Price and Prejudice

For any company with a large number of overseas subsidiaries, it makes sense to declare the highest profits where taxes are lowest, and minimise the returns where taxes are high or efficiently collected. Robin Murray explains why this technique of 'transfer pricing' is so tempting to today's big corporations, and outlines the strategies needed to combat this.

How much should the British ITT subsidiary pay its French associate company for the French-built telephone exchange system imported into the UK? And what allowance on price should be made for research on the system undertaken at Harlow, Essex? What was the value of the bananas exported by United Brands from Panama to its parent company in the US in 1973? Was it $52 million as the company claims, or $64 million as estimated by the International Monetary Fund? How, in short, should you calculate prices for goods and services where the international trade is not between independent firms, but *within* the same multinational corporation?

This apparently technical problem has come to assume substantial importance with the post-war development of multinational corporations. For latest estimates suggest that *one third of all international trade takes place within firms rather than between them.*

This means that a large proportion of international trade or more accurately, 'pseudo' trade – takes place at prices which are set by the multinational firm itself. They are administered prices, adjustable to suit the needs of the firm. *They amount to a massive, daily practice of price fixing.*

There are many circumstances which encourage firms to manipulate their international transfer prices:

● profits can be shifted to low tax countries by over-invoicing the intra-firm imports to, or under-invoicing the intra-firm exports from the operation in the high tax country.

● 'loss-making' sections of the company – often at headquarters with high administrative and research and development costs – whose losses cannot be offset against international tax, can instead be made to break even by billing the central overheads to profitable foreign subsidiaries.

● companies may declare losses to strengthen their bargaining hand with trade unions during wage negotiations (as Ford have done in the UK), or to gain tariff protection or government subsidy. For example, the UK government recently agreed to fund all Chrysler UK's losses up to £40 million and half of any extra loss during the first year of the rescue operations. Chrysler announced losses for this first year of – coincidentally – £42.9 million. During that year they were importing Alpine car parts from their French subsidiary for assembly in the UK. We do not know if they manipulated the prices on these parts, but they had both the means and the incentive to do so, and we have no evidence of any British government control of the transfer prices to prevent an abuse of the subsidy agreement.

● companies selling to state bodies on the basis of costs, plus a standard profit, may inflate their costs by over-invoicing their intra-firm imports. This has been sharply exposed in the sales of drugs to public health authorities.

● companies often adjust their holdings of currencies by transfer pricing according to expected exchange rate fluctuations.

Of course it is one thing to suggest that there is *scope* and *incentive* to manipulate transfer prices. It is another to *prove* that such manipulation has occured. There are three types of evidence we can turn to.

The first is business literature. There is a whole catalogue of work by financial analysts, tax consultants and business school professors with advice on why and how to shift funds internationally using a variety of intra-firm accounting techniques.

Secondly there is the evidence of government bodies charged with monitoring transfer prices. Many of these keep their size and their activities to themselves, believing this adds to their effectiveness. Firms generally prefer to settle disputes with customs and tax authorities over intra-firm pricing out of court and out of sight. The revelations on the UK over-pricing of the ingredients of Librium and Valium by the Swiss drug form Hoffman de la Roche (by 4,000 and 4,500 per cent respectively) were significantly made by the UK Monopolies Commission, rather than Customs or the Inland Revenue.

Nevertheless some units have made public their results. The Colombian control body (about 30 people strong) estimates it prevents some $80 million loss of foreign exchange through transfer of pricing per year. The Greek unit, during its brief active existence, discovered foreign exchange losses during one year of $10.2 million on imports, and $8.4 million on exports. Most strikingly, the US Treasury Department published the results of their monitoring for the years 1968 and 1969, during which time they made 886 transfer pricing adjustments to the value of $662 million. These figures belie the claims of many multinationals that transfer manipulation is seldom practised and is quantitatively insignificant.

Finally, there is the evidence of studies of particular firms and products. Those relating to exports – mainly Third World exports – are summarised in Table 1.

Price Manipulation

One notable example concerns the copper companies in Chile. President Allende's government estimated – on the basis of comparative profit rates – that US firms had under-invoiced their copper exports from 1956–71 to the extent of $440 million. Another example comes from Venezuela where the Bank of Venezuela found that iron ore exports were under-priced relative to the iron ore traded elsewhere. In the case of Caribbean bauxite exports such comparative data is lacking since international bauxite trade is dominated by a few multinationals, who maintain a tight secrecy on the prices and terms of the few international open market transactions which do take place. Nevertheless the Jamaicans found clear evidence of manipulation by Canadian and US companies who were declaring values of $15 a ton in their reports to the Canadian and US customs authorities, although valuing these same exports at $7.50 a ton in Jamaica. When the Jamaicans re-calculated the export price to include a proportional share of the international profit, the country's tax revenues rose from 28 million Jamaican dollars to 210 million Jamaican dollars. Even in commodities like tea, coffee and grain there is growing evidence of price manipulation, in spite of apparently free markets.

