Discussion Paper
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TNCs and Transfer Pricing in India
Regulatory Strategies and Corporate Structures

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Introduction and Definition

It is now being recognised that international exchange of goods and services, like equivalent domestic exchange, takes place both through hierarchies and on markets.[1] The growth of management contracts, technical assistance agreements, licensing arrangements, etc. probably implies the expansion of non-market hierarchical influences even upon `arms length' market transactions. The increasingly problematic role of the market as the main instrument in the allocation of resources which these tendencies imply, seems to be the result of increases in mechanisation, organisational scale and R and D activities which are the basis of the joint production operations so characteristic of modern capitalism. They often make the market irrelevant even for the distribution of end products, as prices which earlier operated as equilibrating mechanisms now are merely accounting devices to serve corporate objectives. It is not surprising therefore that many ostensibly arms' length transactions can now easily take on some of the characteristics of intra-firm trade.

Opportunities for the pursuit of `restrictive business practices' within intra-firm trade (however defined) are certainly great. The practices which are conventionally so described, when undertaken within transnational corporate hierarchical systems are considered the basics of good transnational corporate management. This contradiction in approach (of the state on the one hand and private corporate entities on the other), is reflected in their respective strategies of operation vis-a-vis each other, often to the detriment of the economy as a whole.

Transfer pricing is one such practice which refers to prices used for `internal' sales of goods, services and technology between divisions and/or associated companies of a business enterprise. The concept relates not only to trade operations proper, but also to other intra-firm transactions, such as those relating to transfer of technology, dividend remittances, royalties and technical fees payments. These transactions are mostly market transactions between unrelated parties (ie. from arms' length prices). However transfer pricing may also arise in transactions between unrelated parties, for eg. where one company supplies an LDC company with more than one item, and receives more than one kind of payment. In such cases (eg.when machinery and parts are supplied along with know-how) payments for one item may be artificially attributed to another, for tax or other reasons. The scope for transfer pricing in such transactions also increases in cases with `tie-in' clauses in licensing agreements or technical/ financial collaborations which require the purchase of goods from the licensor or party designated by the licensor.

In keeping with this broad definition of transfer pricing, in this essay we outline the variety of forces which influence the inception, use, regulation, control and estimation of such pricing practices. In doing so we attempt to move towards a framework within which to analyse and check transfer pricing by large international corporations in developing

1. Refer Williamson O.E. (1975).

countries. **Section I** deals with structural and policy induced motivations for transfer pricing and their operational manifestations in the accounting practices of transnational corporations. The impact of these practices on the economy and the relevance of the regulatory mechanisms, (both Indian and international), given the underlying motivational factors, are discussed in **Section II**. **Section III** critically reviews various efforts to control transfer pricing in some developing countries, in the context of the discussion on the motivational, operational and regulatory aspects in the previous sections. It highlights the divide in the existing literature, between the regulatory and control aspects of transfer pricing, and attempts at estimating its extent in various sectors/industries or in the Indian economy as a whole. The **Conclusion** calls for a more realistic policy framework, both at the national and international levels, for the estimation and control of transfer pricing practices in developing countries.

Section I
Motivational and Operational Aspects

By virtue of their international spread TNCs can avail simultaneously of complex tax laws, corporate structural and other organisational laws to achieve the overall goal of profit maximisation. Taxation of foreign income provides a legal incentive to invest abroad and also the proliferation of `unfair' transactions and financial manipulations.

Operationally the financial manipulations for transfer pricing take the form of false invoicing. This practice is defined by the OECD Committee on Fiscal Affairs (1976), as

> `a transaction intended to evade tax by putting taxable objects outside the reach of national tax authorities by means of an invoice that does not accord with economic facts.'

This objective is achieved through both under and over invoicing (of imports and exports), often by the same company.

Over invoicing of imports occurs in those commodities with low or zero import tariffs, mostly for illegal repatriation of capital to head offices ; and also in sectors with internal price control to increase the cost of production so that higher official prices/ subsidies can be obtained. Under invoicing may be found in imports of products with high tariffs or sales tax. Over invoicing of exports is found to be practiced by transnationals which produce or assemble manufactured products. The objective may be to obtain a greater value from government export incentive schemes. Under invoicing may be undertaken to avoid foreign exchange stipulations of domestic banking authorities.

Typically the issue of transfer pricing arises because of the existence of intra-firm trade across national borders; but direct foreign investment, licensing agreements, joint ventures (both technical and financial), often also provide ample scope for transfer pricing, not only to circumvent adverse government policies, but also as a part of the corporate strategy and organisational structure of transnational entities.

Policy induced motivation for transfer pricing manipulations may arise because of both tax and non-tax factors. Corporate tax rates and fiscal provisions, exchange rate fluctuations and import duties as also labor laws, policies restricting monopolies and restrictive trade practices, laws governing profit repatriation in particular and foreign capital in general and import substituting/export promoting policies; all influence (and in turn are affected by) the nature and extent of transfer pricing by transnational corporations (refer Appendix I). But such manipulations can occur even in the absence of government policies designed to advance domestic economic and social goals, often in variance with those of TNCs. **Structural motivation** for replacing arms length market transactions in the acquisition of inputs, or disposal of outputs by non market devises, may arise out of considerations of security (with respect to both prices and access to supplies, especially in cases of long gestation period investments), transaction costs, externalities and the need for secrecy.

Such a motivation for transfer pricing, cannot in practice be separated from policy related inducements as both together form the framework within which TNCs operate in order to minimise tax payments and maximise profits. However a TNC may transfer price even in the absence of adverse government policy, in order to: maintain its market power, sustain a high rate of self-financed DFI for further expansion, hide information from competitors, finance R and D projects, compensate losses of one or more subsidiaries, finance portfolio investments in other firms or sectors, finance joint ventures, provide for losses due to nationalisation etc.

TNCs combine centralised control and integrated corporate functioning with a geographical dispersal of their production and investment activities. Their multinational character is an attempt to `internalise' market imperfections so as to maximise current global profits or minimise future risks and uncertainties in order to ensure long-term gains for the corporation as a whole. A key profit motivator is global tax minimisation and their often exists an explicit tax strategy that best serves the interests of the corporation.

