

# Transfer Pricing in export processing zones

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**POLICIES, IDEOLOGIES AND  
THE RISE OF EXPORT  
PROCESSING ZONES**

## Summary and wider implications of neoliberal approach to taxation in LDCs

- 1) **The triumph of neo-liberal neoclassical economics:**
  - a) keep taxes as low as possible since they distort resource allocation;
  - b) promote FDI with ‘investor-friendly’ tax regimes
  - c) privatise SOEs;
  - d) liberalise financial markets and the capital account;
  - e) liberalise trade [lower import tariffs, and eliminate export taxes as much as possible]

=> This is **supply-side economics**, which views a small state as the best pro-growth policy.

## **Summary and wider implications of neoliberal approach to taxation in LDCs**

### **2) The influence of the mainstream administrative view:**

- a) simplify and lower taxes;
- b) Collect 'easier' taxes such as VAT;
- c) create SARA's guided by the logic of new public management
- d) re-structure SARAs by type of tax payers (create Large Taxpayer Offices);
- d) offer high paying positions and computerise tax system;

## Summary and wider implications of neoliberal approach to taxation in LDCs

### 3) Features of a combined neo-liberal and mainstream approach

- **The conception of capacity in this approach is static.** No attempt to explain why administrative capacities differ across countries or why and how capacity changes
- **Taxation is not considered one of the five fundamentals of good governance** (as spelled out in the *World Development Report*, 1997). Tax reform features in less than 5% of structural adjustment programmes 1985-1995.
- Pro-revenue, technocratic/apolitical approach to tax **as opposed to pro-developmental approach** to taxation. Divorces tax collection from tax policy and other developmental strategies

## Having a SARA is unlikely to help generate more developmental tax revenue

Because SARA officials buy in to neoliberal prescriptions, they are less likely to think of tax collection and tax policy as part of a production strategy.

- “Senior tax professionals are: (a) increasingly well-connected transnationally, through personal and organizational linkages; and (b) increasingly able to migrate between domestic public sector posts (with tax agencies), international public sector roles (with the International Monetary Fund (IMF) or aid agencies, as employees or consultants), and private sector posts, including jobs with the fast-expanding “Big Four” international accounting firms and international banks...” (M. Moore reading)
- while the reforms have made it possible for governments to raise revenue from the organized private sector, they have also increased ***the possibility that taxation systems will be shaped by private sector interests, making it difficult for governments to raise the revenue that they claim they need.***” (M. Moore reading)

The mainstream pays far too little attention to an important issue:

## **THE ISSUE OF ILLICIT FLOWS**

## **Mainstream approach pays insufficient attention to the drain of resources through illicit flows**

- Adjusting the \$854 billion estimate to take into account some of the components of illicit flows not covered, it is not unreasonable to estimate total illicit outflows from the continent across the 39 years (1970-2010) at some \$1.8 trillion (Global Financial Integrity Reading)
- During 2000-2008, when Sub-Saharan Africa enjoyed its strongest period of sustained economic growth, the pace of illicit flows from the region also accelerated relative to previous decades. Some of the acceleration in illicit outflows was undoubtedly driven by oil price increases and increased opportunities to mis-invoice trade that typically accompany increasing trading volumes.

