally allow for tax-efficient repatriation of earnings with little or no withholding tax and should generally minimize the tax on exit.

In sum, a commissionaire or LRD structure can be used by MNCs to reduce their global tax rates. Both types of structures should result in substantially similar tax savings. The choice between which structure to use will likely depend on practical implementations and operational issues (Buss, Hryck, Rothman 2006).

When considering potential impact of monetary integration on this part of the financial management at MNC one can note that taxation of capital income (including dividends) is very often subject to unification at economic union stage. Monetary union creates incentives for emergence a common capital market and what follows, unified taxation (if any) for capital gains and profits. Therefore under monetary union

arrangement one can perceive transferring economic benefits to one country and then distributing them in the form of capital income (dividends) to avoid restrictive taxes – obsolete because there should be no differences in any of member countries that could bring significant benefits. The only way to utilize this method is to move economic benefits outside a union to some other region that offers different capital gains taxation to benefit from.

Intellectual property method in a monetary union

The main idea behind international tax planning at MNCs is moving economic benefits to low-tax jurisdictions and then distributing them to owners. A key objective is to eventually repatriate profits in a tax-efficient manner. Implementing a basic offshore holding company structure can usually be managed so that there are little, if any, tax costs involved. A MNC with valuable intellectual property used in its foreign operations should consider the possibility of transferring some or all such property to a separate intellectual property offshore holding company formed in a low-tax jurisdiction. A MNC that is a manufacturer or a distributor may also want to consider an offshore holding company structure with a production or distribution company located in a low-tax jurisdiction. To use this method the MNC should have significant offshore sales (Buss, Hryck, Rothman 2006). When we consider monetary integration influence this strategy is conditional. As long as the off-shore territory is not a member of a the monetary union or the union has fully liberalized all BOP accounts, this strategy is not negatively affected and can be used after full monetary integration.

Cross-border investments and liability

In the context of incomplete contracting, limited liability results in private sector overinvestment in risky technologies relative to levels of investment that the society, as a whole, would consider optimal. This social agency problem is exacerbated from the standpoint of a host society in the context of cross-border investments by the MNC when there is an ill-defined or an incomplete cross-border liability. Monetary integration seems to have a significant influence on this issue. Currency union requires free flow of capital and therefore this implies a well defined and unified legal provisions for the intra-union investment.

An issue associated with cross-border investments arises in the form of localization of costs in the host country while the benefits from MNC investments are most often world-wide. Consequently, the host society would desire less investing abroad. A tax on equity can correct the distortion. When the host government operates a tax structure with both personal and corporate taxes, then it has an incentive to impose dividend withholding taxes on MNC profits. The mentioned problem could emerge if monetary union member countries significantly differed in terms of the level of technological development and use protective/stimulating policy in order to manage this issue. This is however rarely the case (e.g. Common Monetary Area) and even then – this problem is resolved by the requirement for the free flow of capital in the union and a unification of tax treatment of investment (achieved at economic union stage). Therefore this problem might arise in non-unionized economies where personal and corporate taxes on equity are present. It is likely to observe there border (or dividend-withholding) taxes on the repatriated profits of MNCs.

There are additional issues raised by cross-border investments in an international environment characterized by ill-defined liability rules. The investment project can be coinsured by the assets of the acquirer, and hence diminish the negative consequences to the host society. The degree to which coinsurance affects the policies of the host country toward the MNC depends on the clarity of cross-border liability and the global enforceability of limited liability laws. Dividend withholding (border) taxes are common in most countries, as is the provision of debt-related subsidies to MNCs

(Kose et al. 1991). It was mentioned previously, that issues associated with clear definition of cross-border liability when investment is concerned are resolved most often at some earlier stages in economic integration and are actual prerequisites for a successful monetary union which requires free flow of capital within it.

MNC dividend repatriation in a monetary union

Dividend repatriation is surprisingly persistent and actually resembles dividend distribution to external shareholders. As previously, these are the tax considerations that influence dividend repatriations. Parent company requiring cash to fund domestic investments, or to pay dividends to its shareholders, draw on the resources of its foreign affiliates through repatriations (Desai, Foley, Hines 2007). But in a monetary union tax considerations when dividends are paid are no longer an issue. Incompletely controlled affiliates are more likely than others to make regular dividend payments and to trigger avoidable tax costs through repatriations.

The crucial issues in MNCs financial management are in many cases affected by economic integration initiatives mainly by removing differences in institutional and legal framework. A question of the actual scope of this influence could be posed, considering one of the prospect monetary unions that is well designed and almost ready to start its operations. The initiative in question is the Gulf Cooperation Council Monetary Union. In order to present the expected impact of prospect integration in this region, a brief history and description of an institutional design of the GCC will be followed by a quantitative assessment of the MNCs role in the Persian Gulf Region economy and this way the extent in which monetary integration can affect microeconomic level.