International tax avoidance to achieve these and other objectives may occur through general manipulations, as well as through specific items in the balance sheet and the profit and loss account.[2] The former category would include: location of affiliates in tax havens[3] and their dual use as intermediaries both in purchase and sale of goods. By adroitly invoicing goods through tax haven affiliates, the greater portion of profits unrelated to any function performed by the tax haven affiliate, can be erroneously recorded in the affiliate.

2. For details of these manipulations refer to US Internal Revenue Service, Multinational Companies, Tax avoidance and/or evasion and Available Methods to Curb Abuse, in R. Murray(ed) (1981).

3. A tax haven can be described as any country whose laws provide an escape from taxes on an economic gain that would other-wise be taxable in another country.

The existence of` unexplained' corporations in the organisation, which do not seem to have a valid function, may also be a vehicle for tax avoidance. The same may be true in the case of the operation of permanently loss making units and transactions between companies which are under common control but which do not belong to the same corporate group.

In the **Balance Sheet**, loans to foreign affiliates may represent the repatriation of foreign profits in an attempt to avoid domestic payment of dividends, as also may, excessive balances with affiliates. Write-off of inter-company debt may be attempted to reduce balances that may have resulted from non arms length transactions. Omissions in the balance sheet of expected assets or liabilities may indicate transfer or sale of intangible assets like patents, knowhow etc. to tax haven affiliates.

In the **Profit and Loss Account**, R and D expenditures may be hidden, pooled or distributed among companies to avoid taxes; royalties may be excessive and may go to unlikely recipient affiliates; patents and trademarks may be charged for at monopolistic rates, or involve reciprocal benefits and may be priced even after their expiry. In the case of payments, for both royalties and patents and trademarks, to affiliates, the charges may not meet with the arms length criterion. Payments for home-office administrative support, R and D etc., may be excessive and may contain hidden profits which are not assessed in the country of receipt. Sales of partly finished goods, third party commissions or discounts to foreign affiliates, unexpected purchases or sales, rentals, office and travel expenses, changes in the pattern of accounts, liquidation and sales of foreign affiliates etc. , also provide ample opportunity for transfer pricing and consequently tax avoidance.[4]

Thus merely by being true to themselves the TNCs can come in conflict with the state which considers that it has suffered losses of tax revenue and see in this a challenge to its sovereignty; and with domestic firms which see it as a serious distortion of competition and one of the chief reasons for the expansion of TNCs. This attitude of the state reflects the structural and resource constraints faced by most LDCs and determines the nature of regulations to which the activities of TNCs in host economies, are subjected. The predominance of anti-monopoly and taxation related measures to deal with TNC operations in general and transfer pricing manipulations in particular, seem to be a response to factors endemic to LDCs. The effectiveness of these measures depends on the extent to which they take into account the tendency of TNCs to maximise global profits.

4. Refer to the report of the Public Accounts Commission on ` Computerisation in Government departments' 1976, for details of such practices indulged in by computer giants IBM and ICL, in India.

Section II
Regulation of Transfer Pricing

Rules and regulations affecting transfer pricing activities of any corporate entity are usually a combination of preventive, penalisation and adjustment measures to minimise the impact of such manipulations on the economy. One set is concerned with restricting/preventing such pricing manipulations. This would require the creation of an economic environment in which the incentive to indulge in transfer pricing is minimised. Given the intrinsic propensities of large corporations on the one hand, and the structural constraints faced by LDCs on the other, such measures may prove difficult to implement. Others help in identifying such manipulations and in penalisation once they have been found to exist.Such regulation usually takes the form of either information disclosure requirements at various levels, or valuation rules in cases of ambiguous related party transactions.

The impact of TNCs on world output arises partly from the extent to which these enterprises are themselves more efficient, as a result of their multinationality, and partly by the response of such companies to government policies designed to advance their own economic and social goals. Where ever they occur, the response of TNCs and their affiliates to the economic environment of which they are a part, or to changes in that environment, will, to some extent be different from other (similar) firms. This along with the fact that some of the output generated by the affiliates in one country will accrue to owners of resources in other countries, causes both international allocation of resources and the distribution of economic welfare to be affected. Although in a world context transfer pricing is primarily a distributional matter, from the point of view of a particular country, it would influence efficiency of resource usage and share of output produced. In a mixed economy like ours this could mean a misallocation of resources (away from planned priorities), accompanied by an adverse redistribution of incomes away from national entities and the related BOP effects. Besides dealing with transfer pricing before it can occur (preventive measures) and after it has occurred (penalisation measures), policy regulation is therefore also required, to deal with its macro and micro economic consequences. The adverse impact on host government foreign exchange inflows and hence on the balance of payments; the growth of a parallel (black) market for foreign exchange; revenue losses and the consequent implications for internal resource mobilisation; distortion in the functioning of specific policy instruments resulting in the non-achievement of plan targets; all call for an active role of the state. Similarly, at the micro level the proliferation of market concentration and oligopolistic practices require state intervention.

The policy environment in most LDCs, characterised as it is by greater protection of domestic industry and closer regulation of TNC operations, is thought to be conducive to the practice of transfer pricing manipulations. Rules regarding corporate taxation, import duties and exchange controls, (including restrictions on repatriation of returns on foreign investment), usually prompted by weak BOP positions and overvalued currencies, often create incentives for transfer pricing.[5]

In India, the emphasis on self reliant, import substituting industrialisation and consequently strict regulation of foreign investment, has led to the belief that manufacturing and trading operations are over protected. The result, it is said, is inefficiency and high cost in production, and backwardness in technology, marketing and management techniques. The encouragement of foreign investment, especially foreign technical collaborations and joint ventures, since the late 1970s has thus been in response to the need for greater competition, superior technology and more efficient organisational techniques. This has been accompanied by tax regulations, equity restrictions and foreign exchange controls, through FERA, MRTP, and provisions in the income tax, customs and companies acts, to restrict malpractices associated with TNCs and prevent foreign exchange outflows. The chronic foreign exchange problem and the corresponding negative impact on the BOP has also led to a proliferation of measures to monitor and control outward remittances. These include an upward limit for royalties and technical fees payments, discretionary control on lumpsum payments, monitoring of dividend remittances, high levels of corporate taxes etc.