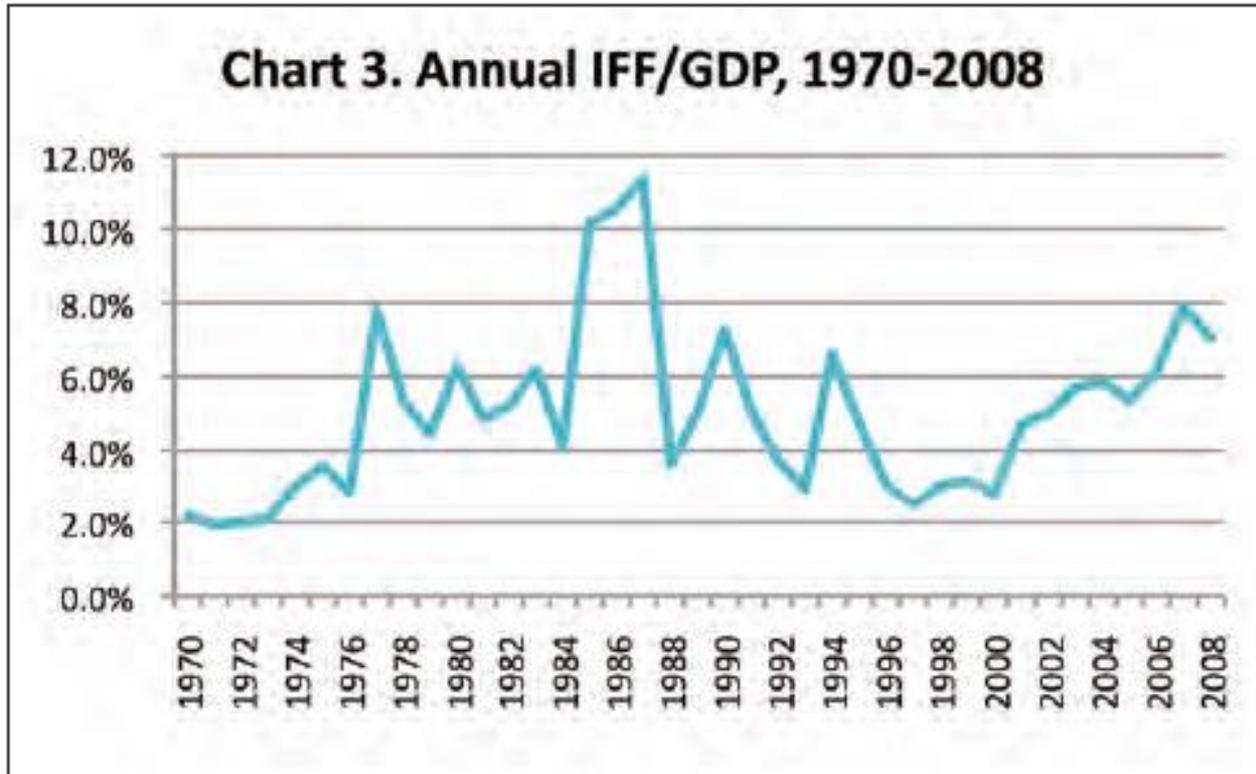
- The stock of private assets held abroad by Sub-Saharan Africans exceeds the combined stock of the region's external debt making it a **net creditor to the world**.
- The proceeds of commercial tax evasion in SSA, mainly through trade mispricing, are by far the largest component, at some **60 to 65 per cent** of the global total of \$854 billion. |

