Chapter VII

Multinationals, Development and Corporate Arbitrage

VII

A. INTRODUCTION

Between 1945 and the early 1980s, an increasing volume of foreign direct investment (FDI) flows occurred among advanced countries. It was closely connected to their rapid post-war rates of industrial expansion, particularly in more capital and technology intensive sectors, and their rapidly growing and converging levels of income. These tended to be two-way flows, often in the same sector, undertaken by large firms operating in the already well-established export markets.

Given these structural determinants of FDI, developing countries offered only marginal attractions to international investors. Incoming foreign capital was directed towards primary resource extraction, although technological changes in the consuming countries and rising political tensions in some host countries increased the economic risks for foreign investors in that sector. Expanding local markets could also attract multinational enterprises (MNEs) to some selective sectors requiring medium levels of skill and technology, such as chemicals and transportation, primarily in larger developing countries with an emerging middle class, where tariff barriers offered assured rents that could offset the perceived economic and political risks.

Since the early 1980s, FDI has grown considerably faster than both output and international trade in goods and services, with a marked increase beginning in the early 1990s in the share going to developing countries, including through the spread of global value chains (GVCs). Policymakers in the developing world have not only placed much greater emphasis on attracting FDI as a trigger for catch-up growth, but as carefully documented in UNCTAD's *World Investment Reports (WIRs)*, have done so by allowing much greater freedom to MNEs to choose how they operate in their countries: of the thousands of country-level reforms in FDI identified since 1990, the vast majority have been liberalizing (*WIR*, various years).

Bilateral and regional treaties and agreements have been a particularly important force behind this "liberalizing" trend. In most cases, these have been linked to a wider package of measures aimed at extending the influence of market forces. Indeed, because affiliates are generally more dependent on imported inputs than domestic firms, and as they rely on close financial relations with their respective parent companies, other affiliates and foreign financial institutions, competition to attract and retain inward FDI has been associated with broader efforts to accelerate the liberalization of trade and finance.

Liberalization is often presented as a simple policy choice of scaling back politically inspired infringements on an otherwise pristine world of economic decision-making based on relative prices and perfect competition. In reality, liberalization – whether of trade, the movement of capital or labour markets – is itself an act of state (and regulatory) intervention that requires political decisions and a change in the legal framework, usually paralleled by the creation of new norms and rules, as well as adjudication and enforcement mechanisms which also require political construction. All these have profound consequences for how businesses operate and who benefits (and loses) from their implementation and operation. Moreover, as liberalization can be pursued through domestic, regional and global processes, harmonization across the different constituencies is an additional political challenge on the liberalization agenda.

Whether conceived as a move away from previously agreed-upon multilateral norms or as the establishment of complementary regulations, regionalism – be it in trade, production, finance or the digital sphere – rests on negotiated agreements among a select group of (predominantly national) decision-makers who alter the rules and norms governing the economic activities in a particular space. Therefore, regional integration typically involves multiple layers of new regulations, with varying degrees of influence in national territories.

Whether the changes in rules and regulations have a positive effect on development is determined not only by the details of negotiated treaties, but also by the behaviour of large private actors – particularly the MNEs – navigating the global treaty space. This chapter sets forth some of the key aspects of this corporate maneuvering between jurisdictional niches – a phenomenon known as corporate arbitrage.

The behaviour of MNEs is partly affected by the sets of rules and regulations of the jurisdictions in which they operate and partly by the capacities of the corporations themselves to anticipate, shape and accommodate regulatory shifts in the political and economic context. In recent decades, the power of these actors to influence outcomes and shape regulatory contexts has grown in relation to other economic agents; it has also been transformed and amplified, as mechanisms of corporate control have been reengineered by the wider forces of legal and financial innovations, or financialization.

The focus of this chapter is on two dimensions of the financialization of the corporate realm pertinent for the developmental outcomes at both national and regional levels. The analysis reveals the way the core group of actors in the global economy – leading MNEs – interacts with the global system of multiple regulations and does so by making an incision into the way MNEs navigate the global regulatory system when planning their investment strategies generally and particularly when investing in the developing countries. The latter are vulnerable to the two-fold problem of global financial and corporate governance.

First, at the level of global political economy, regulatory complexity has been conducive to the rise of the "fragmented firm." Second, the inner transformation of the corporation itself, or the "code of capital" (Pistor, 2019), paralleling the technological, financial and regulatory shifts in the global economy, has meant that notwithstanding the macro-financial data on FDI flows, the economic substance of international investment, including in developing countries, is often structured much like a variant of asset management.

In the context of developing economies, when investing in these places, top multinationals tend to structure their FDI flows indirectly, taking ownership and control over the nature of investment (i.e. the type of economic activity, if any, associated with the investment), away from the host country and the purview of its regulatory institutions. Moreover, around a quarter of the subsidiaries of the top MNEs in the Global South present only balance sheets as evidence of their presence in a country, with no (or few) income statements reflecting real economic engagement. This has multiple implications for policymakers at national and regional levels and more crucially at the multilateral level.

The chapter is organized as follows. Section B features an explanation of the evolution of the linkages between the organization of production activities and the internationalization of MNEs and notes the role of financialization mechanisms in augmenting those links. Section C contains an analysis of the regulatory structure of the global economy that facilitates and determines the nature of international financial flows and investment. Importantly, notwithstanding recurring financial crises and reform attempts, including at the level of regional integration, the analysis indicates the system of global finance and investment is anchored in long-established regulatory niches and specific jurisdictions favouring financial capital, to the disadvantage of the developing countries seeking to attract long-term, productive investment.

Section D presents an empirical study of the investment activity of the top-100 non-financial MNEs globally. It is revelatory of a stark contrast between indirect ownership of subsidiaries of top MNEs and the type of their economic presence in the advanced vis-à-vis the developing countries. Section E contains a conclusion drawing lessons for the macro-financial regime governing global corporate behaviour, for the efforts of national governments seeking to attract foreign capital into their economies and for the efficacy of regional integration efforts, which are imperilled in the global regulatory topography exploited by the interests of global corporations and amplified by the structure of global finance.

B. CORPORATE CONTROL, INVESTMENT AND THE EXPANSION OF MNES

1. Corporate strategy, international production and regional development

The spread of cross-border supply chains is not an altogether new feature of the global economy, but the emergence of GVCs, particularly in manufacturing sectors, has brought fundamental changes to the way international production is organized. Whereas firms previously expanded abroad by essentially cloning themselves in another location, today, separate activities are performed in different locations and valued according to how they contribute to the objectives of the firm as a whole, not simply based on their profitability in the host country. Moreover, as the universe of MNEs has expanded, inter-firm agreements, networks and alliances of various kinds have emerged alongside FDI, to coordinate dispersed activities and deal more effectively with the growing complexity and contestability of international markets (*WIR*, 2011, 2013).

There is broad agreement that the adoption of market-driven reforms, along with technological developments and greatly reduced transport, communication and coordination costs, has stimulated the expansion of FDI over the past two decades. There is no consensus, however, particularly given the uneven distribution of investment flows across developing countries, on why some countries have proven more attractive to international business than others, and what the developmental impact of a global corporate presence in a country is. Outside the macro discussions, there is considerable analytical confusion surrounding the decision of firms to expand their activities abroad.

International trade theory provides little guidance. Its assumptions of identical production functions and competitive markets are far removed from the world of international big business and cannot explain why significant cross-border flows of investment occur between countries with similar factor endowments. Instead, conventional explanations of why firms invest abroad focus on efficiency considerations, with the commitment to invest seen as reflecting the comparative costs of hierarchy and markets in managing intangible assets. Given the mix of factor endowments in the host and home countries, the presence of scale economies in production and the transaction costs arising from trade and setting up production abroad, cost efficiency will dictate whether investment abroad emerges as the optimal market outcome in industries where firm-specific assets are important. This argument downplays and may even ignore the significance of firm size and corporate control in maintaining and expanding profitability; simply stated, it fails to recognize the potential economic distortions that can accompany very large firms' rent-seeking behaviour (Hymer, 1979, p. 65; *TDR*, 2018).

Big firms can and do shape market outcomes. These firms tend to be the first to move into production abroad. Recognizing this means abandoning the fiction of price-taking firms in perfectly competitive markets and contemplating instead a global economy structured by hierarchical power relations, inherently imperfect markets and (private) rent-seeking behaviour. Including these features in the argument adds an historical dimension to the FDI story, both by recognizing the evolutionary progression of international production and by acknowledging first-mover advantages.

The creation of MNEs is, from this perspective, best understood as an extension of the processes which originally gave rise to national corporations (Hymer, 1960). In essence, national firms become internationalized because they possess specific assets – such as a superior production technology, a distinct product design, superior managerial and marketing skills and other intangible capital – and have sufficient economic size to undertake profitable investments and manage costs internationally, despite the higher risk and additional costs deriving from coordinating production activities over large geographical distances and across political borders.

The transfer of production abroad is, however, rarely an all-or-nothing affair, and certain functions often continue to be performed in the country of origin or to be registered in jurisdictions offering favourable conditions for this specific type of business activity. These include higher-level strategic functions, such as research and development (R&D) and financial and service operations, with only the more routine types of production located in the jurisdiction where the actual production takes place. There can be strong neighbourhood effects to the organization of FDI: within Western Europe, for example, the consolidation and expansion of the European Union via the internal market program has been a steady influence on the growth of intraregional FDI which, as a result of both mergers and acquisitions (M&As) and greenfield investment, has facilitated the formation of pan-European firms (Dicken, 2003), with a Europe-wide corporate bond market developing in the same direction (Plender, 2003).

This process is also quite advanced in North America, where the historically close relations between Canada and the United States were extended under the North American Free Trade Agreement (NAFTA), particularly in some key industries, such as automobiles, where regional production structures played a central role. In the 1980s, Japan also started to invest heavily in some of its neighbouring economies, with much of the investment going into manufacturing (UNCTAD, 1996). But because the development gap between Japan and its neighbours was still considerably wider than that within other advanced regions, this left an opening for firms from the first-tier newly industrialized countries (NIEs) to become an important source of FDI in the regional economy of East Asia.

Within these regional blocs, direct investment and trade are often complementary, reflecting the development of an internal division of labour within a firm, whereby plants in different countries of the bloc either collaborate in the creation of a single product or specialize in the production of different finished goods for export to the entire bloc or beyond.

An additional set of barriers to the developmental gains from corporate expansion comes from the financialization of the corporation itself. As the next section shows, financialization, understood as the workings of financial and legal innovation driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to control the behaviour of global corporate groups investing into their regions. At the same time, the reorganization of GVCs is paralleled by finance-driven patterns of rent extraction, wherein developing countries remain at a structural disadvantage.

2. The financialization of the inner corporation

From the 1980s onwards, there has been growing evidence that MNEs are responding proactively to the changing regulatory regimes underpinning globalization and regionalization. During the 1980s, the global presence of MNEs in developing countries started to evolve from relatively simple and specialized cross-border structures, predominantly motivated by the search for natural resources and international markets, to more complex and integrated GVCs, built to exploit differences in labour costs and productivity (Zhang, 2021, p. 206). In the 1990s and into the 2000s, this process accelerated, and the two decades witnessed rapid growth in GVCs, a tenfold increase in the global stock of FDI and a fivefold increase in global trade.

More recently, the unbundling and geographical dispersion of MNEs' operational activities has come to affect those functions traditionally agglomerated in the global corporate headquarters of MNEs (Desai and Moel, 2008; McIvor, 2010). The offshoring of business support services has affected back-office and support operations, such as human resource management, legal services and accounting (Wilson, 1995), as well as front-office operations, such as customer support (Breathnach, 2000) and R&D activities (Dachs et al., 2014).