If such a policy framework increases the (theoretical) possibility of transfer pricing manipulations by TNCs , the new industrial policy[6] and the budget of 1991-92, which give greater freedom to TNCs, both in the areas, and in the nature, of participation in domestic manufacturing and services activity, should reduce the incentive for such practices. Indeed a major objective of these policy initiatives is to increase the net foreign exchange inflow as a result of the activities of the TNCs in the economy. The automatic clearance of foreign equity participation upto 51 per cent in high priority industries and in the case of trading affiliates, the allowing of even higher equity participation in high-tech areas and in case of 100 per cent EOUs, the freedom to import capital goods if they are paid for in foreign exchange, the hiring of foreign technicians and foreign testing of indigenous technologies without prior clearance and the flexibility given to the special board on foreign investment, to overrule industrial policy provisions if necessary; are all measures which ostensibly constitute a more liberal environment for the operation of foreign affiliates.

However, the nature of the deregulation in the new policy statement is define by the regulatory framework which was already in existence. The deregulation (as also the previous regulation) focuses on the foreign/ domestic, equity/asset considerations, rather than on an understanding of corporate structures and organisational forms. It therefore suffers from the same inadequacies as the previous formulations. Secondly, while the emphasis is on improving the adverse BOP position, through reduction in the trade deficit, linking of outward remittances to export requirements, encouraging inflow of foreign exchange through various concessions for NRIs etc.; there are no additional measures to prevent illegal syphoning-off of funds, through transfer pricing and other manipulations. In

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5. See Plasschaert, in Rugman and Eden ed.(1985), for a development of this argument.

6. Govt. of India, Ministry of Industry, Statement on Industrial Policy, July, 1991.

fact, some incentives in the budget, like the exemption of inward remittances from NRIs from scrutiny and (gift) taxation by the authorities, will encourage the diversion of normal NRI remittances from legal channels to illegal ones. Adverse implication for outward remittances (specially illegal ones) may also result from the complete freedom to hire foreign technicians and get foreign testing of indigenously developed technologies[7]. Further linking capital goods imports to foreign equity holdings, at least at the installation stage, would certainly encourage transfer pricing. Besides this some proposals, like that of monitoring dividend repatriation to ensure that they are balanced by export earnings over a period of time, may be extremely difficult to implement. These factors together with the problems of the existing legal provisions, discussed later in this section, could exacerbate the tendency for transfer pricing manipulations. Thirdly, the new policy statement may not be a significant departure from earlier statements, at least as far as foreign investment is concerned. Foreign equity upto 80 per cent in high-tech areas and upto 100 per cent in 100 per cent EOUs was allowed for even in the 1977 Industrial Policy Statement. Freedom for remittances of royalties, dividends and profits, for all approved foreign investments, under given rules, was also allowed for in this statement. The only change in the 1991 policy is in terms of freeing remittances of lumpsum payments upto 1 crore from the requirement of prior official approval.

For assessing the possible impact of changes in corporate taxes, customs duties and exchange rates on transfer pricing manipulations by TNCs, one has to look at the budget proposals for 1991-92.[8]

In India nominal corporate tax rates have been higher even than tax rates in developing countries. This together with taxes on repatriated dividends, interest and royalties may have increase tax burdens on TNC affiliates operating in India and hence encouraged under invoicing of sales and rerouting funds to tax haven affiliates. If this be the case then the proposals in the current budget will only exacerbate this tendency. Corporate tax rates have been increased by 5 percentage point and now range from 45 to 50 per cent of profits for all companies. This is not inclusive of the 15 per cent surcharge which will still be levied. Besides this, depreciation allowance on fixed capital has been decreased from 33.33 per cent to 25 per cent. These changes increased both the taxable funds and the tax rates faced by foreign affiliates.

The existence of customs duties on imports, (especially ad valorem duties), as they increase the price of imported goods, provide great scope for transfer pricing manipulations

7. The RBI Survey on Foreign Collaborations in Indian Industry (1985) shows the payments of technical fees and royalties to be the largest component of outward remittances through foreign collaborations.

8. Here it should be pointed out that the budget proposals are not a policy statement of the government, but are primarily concerned with its revenue and expenditure management. As such, they do not explicitly deal with specific issues, like those related to transfer pricing. However they do reflect the general direction of government policy and so become relevant in the present context.

through the under invoicing of imports. Tariffs are often a multi target policy instrument in LDCs, used not only as protective devices to nurture `infant industries' but also as a major source of revenue for the government and as an instrument to achieve BOP equilibrium. As such they are considered to be very high (relative to home country rates) in most LDCs including India.

In the recent budget proposals the preoccupation of the government with considerations of resource mobilisation, has caused the customs duty structures to remain almost unchanged. Specific duties such as those on import of machinery for marine products industry and finished leather industry have been reduced to encourage exports from these industries. Import duties on capital goods and components have also been reduced by 5 percentage points. These changes may be too insignificant to cause a decline in the incentive to under invoice imports. Similarly the elimination of tariff peaks above 150 per cent affects imports of a limited number of product, and leaves comparative tariff rates still to high relative to home country rates, at least from the point of view of importing TNCs affiliates. In other words, these policy proposals may not provide a policy environment which will limit the illegal transfer of funds. Further, in the absence (at present) of a nominal tariff structure if one relies on the budget to provide collection rates, for the stated revenue targets to be achieved, these rates would have to go up by about 9 to 12 per cent, on policy dependent imports. This would mean a even higher increase in nominal tariff rates, as exemptions etc. would have to be included, in their calculation. The pre-budget collection rates on policy dependent imports is about 60 per cent. Thus implicit in the budget estimates, is a higher nominal tariff rate. This could accentuate the compulsion to transfer pricing by TNC affiliates.

However, the tariff minimising aim of transfer pricing manipulations may clash with other conceivable motivations for transfer pricing. For example, successful under invoicing of imports reduces the customs bill, but other things remaining equal will increase taxable profits of the importing subsidiary.