# Illicit Flows

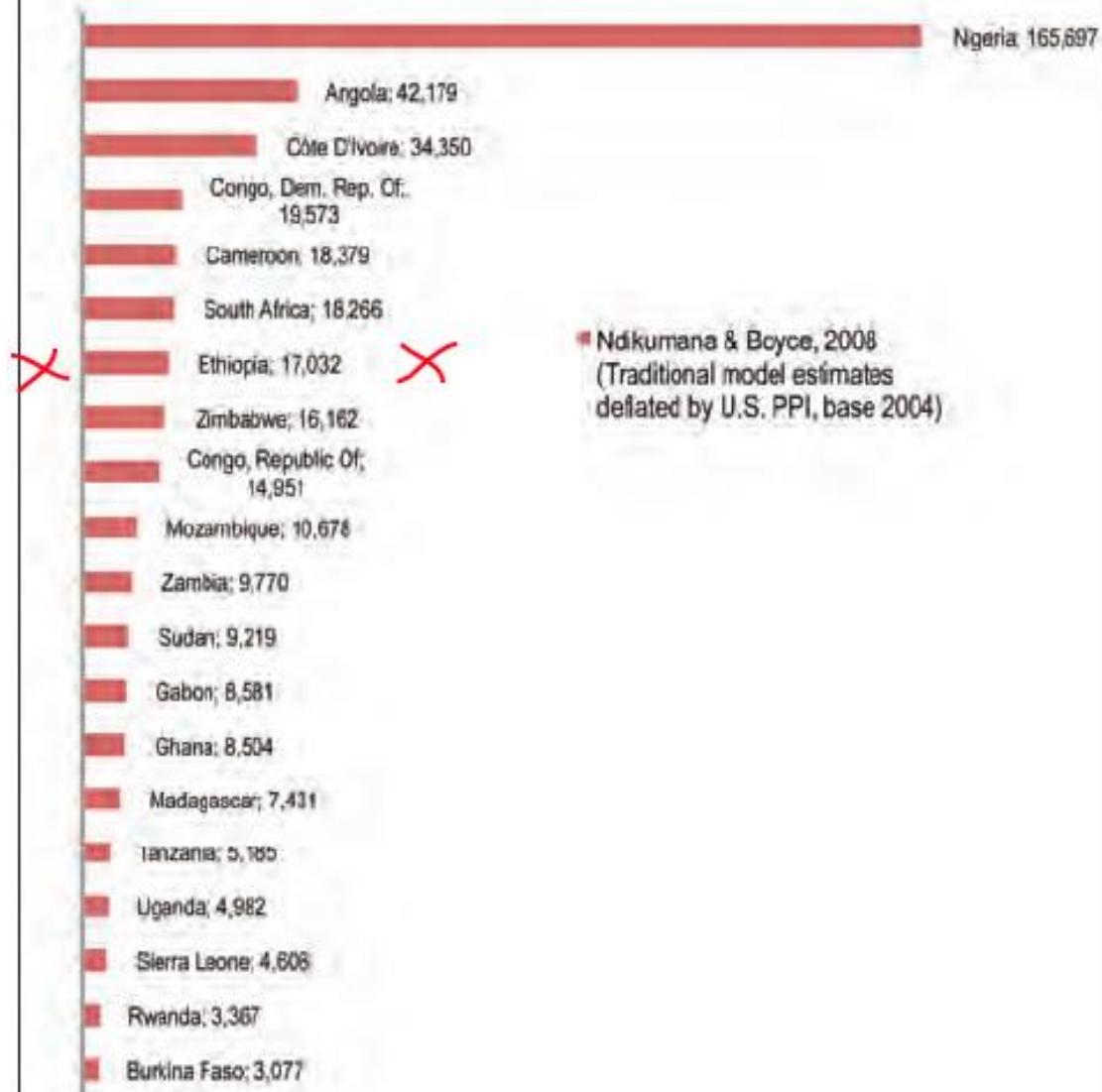
Table 1. Africa: Illicit Financial Flows, 1970-2008  
(in millions of U.S. Dollars)

Group	Total IFFs				
	1970s	1980s	1990s	2000-2008	1970-2008
<b>Africa</b>	<b>57,291</b>	<b>203,859</b>	<b>155,740</b>	<b>437,171</b>	<b>854,061</b>
North Africa	19,161	72,020	59,813	78,742	229,737
Sub-Saharan	38,130	131,839	95,927	358,429	624,324
Horn of Africa	2,354	14,131	5,108	15,603	37,197
Great Lakes	6,925	16,079	4,978	10,285	38,267
Southern	5,894	20,581	31,447	116,828	174,751
West and Central	22,956	81,047	54,394	215,712	374,109
Fuel-exporters	20,105	67,685	48,157	218,970	354,917
Nonfuel-exporters	7,867	26,517	22,375	23,342	80,102
Group	Average IFFs				
	1970s	1980s	1990s	2000-2008	1970-2008
<b>Africa</b>	<b>7,299</b>	<b>21,678</b>	<b>17,813</b>	<b>50,328</b>	<b>29,021</b>
North Africa	3,097	7,754	6,316	9,166	6,866
Sub-Saharan	4,202	13,924	11,497	41,162	22,156
Horn of Africa	249	1,421	715	1,949	1,183
Great Lakes	745	1,778	580	1,286	1,142
Southern	811	2,412	4,659	13,388	9,635
West and Central	2,397	8,313	5,544	24,538	10,196
Fuel-exporters	2,239	6,922	5,105	24,806	9,878
Nonfuel-exporters	1,017	2,729	2,433	2,787	2,502
Group	Rates of Change (real 2008 CPI deflated)				
	1975-1979	1980s	1990s	2000-2008	1970-2008
<b>Africa</b>	<b>18.9</b>	<b>-2.1</b>	<b>-4.8</b>	<b>24.6</b>	<b>12.1</b>
North Africa	14.0	-11.5	0.5	6.0	6.5
Sub-Saharan	n.a.	1.3	-7.0	30.1	15.1
Horn of Africa	n.a.	7.3	-15.5	33.5	20.0
Great Lakes	13.2	-12.7	-17.7	35.0	13.5
Southern	n.a.	13.5	7.3	21.5	16.7
West and Central	21.5	0.0	-11.4	36.0	14.5
Fuel-exporters	n.a.	2.2	-15.6	42.6	21.8
Nonfuel-exporters	n.a.	11.3	-1.6	11.0	13.6

