**Transfer Pricing and Global Poverty**

**Edmund J. Malesky, Duke University**

**Introduction**

A persistent puzzle in the International Political Economy (IPE) is the lack of a robust correlation between Foreign Direct Investment (FDI) and poverty alleviation in emerging markets. This is especially confusing given the compelling theory that predicts poverty reductions following FDI increases (Moran 1999). At least three general channels have been hypothesized linking FDI inflows to reductions in the poverty level (Hanson 2001). FDI is thought to contribute to poverty alleviation through: 1) Spillovers of labor productivity, technology, and corporate governance practices; 2) Market effects, as foreign invested enterprises (FIEs) contract domestic producers and sell their products in the host country, reducing consumer costs through competition; and 3) Revenue effects, as taxes paid by FIEs increase host country coffers and subsidize transfers to poorer citizens of the country. For all of the hypothesized channels, the empirical support is mixed at best. Figure 1 demonstrates the lack of observed correlation using a variety of poverty cutoffs, and the analysis is robust to using changes in FDI stocks as well.

**[Figure 1 about Here]**

By far the weakest support has been found for the revenue channel. There has been very little convincing work demonstrating that FIEs offer substantial increases in revenue above domestic firms, and even less evidence that FDI spurs equalizing welfare transfers. At a distance, this non-finding is the greatest enigma, as budget data is the easiest of the dependent variables to collect and analyze

Explanations are possible to explain the inability of FDI tax revenue to reach the poorest. The first basket of answers is methodological, including: measurement error in poverty rates data, biased selection of foreign investors into wealthier states where poverty increases would be less obvious, and differing reporting rules for FDI in host countries leading to noisy estimates. A second set of explanations accepts the empirical basis for the non-finding, but has sought to explain it theoretically. These answers include: 1) Generous tax incentives and subsidies to attract foreign firms that often exceed the long-term revenue benefits generated (Wells et al. 2001, Head et al. 2000). Transfer targeting that misses the poorest recipients; 3) Inefficient or government spending allocations; and 4) Corruption or leakage which reduces the size and effectiveness of payments.

In this paper, I argue that scholars and practitioners have overlooked a major contributing factor – transfer pricing, whereby FIEs systematically use internal pricing strategies within their global production networks to shift profits out of the host country. The subject of transfer pricing has become a heated and sensitive topic over the past two years in internationally, leading organization like the Organization for Economic Cooperation and Development (OECD) and the government of the United Kingdom to open special investigations into the activity (OECD 2009, Mirlees et al. 2012). Fierce debates have erupted between companies and states around the world, as governments worry about protecting their tax base in order to provide public services to their citizens, and companies worry that high and unpredictable tax policies damage their business prospects and hurts economic welfare. Despite the heated rhetoric between states and corporations, the discussion of transfer pricing has only played a peripheral role in IPE discussions.[[1]](#footnote-1)

**What is Transfer Pricing?**

To be clear, there is nothing illegal, unethical, or unscrupulous about the normal practice of transfer pricing when it is done according to the legal rules of the host country. It may be helpful to begin with some definitions. At its most basic *“Transfer Pricing”* is just the act of assigning internal prices for goods and services that are sold within a company and between subsidiaries of the same company. This is a normal practice that has been a part of business since the invention of the firm (Coase 1937).

In more common usage, “transfer pricing” is defined as a profit allocation method used to calculate and attribute MNCs net profit (or loss) before tax in countries where it does business. Activities that fall within this rubric often include: 1) the setting of prices among divisions within an enterprise; and 2) charges for goods and services between controlled (or related) legal entities within an enterprise, including branches, subsidiaries, and, in some cases, companies sharing members of a board of directors (OECD 2009).

In principle, a transfer price should match either what the seller would charge an independent, external customer, or what the buyer would pay an independent, external supplier. These benchmark transactions are known as *“arm’s length”* prices. Where an “arm’s length” price can be determined (e.g. commodities), the identification of accurate transfer pricing is easy to verify. In some cases, accurate transfer prices are harder to identify, because the good or service in question is an intangible asset, such as a franchise license, intellectual property, or proprietary technology, for which there is no arm’s length prices available (Neighbor 2002). These cases are more complicated, but nonetheless entirely legal and standard operating procedure for modern MNCs.