Together, these tasks are grouped in the category of corporate treasury and financing functions. Today, many of these functions tend to be separated from other headquarter functions and are performed by a separate subsidiary or set of subsidiaries. Furthermore, the groups of subsidiaries performing treasury functions tend to be located in specific jurisdictions providing an optimal institutional environment for the performance of that specific function. Similarly, strategic management might be “offshored” to jurisdictions providing large pools of managerial talent and conveniently located in the proximity of major markets.

An important aspect of the way MNEs are investing is the legal framework underpinning every type of transaction they undertake. Economic and financial operations must be booked through the firm’s subsidiaries and located in a jurisdiction – a sovereign country – for accounting purposes; they also have to be registered somewhere for legal reasons. Along with contracts that reflect the interests of business parties, economic transactions are subject to the laws of a particular jurisdiction where they are nominally located (or registered). The majority of modern multinationals deal with legal structures by decentring into separate legal persons, each of which is regulated by the rules and laws in the country where it is located (Blumberg, 1993; Ferran, 1999; Robé, 2011).[1]

Today’s MNEs are organized, in effect, as a network of entities held directly or indirectly by the parent through equity ownership. The corollary of this separation is that legally the different subsidiaries must trade with one another “as if” they were separate companies involved in typical market transactions. This is called the “arms’ length” principle, as mandated by the Organization for Economic Cooperation and Development (OECD). Estimations by UNCTAD (e.g., *WIR* 2015, 2016) and other organizations suggest between one-third and roughly two-thirds of global trade today is intrafirm – that is, trade between subsidiaries and affiliates of the same MNE that are located in different countries (Zhang, 2021, p. 207).

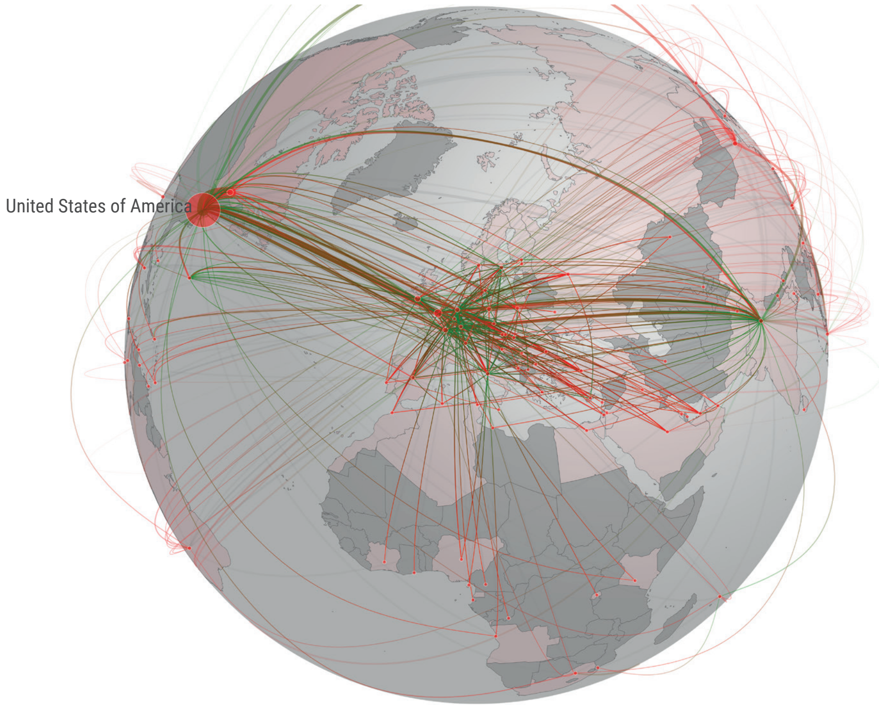
The implication of this chain of legal ownership is that when multinationals invest abroad, they tend to set up a subsidiary or a joint-venture company in the host country. The subsidiary will be controlled directly by a parent company or indirectly by one or more subsidiaries held by the parent, but for all intents and purposes is considered an independent legal person (Palan et al., 2021; Robé, 2011; *WIR*, 2015, 2016).

A multinational firm can opt for different arrangements of chains of ownership. A multinational whose parent holding company and headquarters are located in the United States can invest directly in Argentina by setting up an Argentinian subsidiary held directly by the United States parent. Alternatively, the firm may opt to invest indirectly in Argentina by routing the investment through subsidiaries in a third country – a transit country. While the multinational firm in the United States remains the ultimate owner of the investment in Argentina, the subsidiary in the transit country becomes the immediate owner (Bertz et al., 2021, p. 759; *WIR,* 2016).

Figure 7.1 visualizes the corporate structure of a major United States non-financial corporation. As it shows, nearly all interactions between the parent company in the United States and its subsidiaries in the developing countries are mediated through the group’s United Kingdom subsidiaries. According to Phillips and colleagues (2021), among the largest 100 non-financial MNEs in the world, direct ownership of subsidiaries in developing countries is a rare event. In this figure, there is practically no direct relationship between the United States and the developing country where the corporate entity invests. A comparison of global corporate presence of major MNEs by home countries is presented later in this chapter in figure 7.8 .

[1] Many legal scholars argue the independence of corporate subsidiaries is a fiction (Greenfield, 2008), but courts treat each corporate subsidiary as an independent corporate entity. On rare occasions, courts accept that the subsidiary is acting on behalf of the parent company or on behalf of another subsidiary and thus is not acting as an independent corporate entity. This is often referred to as “lifting the corporate veil.”

Figure 7.1 Global structure of a United States non-financial corporation



Source: UNCTAD Secretariat visualization on the basis of Orbis corporate filings.
Note: All interactions between the parent company in the United States and its subsidiaries in the developing countries go through the United Kingdom. There is no direct relationship between the United States and the developing country where the corporation invests. This pattern is similar for all major corporations (not just those in the United States).

Until recently, the central assumption of economic theory and policymaking has been that these corporate layers are merely functional elements of efficiency: they establish an allocation of ownership stakes across countries but need not affect or reflect the firm's productive operations. However, academic research increasingly recognizes that the form and nature of corporate ownership entail macroeconomic and macro-financial consequences.

First, indirect forms of investment create a distinction between the ultimate and the immediate owners of assets and, as a result, can present a major challenge to governments attempting to reassert control over the investment regime (Bertz et al., 2021, pp. 760-768; Robé, 2020; *WIR*, 2016).

Second, while for a company run as a single entity, the separation between form and function is less obvious, the corporate form is increasingly used to partition assets of the same firm into select pools; as a result, one firm may be comprised of hundreds of legal shells used for entity shielding, loss shifting and possible immortality (Pistor, 2019, pp. 52-55).

Third, in terms of the relationship between the nature of corporate holdings and control over investment, UNCTAD's earlier work on corporate complexity and investor nationality shows that while in the internal ownership structure of MNEs, control generally coincides with (direct or indirect) majority ownership, MNEs can exercise control over affiliates, even when they have a minority stake (*WIR*, 2016, ch. 4).

Fourth, the use of intermediary subsidiaries creates statistical anomalies in FDI accounts, because flow of investment through intermediary subsidiaries located in third countries inevitably creates data anomalies and double counting in FDI statistics (Zucman, 2013). Because data on aggregate FDI positions are typically based on immediate asset ownership, they provide a potentially biased measure of international financial ties, the distribution of asset ownership and risks associated with investment – for home and host countries alike. For example, beginning in 2019, Bahamas and Bermuda both overtook the Republic of Cyprus as a lead FDI investor in the Russian Federation,[2] while Hong Kong, Cayman Island and the British Virgin Islands (BVI) are the top three FDI investors in the People's Republic of China.[3]

Last but not least, by using intermediary subsidiaries in the third country, the owners and managers of an entity or parties to a contract can, if they so choose, register these in the same jurisdiction where they reside or work or where the underlying assets held by an entity are located. This is particularly important for a number of reasons.

3. Intermediary subsidiaries

One known purpose of such intermediaries is the tax-efficient channelling of the value created by operating subsidiaries to the parent company (Eicke, 2009; Lewellen and Robinson, 2013; Palan et al., 2021; Phillips et al., 2021). To achieve this, the debt or equity investments of the parent company are not made directly into a foreign subsidiary but indirectly through an intermediate holding company. Returns on those investments are then channelled back to the parent company through the conduit entity in the form of interest or dividend payments. Intermediate holdings or other entities in the group may also be used to channel royalty payments. Such "royalty conduits" may receive royalty payments because they are the legal owners of an intellectual property (IP) asset itself or because they own the economic rights to the royalty income generated by the asset because of a licensing agreement with the group entity who legally owns the asset (Maine and Nguyen, 2017).

The payments they receive are usually deductible expenses for the operating company and are generally taxed at a favourable rate in the country where the holder of the IP is located. The above-described dividend, interest and royalty conduit functions may also be combined in a single intermediate holding company (Garcia-Bernardo and Reurink, 2019). These techniques involve intermediary subsidiaries who serve as mere "conduit" entities (Garcia-Bernardo et al., 2017; Mintz, 2004). A recent International Monetary Fund (IMF) study called them "phantom investments" and suggested they are conducted purely for tax purposes (Damgaard et al., 2019; Garcia-Bernardo et al., 2017).

As most large multinational corporations are located in OECD countries, the phenomenon of phantom investment is often seen to affect tax receipt from corporate taxation in those home countries (Clausing, 2016; Hines, 1988; Zucman, 2013; *WIR,* 2016). Yet Cobham and Janský (2018, 2019) demonstrated a deleterious effect on developing countries as well, and others have suggested those corporate structures also accelerate capital flight from developing countries. As a recent OECD study argued, rerouting investments through less-regulated environments may raise risks of illicit financial flows (IFFs) (Nesvetailova et al., 2020). This argument, in turn, sparked debate on whether those conduits which are typically located in offshore financial centres (OFCs) are used for tax avoidance or serve as corporate treasury centres

According to Goldman Sachs, corporate treasury plays a central role in the firm's overall strategy, with the specific task of providing appropriate funding to support all firmwide activity while maximizing net interest income. The division allocates financial resources, raises funding and capital to support firm activity and dynamically manages the firm's asset liability risk and liquidity portfolio.[4] Corporate treasury actively engages in public markets and with businesses across the firm, investors, ratings agencies and regulators. At times, corporate treasury functions as an in-house bank (KPMG, 2016).

[2] See Inward Direct Investment in Newly Issued Shares of Banks and Other Sectors by Geographical Allocation. Data from Central Bank of Russia.

[3] Data from Republic of China Ministry of Commerce (MOFCOM).

[4] https://www.goldmansachs.com/careers/divisions/corporate-treasury/

Importantly, the use of corporate treasuries is not confined to companies in the financial sector but is standard across non-financial corporations (see box 7.1). In reality, they can function in both. According to Bertz and colleagues, the use of such intermediaries goes beyond accounting: it has implications for multilateral dialogue and reform because of the effects of shared investor nationality on economic diplomacy, the consequences of existing investment ties and regulations for military conflict and risks of illicit financial flows (Bertz et al., 2021, p. 786).

Box 7.1 The rise of corporate treasury operations

Before the advent of financial innovation, treasury operations in a corporate organization tended to centre on cash and very specific hedging operations serving investments. For a number of reasons – mainly but not only associated with financialization – these treasury tasks have, on the one hand, expanded in scope internally (within the corporate structure), but on the other, become dependent on being located in specialized intermediary subsidiaries typically registered in OFCs (Polak, 2010; Polak and Roslan, 2009).

