CHAPTER - II

RETAINED VALUE, OUTFLOW PAYMENTS AND SURPLUS TRANSFERS

2.1 Retained value and outflow payments.

Some recent studies have focussed attention on the transfer of surpluses by TNCs, in the industries of LDCs, with a view to minimising this transfer. Notable among them are the studies carried out by ESCAP (1978 a, 1979 a, 1979 b, 1979 c, 1979 d, 1979 e, 1979 f, and 1979 g) and Vaitsos, (1974).

TNCs could be defined as enterprises controlling assets in two or more countries (U.N. 1973). Such a definition would permit the estimation of the surplus transfers by not only the giant international corporations but the smaller foreign companies as well.

The concern in the ESCAP studies has been with estimating the distribution of gains between TNCs and host countries, in the various export commodity sectors. Towards this end in view, the notion of retained value has been introduced, which is an aggregation of local disbursements and is computed as a proportion of f.o.b. export revenues.

1 For the estimation procedure see ESCAP, 1978 a, p.24. Only one of the case studies has made detailed estimates of retained value and outflow payments (See ESCAP, 1979 a, pp. 55-60).
The aggregate income of the TNC in an industry, would have two components - retained value and transfer payments. The aggregate income in any year for a firm would be equal to export sales plus domestic sales.

Aggregate income - Aggregate revenue = Export Sales + Domestic Sales = Retained Value + Outflow Payments. It would be useful to distinguish the above from the Income and Value of Production, computed by the RBI for various companies (For instance see, RBI, Dec., 1987, p. 1186).

Income and Value of Production = net sales + increase (+) or decrease (-) in value of stock of finished goods and work in progress + other income (e.g. dividends) + non-operating surplus (+)/deficit (-) (viz. from sale of assets), = Expenditure + Appropriations. While the ESCAP takes only sales income into account, RBI takes income from other sources as well into account. Further, RBI estimates the value of production, which includes inventory adjustments.

The treatment of income in the ESCAP studies, differs from that used in the conventional national income accounting, in as much as it includes not only value added but expenditure on intermediate goods. The purpose of such a notion of income is presumably to enable the estimation of the overall foreign exchange drain implied in the outflow payments, which are given below in table 2.1.
Such a procedure leads it to include in the outflow payments not only the constituents of surplus value (which is value added minus wages) that is profits and interest, but imports as well. The ESCAP framework is altogether distinct from the notion of surplus value.
### Table 2.1

**Components of Gross Income or Revenue (Y)**

<table>
<thead>
<tr>
<th>Components of Retained Value (RV)</th>
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<tbody>
<tr>
<td>Wages and Salaries Paid to Indians (W)</td>
<td>1</td>
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<tr>
<td>Domestic Purchases of goods and Services less the Import Content of Domestic Purchases (DP-MD).</td>
<td>2</td>
</tr>
<tr>
<td>Retained Profits (RP).</td>
<td>3</td>
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<tr>
<td>Government Share of Revenues (GR)</td>
<td>3</td>
</tr>
<tr>
<td>Dividends Paid to local Investors (D)</td>
<td>4</td>
</tr>
<tr>
<td>Interest Paid to local creditors (I)</td>
<td>4</td>
</tr>
<tr>
<td>Rent (R)</td>
<td></td>
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<tr>
<th>Components of Outflow Payments (OP)</th>
<th>5</th>
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<tbody>
<tr>
<td>Imports of Goods and Services (MGS)</td>
<td>5</td>
</tr>
<tr>
<td>Import Content of Domestic Purchases (MD)</td>
<td>5</td>
</tr>
<tr>
<td>Salaries of Expatriates Accuring Abroad (SE)</td>
<td>5</td>
</tr>
<tr>
<td>Loan Repayments, Abroad, Including Interest (LP)</td>
<td>5</td>
</tr>
<tr>
<td>Corporate Profits, Transferred Abroad (TP)</td>
<td>5</td>
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1. W includes retained salaries of expatriates.
2. $RP = \text{Depreciation} + \text{reinvested profits} + \text{changes in cash holdings in local banks}$.
3. $GR = \text{Corporate taxes} + \text{indirect taxes} + \text{dividends}$.
4. I includes repayment of principal.
5. MGS includes advertising, sales promotion and other expenses incurred abroad. Further, it includes invisibles such as patents.
Imports could be a sheer necessity for the production process and their inclusion in the outflow payments seems improper. TNC activity for instance, could consist of refining crude oil in a particular country, which however, has to be imported as crude oil may not be available locally. In such a case, the import of crude oil becomes a necessity and therefore, imports cannot be viewed at par with other constituents of outflow payments, such as profits transferred abroad. In one of the components of retained value, namely, the net domestic purchases of goods and services, the import content which have to be netted out.