The overpricing of intermediate imports – Buying Too Dear – has been best documented by Constantine Vaitsos in Colombia (see New Internationalist issue No. 37). He found intra-firm intermediate imports overpriced by 155 per cent for the drug industry, 26 per cent for chemicals, and between 16 per cent and 66 per cent for electronics. The study inspired other Andean Pact countries to look at their intra-firm imports. In Chile 50 imported products of 39 firms were studied and 78 per cent of them were found to be overpriced. In Peru the imports of two-thirds of the 22 firms studied were found to be overpriced by more than 20 per cent. In Ecuador nearly half the firms importing electronic intermediates were being over-invoiced by more than 75 per cent. These results are summarised in Table 2.

Impossible to Price

Most researchers and government monitoring units would argue this accumulated evidence understates the extent of transfer pricing. The studies have largely been restricted to cases where the product can be accurately described and a world market price established. For an increasing number of goods and services this is virtually impossible. There is no one objective 'arms length' price for intra-firm technical services for example, or for the transfer of an obsolete car model and its assocated equipment to a Third World subsidiary, or even for the imported ingredients which make up Librium and Valium. Even with exchange rates on that most competitive of markets – the international money market – there is a range between buying and selling rates which allows international banks to transfer profits to tax havens in ways which are effectively undetectable.

Not only is intra-firm trade growing, but more and more goods and services cannot be assigned an objective price by authorities seeking to control the manipulation of transfer pricing. *The significance of both these trends is profound for national governments and for working people.*

By-passing the Government

First, multinationals have the power to move capital internationally to where they wish to invest it. They can by-pass national exchange controls, geared to prevent profits gravitating to the place of greatest international profit regardless of local need.

Second, a whole set of government policies based on *public* intervention by price adjustment in the *private* market are called into question by transfer pricing. For in the world of multinationals, declared

Continued overleaf

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Photo: Camera Press

Pineapple Profits

FIFTEEN years ago the Kenyan government invited the US-based multinational Del Monte to take over its pineapple canning industry. It seemed like a stroke of genius. Jobs, tax income and much-needed foreign exchange from pineapple exports were obvious attractions to the Kenyans. But Del Monte turned out to be the real winner. As well as Kenya's cheap labour and production costs the company gained access to British and eventually EEC markets. However, the real prize for Del Monte negotiators was the near-monopoly terms of the agreement.

The company, through its 95 per cent ownership of Kenyan Canners, was guaranteed control over expansion of the national pineapple industry for 33 years from the time of its initial investment in 1965. Without the threat of competition, Del Monte was free to engage in some clever corporate sleight-of-hand.

Nevertheless, at least part of the original Del Monte promise came true. The Kenyan Canners subsidiary has produced about 4,500 jobs and brought in $20 – $30 million annually in export revenue. However, on the tax front the picture has not been quite as rosy. According to a 1977 study by a University of Nairobi based economist Raphael Kaplinsky, Del Monte rigged export prices and cooked its accounts so that despite large profits it paid no taxes to the Kenyan government from 1965–75. It was a classic example of 'transfer pricing'. Kenya Canners sells its pineapples to Del Monte's British subsidiary on paper at ridiculously low prices. The British company then resells it in Europe at the market price. The tinned pineapple is shipped directly from Kenya to France, Germany and other European countries.

When the company did begin to show taxable profits in 1976 they carefully arranged to coincide paying back 'service charges' or loans to their Del Monte parent, eliminating both the profits and the potential taxes. Kaplinsky also found that Kenya Canners bought labels, tins and second-hand equipment from other Del Monte foreign subsidiaries, often at inflated prices, instead of from local producers. In addition, the company's expansion was financed largely by borrowing – most of it local capital. The result has been a continual outflow of cash to service the debt and a drying up of local finance capital for domestic business.