Currency risks, as denoted by fluctuations in exchange rates, faced by TNCs in trade transactions in foreign (LDC) currencies, are also conducive to transfer pricing manipulations. To avoid exchange losses TNCs often convert assets in a currency which is expected to weaken into a stronger one, before devaluation occurs. This is done by accelerating prospective payments in weak currencies (`leading') and delaying payments in strong currencies (`lagging'). Transfer pricing manipulations reshuffle cash balances between units of TNCs but cannot avoid exchange risks. If however, such manipulations are grafted on to successful leading or lagging moves they could amplify the outcome as more funds in weak currency could be converted into the strong currency or less units of the strong currency could be exchanged into the weak one.[9] The recent two stage devaluation of rupee may have provided an incentive for such leading-cum-transfer pricing manipulations combinations.

9. See: Plasschaert, (1979).

It is important to note that given these temptations for transfer pricing manipulations which the policy environment provides, such practices can only be indulged in to the extent governments are unable to monitor them. Therefore, the specific measures to scrutinise relative party transactions have great significant. In India, provisions under the Companies Act, Customs Act, Income Tax Act, and FERA exist to regulate such transactions. Sections 212, 594 and 615 of the **Companies Act** require disclosure of information about operations and finances of subsidiaries of all units falling under the purview of the Act. Section 14 1(A) and 14 1(B) of the **Customs Act**, the **Customs Valuation Rules** and the **Customs Valuation Act** (1988), all provide for customs valuation of transactions which are not arms length; Sections 112 and 114 (or Section 167(8) ofthe **Sea Customs Act**), penalise `improper' trade transactions and Section 111, allows for their confiscation. Over- as well as under invoicing of imports(section 112) and exports(section 114) are recognized as punishable economic offenses.[10] Cases of violation of the Act, including those of false invoicing, come up for hearing under Sections 128, 129 and 130. Section 128 provides for appeals against decisions taken under the Act, Section 129 for the constitution of an Appellation Tribunal and Section 130 for referring cases to the High Court, and at times to the Supreme Court (Sec.130-A). The taxation of various sources of income (viz. dividends, royalties, technical fees), of foreign companies and non residents falls under Section 115 A, of the **Income Tax Act**; while section 44 D of the act and Rules 10, 11 (**Income Tax Rules**), relate to the computation of this income. Sections 92, 93 deal with cases of tax avoidance in related party transactions involving non-residents, and Section 173 with the recovery of these taxes. The domestic and unilateral powers regarding discovery, production of evidence or attendance of any person (Section 131); search and seizure (Section 132); requisition of books of accounts (Section 132A); calling for information (Section 133); survey (Section 133A); collection of information (Section 133B); inspection of registers of companies (Section 134); inquiry before assessment (Section 142, 143(2), 143(3)), are ineffective in obtaining overseas information. The Income Tax Act does not provide any investigative power to tax administrators to have access to information relating to an international transaction. A foreign company cannot be compelled to produce relevant books and records kept by it abroad and foreign nationals cannot be compelled to give evidence or produce documents. This underlies the need for international cooperation. Such cooperation is sought and extended through double taxation agreements. Sections 90, 91 relate to the existence of double taxation agreements with different nations, according to the UN model (1980). Article 26(1) of this model provides for the exchange of relevant information between tax administrators of the contracting states. The **Foreign Exchange Regulation Act**, covers foreign exchange violations of RBI directives. Section 12 (1) requires exporters to declare the full value of

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10. Sections 2(41), 46(4) and 111(m), deal specifically with under invoicing of imports. Refer to the case of Macneill Magor Ltd. Calcutta v Collectorate of Customs, Calcutta 1987(10) E.C.R.609 at p. 613(CEGAT):1987(28) E.L.T.318., which was prosecuted under these sections.

goods to be exported. Violation of this section is dealt with invoking Section 19, which gives powers of inspection and Section 22, which penalises false statements; Section 23 (1A), punishes any contravention to the provisions of the Act for which no penalty is expressly provided.

While laws/rules do exist for dealing with malpractices in related party transactions, they do not seem to be based on an understanding of the intrinsic logic of these manipulations. This leads not only to inadequate coverage of intra-firm transactions at the detection stage but also to a lack of coordination between the various statutory authorities at the implementation stage. Each set of rules is implemented in isolation from the others and fulfills a separate objective. The Customs Rules deal only with goods traded across the national border and focus on their `arms length' valuation; FERA regulations are concerned with the violation of RBIs foreign exchange directives and prevention of undue foreign exchange losses therefrom; and the income tax laws deal with the taxation aspect of non-resident remittances abroad. Any specific malpractice, in this case transfer pricing, is thus approached in a fragmented and disintegrated manner. For example, either from the tax angle or the valuation angle or the FERA violation angle[11].

Overall the general policy towards foreign investment does not recognise TNCs as tangible legal entities. Rather subsidiaries of transnationals are treated in isolation from their global operations. Such an approach precludes the possibility of detection (and hence monitoring) of a large number of related party transactions; both within the economy and in trade/investment transactions with the international economy.

In contrast to the national level where legal/professional requirements for disclosures about amounts transferred and accounting policies used are sparse, at the international, inter-government level, the **UN (UNCTAD, UNCTC), OECD and EEC** have been for many years attempting to standardise accounting methods and information disclosure norms world wide. The global reach of TNCs is sought to be countered by global regulations. To this end, the UN proposals (1977, 1988, 1989) and the OECD guidelines (1976, 1979, 1984, 1988), recommended disclosures of the volume and value of transfer pricing and/or related party transactions, as well as of the accounting methods used to determine their prices, both for the TNC as a whole and its individual sub-groups. The Report of the Committee on Fiscal Affairs (OECD, 1979), even attempts to set out detailed guidelines for actually determining arms length prices in transactions between associated

11. The divide is so sharp that in some cases a manipulation detected in a transaction not under its jurisdiction, cannot be upheld in a court of law by the detecting authority, even if it has regulatory powers in that area. To illustrate, two cases of under invoicing in 1969 and 1970 detected by the Customs authorities before the exports were effectuated, were ruled by the Supreme Court not liable to prosecution by them under the Sea Customs Act, Section 167(8), as the violation fell under Section 12(1) of FERA(1947) and prosecution was possible only under Section 23(1A) and Section 22 of FERA by the relevant authority, in this case the RBI and the Directorate of Enforcement, not the Customs. In March 1991 however, in a similar case the SC upheld the authority of the Customs to prosecute the under invoicing party before it had effectuated the exports. (Hindustan Times, 16.3.91).

enterprises.