Today, these types of subsidiaries perform many tasks, including hedging, investment, use of derivatives and compliance techniques, as well as capital market, accounting and tax arbitrage and, in some cases, in-house banking. With the expansion of these corporate treasury centres, many of the most value-added tasks of the organization have been shifted to corporate treasury units. The phenomenon is noted as the extraction of value in the literature on GVCs, where it is apparent that primary production of raw materials or basic agriculture goods constitutes only a fraction of the price paid by the consumer. This means much of the value added is absorbed within the corporate groups themselves or through transactions between groups along those value chains. The use of intermediary subsidiaries in third countries may be used, therefore, not simply for tax avoidance functions, also for treasury operations, along with the absorption of value, or earnings stripping (Robé, 2020, ch. 8).

As Haberly and Wojcik (2022) recently explained, the financialization of the inner corporation takes the form of larger portions of tasks and revenue assigned to these treasury operations and is intimately linked to broader trends in the global financial topography. Top companies in banking, insurance, real estate, investment management and other financial services, as well as in law, accounting and business consulting, drive the process of financial innovation at the macroeconomic level, with new financial products and services arising from the interactions between the sector and its consumers in both private and public realms.

In the emergent financial business services complex, the activities of many “non-financial” firms are just as impactful as those of the financial institutions. Law firms, for example, in addition to their key role in the economy of contracts, play an indispensable role in the structuring of assets and liabilities into investable funds and securities. Meanwhile, the concept of “value” in finance is often vague and thus frequently manipulated by accounting firms (Haberly and Wojcik, 2022).

Schwartz (2021) recently gave an empirical illustration of the social construction of value by pure financial vis-à-vis intellectual property rights (IPR) companies in the United States. He found a notable convergence in the business models of high-profit finance and IPR-based firms, particularly tech firms, as the latter become increasingly co-dependent at the level of business models and production processes. This concerns the way firms capture profit and what they do with that profit. The four homologies noted in his study involve: splitting standardized goods into an IP component firms control and a generic good or service, with low barriers to entry spun off to someone else; the salience of patenting (and state-sanctioned monopoly more generally) in creating a tollbooth around that IP; the nature of production processes; and reliance on proprietary data collection and manipulation (Schwartz, 2021, p. 10).

From the perspective of developing countries, these changes in the inner structure of MNEs mean the use of intermediaries can be very significant and entail serious macroeconomic consequences.

First, their use highlights the limitations of traditional FDI data for macroeconomic strategy, illustrating that a country's ability to attract large FDI flows into the economy does not necessary translate into national fiscal revenue. Second, corporate conduits are used for tax avoidance purposes and raise risks of illicit finance (Nesvetailova et al., 2020). Third, if used as corporate treasury centres, the jurisdictional location of these entities is important, especially for developing countries, because the operations they perform are very lucrative. If investments are mediated through foreign intermediaries, and these intermediaries serve as corporate treasury centres, a considerable portion of the high-value activities is clearly taking place elsewhere.

C. REGULATORY COMPLEXITY AND THE FRAGMENTATION OF THE FIRM

The lack of harmonious regulation governing international trade and investment is widely cited as a by-product of the regional integration initiatives that have increased during the last three decades. At a broad level, this is the result of the historical layering of regional integration initiatives that originated in the creation of trading blocks in the post-war years. More specifically, it is also an outcome of the changes in the very nature of regional agreements – in scope, depth, type of participation and coverage. Finally, the regulatory governance of regional integration is affected by the global politico-economic context.

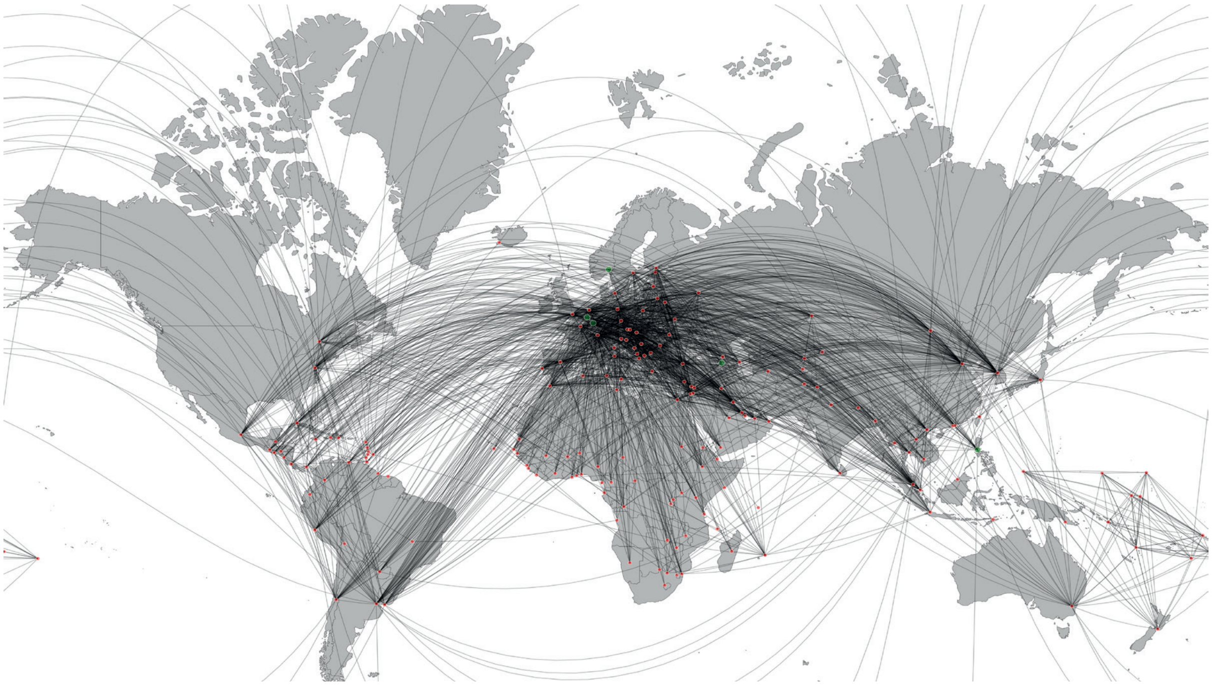
1. Regulatory complexity as a by-product of regulatory layering

As a result of regulatory layering, most regional and bilateral initiatives across trade and investment have tended to expand in a manner not controlled by the multilateral regulatory framework. From the perspective of large MNEs, the global economy has become a complex and uneven set of what Douglass North called "the rules of the game of society." These are national rules shaped by particular states, their own macro-financial regimes and competition priorities, combined with a multilateral or regional layer of rules and regulations superimposed on the national rules.

Figure 7.2 visualizes the complexity of the global regulatory landscape governing international investment flows – known as the international investments agreement (IIA) regime. It shows all currently active IIAs, pointing to the centrality of Europe as a global hub for international investment structures and the key connecting role of OFCs, as well as the comparatively weaker presence of "attractor states" in the developing South.

The multilateral investment regime is known to have many problems related to complexity and lack of coherence, with treaties often exposing gaps and overlaps. In this respect, as noted by UNCTAD, regionalization initiatives represent a rare opportunity to rationalize the regime and create a more coherent, manageable and development-oriented set of investment policies. In reality, however, regionalism has moved in the opposite direction, leading to a multiplication of treaty layers over time (figure 7.3), making the network of international investment obligations even more complex and prone to overlap and inconsistency (*WIR*, 2013). In effect, more than half a century after the first bilateral investment treaty was concluded (between Germany and the Islamic Republic of Pakistan in 1959), the multilateral investment regime has evolved from a system originally developed to foster legal predictability in investment relations between countries to become a source of legal uncertainty, debate and controversy (UNCTAD , 2020, p. 117).

Figure 7.2 International investment agreements, 2022



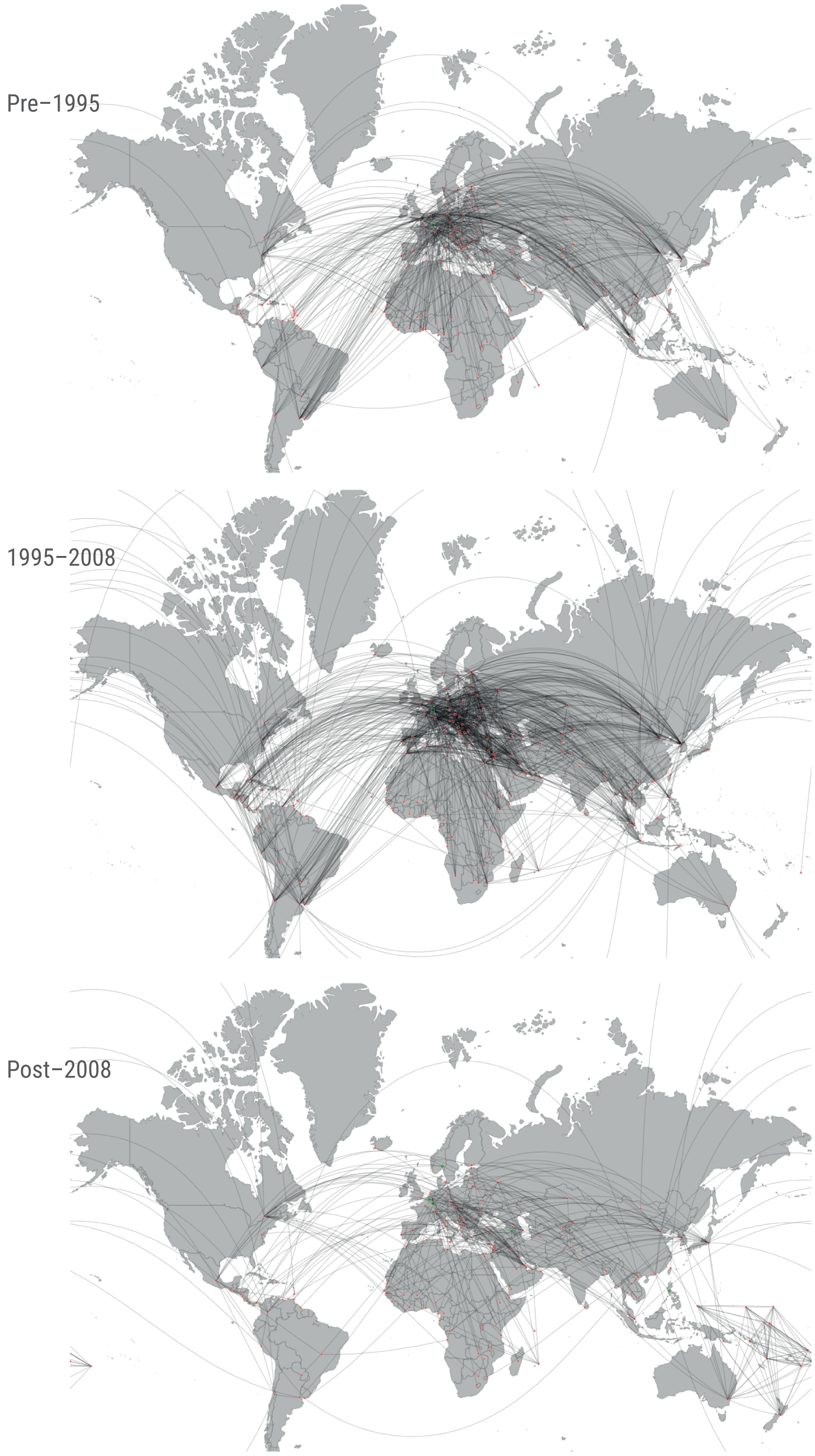
Source: UNCTAD Secretariat visualization based on UNCTAD investment agreements data.
Note: Only agreements that entered into force are represented.

