

Effects of transfer pricing beyond tax revenue loss: a threat to economic development

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Transfer pricing and its negative impact on tax revenue generation is an issue that has been well discussed and documented. There is significant empirical literature that analyses how transfer pricing abuse negatively affects tax revenue generation and the wider impact on development and poverty alleviation. However, the effects on labour disempowerment, poor management of resources, distortion of information for entrepreneurial development and investment, challenges with implementation of tax related government policies, and their multiplier effect on extreme poverty have not received equivalent public attention. A deeper analysis of these other effects highlights that tax dodging perpetuates extreme poverty and creates serious economic distortions that hinder sound investment decisions in economies where the practice is predominant.

MNEs tax avoidance, an unethical practice

Terminologies such as transfer mispricing, transfer pricing abuse, profit shifting, profit splitting, income shifting, income splitting, earnings stripping, and tax base erosion, all refer to various acts of manipulating financial transactions in multinational enterprises with the view to reducing the amount of corporate income tax these enterprises should pay. While most of the activities involved in transfer mispricing are not illegal, they are unethical, and have been criticised as irresponsible corporate practices.

They are considered irresponsible practices because they undermine the important contributions that other stakeholders such as government, labour and minority shareholders make to the success of the organisation. Secondly, they involve manipulation of financial transactions and secrecy, thereby making financial reports of such companies difficult to access and assess. Even the financial reports that are accessible may not be reliable. This is because companies who report false profits or losses provide complex and misleading explanations to their performance. The purpose for these complex explanations is to conceal the act of tax dodging.

For instance the Chairman of Accra Brewery, a subsidiary of SABMiller that is alleged to be dodging taxes, stated in the company's 2009 annual report that the company made significant progress in the year, yet the company reported a net loss of Ghs 2,240,000. It is extremely difficult to reconcile how a company make significant progress in a year, and yet report such significant net loss in the same year.

Transfer mispricing, a threat to effective redistribute policy

Taxation is a critical element of fiscal policy. Apart from the revenue mobilisation function of taxation, it is also used to redistribute resources. Economically less endowed sectors of the economy are developed with tax revenue from economically well endowed sectors. Similarly, high income earning individuals are progressively taxed to generate revenue for provision of essential services for the citizenry. In fact the first of Adam Smith's principles of taxation emphasised the need for a tax system to be equitable and based on

income and protection enjoyed from the state. John Stuart Mill, also a renowned political economist, added that since the burden of taxation weighs differently on the rich and the poor, although always to the disadvantage of the poor, taxation should be progressive with the rich paying more taxes.

Unfortunately, transfer mispricing and associated tax dodging practices endanger this principle. When MNEs such as SABMiller with the ability to enjoy economies of scale to minimise their cost rather report losses and do not pay tax, government is compelled to shift tax payment to households whose incomes may not be high enough to enable government secure reasonable tax revenue for public expenditure. In some cases, the true income of some households who may not fall within the taxable income bracket but due to poor records, but may be compelled to pay taxes under these circumstances. The results of this are entrenchment of poverty and denial of economic rights of the people.

Transfer mispricing, a threat to labour empowerment and welfare

Labour empowerment has been considered critical in labour autonomy and performance. An empowered, organised labour force is able to support strategic decisions, influence organisational culture and social norms to increase productivity and also bargain for working conditions that improve the welfare of workers. Tension, threats of restructuring, and poorly organised labour is rife in organisations where transfer mispricing thrives. These create fear and job insecurity in the labour force, making it difficult for workers to enjoy their basics rights.

Workers value addition to the production process – which is often measured as the difference between value of output and input units – is one of the key variables for salary negotiations between management and organised labour. When workers value addition to the production process is depleted by overstatement of expenditure such as materials cost, organised labour is disadvantaged in its bargaining position. Workers then have no basis to negotiate for fair wages. Then workers are left at the mercy of management to determine working conditions arbitrary

In companies where profit shifting is part of their modus operandi, workers are oppressed with unreasonable performance targets, but are provided with minimal capacity support with the excuse of high overheads. So workers work under extreme pressure to meet targets, but earn less salary, out of which they manage their increased medical bills due to stress and other related ailments. All these factors reduce the savings potential of workers, their welfare and the welfare of their dependants. The long term effect is poverty.

Transfer mispricing, a threat to entrepreneurial development and investment

Credibility of information about business environments is critical to entrepreneurial motivation and development. Entrepreneurial ingeniousness depends partly on analysis of the business environment to obtain information upon which business opportunities can be identified. Transfer mispricing makes access to credible information impossible.

As MNEs continue to report false losses, it sends wrong signals about business potential in the economy. If the false information is the only information available, potential investors may rely on this information and judge the business environment as hostile. Such investors will relocate to a supposedly friendly environment for their enterprise, resulting in a loss in employment and national income.

Transfer mispricing has been considered one of the major causes of joint venture disagreements. When related party transactions are manipulated to reduce profits, minority shareholders are affected as dividends reflecting the true performance of the organisation are not declared. This denies these shareholders the return on their investment. For instance The Social Security and National Insurance Trust (SSNIT), which has significant investment in Accra Breweries did not receive any dividend in the periods that Accra Brewery made losses and did not declare dividends. Apart from SSNIT, there were individuals who also have investment in Accra Brewery. They were denied the return on their investment because SABMiller moved all the profits into tax havens so it can dodge taxes in Ghana.

Transfer mispricing, a threat to resource optimisation

In highly competitive environments where profit margins could therefore be low, innovative cost management practices, efficient technology, quality goods and services, and highest standard customer service is usually the strategy to survive competition and improve profitability. However, where there are other means of cutting corners to make profit, there is no motivation to espouse competitive strategies. Interestingly, companies that dodge taxes report huge profits in their holding companies located in tax havens. These easy ways of making profits do not place management under any pressure to be creative in cost minimisation strategies to increase their profits. The results include significant waste in materials and poor customer service.

Additionally, these companies invest in phantom structures to orchestrate tax dodging practices. They also invest in Accountants and Lawyers whose preoccupation is to study loopholes in tax laws to enable the organisation prey on the loopholes. Additionally, they invest in other logistics to help conceal the tax dodging. All these investments could have been productively used to generate more revenue to benefit the company and the state. Obviously, it takes significant resources to investigate and detect these activities, and when detected, it may require significant legal tussles between the tax authorities and these companies. Until they are proven guilty, they do not admit the offence.

Tax dodging is infectious and must be stopped

In October 2010, Google Inc, one of the giant technology companies in the United States was accused of using transfer pricing to avoid paying taxes in the United States. Google was alleged to have cut its tax liability by USD3.1 billion in just three years. The report revealed that the strategy Google Inc used had gained favour among companies such as Facebook Inc and Microsoft Corp.

For the first time, the UK biggest companies' – known as FTSE 100 – use of tax havens has been compiled and analysed. ActionAid UK has uncovered how about 98% of these companies use tax havens to avoid payment of taxes. Many of these multinationals have subsidiaries in Ghana, operating in various sectors of the economy.

As discussions around tax dodging gradually gains prominence in Ghanaian development discourse, multinational enterprises should acknowledge the potential reputational risk of tax dodging and its effect on their business. There is now a worldwide campaign against tax havens because of their potential to cause poverty. Therefore companies that rely on tax havens for their global profits will need to revise their strategies and start reporting the correct profits.

It is also worth noting that organisations such as ActionAid will continue to campaign against unethical corporate practices, especially those that have the potential to create injustice and perpetuate inequality. ActionAid aims at working together with people to demand their rights. The organisation will therefore continue to engage the public to create awareness of such corporate practices so that together we can end these practices and end poverty in our country.