Although Kenya Canners has vigorously denied Kaplinsky's charges, the Kenya government is taking the transfer pricing accusations seriously. The first victim will be Del Monte's 'Sweetheart' monopoly arrangement for pineapple production. The government hopes to drive a wedge into Kenya Canners control by encouraging the rival $4.9 million Machakos pineapple operation. The new company will be a joint venture between the government, a local development bank, local investors and, despite the Del Monte fiasco, another foreign company. ■

prices may no longer be the accurate reflection of efficiency or profitability. Firms may declare regular losses but continue to expand. Where the trade is corporately planned, export subsidies or currency devaluations will have little short term effect. If the local money supply is controlled, multinationals can tap new sources from abroad. Whether it is tariff protection, balance of payments adjustment, monetary and fiscal policy, or a whole range of industrial instruments or anti-monopoly controls the interventionist state is left in an Alice in Wonderland world where the prices on which their policies are based are no longer what they seem.

Thirdly, the fact the multinationals may now make profits in one country, declare them in another, and invest them in a third, means that a new form of interstate competition has emerged. It is a contest not for new investments, but for *declared* profits. Small countries, with little local production, and only a small state budget to finance are ahead in the race. These are the tax havens like the Bahamas, Bermuda and Liechtenstein, who are undercutting established nation states and contributing to a general lowering of the international corporate contribution to world-wide tax. This does not mean state spending declines. It means it is funded from taxes on those who cannot transfer price (labour, as well as some smaller national firms) and by loans from the international money market. Transfer pricing thus marks a shift in power not just from nation states to firms, but from labour to capital. Labour is called on to fund a greater part of state expenditure (or suffer its cuts), and is subject to an indirect discipline via its government's dependence on the international money market for public financing.

The Alternatives

What then can be done? The control of transfer pricing through government monitoring units has some scope but is likely to be limited in effect. With multinationals monopolising the crucial technical and financial information, external monitoring units are necessarily at a disadvantage. Certainly we can establish certain minimum conditions for effective control: full access to a firm's international accounts; the ending of confidentiality rules which prevent a sharing of information between different government departments; the shifting of the burden of proof from the government to the firm; the grant of discretionary powers to controllers; and the co-ordination of international action against tax havens.

With the incentive for one country to undercut another, and with the internal political power of multinationals often so great, such measures are liable to be difficult to implement. Put another way, it is not possible to control *international production* through powers limited to *national circulation.* States and labour movements can no longer expect to control their national economies through intervention at the level of prices.

There are only two alternatives. First, labour – which has a real interest in controlling transfer pricing – should be given powers to monitor prices of the firms within which they work. Second, states should extend their powers to production. By directly controlling production, governments will at last have direct access to corporate information, and a direct control on the way in which productive concerns connect to the world economy. This is one of the benefits which resulted from the nationalisation of copper production and marketing in Zambia, and a range of manufacturing operations in Ethiopia.

In the face of the challenge of the multinationals, it is being realised in both developed and underdeveloped countries that an adequate response will involve more than new government departments and new laws. It will involve a direct counter-challenge to the multinationals' control of production itself.

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TABLE 1

Selling too cheap

METHOD: whereby an international company shifts profits from one national subsidiary to another to minimise tax payments. The products of the first subsidiary are sold to the second **too cheaply**, ensuring the first makes a loss or breaks even whilst the second makes an exceptionally high profit.

Commodity	Country	Date	% under-invoiced	Sum lost	Source
Copper	Chile	1956-71		$400mill.	
Bauxite	Jamaica		100%		US import prices
	Greece	1976	9%	$4mill.	Other export prices
Metal Products	Greece	1976	9%	$4mill.	
Tea	Kenya	1976		$4mill.	Tea price comparison
Bananas	Panama	1973	22%	$12mill.	IMF
Bananas	Costa Rica, Honduras, Guatamala, Panama	1947-51	221%	$358mill.	IMF
Pineapples	Kenya	1976	25%	$5mill.	Various
Wattle	Kenya	1976	17%	$1mill.	
Canned Meat	Ethiopia	1964-8	100%		FAO
Salt	Ethiopia	1975	25%		Co files
Crocodile Skins	Ethiopia	1969 & 70	127%	$1mill.	Ministry of Commerce
Fish	Papua New Guinea		9%	500,000k (extra tax)	PNG Tax Authorities

TABLE 2

Buying too dear

METHOD: One subsidiary pays **too high** an import price from an overseas associated company. Unnaturally high profits are made abroad whilst the home subsidiary stands still.