Transfer prices become a concern when they are incorrectly applied to lower profits in a division of an enterprise that is located in a country that levies high taxes, and raise profits in a country that levies no or low taxes, such as a tax haven (OECD 2007). This activity can be problematic when it deprives host countries of legal, tax revenue. Such activities include over-charging for equipment and inputs, over-valuing internal consulting services, payments for brands and licenses that are not charged to similar subsidiaries in other countries, and borrowing from subsidiaries in low tax environments (often tax havens). These activities place countries in the difficult position of protecting their tax base while maintaining a hospitable environment for foreign investors.

Transfer pricing is the most common form of a set of techniques known as *“Profit Shifting,”* which is defined as “The manipulation of costs and revenues within an MNC across taxing jurisdictions (countries) so as to record profits where they will be taxed at the lowest rate.”[[2]](#footnote-2) Figure 2 provides two schematics of common techniques. In Panel A, an MNC (perhaps from the US) sets up two subsidiaries in Singapore (with low profit taxes (CIT=10%) and in Vietnam (with mid-range profit taxes (CIT=20%). The Singapore affiliate is listed for tax purposes as the owner of the MNC’s valuable intangible asset (perhaps a proprietary piece of software or industrial technique). But the MNC does not intend to use the intangible asset in Singapore; rather, it sells it to its Vietnamese subsidiary where the manufacturing is taking place. The Singapore branch then charges the Vietnamese subsidiary an internal royalty for the use of the asset. Because of the expense of the asset, the Vietnamese subsidiary ends up in the red which translates into zero profit taxes in the high CIT environment. The MNC reports profits in Singapore, where it pays the lower CIT. Panel B shows a second version of the technique whereby the Singapore subsidiary loans capital to the Vietnamese subsidiary, booking the debt in Vietnam and the interest payments in Singapore.

**The Global Cat and Mouse Game**

In the summer of 2013, Vietnamese tax authorities engaged in a war of words with *Coca-Cola,* publically ridiculing its decision to expand operations by $300 million with new beverage plants in three provinces, despite never having declared a profit in its ten years in Vietnam, and therefore never paying any money in corporate income taxes (CIT) (VietNamNet Bridge 2013). *Coca-Cola* executives denied the charges immediately and vehemently. They admitted to reporting losses in Vietnam, but argued that it often took the company many years to reach profitability in emerging markets, where it needed to build out substantial distribution and brand loyalty. Senior Vice President Clyde C. Tuggle claimed that, “Even in Coca-Cola’s most profitable markets, it took 25 years to earn our first gains. Moreover, they reminded officials that despite not paying CIT in Vietnam, their overall tax bill was still substantial, including VAT, personal income taxes, and import duties (Tuoi Tre 2013).

Soon it emerged that *Coca-Cola* was not the only company under scrutiny. The General Department of Taxation (GDT) issued a report declaring that 57% of the 5,500 FIES it investigated (representing 60% of total foreign operations), reported net losses between 2010 and 2011. Pushing deeper in December 2012, the GDT announced an extensive audit in several provinces, finding 122 FIEs in violation of transfer pricing rules under Circular 66/2010/TT-BTC (Circular 66), requesting additional tax payments of over $10 million. On the list was *Coke*’s main global rival *Pepsi-Cola,* which also has been in Vietnam for over thirteen years with only minimal profits reported. In addition, several other iconic companies were cited including *Adidas*, *Unilever, British American Tobacco, Big C,* and *Metro Cash & Carry* (Pham 2013a). The highest level of derision was reserved for Taiwanese Keagnim Vina (122 trillion VND) and Malaysia-Taiwanese Hua Lon both cited for over $70 million in transfer pricing diversions. Famously, Keangnam declared a value of $16 million for a used production line that, if sold to a third-party, would most likely be priced at $400,000 (Pham 2013b).

Vietnamese government officials have been consistent in their claims. They believe transfer pricing is taking place. After all, the country’s General Statistical Office (GSO 2014) currently lists the British Virgin Islands and Cayman Islands, well-known global tax havens, 5th and 9th largest home countries for foreign investment into Vietnam. More importantly, officials believe it is damaging the Vietnamese economy by depriving it of revenue that could be channeled to improve exactly the issues that FIEs consider to be Vietnamese biggest weaknesses: infrastructure, education, and other forms of public service delivery. FIEs, they insist, cannot have it both ways, complaining about adequate facilities while depriving the government of the resources that they need to achieve those goals (Thanh 2013).