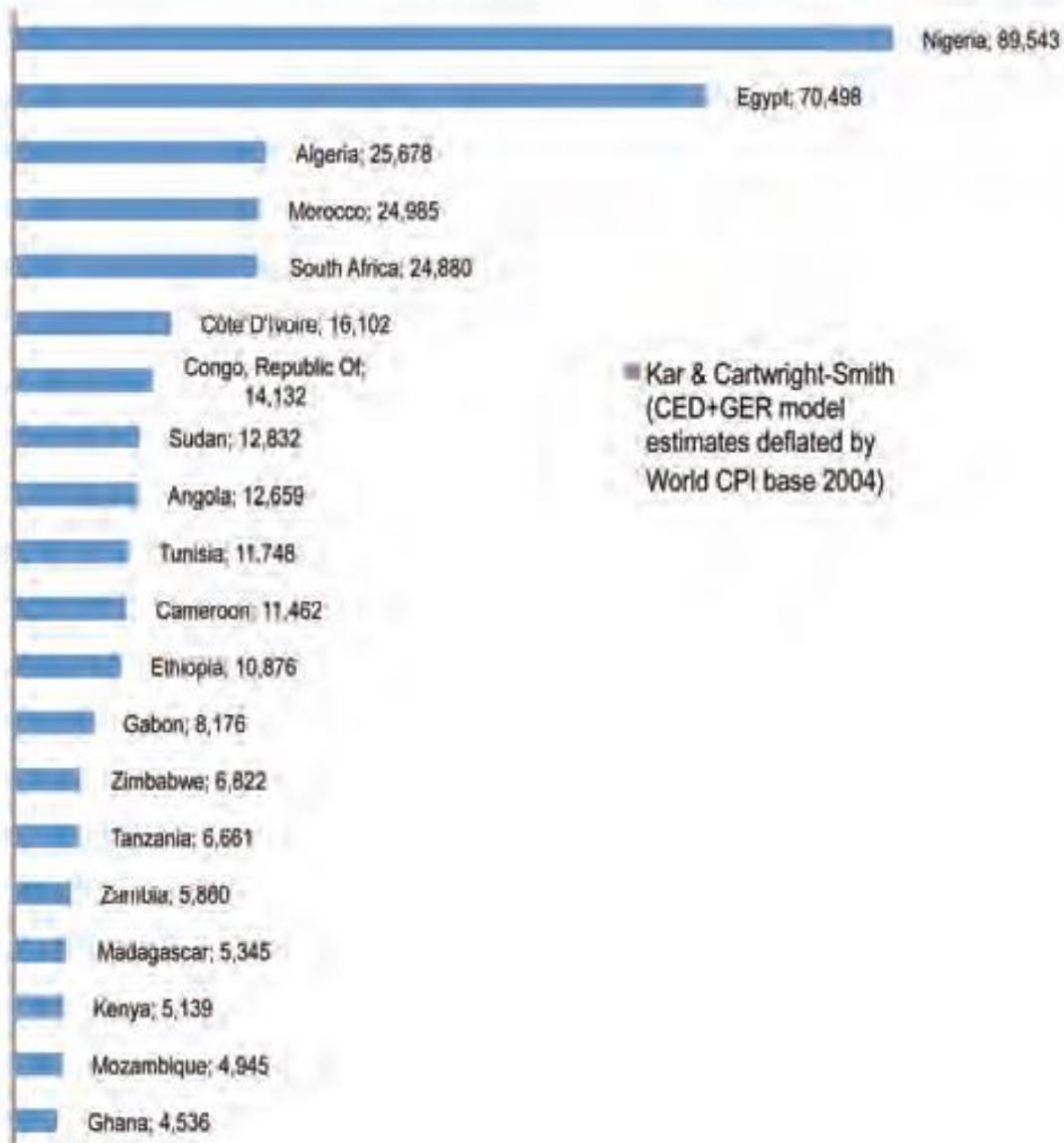
# Illicit Flows



**Chart 5. Top 20 African Countries,  
Cumulative Illicit Flows, 1970-2004**  
(US\$ millions)



**Chart 6. Top 20 African Countries,  
Cumulative Illicit Flows, 1970-2004**  
(US\$ millions)



# Tax-Related Incentives for Misinvoicing Trade

	...Under-invoicing	...Over-invoicing
Export	Reallocation of taxable profits to low-tax jurisdictions	Collection of export subsidies or export-related tax credits
Import	Circumvention of applicable tariff rates and value added taxes (VAT)	Lower taxable income due to artificially inflated input costs

# Illicit Flows—Trade Misinvoicing in Tanzania

(see Hiding in Plain Sight Reading, pp. 31-36)

- Cumulative gross illicit flows because of trade mis-invoicing amounted to nearly \$19 billion in the period 2002-2011.
- On average, illicit flow represented 9.4 percent of annual GDP
- the ratio between gross illicit flows and GDP was four percent from 2002–2007, but by 2011 it was up to nearly 25 percent of GDP.
- most of these illicit flows occurred in the last five years of this period and the **illicit outflows** came exclusively in the form of import over-invoicing and export over-invoicing
- This raises questions about Tanzania's reliance on import duties to finance government budgets

# Illicit Flows—Trade Mis-invoicing in Tanzania

**Table 6. Tanzania: Trade Misinvoicing Vis-à-Vis the World, 2002–2010**

(in millions of U.S. dollars) 1/

Year	Export Misinvoicing		Import Misinvoicing		Illicit Outflows (A+D)	Illicit Inflows (C+B)	Gross Illicit Flows	GDP	Total Trade	Total ODA	Gross flows as percent of GDP	Gross flows as percent of Trade	Gross flows as percent of ODA