The ESCAP procedure does not take into account, transfer pricing which is the most important instrument for transfer of surpluses. In a sense, the inclusion of imports in the outflow payments partially takes transfer pricing into account. The over invoicing of imports would appear in the outflow payments. However, it is only that part of the import payment which is on account of over invoicing which constitutes a part of the surplus transferred and not the entire import payment. Further, under invoicing of exports to its affiliates, would understate the gross revenues of the firm, as well as the magnitude of outflow payments. Under invoicing of export is clearly a means for the transfer
of real surpluses by the firm, to its affiliates abroad.

2.2 Other Structuralist - Nationalist Nations

Both Vaitsos and ESCAP belong to what could be termed as a structuralist - Nationalist framework involving an enumeration of costs and benefits, and in the case of the ESCAP study, the costs are in terms of the outflow payments and the benefits in terms of retained value. Vaitsos sees an additional benefit in terms of lower prices, which TNC production may imply to local consumers, than what would have been the case in their absence. The Structuralist - Nationalist notion has a third world perspective. It is not concerned with surplus value but a spatial distinction of transfers. Dadabhai Naroji could also be seen as having had this perspective. These perspectives lack both a class view as well as the surplus view.

These views obscure the exploitation of labour and natural resources in LDCs by TNCS in their efforts towards accumulation on a world scale. It is by the exploitation of labour that surpluses are created and transferred by TNCs for consumption and further accumulation. In the colonial

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2 In our estimates of aggregate transfer pricing and surplus transfers in the drugs and pharmaceutical industry, which appears subsequently, we included only overinvoicing of imports because of the difficulty in procuring data on underinvoicing of exports and to this extent our aggregative estimates are if anything underestimates of the real magnitude of transfer pricing.
situation, this transfer of surpluses was nothing but a drain of the wealth of the colonies.

Vaitsos points to the need for viewing income flows from the LDCs, as a collective return on the package of capital and technology inflows, rather than disaggregatively as returns on individual inputs because the market imperfections, create a system of distorted pricing. For tax avoidance, the declared dividends may be grossly understated and the profits transferred through transfer pricing, which is made possible by the monopoly conditions obtaining in the market. The contracts of foreign owned subsidiaries and nationally owned firms contain tie-in clauses, which ensure dependence on imports of intermediates and capital goods. The process of direct foreign investment and technology commercialization, contains within itself the creation of monopoly conditions (Vaitsos, 1974, p. 92). Patents and tariff, and other forms of market protection contribute to these monopoly conditions.

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3 In 1968, the wholly owned foreign subsidiaries in the pharmaceutical industry in Colombia, had only a 6.7% return on investment if only declared profits were considered. On the other hand, bringing royalty payments and overpricing of imported intermediate products, into the calculation, pushed the return to 136.3%. Declared profits accounted for only for 3.4% of the latter, royalties accounted for 14% and overpricing accounted for 82.6%. Interest payments were not included in the calculation (Vaitsos, 1974, p.62).
The objective of TNCs is maximization of profits globally and minimization of tax payments is an aspect of this. In other words, the objective of TNCs is maximization of post tax profits globally. As we shall see later, the subsidiaries of the TNCs, remit the surpluses which are not required for local investment, to their parent and the particular form in which the surpluses are remitted would be dictated by tax considerations. In other words, a particular form for remission of surpluses, may imply lower tax liability than remission through another form. So the TNC selects such a combination of forms for remitting the surpluses which minimises their global tax liability.

For a TNC, the decision of declaring profits in a particular location, rather than in another, would be determined by the tax rate, which the declaration of profits in the host country would invite, compared to the tax rate prevailing in some other country to which the profits could be transferred through transfer pricing. Interest payments on inter-affiliate loans could constitute an important channel of remission because: One, it generally faces lower taxes than corporate profits; Two, does not face limits on remission as profits do and; Three, does not involve additional costs such as tariffs, which transfer pricing on intermediate product import does (Vaitsos, 1974, p.83).

A TNC is free to choose the form for remission of surpluses. Royalty payments on technology is one such form and in countries where such payments are not tax deductible,
they may still be utilised in the event of a ceiling on profit remission, prevailing in the host country. That is to say that not only can there be overpricing of product imports as a means for remitting surplus, but even overpricing of technology related payments. Where the tax rate on corporate profits is higher in the host country than in the parent country, the TNC would choose to declare profits in the parent country, as this implies a lower tax liability; and where the royalty payments on account of technology are tax deductible, then, this channel would be utilised for remitting the surpluses and for declaring the profits in the parent country. The TNC aims for an optimum combination of the various channels of remission, which in turn depends upon i) Government policies regarding tariffs, taxes, royalty negotiations, limits on profits remissions etc. and ii) the presence of monopoly conditions, such as monopoly in the import of inputs, which enables the firm to select channels, which imply the least tax cost (Vaitsos, 1974, pp. 85 and 93).