Attracting FDI is now a key reason for developing countries to seek regional trade agreements (RTAs), especially with the developed countries, as a way to join GVCs.[5] Theoretically, one would expect continued support for a multilateral regime governing investment – that is, a set of rules to protect the rights of the corporation – among leading MNEs. However, because of the layering and multiplication of treaties, the largest MNEs tend to already have access to investment treaties for most of their target markets or can get such access with relative ease.

As illustrated by figures 7.2 and 7.3, Europe and OFC states serve as key hubs or conduit spaces in providing such access. This might explain both the lack of corporate support for a multilateral investment regime after its failure in the 1990s and the slow-down in the creation of new investment treaties, as illustrated by figures 7.3 and 7.4 (Jandhyala et al., 2011). Unsurprisingly given the market reach endowed in bilateral investment treaties, large MNEs tend to be less supportive of (and may even oppose) a multilateral regime than they would have been without an existing bilateral investment regime. This echoes arguments about preferential trade agreements, which similarly create opposition to multilateral liberalization among beneficiaries (Mansfield and Milner, 1999; Bertz et al., 2021, p. 786).

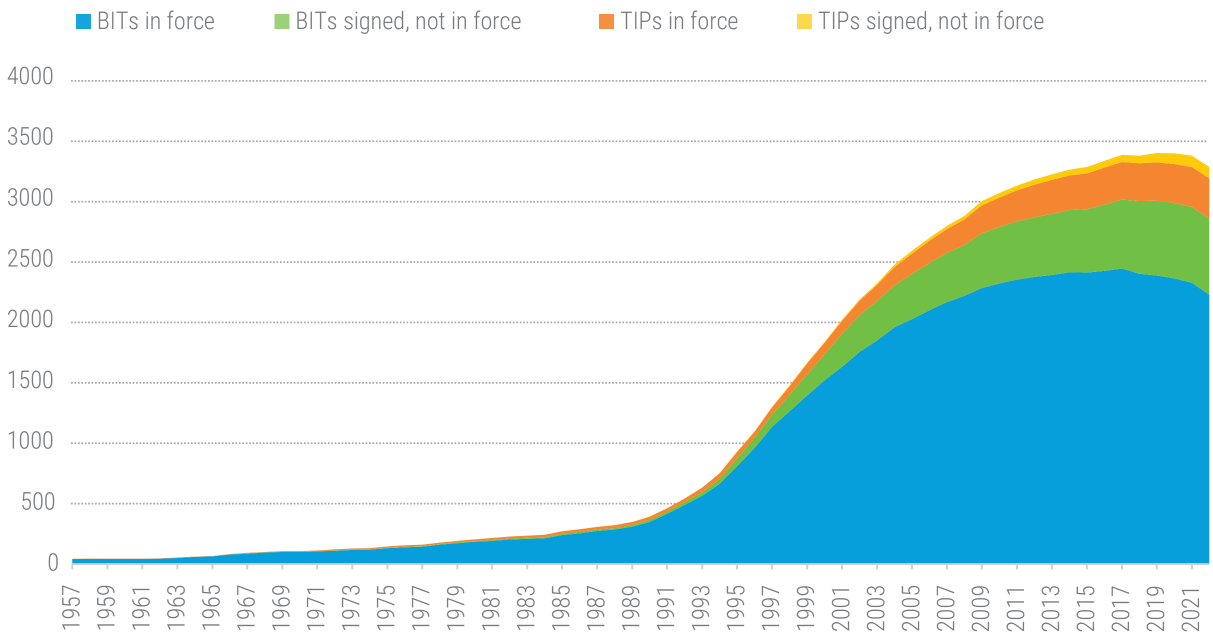
[5] Balassa conceived his typology in the 1960s when the roles of FDI and cross-border production networks were less important. The motives for reginal integration have been extended from the traditional area of trade into new areas, such as investment and regional trade, both of which relate to deep integration (Kang, 2016).

Figure 7.3 The evolution of international investment agreements, 1957–2022



Source: UNCTAD Secretariat visualization based on UNCTAD investment agreements data.
Note: The figure periodizes all active IIAs based on when the agreements came into force. The three periods captures agreements in force pre 1995; agreements that entered into force between 1995 and 2008; agreements that entered into force post 2008.

Figure 7.4 International investment agreements by type, 1957–2022



Source: UNCTAD secretariat calculations, based on UNCTAD, Investment Policy Hub, International Investment Agreements Navigator.
Note: International investment agreements (IIAs) are divided into two types: bilateral investment treaties (BIT) and treaties with investment provisions (TIP). BIT is an agreement between two countries regarding promotion and protection of investments made by investors from respective countries in each other's territory. TIP brings together various types of investment treaties that are not BITs.

By default, the visualizations presented in figures 7.2, 7.3 and 7.5 offer only a snapshot of the scope of regional agreements and do not reflect the specifics of each deal and type of partnership. Yet they do give a clue about the political geography of international trade and investment governance. While RTAs (figure 7.5) broadly correspond to major zones of market integration and trade, as reflected by the established regional blocs and wider participation of the developing countries, the network of IIAs points to the central role of the European hub and OFCs as central nodes in the regulatory landscape governing the corporate intermediation of FDI flows.

The outcome of this layering is the increasing regulatory complexity of the global economy; this tends to disadvantage the developing countries seeking to establish new regional integration projects and governance institutions (Kang, 2016, p. 243). For instance, bilateral investment treaties include a dispute settlement clause that allows investors to sue host states, typically bypassing domestic courts and allowing investors to bring international arbitration proceedings directly, most often at the International Centre for Settlement of Investment Disputes or under the United Nations Commission on International Trade Law arbitration rules. Originally based on a system of ad hoc confidential commercial arbitration between private parties, the legitimacy of the investor–state dispute settlement system is now challenged (*TDR*, 2018). By mid-2019, investors had brought more than 1190 investor-state dispute settlement cases against 130 countries, including 117 cases against at least 30 African countries (*EDA*, 2020, p. 117; *WIR,* 2022, p. 73). The interplay between the legal infrastructure of asset creation at the level of the corporations and the international financial system poses a set of challenges not only to national and regional regulators, but also to the strategies of developmental regionalism more generally (see box 7.2).

Figure 7.5 Regional trade agreements, 2022

Source: UNCTAD Secretariat visualization based on World Trade Organization data.
Note: Only agreements that entered into force are represented.

The introduction of IP laws in international trade and investment agreements has added further complexity to such agreements in recent decades, largely to the detriment of the needs and interests of the developing countries. The adoption of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) by the World Trade Organization (WTO) in 1995 established binding multilateral minimum standards on all WTO member states for granting and protecting the use of IP (i.e. patents, copyrights and trademarks) in foreign markets.

The negative impact of these IP protection measures on the developing countries, particularly with respect to the healthcare and pharmaceutical industries, resulted in the Doha Declaration in 2001; the developing countries' rights to use flexibilities and safeguards were reaffirmed in the Declaration and clarified at the WTO Ministerial Meeting. However, despite these supposed safeguards, in practice, the bilateral, regional and plurilateral agreements signed in recent years have included IP protection provisions that are far more stringent than those envisaged in TRIPS. Such provisions, often referred to as TRIPS-PLUS, include the expansion of existing obligations under the TRIPS Agreement (e.g., patent term extensions[6]), restrictions on the use of safeguards or flexibilities (e.g., compulsory licenses,[7] parallel imports[8]), and the introduction of new provisions not even addressed by TRIPS (e.g., data exclusivity[9]) (Correa, 2017). These provisions are often imposed on the developing countries as a necessary component of international trade and investment agreements.

[6] These are provisions to extend the duration of a patent beyond the 20 years required by TRIPS.

[7] This provision gives the government the authority to grant permission to another party to produce a patented product or process without the consent of the patent owner.

[8] This provision refers to the purchasing of patented goods in a foreign market for their resale in the domestic market.

[9] This provision means that for a specified period of time the regulatory authorities cannot rely on the originator's safety and efficacy data for the registration of generic versions of a drug.

Box 7.2 Investment protection and climate change

One aspect of investment treaties subject to intensified scrutiny in recent years is the legal protection of investments.[10] The investor-state dispute settlement (ISDS) mechanism included in thousands of investment treaties allows investors to sue governments for any action they claim violates their legitimate expectations of profits. These cases can run into billions of dollars, often involving claims against future profits: in July 2019, the Australian subsidiary of Tethyan Copper Company[11] was awarded $5.8 billion against the government of the Islamic Republic of Pakistan, more than 25 times the $220 million the company invested in the project and 16 per cent of the entire Pakistan budget for 2018-2019 (Bonnitcha and Brewin, 2020).

Cases are often initiated in response to public interest policies, such as financial regulation, public health, land use, environment and social protection policies (Thrasher, 2021). Risk of exorbitant penalties curtails governments' right to regulate, causing a regulatory chill. Climate and environmental regulations are the most common, most lucrative and fastest-growing trigger for claims (Salvatore, 2021). The fossil fuel sector has been the most litigious, initiating 20 per cent of total investor-state disputes so far and winning almost three-quarters of them (Salvatore, 2021).[12]

A recent study estimated the costs of possible legal claims from oil and gas investors in response to government-led transitions in line with International Energy Agency's 1.5°C scenario (IEA, 2021). It found claims could reach $340 billion (Tienhaara et al., 2022). As a consequence of treaty shopping, this is an underestimate of the true extent of protection of 1.5°C – incompatible oil and gas assets, with law firms already advising investors to adjust corporate structures to avail themselves of ISDS benefits from climate claims (Jones Day, 2022). Considering the total public climate finance in 2020 was less than this at $321 billion, these protections pose a significant financial risk, draining resources from necessary mitigation and adaptation efforts.

The Energy Charter Treaty (ECT) which protects energy investments is the most commonly used ISDS mechanism in the world. There is increasing awareness of the threat the ECT poses to a just energy transition, with governments facing liability for a range of net zero actions, such as cancelling pipeline developments and denying drilling permits. As a consequence, ECT members recently agreed to a process of "modernization" to "align the ECT with the Paris Agreement and our environmental objectives." However, the "agreement in principle" did not go so far as to remove fossil fuels and other carbon-intensive energy sources from protection and did not alter the basic mechanics of the Treaty to shield corporate power from public policy decisions (European Commission, 2022).

As many more countries in Africa and the Middle East, Asia and Latin America are in the process of joining the Treaty, litigation will drive up the bill for global transition, posing a barrier to sustainable and climate-resilient development. Given the obvious threat to public interest and the failure of such investment protections to deliver promised levels of productive FDI, governments should terminate their existing Treaty (Moehlecke and Wellhausen, 2021).

[10] For UNCTAD's work on this, please see: https://investmentpolicy.unctad.org/publications/1269/the-international-investment-treaty-regime-and-climate-action and https://investmentpolicy.unctad.org/publications/1270/treaty-based-investor-state-dispute-settlement-cases-and-climate-action

[11] Mention of any firm, product, service or licensed process does not imply endorsement or criticism by the United Nations.

[12] For breakdown see: https://investmentpolicy.unctad.org/investment-dispute-settlement

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Although a central argument justifying the adoption of these IP protections is that they promote the transfer and dissemination of technology, recent evidence suggests IP protections do not have a positive impact on technology transfer to the developing countries (Kirchherr and Urban, 2018). Rather, the inclusion of so-called TRIPS-PLUS provisions in international agreements is largely a result of intense lobbying by large corporations seeking to leverage technological leadership to enhance market power, set a barrier to market entry and create a source of super-profits (*TDR*, 2020).