More generalised formulations, regarding harmonisation of divergent accounting standards (UN Commission on Transnational Corporations,1989), use of market/arms length prices in intra-corporate transactions (UNCTC, Code of Conduct for TNCs), and Customs valuation of goods in conformity with commercial realities (**GATT**, Article VII)[12], also exist as part of the global efforts to regulate transfer pricing policies of TNCs.

However, what seems to be required is a more integrated, coordinated and consistent approach towards related party transactions based on a deeper understanding of the specific structural factors underlying them. Both at the policy level and at the implementation level, there is a need to try not only to improve but also to move beyond the information disclosure- market valuation approaches; towards a regulatory framework which incorporates the specific structural factors endemic to LDCs on the one hand and transnational affiliates on the other.

Section III
Estimation and Control[13]

In the context of the previous two sections it can be seen that any proper appraisal of the scope of transfer pricing manipulations on the part of transnational corporations, and of their actual practice, must be assessed within the framework of the specific set of government measures and structural factors endemic to TNCs which tend to be the motivational forces behind such practices. In other words the most effective way of dealing with transfer pricing is to focus on the causes of such manipulation and the economic conditions permitting them. For eg. if the global profit maximisation strategy of TNCs is considered a causal factor and the existence of monopolistic/ oligopolistic markets, the underlying economic condition, then one method of dealing with transfer pricing would be to make market conditions more competitive.[14] This would be in keeping with the tenets of traditional trade theory which advocates free trade under competitive market conditions for the most efficient exploitation of comparative advantages in international exchange of goods and services.

Another approach would be to abandon the free market model and allow for a changed role of the state, from one of trying to restore some traditional version of market relations to that of an active intervener in the struggle over international distribution of

12. India became a signatory to the GATT Code of Valuation in August 1988 when the Customs Valuation (Determination of Prices of Imported Goods) Rules came into force after an understanding was reached in the Tokyo Rounds of GATT.

13. In this section we deal with various methods used foe estimation of the extent (and scope) of transfer pricing in developing countries, in the context of checking such practices.

14. See Rugman and Eden(1985), for this `restrictive business practices' approach.

surplus. In this context the discussions on the important role of the state in bargaining with TNCs, to ensure a better deal for developing host countries, become relevant. For the distribution of gains from trade is considered to be dependent upon comparative bargaining strengths of the various economic agents.

Keeping in mind these approaches, we would like to focus on the problem of estimating the extent (and scope) of pricing manipulations by TNCs, in various sectors and industries in developing countries, in the context of relevant government policies and regulations, as well as endemic structural factors, affecting their occurrence; and see whether existing attempts in developing countries have in fact incorporated this factor in their analysis.

Early attempts to analyse and regulate transfer pricing used as a reference price the quotations of imitating suppliers. But it was realised over time that this was unfair to the innovating TNCs because these innovations were easy to copy and the marginal cost was much lower for the imitators. Some scholars resorted to checking if similar prices were declared in different destinations, by comparing partner-country trade data.[15] But this method was found to have serious limitations[16], as it assumes that faking of invoices can occur only at one end or that the incentive to fake runs in contrary directions at the two ends. There often also exist irreconcilable discrepancies in partner-country trade data which reduce the plausibility of this method. These discrepancies may arise due to: `misallocation' of the same traded item by both the SITC category and the country, a lag between shipment and arrival in the importing country, inaccuracies arising from conversion calculations etc.

Studies relating to the extent of transfer pricing in the trade transactions of developed countries abound.[17] This is due to, the detailed statistical information relating to intra-firm trade made available in most developed countries, for eg. by the US government`s Department of Commerce; the greater transparency of the activities of TNCs required by law, as well as the wider dissemination of the available information. In comparison, the availability of intra-firm trade data in developing countries is minuscule.[18] However studies[19] using trade statistics, usually invoices for trade transactions available with the customs authorities, to gauge the extent of transfer pricing in certain sectors or industries (especially drugs and pharmaceutical, chemicals, minerals, rubber etc.), do exist; and attempts have been made in some cases to check these activities.

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15. Bhagwati(1964).

16. See Bhagwati(1974), for a detailed critique of this method.

17. See for eg. S.Lall(1973), Rugman and Eden(1985).

18. Bhagwati(1974), Nayyar(1978), Lall(1979), Helliner(1981), discuss problems associated with trade data in developing countries.

19. Bhagwati(1964), Vaitsos(1974), Lall(1974), Majumdar(1974), Nayyar(1978), Goyal(1979), Plasschaert(1979), Subrahmaniam and Pillai(1976),Kumar(1980), Krishna(1984), Chandrasekhar and Purkayastha(1982); Sierra and Ganiatsos in Murray(1981).

In the latter genre are the successful attempts by the governments of two developing countries, Colombia and Greece, which need to be catalogued. In Colombia, INCOMX,[20] a government agency for the control of invoicing of all transfers in the external trade of the country, was set up in April, 1967. Its price division consists of three sections which collect the relevant information on exports and imports of goods from various sources, classify and process it, to publish price lists giving `maximum and minimum import prices' as well as `normal prices'; and finally, compares actual customs declarations of imports and exports with this information, to check illegal outflow of foreign exchange. The import prices are calculated keeping in mind the tariff structure for each commodity, and the `normal prices' are derived from the observation of international prices. The success of this effort of the Colombian government can be gauged from the fact that they are able to save about US$ 80 million per annum since the INCOMX was set up.