	Under-Invoicing (A)	Over-Invoicing (B)	Under-Invoicing (C)	Over-Invoicing (D)									
2002	0	-199	0	233	233	199	432	10,806	2,563	1,270	4.00%	16.86%	47.50%
2003	0	-320	0	189	189	320	509	11,659	3,255	1,725	4.37%	15.64%	52.67%
2004	0	-689	0	118	118	689	807	12,826	4,200	1,772	6.29%	19.21%	78.35%
2005	0	-556	-108	0	0	664	664	14,142	4,962	1,499	4.70%	13.38%	77.13%
2006	0	-301	0	9	9	301	310	14,331	5,982	1,883	2.16%	5.18%	31.13%
2007	0	-611	0	98	98	611	709	16,826	7,359	2,822	4.21%	9.63%	38.54%
2008	0	-1,039	0	1,170	1,170	1,039	2,209	20,715	9,755	2,331	10.66%	22.64%	160.86%
2009	0	-1,967	0	1,661	1,661	1,967	3,628	21,368	8,663	2,933	16.98%	41.88%	257.41%
2010	0	-2,065	0	1,431	1,431	2,065	3,496	22,915	11,217	2,958	15.26%	31.17%	211.15%
2011	0	-2,588	0	3,373	3,373	2,588	5,961	23,874	15,094	2,436	24.97%	39.49%	357.38%
<b>Average</b>	<b>0</b>	<b>-1,034</b>	<b>-11</b>	<b>828</b>	<b>828</b>	<b>1,044</b>	<b>1,873</b>	<b>16,946</b>	<b>7,305</b>	<b>2,163</b>	<b>9.36%</b>	<b>21.51%</b>	<b>131.21%</b>
<b>Cumulative</b>	<b>0</b>	<b>-10,335</b>	<b>-108</b>	<b>8,282</b>	<b>8,282</b>	<b>10,443</b>	<b>18,725</b>	<b>169,462</b>	<b>73,050</b>	<b>21,630</b>	<b>...</b>	<b>...</b>	<b>...</b>

1/ Outflows (export under-invoicing and import over-invoicing) have a positive sign whereas inflows (export over-invoicing and import under-invoicing) have a negative sign. Estimates of misinvoicing are based on export and import of commodities reported by all member countries to the United Nations for publication in the Commodity Trade database (UN Comtrade). Capital flows due to trade in services are not included in the above estimates.