Consequently, the IP provisions and frameworks in international agreements have shown an increasing bias towards the excessive protection of private investor interests, often at the expense of wider public interests (*TDR*, 2017). This is particularly the case when international agreements are signed between developed and developing countries, evidenced by the fact that North-South agreements contain a larger number of TRIPS-PLUS provisions than either North-North or South-South agreements (*TDR*, 2014; WTO, 2011).

The next section focuses on the fragmented corporation in the political economy of development to reveal the role of control in global corporate groups. The analysis of the configuration of corporate ownership structures offers important lessons for development, including through regional arrangements, because when analysed in a systemic framework, they point to where value and earnings stripping occur.

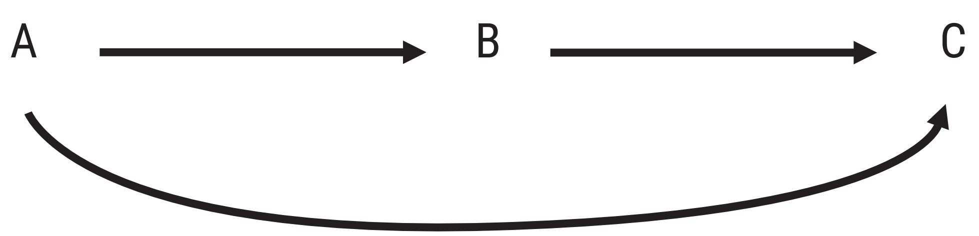
2. Legal implications of the use of subsidiaries

Section B included a description of the potential uses of intermediary subsidiaries of MNEs. The importance of diverging functions of such intermediaries within corporate groups becomes clearer in the context of the rules of incorporation and transaction. As mentioned above, each subsidiary is subject to the rules of its country of registration.

Figure 7.6 presents a scheme of direct and indirect holding. In a direct holding, A→C, the investment is subject to the rules and regulation of country A and country C, to the bilateral trade and investment treaties between the two countries and to multilateral treaties in which they participate. In an indirect investment, A → B → C, the investment is subject to a much more complicated set of rules. The investment takes the form of A→B and is subject to the rules and regulations of country A and country B and the bilateral and multilateral agreements between them, and between country B and country C and the bilateral and multilateral agreements between them.

Indirect investment through intermediaries is more complicated, but it may have the advantage of redirecting the rules under which the investment takes place. An MNC may react to a more favourable environment presented by a regional trading agreement by locating an intermediary in the most favourable jurisdiction in that agreement and direct most activities to that intermediary, thus denying much of the coveted advantage of FDI to other countries in the region.

Figure 7.6 Direct and indirect ownership patterns



Source: Phillips et al. (2020).

In a more sophisticated scenario, an MNC can use two intermediaries. One is located in a country that is not part of a regional agreement but shares a bilateral agreement with one of the countries in a regional agreement. The upper intermediary is then accessing the regional trading or investment agreement through the lower subsidiary, whereas much of the actual activity is moving to the upper subsidiary located in a country that is not part of the regional agreement. An even more sophisticated scenario can involve three intermediaries in three different countries. These techniques of setting up an intermediary can ensure that every regional agreement is "arbitraged."

In a yet more sophisticated scheme known as a "put out" option, the corporation may move business out of an entity via an apparently innocuous contract:

1. Company A in Country B has a business of producing widgets sold to distributors. It has a turnover of 100 and makes a margin.
2. Company A is indirectly controlled by Company Z in the Global North.
3. Company Z prefers Company A's business to be located in Country B.
4. Subsidiary B signs a contract with Company A. It will supply components to A; A will produce the same widgets with these components and will deliver the finished widgets to B for the price of manufacturing the widgets.
5. Company B sells the widgets to distributors.
6. End result: Company A gets enough to pay local production costs (mainly employees' salaries but nothing more); Company B now owns the business (it has the clients) and earns the margin.

In sum, the corporate world, particularly large MNEs, often manoeuvres the changing regulatory environment at two main levels. First, while regional trade and investment agreements may well encourage investment into the region, the way the investment is structured through subsidiaries is crucial for the economic nature of the investment. The default assumption in FDI research is that all investment is structured as a set of directly held subsidiaries, and those subsidiaries perform operational activities (as above).

Second, MNEs can and, as shown below, do structure those investments indirectly through intermediaries and ensure a considerable portion of operational activities takes place elsewhere. They may do so because certain countries offer a better regulatory environment, lower taxation and other advantages – as reflected in the phenomenon of the competition state. As detailed in box 7.3, there is strong evidence to suggest countries have chosen to participate in the global economy by competing over lucrative segments of corporate "parts." Due to statistical anomalies discussed above, none of these outcomes is picked up in FDI statistics.

The internal organization of corporate groups and the way subsidiaries relate to parent companies and to each other are now recognized to play major roles in enabling corporate access to international arbitration . The techniques can also come into conflict with national governments, especially in the context of developing countries, where corporate groups arbitrage national rules through access to investment treaties. Consequently, analysing the specific role of corporate subsidiaries in host economies and mapping their linkages to their parent may point to a central way in which value and earnings are being created (and stripped) in the process of international business.

Box 7.3 The competition State and OFCs

The neoliberal reforms of the 1980s gave rise to a development that remains at the centre of globalization, including regionalization processes. With the hollowing out of post-war models of welfare states and the rise of global markets, states became increasingly engaged in a peculiar competitive game, wherein “they are competing for world market shares as the surest means to greater wealth and greater economic security” (Strange, 1987, p. 564).

The phenomenon is known as the rise of a competition state – a process where key institutions and policies of the state are adapted to the new conditions of the global market, and where the very concept of the national interest is expanding to embrace the transnational dimension: the so-called competition state is itself obliged by the imperatives of global competition to expand transnationalization (Cerny, 1994, p. 225). One major implication of the transformation, as maintained in the Washington Consensus, is that rather than directly controlling the economy, in order to compete for a share in the global marketplace, the state is better off providing the conditions for generating growth (Palan and Abbot, 1996, p. 4).

The transformation has unfolded globally in the era of what Philip Cerny has referred to as “embedded financial orthodoxy” – an extended phase of crisis marked by unstable cycles of boom and slump. In the context of heightened fragility, the policy instruments available to the state have changed from tools of fine-tuning to more blunt options, such as interest rates, while the central concern of financial stability is to ensure a contagion-free environment conducive to further and deeper financialization (Cerny, 1993, p. 158). In parallel, economic policymaking has shifted from predominantly demand-side measures of the Fordist era and the immediate post-Second World War decades to supply-side measures.

The broad principle of deploying state rules and regulations as a developmental strategy has achieved its extreme form in some of the very small states in the world, particularly island economies in the Caribbean and small states of Europe, who historically found it difficult to develop a strategy of competition based on diversification of economic sectors. They learned to commercialize their sovereignty by offering a free and liberal regulatory environment of low or zero taxation, secrecy and light regulation. By the early 1990s, with over 40 states offering a variety of facilities for tax havens and offshore banking, the tax haven model was, at least numerically, one of the most popular state strategies.

In effect, the strategy drew a new political and economic map, with each of the major and minor trading blocs now surrounded by an archipelago of small tax havens (Palan and Abbott, 1996, p. 167). While many of these states were initially accused of becoming tax havens, over time, their models of the competition state became more sophisticated and targeted, and many established themselves as more diverse OFCs (Haberly and Wojcik, 2022).

In Europe, with the creation of the European market and the concept of subsidiarity, states were given free hand to determine their fiscal structure. Some began to compete to become the gateway for investment into Europe (early 1990s). Some states targeted real investments, while others became conduits for financial presence of chiefly United States companies, accommodating, in part, the hosting of corporate treasury centres (Garcia-Bernardo and Reurik, 2019). Over time, these European attractor states drew not only United States capital, but also European and Asian corporations. The effect of this structure is that the services aspects of the investment value – the highest value-added of the value-creating components – are being located in very specific jurisdictions, led by the Netherlands, Ireland, Luxemburg, the United Kingdom and Switzerland. As a result, FDI into developing countries is rerouted through these territories (Garcia-Bernardo and Reurik, 2019).

As Haberly and Wojcik (2022) recently noted, the institutional and historic legacy of European legal frameworks looms large over the global web of not only offshore financial havens but also the global financial system. Laws and institutions that once served the extraction of wealth now prove useful for jurisdictional arbitrage (Haberly and Wojcik, 2022; Palan et al., 2010; Eden and Kudrle, 2005; Shaxson, 2011). The role of these tailored jurisdictional niches is key to the global pathways of FDI and the flows of international finance as mediated by MNEs. These historical jurisdictional niches constrain the national policy space available to governments when regulating the economy and pose a challenge to multilateral attempts at economic governance (Robé, 2020).

As a result, the structural impact of the global architecture built by early regionalization initiatives is the creation of regulatory layering: the regionalization initiatives are being layered onto each other, amplifying complexity in the process. In this increasingly complex global economy, where the very process of value creation and extraction proceeds in many stages across several economic and legal spheres, typically involving multiple agents in many jurisdictions, financialization, including its legal and corporate underpinnings, is the main channel that not only connects capital and regions, but also sustains the value-creating operations of MNEs at the transnational level. Both dimensions of financialization pose a spectrum of challenges for development in general and for the outcomes of regional integration in particular.

D. CORPORATE ARBITRAGE AND DEVELOPMENT: MAPPING CORPORATE EQUITY CHAINS

It is clear that an understanding of whether or not regional arrangements can accommodate a strong development dimension must address the issue of changing corporate structures, especially the growing ability of large international firms to circumvent regulations and policies. Doing so requires a more granular approach to FDI and includes the analysis of corporate organization and intrafirm trade, of the sort pioneered by UNCTAD (*WIR*, 2015, 2016). The challenge that has so far impeded the advancement of the analysis of corporate intermediaries and groups is two-fold.

First, the number of subsidiaries and groups has tended to multiply over the past few decades, making it difficult to have an overview of the corporate organization at the aggregate level. Second, some subsidiaries, especially indirectly held subsidiaries, do not acknowledge in their annual report their relationship to the group or the parent of the group. Phillips et al. (2021) relied on the Orbis database to chart the visual maps of the groups as whole (these were called *equity maps*). More specifically, the authors innovated an algorithm linking subsidiaries to the overall group, even when this relationship is not formally declared. As a result, the technology visualizes all subsidiaries and affiliates.

With the authors' permission and having access to their original database and the algorithm, the following box combines the spatial mapping technique with the analysis of subsidiary accounting data to gauge the degree to which investment in developing countries follows the phantom FDI pattern. The more general goal is to establish to what extent jurisdictional arbitrage-seeking is a key feature of the foreign investment patterns of multinationals.

Box 7.4 The CORPLINK study and its limitations for development research

The Corplink study examined the way the largest 100 publicly traded non-financial MNEs in the world structure their investment in the Global South and around the world. It should be noted that many of the largest companies from the developing economies are state-owned or partly state-owned, and the Orbis database does not record any of the largest Global South MNEs in its top 100. As a result, there is a bias of composition in the sample of companies: the top 100 largest non-financial MNEs tend to be companies from the advanced economies. Importantly, however, the present analysis focuses on the location and organization of subsidiaries, not on the flow of funds.