Similarly in Greece[21], in order to overcome existing gaps in the various national policies relating to foreign capital and the balance of payments, a specialised committee for the Surveillance and Control of Prices of Imported and Exported Goods(EPETEE), was set up in 1975.[22] Using invoices pertaining to previously concluded transactions, its technical unit tried to estimate the extent of overpricing of exports (or underpricing of imports) in those sectors which were relatively more important in Greece's BOP (viz. chemicals, pharmaceutical, minerals and metals), and proposed appropriate remedial action, mostly of an administrative nature. In this case too, observed prices were compared with some reference prices obtained from published and other outside sources.

These two cases reveal that even developing countries with their limited resources and skills can develop an information bank and surveillance mechanism to successfully check illegal transfer pricing activities of TNCs. An important factor contributing to their success is that they were able, at least to some extent, to relate their efforts to control transfer pricing with their national policy objectives and the institutional (and other) constraints their economies face in achieving these objectives.

Such coordination requires an objective assessment of the actual impact of specific policy measures on the behavior of TNCs, and of their consequent organisational and operational transformation on the host economy. Subsequently this perception of the functioning of various economic agents in the domestic economy would be used to work out the methodological basis for the control of transfer pricing in the national context.

Unfortunately in India, there does not exist any specific judicial or administrative body to monitor and check illegal outflow of resources through transfer pricing practices. Such practices do however fall under the purview of several authorities, ranging from the

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20. Refer to Sierra,` INCOMX and Transfer Pricing Control in Colombia' in Murray(1981).

21. Refer to Ganiatsos,` The Control of Transfer Pricing in Greece: A Progress Report', in Murray(1981) for a detailed account.

22. In 1979, it was replaced by the Price Research Council(SET) which has much greater authority than the EPETEE, in dealing with transfer pricing practices.

Customs to the Enforcement Directorate, often forming only a minuscule part of their areas of jurisdiction . Secondly, no systematic attempt has been made, like in Colombia and Greece, to collect and analyse relevant data at one place and for a single purpose; even though this information probably does exist with various government and semi-government departments, legal and administrative authorities and private business organisations or groups.[23] This fragmented approach to data collection is probably an offshoot of the fragmentary nature of existing regulations and often accentuates their inadequacies. These tendencies point not only to a lack of coordination between policies, procedures and their practical application; but more fundamentally, to a discord between stated national objectives and the existing structural and institutional factors to which they are addressed. This means, that while regulating the activities of foreign capital for domestic gain ,is an objective to which many of our policy measures are addressed, most rules do not take into account many of the strategic factors responsible for the existence of tendencies to defeat this objective.[24]

In the discussion in this section however, it is not the relevance of the existing rules and regulations, but to what extent the are incorporated in any assessment of the practices (in this case transfer pricing), which they are regulating, which is the issue. The regulatory framework along with organisational and operational factors endemic to TNCs provide the environment (within the domestic economy) for the practice of transfer pricing. International differences in taxation and exchange rates, as well as in corporate structural and other organisational laws also create incentives for transfer pricing manipulations. However these fall outside the purview of individual states and cannot be explicitly accounted for in any analysis of transfer pricing in the domestic economy.[25]

The literature that exists (for India) seems to fall into two broad categories. One vast, dealing with the inadequacies/irrelevance of the regulatory framework and enforcement mechanisms in dealing with TNCs, and calling for either liberalisation or greater protection.[26] This set also consists of some studies on the organisation and functioning of TNCs in India.[27] The other set is tiny by comparison and consists of some

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23. To illustrate, Customs Houses receive key information regarding the inflow of goods into the country, through the shipping bills submitted to them. The Customs department however, is interested only in valuation for revenue collection purposes, and not in the intricacies of keeping records. So these valuable sources of data, which can be used to scrutinise trade transactions for various regulatory purposes (including the control of transfer pricing), are neither properly maintained nor passed on in any relevant format to other concerned departments.

24. Refer to the discussion on the impact of recent policy changes in the Indian economy on transfer pricing manipulations, in the previous section, for an elaboration of this argument.

25. They may of course be accounted for indirectly if they are taken into consideration while framing domestic laws.

26. Chaudhury(1979), Chenoy(1985), Kumar(1982),(1985),(1990), Goyal(1979), Subrahmanium and Pillai(1976),(1979) etc.

27. Kumar(1987),(1988),(1990), Chaudhuri (1976), Siddharthan(1981), Chandra(1977) etc.

estimations of transfer pricing, mostly in the chemicals, drugs and pharmaceutical industries.[28] The ineffectiveness of policy formulations in checking these practices is often emphasised, but neither structural factors nor policy inducements are incorporated into the analysis. Consequently any concrete suggestions for the control of transfer pricing in these industries are also absent. The lack of any government sponsored studies, like those in Colombo, Greece and Sri Lanka, may be partly responsible for this gap; although successive governments have shown awareness of the fact that many large TNCs operating in India are indulging in transfer pricing.[29] Appendix III, shows the extent of related party transactions in the imports by affiliates and collaborators of TNCs in India, in April to December 1990. These imports accounted for 40 to 100 per cent of total imports of the units under consideration and point to a possibility of transfer pricing manipulations.[30]

The report of the Public Accounts Committee on computerisation in government departments,[31] refers to specific cases of transfer pricing by transnational computer manufacturers IBM and ICL, resulting in syphoning off funds through inter-company billing systems, misuse of import entitlements and export benefits, exchange rate manipulations etc. Specific instances of false invoicing are also dealt with by the Monopolies and Restrictive Trade Practices Commission.[32] The Commission`s report on electronics giant Philips India Ltd. reveals it to be in the Ministry of Finance reported eleven cases of under invoicing of tea exports to the extent of eighty-four thousand rupees in the six month period of 1971-77. These included big players like Brook Bond India Ltd. and Lipton India Ltd[33] .(Refer Appendix III)

These references to transfer pricing in various government reports concerning the operation of TNCs in the Indian economy, though they reveal an awareness of such practices and of the issues involved, do not form part of a consistent strategy of any particular regulatory body to check transfer pricing. In fact they reflect the lack of a holistic policy approach to FDI in general and the operation of TNCs in particular, which has been highlighted in the previous section. The divide in the literature, between the discussion on the efficacy of the existing regulatory mechanism on the one hand and estimation of transfer pricing on the other, also reflect the lack of integration of policy with the actual functioning of economic agents. However, the experience of some other developing countries as well

28. Sudworth(1971) and Subrahmanium and Pillai(1976) for the Dyestuff industry; Majumdar(1974), Kumar(1980), Kumar and Chenoy(1983) for the drug industry; Chandrasekhar and Purkayastha(1982), Krishna(1984) for the drugs and pharmaceutical industry.