III. The Gulf Cooperation Council history and its institutional design

The Gulf Cooperation Council (GCC) was formed on May 25, 1981, to facilitate policy coordination and integration among its six member states: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The GCC started with a free trade area and evolved to a full customs union by the end of 2005 (Kamar, Bakardzhieva 2006). The GCC countries share many common economic characteristics. Oil contributes about one-third to the total GDP and three-fourths to annual government revenues and exports. Together, these countries account for about 45 percent of the world's proven oil reserves and 25 percent of crude oil exports (Saudi Arabia is the largest world oil exporter), and possess at least 17 percent of the proven global natural gas reserves. Qatar has become the fourth-largest exporter of liquefied natural gas (Fasano and Iqbal 2003).

In 2010, the six member countries of the Gulf Cooperation Council (GCC) are scheduled to unveil a single currency and this complete their most ambitious step so far towards economic integration. The new currency will represent an area accounting for a fifth of current world oil exports and two fifths of known oil reserves. Prior to 2002, with the exception of Kuwait, which had pegged its currency to the IMF's SDR, all the GCC members already had USD pegs. The USD was chosen as the nominal anchor both during the interim period and in 2010 primarily because such a bilateral peg has served these countries well in past decades. While their collective official reserves are 'only' USD63 billion, most of their foreign asset holdings are managed by public fund management firms and are substantially larger than this figure.

The six countries have agreed to five criteria for a European Union style economic union, including capping budget deficits at three percent of gross domestic product, capping public debt at 60 percent of GDP and inflation at the GCC average plus two percent.

Interest rates are to be not higher than the average of the lowest three states plus two percent points and countries must have foreign exchange reserves to cover four to

six months of imports. In economic terms, the GCC countries are structurally similar and exhibit a high degree of monetary and fiscal convergence.

Significant progress toward regional integration has already been achieved through elimination of barriers to free movement of goods, services, capital, and national labor and though a common external tariff. All GCC countries continue to have strong macroeconomic fundamentals characterized by large surpluses in the fiscal and external current account positions, credible pegged exchange regimes, and low nominal interest rate environments (Dizmen 2006).

Over the past years, the member countries of the GCC have witnessed an unprecedented economic and social transformation. Oil proceeds have been used to modernize infrastructure, create employment, and improve social indicators, while the countries have been able to accumulate official reserves, maintain relatively low external debt, and remain important donors to poor countries. Life expectancy in the GCC area increased by almost 10 years to 74 years during 1980—2000, and literacy rates increased by 20 percentage points to about 80 percent over the same period. Average per capita income in the GCC countries was estimated at about $12,000 in 2002, with their combined nominal GDP reaching close to $340 billion. With very low inflation, overall real economic growth has averaged 4 percent a year during the past three decades, while the importance of non-oil economic activities has grown steadily, reflecting GCC countries' efforts at economic diversification. Moreover, central bank international reserves alone in some GCC countries are equivalent to about 10 months of imports. This progress has been achieved with an open exchange and trade system and liberal capital flows, as well as open borders for foreign labor.

With monetary policy directed at maintaining a fixed exchange rate and controlling inflation, fiscal policy has been the primary instrument to achieving other economic objectives, including growth, employment, and equity. However, fiscal policy has been constrained by the heavy dependence of government revenues on volatile oil export receipts. In addition, in many of these countries, a large and rising wage bill and, in a few cases, high domestic debt service payments have also diminished fiscal policy flexibility.

Given that the hydrocarbon wealth accrues entirely to the government, an extensive welfare system is in place in all GCC countries. Government services in many GCC countries are provided free or at highly subsidized prices, particularly water and electricity, while non-oil taxation is low, consisting mainly of income tax on foreign corporations—except in Oman, where local corporations are also taxed. Some of these countries have recorded overall fiscal deficits over the years, reflecting volatile global oil prices and relatively high levels of current expenditure. In the process, in a few of these countries government domestic debt has increased considerably. All GCC countries share sound and well-supervised banking systems. Banks are well-capitalized and profitable. Their supervisory framework has been strengthened and is largely compliant with international standards and codes. Moreover, GCC countries have gradually taken a number of steps toward implementing a market-based monetary policy, though direct instruments (such as interest rate and credit ceilings) continue to play a role in a few of these countries.