By definition, not all entities may have or report financial statements (they can be dormant, for instance). Furthermore, countries' record collection practices and filing requirements may influence whether records exist in the Orbis dataset; companies, in turn, may seek out specific jurisdictions for secrecy reasons. Indeed, the financial management practices of multinationals can mean economic activities are "booked" in certain entities and not in others. All of this means it is normal for only a fraction of MNE subsidiaries and affiliates to have visible financial reporting data; consequently, research should be taken as indicative, not definitive.

1. Mapping corporate equity chains

The approach taken in this Report comprises a two-stage analysis:

Stage 1. Estimate the significance (if any) of indirect investment via third-party jurisdictions, as opposed to a simpler form of investing directly, in the structure of investment between the parent company and its subsidiary undertaking in a developing country.

To do this, we first identify all the corporate entities where equity ownership is traceable to the parent multinational (i.e. the global ultimate owner or GUO). The "group subsidiaries" considered here represent two types of equity holdings underpinning the foreign investment activities of a multinational:

i) Those entities where the estimated weight across an observed chain of equity holdings is greater than 50 per cent. These entities are estimated to be "owned" and "controlled" by the GUO; thus, their financial activities are most likely to be attributed to that GUO entity as part of its consolidated accounting and financial reporting.

ii) Those entities with a discrete estimated equity value below 50 per cent and either directly owned by a subsidiary as defined in (i) above or by the parent GUO itself. These entities represent the "affiliates" of a group. All other sub-holdings of these entities are excluded from analysis, as they pertain to investments relative to some other GUO outside the present research focus.

With this set of group subsidiaries defined, we focus on foreign incorporated holdings (relative to the parent company) and differentiate these entities along two dimensions:

i) Foreign holdings incorporated in the Global North versus those incorporated in the Global South.

ii) Foreign entities identified in terms of their direct versus indirect ownership structure. Direct holdings are those where the GUO entity is the sole immediate owner and/or where all other entities in a chain of intermediate shareholding to a foreign entity are incorporated in the same jurisdiction as the parent. In contrast, indirect holdings are situations where a foreign subsidiary is held via a known entity incorporated in a third-party jurisdiction (or jurisdictions) different from both the GUO and the jurisdiction of the foreign holding in question. The results of this stage of the study are presented in figures 7.7 and 7.8.

Stage 2. Differentiating between operational and asset-based subsidiaries.

We differentiate between subsidiaries presenting an income statement and those providing only a balance sheet.[13] We introduce an additional nuance to this classification by acknowledging income statements can be "thin" presentations of only financial transactions and non-operating expenses. In addition, some subsidiaries' income statements may be dwarfed by large balance sheets, signalling a stronger likelihood of the subsidiary being an investment vehicle.

We resolve this by making an additional quantitative assessment of the proportion of the two types of activities in a given entity. We then define our categorization of MNE investments as "asset dominant" when the income statement is less than 1 per cent. We take the mean average of all reported balance sheet items and compare this to the mean average of all income statement items to determine whether a subsidiary is likely to serve operational or merely financial purposes.[14] The results are displayed in figure 7.7.

All entities with financial reporting fall into two basic groups: those with income statement information plus balance sheet reporting and those with only balance sheet data. Entities only reporting balance sheet information are treated here as pure investment vehicles, because available evidence suggests their role is primarily to manage some underlying asset.[15] The presence of additional income statement reporting requires further consideration, as this information does necessarily signify the presence of substantive operations or "real FDI." For instance, income statement reporting may only be a description of relatively small administration costs of an enterprise managing a larger pool of financial assets.

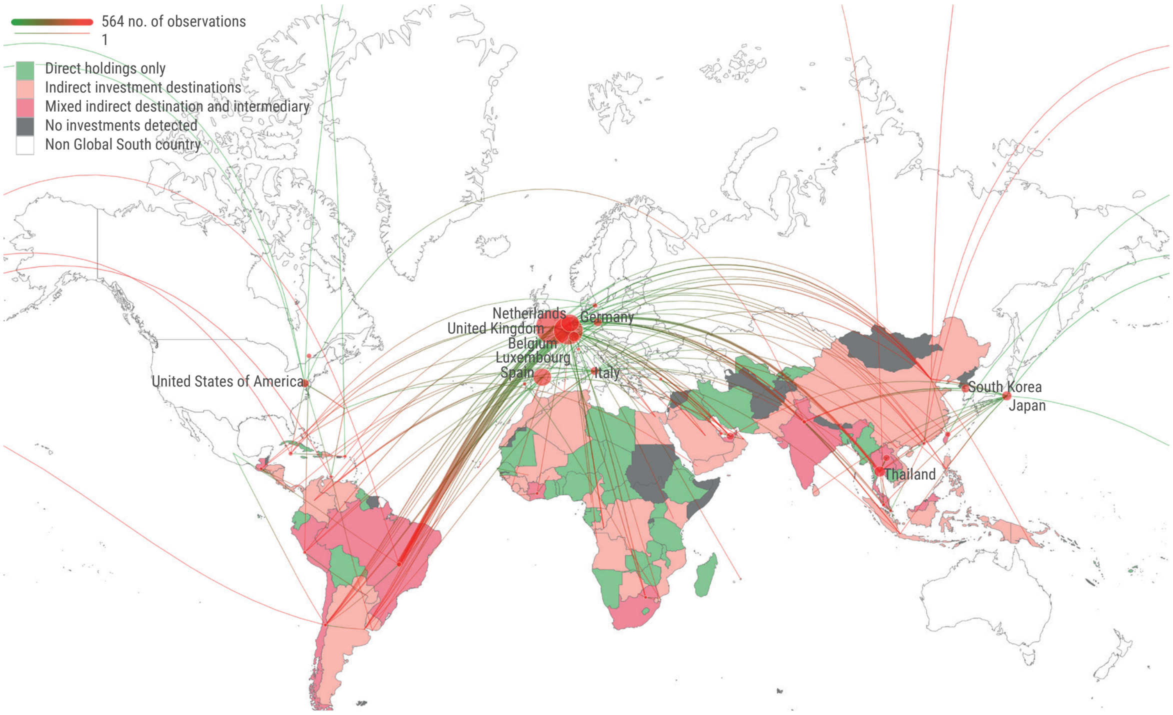
To discriminate between operational and asset-based subsidiaries when both forms of financial reporting are available, we compare a three-year weighed average of two indicative variables taken from both areas of reporting. From the balance sheet, capital and total fixed assets are used as comparative measures, with operating revenues and net income evaluated from the income statement reports. We use a weighted average estimate for the latest three fiscal years. As the data were collected in mid-2018 and reflect the state of available information in Orbis at that time, the three-year period covered here is 2015 to 2017. Cases where the weighted average of the balance sheet is greater than the weighted average of the income statement are classified as "asset dominant" situations, more likely to be financial investments or phantom FDI cases than substantive operational investments of the MNC itself. The results of this analysis are summarized in figure 7.9.

[13] There are two forms of financial reporting at the level of a private subsidiary in Orbis: (1) balance sheet reporting and (2) income statement reporting. We identify several key components from both, if available, and compare them. If no financial reporting is associated with an entity, the case is not part of the equity maps. If there are both balance sheets and income statements, we use their comparative weight to gauge the type of economic activity associated with the reporting entity.

[14] For an explanation, see box 7.4.

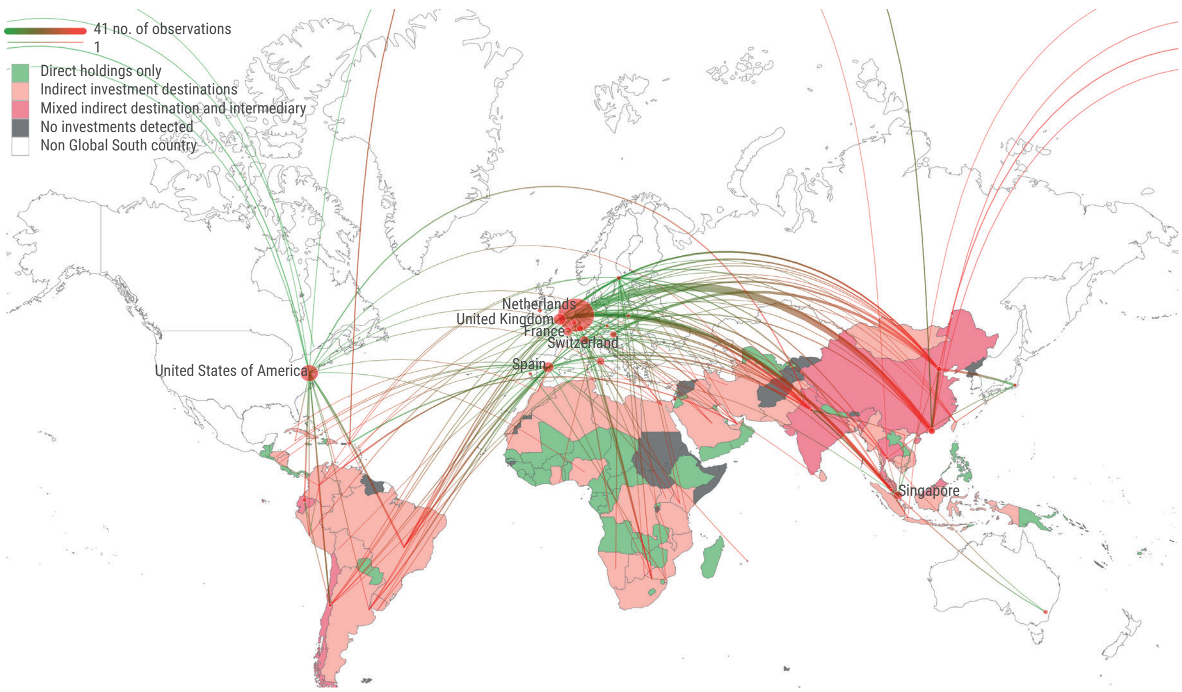
[15] Under English law, such companies are defined as dormant: these companies had no "significant" transactions in the financial year (https://www.gov.uk/dormant-company/dormant-for-companies-house)

Figure 7.7.A France indirect investment in the Global South



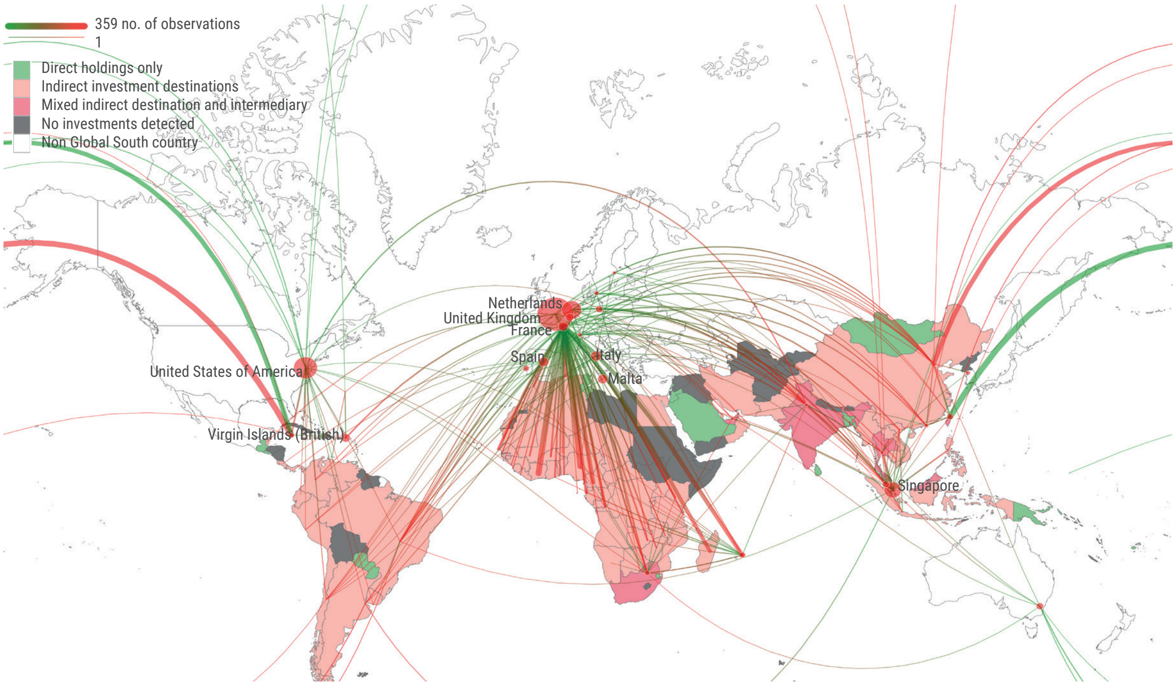
Note: Number of corporate groups with FR GUO: 9; total holdings of FR GUO: 12,204; total foreign holdings: 7,414; total holdings in the Global South (GS): 1,858; total GS holdings held by third party country: 809.