Commodity	Country	Date	% over-invoiced	Sum lost	Source
Synthetic Textiles	Ethiopia	1967-71	46%	$2mill.	Tariff Commision
Steel	Kenya	1976	6%	$4mill.	Ministry of Industry
Metallurgical Products	Greece	1975-76	20%	$8mill.	Comparative International Price Data
Pharmaceuticals	Iran	Late 1960s	varied		
	Colombia	1968	155%	$3mill./$20mill.	
	U.K.	1966-72	4000%-4500%	$32mill.	U.K. Monopolies Commission
	Spain		880%		Foreign Market Prices (UNCTAD)
Rubber	Colombia	1968	440%		World price comparison
Rubber Tyres	India	1955			
Chemicals	Colombia		26%	$1mill.	
	Latin America		143%		
	India	1970-71	143%-34%		
	Greece	1975-6	35%	$2mill.	
Electronics	Colombia	1968	16%-66%		
	Ecuador				
Capital goods	Colombia			$1mill.	

Photo: Margaret Murray

A Kenyan executive in the driving seat. Managing in the interests of his country or corporation?

With a little help from their friends

Third World nations bargain with foreign corporations to maximise the benefits from the commercial investments. Corporations minimise the returns with a little help from their friends. Christopher Sheppard looks at a business survey in Kenya* – one country which has gambled on the wholesale involvement of foreign companies in its economy.

Corporate investment in the Third World is no longer a simple matter of planning the factory, signing some documents and posing for photographs with the relevant government minister. Developing countries are increasingly insisting on certain conditions before letting international companies set up shop. Foremost amongst their demands is local employment – not only unskilled jobs but also senior managerial positions. And often there is an insistence on sharing the profits of the proposed venture by permitting nationals, and sometimes the government, to own a substantial number of the shares in the concern.

Stiff terms? Possibly. Certainly such demands have caused a lot of friction between governments and foreign businesses in the past. But the more flexible and forward-looking corporations have found that native managers and local government shareholding in their overseas operations can work to their advantage. At worse, it can mean little more than a facade of local control and ownership while allowing the foreign firms to effectively silence cries of exploitation. Nevertheless, corporate partnerships with Third World governments for 'mutually beneficial' goals are increasing. And with 50 per cent of the shares locally owned, how can multinational subsidiaries possibly act against the interests of the country where they are based? When local people run the company, the proposition seems even more absurd.

Evidence from Kenya contradicts this. It shows that in negotiation with foreign business, officials are often willing to sell their national interest short. Outside control can remain as tight as ever, sometimes with the added benefit of inside information. Company profits, shared by the local elites, are seldom seen by ordinary citizens of the country.

Canadian economist Steven Langdon surveyed more than seventy international corporate subsidiaries doing business in Kenya. These companies were given easy access to the country soon after independence in the 1960s. Today, control of the economy is in few hands; the biggest twenty companies in Langdon's survey have 86 per cent share of all national business investment. Few of them are constrained by competition. More than 60 per cent hold a virtual monopoly in the main product they sell – helped by high tariffs on foreign imports that might undercut their prices. And all this has occurred with the consent of the Kenyan government.

Of course, when foreign businesses are negotiating for a share of the Kenyan market, they bring a lot of firepower to the bargaining table. Kenya requires highly skilled people to gather and analyse information in order to assess the proposals of foreign corporations and bargain effectively. They frankly admit they have too few such people, spread too thinly. On the other side, corporate negotiators are skilled specialists, with easy access to information and the experience of parent company operations elsewhere to guide them. The corporations also control much of the technology required to develop new industries. Third World governments find it difficult to bargain for such know-how, since they can't fully assess its importance. And behind the corporate investor is the power of their institutional allies: trade federations, cartels and sympathetic Western governments. 'Even if the days of gunboat diplomacy are over,' Langdon observes, 'the involvement in a business dispute of the governments of such large aid donors as the U.K., the U.S. and West Germany, seems to lead to settlements that favour the British, American and German firms involved.' 'I get on the 'phone to Kenyans if I need to,' said one British High Commission official in Nairobi. 'That's why we're given entertainment allowances – so that we know someone who knows so-and-so who is dealing with it, when the issues come up.'

It is against these odds that Third World negotiators must bargain when trying to get the best deal for their nation.

The Kenyans appear to have done particularly well in their insistence on a local share of the equity holdings in foreign concerns. Indeed, 75 per cent of the multinational subsidiaries in Kenya have local shareholders. More than half are in partnership with the government. But shareholding does not mean control. Two-thirds of the companies with hefty local ownership of shares in the Langdon survey still had their corporate investment, spending and recruitment decisions cont-

* *'The Multinational Corporation in the Kenya Political Economy' by Steven Langdon, Dept. of Economics, Carleton College, Ottawa. Published in 'Readings on the Multinational Corporation in Kenya' ed. Raphael Kaplinsky.*

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