There are, however, important differences among the GCC countries. Per capita income ranges from less than $8,000 in Oman to $28,400 in Qatar. The structures of GCC economies and the composition of their exports are also changing. The weight of the manufacturing sector has been growing very rapidly in Saudi Arabia, as has trade and related activities in the United Arab Emirates, while the banking and insurance sector is by far the single most important sector in Bahrain. In Qatar, natural gas is well on the road to bypassing oil as the key sector in the economy, and in Oman the growth strategy centered on developing its natural gas resources and tourism has just begun to bear fruits. Reflecting these trends, non-oil growth has varied across the GCC area. Domestic inflation—albeit low—has differed across countries, leading to diverging paths

for real effective exchange rates. Differences also remain in bank regulatory practices, particularly regarding entry restrictions, liquidity requirements, and loan classification and provisioning. Notwithstanding progress toward economic diversification, growth of the non-oil sector has remained weak relative to the growth of the domestic labor force in most of the GCC countries.

Following the sharp drop in oil prices in 1998–99 and the associated financial pressures, the authorities in the GCC have reinforced their structural reform programs along the lines of the strategy set out above. Since the programs are driven by specific pressures in each country, they are at different stages of implementation. In all GCC countries, progress has been made over the past few years toward fiscal consolidation, lessening the budgets' vulnerability to terms of trade shocks from oil price volatility. Some countries have made progress in separating public expenditure decisions from the short-term developments in oil revenues, including (as in Kuwait and Oman) through formal oil savings and stabilization funds. Attempts to raise non-oil revenues have met with mixed results; they are expected to be more successful in the medium term. Moreover, containment of public expenditure has proven to be harder than expected: reducing public sector employment and curtailing the scope and budgetary impact of subsides have been difficult and the generous welfare systems have remained largely unchanged. More steadfast attempts to structurally strengthen the budget, including through the implementation of fiscal rules with strict transparent reporting and accounting procedures, would be useful.

The restructuring and privatization of utilities and related services have been placed at the top of the agenda in many GCC countries. Oman, Qatar, and the United Arab Emirates are presently relying on the private sector and foreign direct investment to fund and manage infrastructure projects in the energy and water sectors, while Saudi Arabia has moved aggressively to privatize telecommunications. The state enterprise reform and privatization can be sustained by a more sequenced approach, including establishing a process-monitoring system, further reducing regulation, offering common treatment of investors, implementing time-specific programs to improve the efficiency of state enterprises, and gradually increasing energy and water tariffs to recover costs.

New incentives have been recently adopted in all GCC countries to attract foreign direct investment. These include the establishment of regulatory, institutional, and legal frameworks to govern foreign capital inflows under a generally liberal exchange and trade system. In fact, 100 percent foreign ownership of companies has been allowed in most non-hydrocarbon sectors. Corporate income tax on foreign corporations has been reduced substantially, administrative steps for investment approval streamlined, and foreign investors' access to local stock markets improved.

More significantly, the banking systems of all GCC countries have remained resilient to the volatility in oil prices, as high capitalization and strengthened prudential oversight, together with cautious monetary policies, have helped preserve the quality of banks' assets. Steps have also been taken to deepen the financial system through the promotion of capital and equity markets in a number of GCC countries.

Indeed, significant progress toward regional integration has already been achieved since the GCC was established. Barriers to free movement of goods, services, national labor, and capital have been largely eliminated, prudential regulations and supervision of the banking sector are being gradually harmonized, banks are now allowed to open branches in member countries, individuals and corporations of GCC countries have been granted national treatment for tax purposes, and nationals have been permitted to own real estate and invest in the stock markets of all GCC member states.

A GCC single common external tariff (CET) is now in place. Also, imports originating from GCC countries are exempt from duties if 40 percent of their value added is from the region. However, differences in regulations on foreign investment, ownership, capital markets, and integration with the global banking system remain and have militated against the development of an enlarged regional common market.

The planned monetary union of the GCC countries by 2010 will reinforce the beneficial efforts of ongoing structural reforms and related macroeconomic polices. The monetary union is likely to promote policy coordination, reduce transaction costs, and increase price transparency, resulting in a more stable environment for investment. In particular, the introduction of a common currency is likely to enhance growth prospects by contributing to the unification and development of the region's capital markets and improving the efficiency of financial services (Fasano and Zubair 2003).

Conclusion

This brief overview of the financial management of an MNC shows that it depends on the economic policies of base- and host countries, in which the taxation, exchange rates, monetary and fiscal regulation play a decisive role. To hedge risks that appear from different economic conditions of host-countries, the MNC applies different methods (organizational and economic) of doing business across borders. In the case of Regional Economic Intergarion among host-countries (as in the GCC example), those risks are eliminated: exchange rate risk is minimized, taxation is small and simplified, customs are mostly eliminated, fiscal policy is harmonized, inflation is controlled, there is no need for specific methods of financial manipulation. Evidently, the terms of monetary union will make MNC's operations and financial management easier and attract FDI to the host-countries members of the GCC monetary union.

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