Figure 7.7.B Germany indirect investment in the Global South



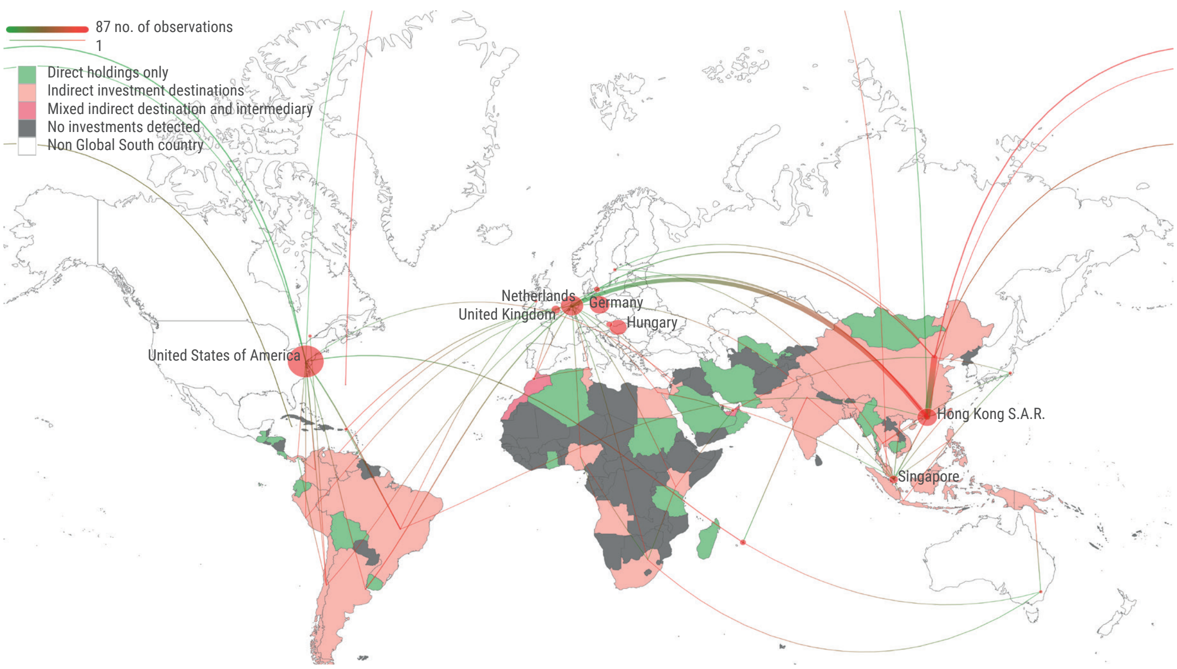
Note: Number of corporate groups with DE GUO: 16; total holdings of DE GUO: 14,840; total foreign holdings: 10,552; total holdings in the Global South (GS): 2,141; total GS holdings held by third party country: 631.

Figure 7.7.C Japan indirect investment in the Global South



Note: Number of corporate groups with JP GUO: 9; total holdings of JP GUO: 11,939; total foreign holdings: 9,240; total holdings in the Global South (GS): 3,102; total GS holdings held by third party country: 1,285.

Figure 7.7.D Republic of Korea indirect investment in the Global South



Note: Number of corporate groups with KR GUO: 6; total holdings of KR GUO: 2,057; total foreign holdings: 1,611; total holdings in the Global South (GS): 623; total GS holdings held by third party country: 209.

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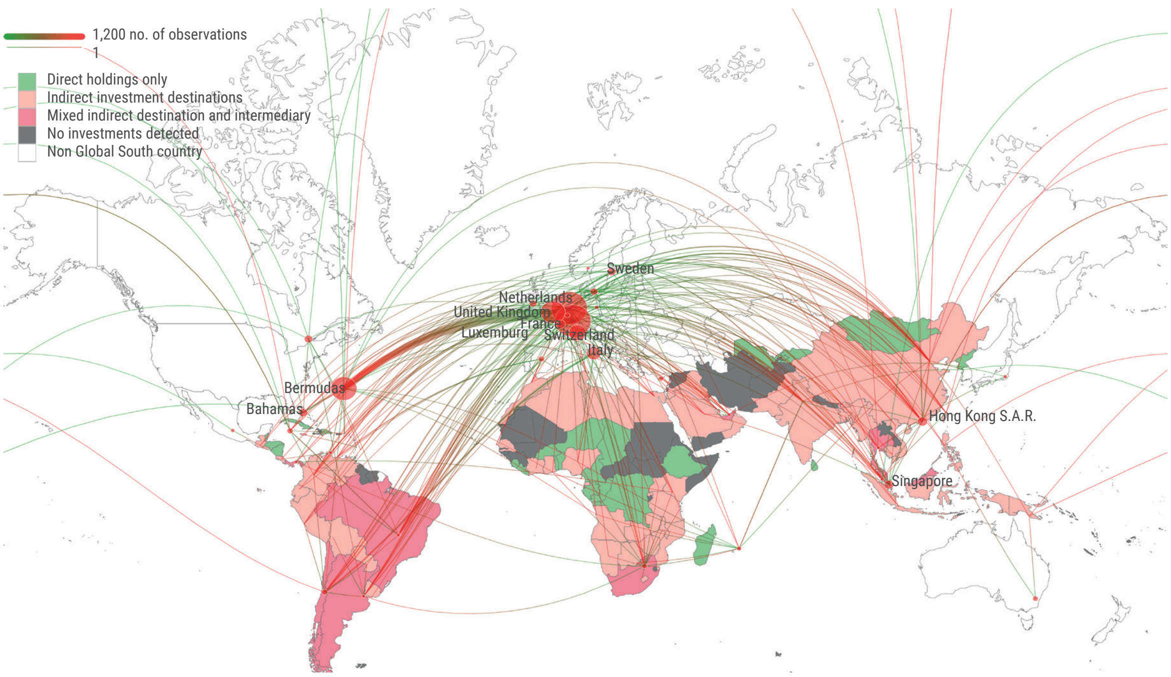
Figure 7.7.E United Kingdom indirect investment in the Global South

Note: Number of corporate groups with GB GUO: 6; total holdings of GB GUO: 6,057; total foreign holdings: 5,004; total holdings in the Global South (GS): 1,241; total GS holdings held by third party country: 614.

Figure 7.7.F United States indirect investment in the Global South



Source: UNCTAD calculation and visualization of equity holdings (2018), based on Orbis data as compiled by Corplink in Phillips et al. (2021).
Note: Number of corporate groups with US GUO: 40; total holdings of US GUO: 34,893; total foreign holdings: 12,249; total holdings in the Global South (GS): 3,130; total GS holdings held by third party country: 1,269.

2. Interpreting the results

Two key patterns emerge from our analysis. First, our examination of the top 100 MNEs shows large MNEs tend to structure their FDI investments through intermediary subsidiaries, and those are typically located in a developed country. Within this general pattern, there is a divide in the type of relationship between the parent company and its subsidiaries in developed and developing countries: between 65 per cent and 80 per cent of subsidiaries in the Global North are held indirectly; the figure rises to between 70 per cent and 95 per cent for investment in the Global South.

In other words, companies from every developed country that make it into the top 100 MNEs by revenue hold a larger proportion of their Global South subsidiaries indirectly through intermediaries compared to their holdings in the Global North.

The second pattern that emerges from the analysis is that those intermediaries tend to be located in Europe, with very little in the way of investments flowing between the regional blocs. Figure 7.7 shows the multinationals from all the GUO jurisdictions analyzed in our sample structure, with the majority of their foreign equity investments using indirect holding structures. Moreover, the general tendency across our sample (MNEs from Japan and Republic of Korea are exceptions) is that investments into the Global South have a greater tendency to be structured indirectly than respective investments into the Global North.

There are some important nuances in the data worth highlighting. Figure 7.7 provides a visual summation of how the largest multinationals from six major economies structure their indirect investments in the Global South. With around 35,000 equity investments, United States multinationals dominate the top 100 companies in the world (there are 40 United States multinationals in our sample).

However, United States multinationals have noticeably fewer investments going into the Global South than corporations from other countries. For instance, less than 9 per cent of United States investments are entities incorporated in the Global South. In contrast, Germany, France, Japan, Republic of Korea and United Kingdom multinationals have, on average, 19 per cent of their investments located in the Global South. As can be observed across the different exhibits in figure 7.7, subtle differences aside, the largest multinationals share a tendency to structure their investment into developing countries through intermediary subsidiaries located primarily in those advanced countries that serve as OFCs.

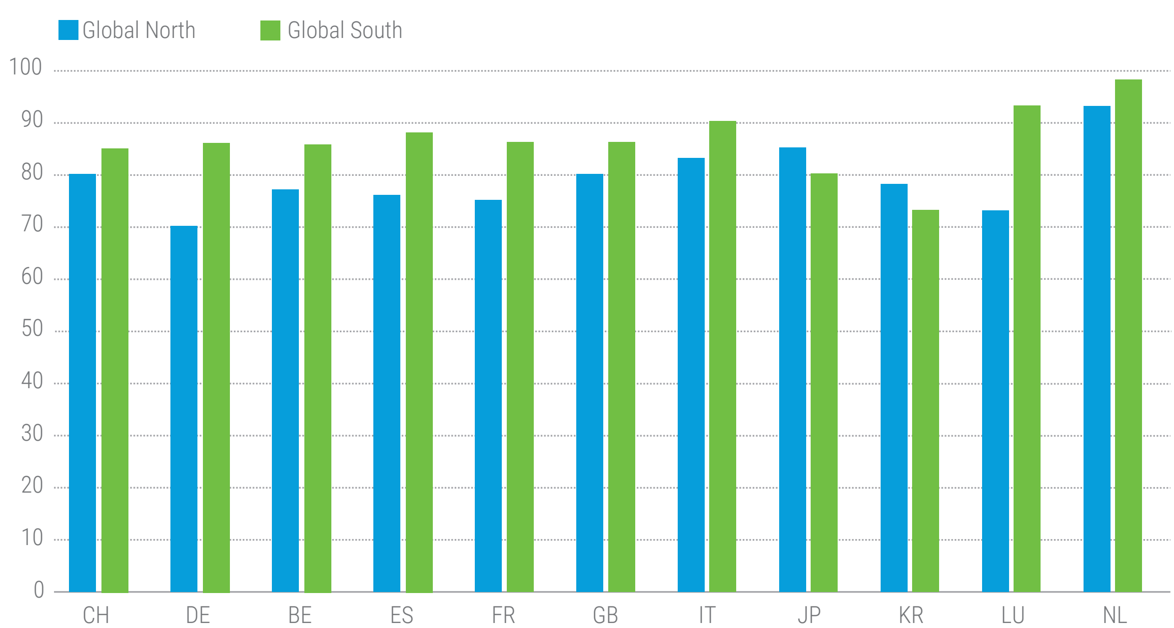
Unlike indirectly structured investments into developed economies, the overwhelming majority of direct equity investments into the Global North are cases where the value of income statement reporting is typically greater than balance sheet reporting (figure 7.9). This stark discrepancy is a further illustration of how the substance and function of intragroup corporate financing are linked to the form of legal structures managing those foreign investments. This difference is a managed one, likely to reflect the reality that a differential regulatory pressure is exerted on subsidiaries in the Global North.