Vietnam is not alone in its battles with famous MNCs. In 2002, Chinese tax authorities claimed that the government annually loses over 30 billion Yuan ($5 billion) due to transfer pricing by MNCs (Yang 2002). In a story very similar to the Vietnam-*Coca-Cola* stand-off, the British Government questioned the tax payments of the US coffee retailer *Starbucks*, arguing that the company paid just $14.11 million in taxes despite reporting over $4.92 billion in UK sales since 1998. *Amazon*, *Google*, and *JP Morgan* were all cited by British authorities, leading Margaret Hodge, a representative of the Labour Party in Parliament, to declare, “This is outrageous and amoral and an insult to British businesses and individuals who pay their fair share” (Mathiason 2012).

In the United States, *General Electric* (GE) famously accomplished a zero corporate tax bill in 2011 through an aggressive strategy of innovative accounting and offshoring of profits in its lower tax operations. The company has over 1,000 employees working on tax law alone (Kocieniewski 2011). In 2013, *Apple*, despite record US profits, posted noticeably low taxes by using cost-sharing arrangements with its Irish subsidiary to ensure that the bulk of profit was recorded in Ireland, where Apple paid a 2% corporate tax rate, instead of 35% in the United States (Sahadi 2013). Apple’s vehicle was actually a technique so common among corporate tax planners that it actually had its own brand name, “The Double Irish Dutch Sandwich.” Court cases demonstrate that the *GE* and *Apple* strategies are not new and have been taking place for some time (Wheerler 1988).

**Drivers of the Global Increase in Transfer Pricing**

Fouor forces have combined to generate what *PriceWaterhouse Coopers* (2013), one of the largest global accountancies with a sizable transfer pricing consultancy business, has called the “Perfect Storm” for transfer pricing.

First, rapidly expanding international trade has increased the magnitude and diversity of products available to companies producing goods and services around the world. Second, the expansion of FDI, particularly the surge of FDI into developing countries in the past two decades has expanded the number of foreign subsidiaries working in any given host country, forcing host countries to deal with different accounting practices, corporate cultures, and the unique home-country tax jurisdictions of their new guests. Third, the rise of Multinational Corporations (MNCs) and the mainstreaming of international production chains that leads to components of products being developed in multiple countries around the world, means that MNCs are now operating under a wide variety of tax codes that provide very different opportunities and risks. Today, more products reach customers through production by MNC affiliates than through direct exports (UNCTAD 2013, Stern 2010). Fourth, the information age has increased the value of intellectual property and technology. The use of proprietary knowledge, techniques, and intellectual property as strategic assets means that there is not a publically available market for these activities. True price discovery for intangible assets is impossible, because arms’ length transactions simply do not exist for most these goods and activities.

These four forces have combined to make transfer pricing an inevitable fact of life for national policy-makers.

**Is Transfer Pricing Reducing the Poverty Alleviation Effectiveness of FDI?**

Although it is hard to know for certain, there is strong reason to believe that transfer pricing activities may be reducing the developmental impact of FDI flows. The best empirical analyses thus far have generated jaw dropping numbers about exactly how much revenue is escaping from developing countries.

Using changes in the economic activities of known tax havens, authors have begun to provide estimates of the change in revenue flows round the world. Hines (2010a), for instance shows that 31% of global FDI now originates in tax havens, 6.06% of foreign employee compensation was paid in havens, and 6.49% of the foreign property, plant, and equipment of American firms is held by these special locations. The Cayman Islands for instance has a population of 57,000 people, but 92,000 companies that account for $1.4 trillion dollars in bank assets and liabilities according to the Bank for International Settlements (BIS) (Sachs 2013). Estimates also show that 42% of US corporate earnings are reported in known tax havens, which is shocking because only 11% of value added is created in those very same locations (Hines 2010b).[[3]](#footnote-3) The juxtaposition of those statistics sends a clear message – MNCs are not booking the profits in the places where they are producing them.

But has this transfer pricing led to substantial revenue loss? Using balance of payments data and a clever exploitation of reported profits in tax havens, Zucman (2014) concludes that the effective tax rate paid by American firms has declined by 33%, from 30 to 20 percent between 1998 and 2013. The net loss to the US tax payer in 2013 was $200 billion. Not all of the decline in the effect tax rate can be attributed to tax avoidance schemes, but after addressing other confounders, Zuchman concludes that such tactics have provided firms with the equivalent of a 6 to 8% tax cut.