29. Refer to the response of finance minister to a question on transfer pricing during a Lok Sabha debate, 13 Dec.1985 in this connection.

30. Refer 'India's Imports and Exports: Some Insights', Unpublished Report,ISID, March 1991.

31. PAC: Report no: 221, fifth lok sabha, April 1976.

32. MRTPC report on Philips India Ltd. for Establishing a New Undertaking for the Manufacture of Medical Electronic Equipment, Oct 1974.

33. Refer to PAC, Report on Customs Receipts, Lok Sabha 1977-78.

as the existing realities in our country (in terms of data collection and availability as well as surveillance mechanisms) seem to suggest that it is possible to integrate these strands usefully and check transfer pricing and other `restrictive practices' indulged in by transnationals as well as large domestic business houses.

Section IV
Conclusions

The expansion of non-market hierarchial influences have characterised the growth of transnational corporate entities and their interaction with various economic agents. Such influences have had their impact both on the functioning of the market and its regulation through state intervention. The increasing irrelevance of the market in the operations of TNCs, has been accompanied by a proliferation of regulatory mechanisms to reestablish the supremacy of the market in the interaction of economic agents, in many developed capitalist economies. The imperfections of markets and problems with their functioning, especially in less developed economies, have however also given rise to the need to move beyond attempts to restore some traditional version of market relations, and establish means of strengthening the bargaining position of the state vis-a-vis TNCs.

The regulation of activities of TNCs, especially those relating to financial manipulations in trade transactions, reflect both these tendencies. The attempt to recreate competitive market conditions underlie the anti-trust/anti-monopoly regulations. The belief in the efficiency of the market is also visible in the valuation rules for related party transactions which require accounting comparisons with `arms length prices'. The information disclosure rules and the harmonisation of accounting standards and taxation norms world wide on the other hand, are part of the attempt to counter the global reach of TNCs by increasing the relative strength of individual nation states.

The experience with such regulatory frameworks in developing countries seems to suggest that there is a need to move beyond the information disclosure-market valuation approaches to check transfer pricing. The underlying structural factors-- those endemic to TNCs as well as the ones obtaining in the national economy-- which provide the intrinsic logic for such pricing manipulations and the dynamics thereof, have to be identified and incorporated in the surveillance, control and estimation mechanisms for restricting these activities. The experience of Colombia and Greece suggests that this may be a step in the right direction for other developing countries too.

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APPENDIX I

VARIOUS INDUCEMENTS FOR TRANSFER PRICING (TP)
Hypothesis: the parent company sells to the subsidiary

Motivation	Action taken by multinational firm	Comments
Corporate profits tax	Underpricing	In case host country tax is lower and profits are not distributed as dividends Affects revenues in two countries
Customs duties:		
Import duties	Underpricing	Affects revenue in only one country
export duties	Underpricing	
Exchange risks:		
claim in weak currency	Overpricing plus leading	Leading or lagging allows MNE to avoid exchange risks; transfer pricing enhances the benefits of leading or lagging.
claim in strong currency	Overpricing plus lagging	
debt in weak country	Overpricing plus lagging	
debt in strong currency	Overpricing plus leading	
Repatriation of profits or capital	Overpricing	
Capitalising machinery, etc.	Overpricing	Also increases the basis of depreciation allowances and of compensation in case of expropriation
Joint ventures	Overpricing	The `gain' from transfer pricing is, by definition, shared with the joint partner
Give support to claims for price increases by showing higher costs	Overpricing	
Avoiding anti-monopoly charges	Underpricing	
Avoiding anti-dumping charges	Overpricing	
Mollify claims for wage increases by showing lower profits.	Overpricing	
Support an infant subsidiary	Underpricing	
Enlarge market share to detriment of competitors ('predatory pricing')	Underpricing	Provided lower cost is shifted into lower price to consumer.

Source: S. Plasschaert, "International Transfer Pricing", in International Financial Management Handbook, Kluwer, 1983, as reproduced in Plasschaert (1985), in Rugman & Eden (ed), Multinationals & Transfer Pricing.

APPENDIX II

Illustrative List of Related Party Imports of Foreign Subsidiaries and Foreign Collaborations

S.No.	Source of Imports	Value (Rs.)	% of Total
MAHINDRA ALLWYN NISSAN LTD			
1.	Collaborator: Nissan Motors Ltd, Japan	112048230.00	100.00
KINETIC HONDA MOTORS LTD			
1.	Collaborator: Honda Motor Co Ltd, Japan and their subsidiary Honda Trading Corpn., Japan	89572844.00	85.08
2.	From others	15704844.00	14.92
3.	Total	105277688.00	100.00
HERO HONDA MOTORS LTD			
1.	Parent: Honda Motor Co Ltd, Japan (26% equity holder) & their subsidiary Honda Trading Corpn, Japan	83182105.00	84.77
2.	From others	14940238.00	15.23
3.	Total	98122343.00	100.00
MODI XEROX LTD			
1.	Parent: Rank Xerox, USA (40 % equity holder) and Subsidiaries of Parent Rank Xerox, UK Fuji Xerox, Japan Rank Ltd, Netherlands Rank Xerox, Japan Xerox Canada Inc. Xerox Brazil Inc.	78530068.00	80.27
2.	From others	19301252.00	19.73
3.	Total	97831320.00	100.00

(Contd...)