In contrast, both directly and indirectly structured equity investments into the Global South exhibit a nearly equivalent distribution of phantom cases where, in our method of detection, the balance sheet dominates the income statement (figure 7.8). Not only are these rates of incidence nearly identical for each GUO country group, but they are also very similar to what MNEs are pursuing by making indirect investments into the Global North. This consistency suggests that despite differing degrees to which multinationals use phantom foreign investments (this range typically falls between 20 per cent and 40 per cent of cases), multinationals all have a “normal” level of demand for constructing foreign investments in a phantom form.

Figure 7.8.A Shares of foreign equity holdings in corporate groups, by region and by jurisdiction of global ultimate owner, 2018 *(percentage of all holdings)*

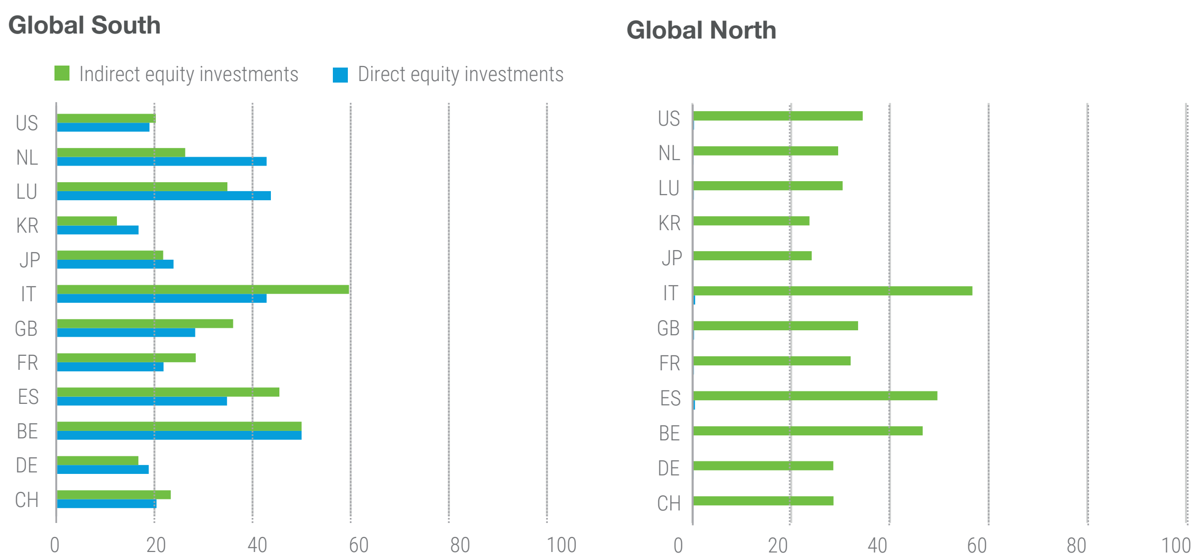
Source: UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

Figure 7.8.B Shares of foreign equity holdings held indirectly through third-party jurisdictions, by region and by jurisdiction of global ultimate owner, 2018 *(percentage of holdings in the region)*



Source: UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

Figure 7.9 Shares of direct and indirect equity investment amounting to "phantom FDI" within top 100 MNEs, by region and by jurisdiction of global ultimate owner, 2018 *(percentage)*



Source: UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.
Note: A "phantom FDI" is defined as a foreign investment into an equity holding, where the balance sheet dominates the income statement.

Table 7.1. presents the summary of the results. Our study of corporate equity chains reveals that 26 per cent of indirect subsidiaries of top MNEs in the Global South present only a balance sheet as evidence of their presence in a country, with no (or few) income statements that would reflect real economic engagement with the host economy. The ratio of balance sheet dominant entities in the Global South that are held directly by the country of the GUO is 22 per cent. In contrast, the proportion of directly held subsidiaries of top 100 MNEs in the Global North that are balance sheet entities is less than 1 per cent. Interestingly, in case of indirectly held subsidiaries in the Global North the ratio of balance sheet only entities is 32 per cent.

These differences may simply reflect the fact that the more stringent regulatory pressures of the developed economies do not apply to entities located in the Global South. Nonetheless, the empirical point remains: the Global South has more cases where foreign investments take on a phantom form. In other words, a considerable portion of large multinational subsidiaries in the developing countries only maintain assets and perform very few operational tasks.

Table 7.1 Distribution of phantom FDI cases, by region and type of equity invesment arrangement, 2018 *(percentage)*

	Global North	Global South
Directly held subsidiaries	<1	22
Indirectly held subsidiaries	32	26
Total	**23**	**24**

Note: See note of figure 7.9.
Source: UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

The pattern is indirectly confirmed by other UNCTAD research. More specifically, UNCTAD found that in 2021, the profitability of the largest MNEs doubled, reaching 8.2 per cent. The developed economies saw the biggest rise in FDI inflows, reaching $746 billion – more than double the exceptionally low level in 2020. In Europe, FDI rose in most countries, although half of the increase was caused by large fluctuations in major conduit economies (UNCTAD, 2022, p. 10).

Our results suggest there is a North-South divide in the registration of value creation in the global economy, with corporate players mostly relying on the financial, accounting and regulatory infrastructure offered to them by competition states (e.g., the Netherlands, Luxemburg, OFC islands). The majority of the developing economies, despite their efforts, remain structurally disadvantaged in the global competition for capital, and there is a structural divide across two major spheres of the global economy: corporate control and international investment. This divide is accentuated by the regulatory architecture governing finance and the activities of the corporate sector itself. Until these structural issues are adequately addressed, regionalization projects will not achieve their full developmental potential.

E. CONCLUSION AND POLICY LESSONS

This chapter has featured an examination of the role of corporate arbitrage broadly and the function of corporate equity chains specifically, across two dimensions.

First, at the level of global political economy, it appears that the inner financialization of the corporate structure can serve as a tool for value extraction and earning stripping. In addition to corporate groups themselves, the beneficiaries of this phenomenon tend to be the advanced countries, especially global financial and corporate hubs located predominantly in Europe and the OFC islands.

Second, at the level of the multinational corporate investment activity, the transformation of the inner corporation paralleling technological, financial and regulatory shifts in the global economy (often referred to as the fragmentation of the firm) has meant that notwithstanding the macro-financial data on FDI flows, the economic substance of international investment, including in the developing countries, is often structured much like a variant of asset management.

In other words, a fifth of directly held subsidiaries of top 100 non-financial MNEs in the developing countries only maintain assets and perform few operational tasks. In the Global Norh, in contrast, the ratio of such subsidiaries in the corporate structure examined in our sample is less than 1 per cent. This stark contrast between the type of corporate activity in the Global North and the Global South warrants further research and policy attention.

Some lessons from the study relate to two aspects of corporate behaviour attracting increasing attention: tax arbitrage and profit shifting. Success in attracting FDI is not, in and of itself, conducive to making incoming foreign capital work for the host economy by, for example, helping it to increase its productive capacity, levels of employment and welfare. Large corporate groups can be structured in such a way that local subsidiaries exploit the local economic advantages in the form of inexpensive labour, natural resources and so on, while other subsidiaries in the corporate group located in other jurisdictions contribute to and benefit from the value extraction via the localization of profits, low taxes and other types of corporate arbitrage.

In terms of the macroeconomy, earning stripping through the use of corporate subsidiaries affects the fiscal space of any host economy. Developed countries can potentially offset a significant part of the direct corporate tax revenue loss by collecting increased investor-level tax revenues on dividends, interest and capital gains, which themselves tend to be boosted by higher rates of global corporate tax avoidance. Developing countries, in contrast, are generally unlikely to recover any significant revenues this way. These countries face an additional disadvantage in the long term: their cost of borrowing is higher, usually several times higher, than that of the advanced economies (Garcia-Bernardo et al., 2022).

Against this global context, the structural asymmetries described above pose challenges to the developmental impact of regionalization efforts. As shown in the chapter, the global corporate-financial regulatory architecture favours private corporate and financial interests and is often guarded by the policies of advanced states. In the absence of a developed set of multilateral regulatory standards and a systemic framework of regulation, the developing countries need to build the relevant financial, accounting, legal and data expertise, with a view to enhancing the visibility of corporate behaviour at the global level. Earlier work by UNCTAD suggested policymakers in some countries have started to develop a range of mechanisms to safeguard the effectiveness of foreign ownership rules, including anti-dummy laws, general anti-abuse rules to prevent foreign control and disclosure requirements aimed at monitoring ownership-based and non-ownership-based control (*WIR*, 2016).

But these initiatives remain in their early stages and are selective. The central role of legal and financial infrastructure in corporate arbitrage and value extraction poses a particular challenge to developmental regionalism and regional institution-building. Therefore, an attempt to consolidate available resources at the regional regulatory level could be an important first step towards harmonizing regulatory policies and curbing – at least at the regional level – opportunities for corporate arbitrage.

In this instance, while many recent efforts by international organizations take a major step towards global tax justice and corporate transparency, these efforts have evolved separately. A more integrated approach towards a systemic multilateral system of measures of corporate and financial regulation is needed to address the power and economic asymmetries dividing developed and developing countries.

The development of such an integrated approach can start on the basis of the initiatives already undertaken at the international and regional levels. For instance, it is clear from the study discussed above that reform measures aimed at tracing tax arbitrage by corporations have to be connected with closer policy attention to advancing FDI statistics. Similarly, corporate accountability measures implemented in the developed countries need to take a closer look at the role and type of corporate subsidiaries and the nature of their de facto (as opposed to de jure) economic activity. The availability of reliable data on corporate financial behaviour, professional expertise and dedicated regulatory mandates at national levels can play a key role here. In light of the results of the study, the regulatory solution to corporate rent-seeking needs to start from the Global North.

In this respect, it is encouraging that the European Union is the first regional power to seriously consider making it mandatory for large companies operating in the region to spell out the details of their group of subsidiaries in corporate registers. This is an important step towards public control over corporate behaviour at the regional level (Foroohar, 2022). Although it is being challenged by countries' concerns about potential revenue losses from data sharing, if implemented and integrated with similar efforts in financial regulation, it can represent the first step towards a wider set of multilateral systemic measures.

And while the phenomenon of corporate and financial arbitrage and rent extraction is by definition multi-faceted, United Nations agencies, especially UNCTAD, are in a unique position to lead a program of reform, capitalizing on the relevant expertise of the organization. UNCTAD's earlier work on the multilateral investment regime focused on treaty shopping and international corporate complexity. Today, the broader goal would be to formulate a multilateral and multi-layered strategy representing the interests of the developing countries and addressing the negative consequences of corporate rent-seeking and financial arbitrage in a systemic manner.

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