These analyses actually underestimate the effect on the world’s poorest countries. The figure of 31% of FDI originating from tax havens, includes developed countries, and does not include money routed through tax havens that originated in other countries. Taking these into account, we would find that 46% (nearly half) of global FDI is channeled through tax havens with the share increasing about 5% annually (ActionAid 2013).

The schemes have become so effective that the handcuff they tax policies of developing countries, who try to obtain greater revenue. Bartelsman and Beetsma 2003 conclude that more than 65% of the additional revenue resulting from a unilateral tax increase is lost because of income shifting. The opposite is true as well; unilateral tax decreases will lead to retained revenue. Pham (2014) uses a regression discontinuity design to show that MNCs in Vietnam which were eligible for a special reduction in CIT (from 25% to 17%) targeted at companies with less than 300 employees as part of a fiscal stimulus. Comparing the firms just above the cut-off to those below, Pham finds that eligible foreign firms were 11% more likely to report positive profits, leading to a 20% increase in revenue collected by the Vietnamese government. Strikingly, the change led to no change in investment behavior, hiring of workers, or output. Eligible firms simply decided to keep more money in Vietnam at the lower tax rate.

Non-Government Organizations, who have been looking closely at the phenomena, have begun to raise activities about the impact of these activities on developing country finances. In a report entitled, “How Tax Havens Plunder the Poor,” which included an introduction by Jeffrey Sachs, ActionAid cited that the next cost to developing countries was $120-160 billion in annual tax revenue, which they estimated was three times the size of the agricultural investment needed to eliminate global hunger and twelve times the amount needed to eradicate childhood malnutrition around the world (Action Aid 2013). While there is a hysterical tone to these types of reports, it is clear that the combination of transfer pricing and tax havens have put developing countries into quite a dilemma even if the figures are substantially overstated.

**An Agenda for Future Research**

In this article, I have sought to demonstrate that transfer pricing is an important feature of the global economy that has not been adequately addressed by the IPE literature. The scale phenomenon will continue to increase, as the four forces that have driven propelled it show no signs of abating. Better understanding transfer pricing is critical for both making sense of the puzzles that have bedeviled IPE research and rethinking some of the lessons we think we might have learned. As I argued above, it is among the most compelling explanations for the lack of a correlation between foreign capital flows and poverty alleviation, despite the multifaceted theories in support of the relationship.

Given the paucity of detailed IPE work, in lieu of a conclusion, I offer an agenda for future research.

*Better Measurement*

The first task for the IPE literature is to properly measure the scale of transfer pricing. Zucman’s (2014) work with balance of payments data is excellent, but overlooks the share of transfer pricing that does not include tax havens. It also does a better job of calculating the total revenue moved to tax havens than the amount foregone by developing country treasuries.

Accurately measuring the scale of transfer pricing is extremely difficult. Methods exist for the reporting and auditing of transfer pricing on individual basis. To perform these techniques, however, precise and fine-grained access to firms’ financial accounts is needed. In most cases, access is also needed to the accounts of related parties, third-parties, and comparators, who have no reason to provide it to non-government researchers.

Even if such access were available on an individual level, it is impossible for large-n statistical analysis, where data on thousands of firms must be processed. Because answering honestly about transfer pricing may force respondents to reveal information to their competitors or place them in danger of reprisals from authorities, it is not clear that accurate information can be obtained by researchers. In many cases, respondents may choose not to answer or answer inaccurately, leading to biased conclusions by analysts.

Consequently, scholars have struggled to accurately measure the scale of transfer pricing globally. Most evidence of income shifting has been obtained indirectly by looking at firm profitability and country-level measures of tax burden. For instance, Grubert and Mutti (1991) and Hines and Rice (1994) use country-level data to identify a negative relationship between the reported profitability of the foreign affiliates of U.S. multinational firms and the corporate income tax rates of their host countries. Until recently almost all of the work was done on United States companies which had the most accurate data on MNCs. Chang et al. (2011), however, recently studied the behavior of MNCs in China, finding that subsidiaries shifted profits to and from China depending on corporate tax rates and that the magnitudes of tax-motivated income shifting activities resulted from variation in the firms’ level of fixed asset investment, intangible assets (e.g. proprietary technology), and its debt ratio.