## Illicit Flows—Trade Mis-invoicing in Tanzania

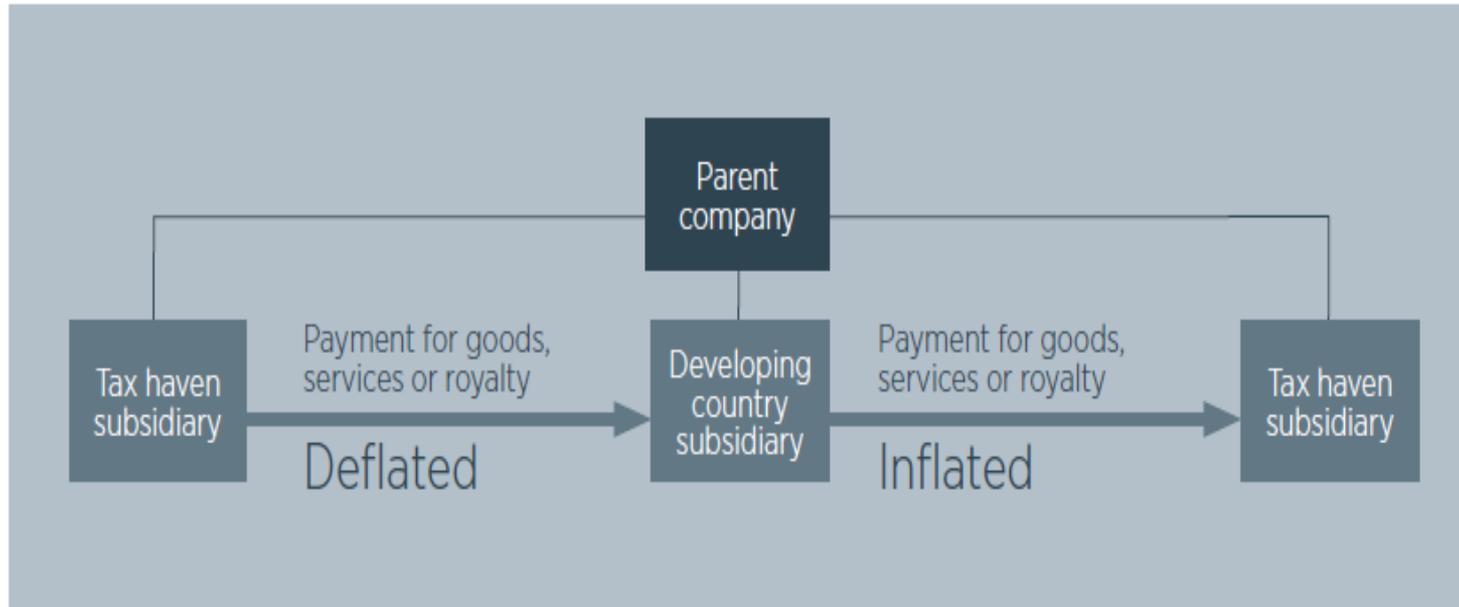
- **The majority of import over-invoicing** present in Tanzania was **shown to coincide with oil imports**, which are typically tariff free for mining companies. Tanzanian imports are most likely over-invoiced in order to lower year-end taxable income.
- The official corporate tax rate for mining companies is 30 percent, so Tanzania misses out on an average of \$248 million dollars per year in lost tax revenue.
- **The drastic rise in import over-invoicing and export over-invoicing that began in 2008 coincides with the implementation of the country's Export Processing Zones (EPZs).**
- Investors who establish firms in EPZ's are granted import-duty exemption on raw materials used in the production of manufacturing goods as well as a 10-year corporate tax holiday.
- **The elimination or easing of import duties provides a perverse incentive to move capital out of the country illicitly through import over-invoicing.**

# Illicit Flows—Trade Mis-invoicing in Tanzania

- Illicit inflows from Tanzania slightly exceeded illicit outflows between 2002 and 2011; cumulative export over-invoicing was \$10.34 billion, and import under-invoicing was zero for all but one year.
- The incentives to over-invoice exports can be explained partly through smuggling and money laundering.
- the vast majority of trade that is misinvoiced in Tanzania occurs with Switzerland and, to a lesser extent, with Singapore, which the IMF and the OECD consider to be tax havens.
- Despite only consisting of six percent of Tanzania's total imports from advanced economies, Switzerland and Singapore represent over 67 percent of total import misinvoicing over the 10 year period of this study.
- Over 25 percent of the total import mis-invoicing present in Tanzania since 2002 was specifically the mis-invoicing of fuel imports from Switzerland alone