Unlike other channels of remission, transfer pricing is concealed and its importance lies precisely in this. While both royalty and interest payments have the limitation of time imposed by the length of the contract and the loan, transfer pricing is free from such a consideration. For the TNC, interaffiliate sale of products involves a cost in terms of tariffs. If the subsidiary in the host country imports from the parent, then it has to pay an import duty.
in the host country, which is a cost to the TNC. To the extent, the TNC chooses to transfer surpluses by transfer pricing, it incurs an additional cost in terms of tariffs in as much as, the TNC has to pay additional import duty to the extent of the overinvoicing of imports. In other words, overinvoicing of imports, involves a cost in terms of the additional import duty which the firm has to pay in absolute terms. Since tariffs usually involve a far lower burden than payment of corporate taxes, hence, transfer pricing is often the most important channel of remission.

Two other important considerations could prompt transfer pricing: i) the relative expenditure requirement - transfer pricing could enable the firm to meet certain expenditures. While meeting these expenditures, transfer pricing could at the same time serve, another objective, that of minimising global tax payments; ii) the relative investment requirement - the opportunity cost of capital to the TNC would be given by the return on its use in a particular location, which it would have to forego in the event of capital not being invested in that particular location. If a firm held its capital idle, instead of investing it, the opportunity cost of that capital would be the return on investment it has decided to forego. Differences in the opportunity cost of capital to the firm, in different locations, may prompt the use of transfer pricing, in declaring profits in a particular location, for its use as investment. Transfer pricing would be used if there are restrictions on the transfer of funds. While
transfer pricing could make funds available for investment throughout the year, remission through profits could be possible only at the end of the year (Vaitsos, 1974, pp.100 and 106).

All the treatment of this subject, in this stream, such as Singer (1950), Penrose (1959) and Lall and Streeten (1980C), enumerate costs and benefits. Singer (1950), requires particular mention as he was among the first to note the adverse consequences of TNC investment and production in LDCs. He highlighted the enclave type of development which the colonial form of investment in export oriented primary commodities resulted in. The benefits of such TNC investment were few and limited to the geographical area of investment, without any spread effects whatsoever. Consequently an enclave was created - an extension of the metropolis through the investment.

2.3 **Surplus transfers**

An important point that emerges from the study by Vaitsos is the inadequacy of income categories such as profits, royalties and interest as returns to specific factors of production, in a situation where the declaration of incomes are determined by tax considerations and involves transfer pricing. In other words it makes little sense in viewing profits as an exclusive return on capital or interest as an exclusive return on money capital or royalty as an exclusive return on technology sales, since surpluses
may be remitted through any one of these channels, apart from transfer pricing. Where substitution is possible, in the transfer of surpluses, a particular income category, ought not to be viewed individually but as part of a collective whole. The notion of surplus value, is a collective view of incomes, composed as it is of all the categories, such as profits, interest and royalties (Marx, 1976).

Surplus value is created in the process of manufacturing by TNCs in third world countries. These surpluses are a fund which could be used, by retaining them in the host country, either for social consumption, when the government in the host country for instance taxes these surpluses and employs these surpluses for social consumption or as social investment, when the government for instance, employs the taxed surpluses for social investment. Alternatively, the firm may itself retain the surpluses for investment. The surpluses in other words constitute a fund for the development of the host country. When the surpluses are retained and invested in the host country by the firm or if the surpluses become available to the government, a means is made available to the host country for capital formation (Bagchi, 1982 and Feer, 1986).

The colonial administration in British India, drained the surpluses through what it termed as home charges—charges for administering India, which were clearly unrequitted transfers (Patnaik, 1973). The economic surplus (Baran and
Sweezy, 1966) and surplus value need not be viewed as separate categories for our purpose here, but as a source for social consumption or investment. In other words, whether the economic surplus, assumes the specific form of surplus value, which it would the moment a TNC invests and produces in a host country, is not of much significance. What is of significance is that the surplus constitutes a fund for capital formation and if it is transferred, the host country is denied the means for capital formation. The underdevelopment of the erstwhile colonies and the present day LDCs, could be traced to the drain of surpluses by the metropolis, rather than its being retained and invested in these countries (Bagchi, 1982).

In the colonial situation, part of the economic surplus was drained away instead of being retained either for consumption or investment. The operations of the present day TNCs could also be viewed in terms of the end use of the surplus. It is the end use of the economic surplus which determines the pace of development of any society (Baran and Sweezy, 1966). The present study looks at that part of the surplus fund which is appropriated by the TNCs.

In this chapter we have surveyed the relevant literature on the subject. We began with the discussion on notions of retained value and outflow payments and considered some important contributions on the subject. This was followed by a discussion of how the surplus constitutes a fund for the development of LDCs and its
transfer implies, a denial of the means for the development of the LDCs. The following chapter is mainly about how technology contributes to the monopoly position of TNCs in LDCs.