S.No.	Source of Imports	Value (Rs.)	% of Total
PEICO ELECTRONICS & ELECTRICALS LTD			
1.	Parent: Phillips NV, Netherlands (40% equity holding) & their subsidiaries Phillips GmbH, West Germany Nihon Phillips Corpn, Japan Phillips Exports, Netherlands Phillips China Hongkong Group Ltd, Chile Phillips Components Ltd, Belgium Phillips Brazil Ltd, Brazil Phillips Exports Ltd, Japan Phillips Exports Ltd, Belgium Phillips Exports Ltd, France Phillips Medical Systems, USA Phillips Ultrasound, USA Phillips Singapore Pvt.Ltd, Singapore Phillips Ltd, Japan	70552546.95	58.99
2.	Collaborator: Akustiche U Kingrate GmbH, Austria	145694.00	
3.	1. and 2. together	78698240.95	59.1
4.	Imports from others	54472248.05	40.9
5.	Total	133170489.00	100.00
ASEA BROWN BOVERI			
1.	Parent: ASEA Brown Boveri, Switzerland (33% equity holder)	10466449.00	13.97
2.	Subsidiaries of Parent ABB Corp, Phillipines ABB Distribution AB, Switzerland ABB Financial Service Inc, USA ABB Hochspannungetechnik AG, Switzerland ABB Medium Voltage Equipments Ltd, ABB Mittelspannungstechnik AG, Switzerland ABB Plast AB, ABB Relays AG, Switzerland ABB Transportation Systems Ltd, ABB Turbo Systems Ltd, Switzerland Micafil AG, Switzerland	29184407.00	38.97
3.	1. and 2. together	39650856.00	52.94
4.	Imports from others	35246421.00	47.06
5.	Total	74897277.00	100.00

(Contd...)

S.No.	Source of Imports	Value (Rs.)	% of Total
BAJAJ TEMPO LTD			
1.	Foreign Collaborator: Daimler Benz AG, West Germany (26% equity holder)	61181852.00	50.97
	From others	58841503.00	49.03
	Total	120023355.00	100.00
VIDEOCON GROUP			
1.	Collaborators: Toshiba Corpn. Japan and Mitsubishi Corpn. Japan (25% equity holding)	332638396.00	44.56
2.	Import from others[34]	415607232.20	55.54
3.	Total	748245628.20	100.00

Source: "India's Imports and Exports: Some Insights", Institute for Studies in Industrial Development, New Delhi, 1991. (mimeo).

34. The procedure for choosing suppliers has been the following: "The company has obtained quotations from suppliers in Japan and has chosen the equipment suppliers on the basis of price and recommendations of Toshiba Corpn, Japan." (Videocon VCR prospectus for issue opening 10 January, 1990.)

Appendix III
Action Taken on Cases of Under invoicing of Tea Exports in the 1970s

Year	Exporters/Name	Description of goods	Declared FOB value	Extent of alleged under-invoicing (in Rs.)	Action taken	Total FOB value at which the goods were allowed to be Exported (in Rs.)
1	2	3	4	5	6	7
1970-71	M/s Gillanders Arbuthnot Ltd.				Penalty of Rs. 2500/- was imposed & collected.	
1974-75	M/s Brooke Bond India Ltd	48 chests Tea weighing 2118.6 kg.	126871.78	51735.00	The case was adjusted by Collector. The goods were invoiced for Export at prices lower than the price offered/accepted by foreign buyers. The goods were however allowed to be exported only at the contracted price. Warning was issued to the party.	178606.78
1975-76	M/s A.Tosh & Sons Pvt. Ltd.	20 chests tea weighing 876 kg.	39437.52	5889.91	The case was adjudicated by Asstt. Collector of Customs. Exporters were allowed to export the goods only at the price offered by the foreign buyers and not the price quoted by the exporters on the S/Bill. They were warned also. Party appealed to Calcutta High Court. Shipment was allowed as per Calcutta High Court's Order.	45327.43

(Contd...)

1	2	3	4	5	6	7
1975-76	M/s A.Tosh & Sons Pvt. Ltd.	20 chests tea weighing 876 kg.	39437.52	5889.91	The case was adjudicated by Asstt. Collector of Customs. Exporters were allowed to export the goods only at the price offered by the foreign buyers and not the price quoted by the exporters on the S/Bill. They were warned also. Party appealed to Calcutta High Court. Shipment was allowed as per Calcutta High Court's Order.	45327.43
1975-76	M/s Inter Sales	7 chests of tea weighing 325 kg.	17511.00	7852.55	Case was adjudicated by Astt. Collector of Customs. Goods have been allowed to be exported not at the declared price but only at the price offered by the foreign buyers. Party was warned.	25363.55
1975-76	M/s The Bloomfield	10 chests of tea weighing 545.8 kg.	27803.05	1226.93	Do	29029.98
1975-76	M/s Kesaria & Co.	5 chests of tea weighing 255.6 kg.	8202.20	1627.71	Do	9829.91
1975-76	M/s Lipton Ltd.	6 chests of tea weighing 241.2 kg.	4182.41	519.57	Do	4701.98
1975-76	M/s James Finley & Co. Ltd.	25 chests of tea weighing 987 kg.	36415.85	9011.33	Case was adjudicated by Astt. Collector of Customs. The Goods were ordered to be exported at the contract price.	45427.18

(Contd...)

1	2	3	4	5	6	7
1975-76	M/s Sheoprasad Surendra Kumar	40 chests of tea weighing 1983.2 kg.	20942.59	1122.01	Case was adjudicated by Astt. Collector. Since the misdeclaration did not appear to be deliberate and the short fall of f.o.b. value amount being covered by excise rebate, the exporters were allowed to have the S/Bill cancelled with a caution.	22,064.60
1976-77	M/s Macneill & Magor Ltd.	1. 40 chests tea weighing 2280 kg. 2. 40 chests of tea	2052.00 1886.00	1368.00 1335.60	Case was adjudicated by Astt. Collector. Offence for violation of Customs Act, 1962 being established fine in lieu of consfiscation to the extent of Rs. 250/- each was imposed.	1,30,894.00 1,28,302.00
1976-77	M/s James Warren & Co.	40 chests of tea weighing 1720 kg.	21061.40	1896.86	Case was adjudicated by Astt. Collector of Customs. The charge made in the S/c memo was established and fine of Rs. 250/- in lieu of confiscation was imposed.	22958.26

Source: Adapted from Public Accounts Committee: Report on Custom Receipts, Lok Sabha 1977-78