# Illicit Flows—How it Works

## Transfer mispricing



The mainstream has for a long time neglected mining taxation

# **THE ISSUE OF HOW TO TAX MINING**

# Vast Under-taxing of non-oil Mining in SSA

- The fundamental reason for the importance of taxation of mining is that mining entails extracting subsoil assets and transforming these into financial assets.
- What is left after costs of production and marketing are deducted (including normal dividend to investment) is defined as economic rent.
- In principle, for a non-renewable resource such as minerals, such rent should be appropriated by the government on behalf of the country.
- Governments cannot appropriate all this rent without negatively affecting the private incentive to invest in mineral production. Therefore, most governments try to balance the competing interests and to acquire as high a percentage of the rent as possible, mainly through taxation or a direct equity share.

# One way to assess reasonable potential revenue

- A benchmarking exercise: the relationship between: 1) the contribution of mining to GDP and 2) the contribution of mining to domestic revenue (DR).
- **The following rule of thumb provides a guide:** 'Mineral revenues should be a greater share of total revenue relative to the sector value added'
- **Neo-liberals do not care about this 'rule of thumb'** since they are interested in 'tax-friendly' policies so poor countries can attract FDI

# The Rule of Thumb helps you identify missed opportunities

Average annual contributions of mining to total GDP and Domestic Revenue, 1998-2011

	Mining value added/GDP (%)	Mining exports/GDP (%)	Mining revenue/GDP (%)
<b>Zambia</b>	21.0	24	4.4
Tanzania	3.1	4.9	2.3
Ghana	4.5	12.5	3.1
South Africa	8.3	11.8	2.3
<b>Botswana</b>	38	32	50
<b>Chile</b>	12.9	17.1	14.9
Australia	6.4	12.1	4

## Comparing Zambia and Chile

If Zambia had behaved like Chile it would have collected \$6 billion in copper tax revenue; it actually collected \$1.6 bn (1998-2011).

# What Chile could teach Zambia

It's not the royalty rates – these are similar – but:

- A) **greater state ownership share** (50-75%) versus 10% in Zambia
- B) greater use of withholding and profit-based windfall taxes
- C) **less extensive use of tax holidays and exemptions** (straight line depreciation allowance, not 100% allowance—which has been shown not to be necessary to attract FDI)
- D) a much greater investment in geological survey capacity (strengthens bargaining position)

## Summarising the impact of neo-liberalism on mining

- Neo-liberal reforms and policies (low export taxes, low equity shares of state, no withholding taxes, no or low capital controls, tax holidays) **are part of the problem**
- **There is no political analysis** of the elite bargain.
- There is no link of mining tax policies and illicit flows data.
- A *pro-revenue* approach takes precedence over a *pro-growth* approach in tax policy.

# **BROADER POLITICAL ECONOMY ISSUES**

## **Political Economy of the Mining Business**

- Many big projects involve personal deals with political party elites. Property rights are selectively protected.
- Many large mining deals are off-budget and contracts remain secret.
- Secrecy of deals can facilitate capital flight into tax havens
- Are these rents necessary to maintain stable elite bargains and therefore political stability?

## Taxation and the Elite Bargain

- The creation and deployment of economic rents and privileges to relevant elites is the essence of elite bargains (North et al, 2007, ‘limited access orders’)
- In turn, exploring tax patterns can illuminate important insights into the shape and character of the elite bargain, which has been argued to be important in generating state resilience in general.
- At the same time, the nature of elite bargains provides a window into the political limits of expanding tax capacity.

## Taxation and the Elite Bargain

- high levels of tax evasion are tolerated
- the negligible collection of urban and rural property taxes
- relatively low rates of taxation on agriculture which (while part of investment incentives) be seen to benefit elite landowners and particularly large farmers and agro-processors.
- a significant decline in the corporate tax burden on big business which has benefitted both foreign firms (particularly in mining) and political and economic elites.
- Almost all mining deals are secret/not transparent