There is much more work to do here. Better measures of transfer pricing are necessary to understand how exactly the activity is affecting our understanding of international interactions. For instance, there is high probability that our assessment of national welfare is inaccurate. Are Singapore and Luxembourg really among the richest countries in the world in terms of per capita GDP, or does their status as low CIT countries simply mean that more income is reported there? Closer to home, international measures of institutional quality are significantly and negatively correlated with CIT rates. In the case of the *Economic Freedom Index*, the tax rate (labeled “fiscal freedom”) is actually one of the sub-indices (Heritage Foundation 2013). Thus, when we observe a correlation between institutions and GDP flow, how much of the relationship is actually a function of tax policy versus the strength of property rights and contracting institutions that we generally attribute to the measure?

*Testable Predictions*

As Pham (2014) shows, unilateral tax decreases will generate more revenue for developing country coffers, but at the cost of an unhealthy competition among developing countries that nobody can win. This harkens back to the discussion of the “Race to the Bottom” literature (Mosely and Uno 2005), but the phenomenon is actually more severe. In the race to the bottom, the notion was that MNCs darted around the world to find the lowest taxes and regulatory quality, setting up shop on the bottom rung. In the case of transfer pricing, the location of production never changes, only the location where the profits are reported. Thus, developing countries still face the same externalities caused by hosting MNCs, but will receive less and less revenue to offset the environmental and regulatory impact because of an unwinnable competition with tax havens. Even the very act of monitoring tax compliance by MNCs is costly. Audits may help introduce greater transparency and trust into this issue, but they are often quite burdensome for developing country tax authorities and a civil service that are already stretched to their limits of their capacity.

The situation is untenable for developing countries, which leads to two political economy predictions: the first is a classic prediction about international institutions to resolve global collective actions problems, and the second is a domestic political story.

Ultimately, transfer pricing will require the emergence of an international institution, a global agreement that guards against the race to the bottom by standardizing treatment of MNCs by developing countries. Along these lines , Zucman suggests an international financial registry where governments could compare how the actual distribution of revenue around the world to the scale of global production. Grander solutions are also possible, such as the abandonment of arm’s length pricing in favor of estimates based on the actual activity taking place in an economy, or Advanced Pricing Arrangements (APAs) where countries negotiate estimated profitability with MNCs, taxing them on the estimates rather than trying to scour for arm’s length pricing equivalents. Getting to an international agreement will be hard, but it seems the best way to resolve the current global collective action problem.

Without an international solution, developing countries will be forced to make up for the loss revenue elsewhere. Because most of these countries are characterized by weak tax capacity making collection of income taxes difficult (Moore 2004), we are likely to see countries enhance value added taxes (VAT) and other sales taxes, which can be more easily collected at the point of sale. Consistent with this theory, Vietnam, after battling the MNCs on transfer pricing ultimately decided this year that it would lower the CIT for all companies to a rate more consistent with the regional average. In its place, they have chosen to broaden the base of the VAT beyond registered companies to informal household firms (Le Thanh 2014). In the coming years, I predict that this switching of tax regimes will become more common, as countries seek to make up lost revenue by turning to citizens and domestic firms, rather than trying to tax globetrotting MNCs.

If the prediction is right, and I believe empirical testing will find support, it will essentially imply a global transfer from the citizens and domestic firms of the developing world to the MNCs of the developed world. In some cases, this transfer to wealthy MNCs will undermine the positive effects of investment flows. In other cases, FDI may actually worsen individual level poverty by imposing externalities on states that are paid for by taxing the poorest. Thus, in a few years, the puzzle may not be why there is no correlation between FDI and poverty, but why FDI actually exacerbates poverty. Hopefully, future IPE scholarship will point the way out of this depressing fiscal trap.

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**Figure 1: The Correlation between Poverty and Foreign Investment Flows**



**Figure 2: Main Forms of Transfer Pricing**



1. A smart exception is Findley et al. 2014, which studies the formation of shell companies which play a big role in the process. [↑](#footnote-ref-1)
2. http://www.businessdictionary.com/ [↑](#footnote-ref-2)
3. Using a different methodology, Zuchman (2014) concludes that 55% of corporate profits from US firms are earned in just six havens ( Netherlands, Bermuda, Luxembourg, Ireland, Singapore, and Switzerland) [↑](#footnote-ref-3)