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Presentation to Hearings on Transfer Pricing and Industrialisation

By Prof Ben Turok
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Held by the Portfolio Committee on Trade and Industry

Parliament, Wednesday 29 April 2015.

This paper will cover the following themes:
1. The origins of transfer pricing
2. Taxation issues
3. Current research on corporations in the mineral value chains
4. Problems in the interface between government and corporations in the mineral value chains.

1. Origins of Transfer Pricing

In the years after the Second World War South East Asia began a rapid process of industrialisation. Foreign multinational corporations saw immense opportunities of building factories in these countries where labour was cheap and taxes low. Substantial investment followed and plants of various kinds were built.

To maximise profit the following model was adopted.
Country A was the source of raw material and a facility was built to harness this.
Country B served as the source of the components needed.
Country C was the base of manufacturing a product.
Country D had an assembly plant and packaged the product.
The final product was exported around the world.
The choice of each country depended on where the appropriate labour was cheapest and where taxes were lowest.
In some cases the production chain included Africa and Latin America.
The Head Offices of these multinational corporations were generally in the U S or Europe.

This was a laborious system but highly profitable.
In the present system of sophisticated financial mechanisms multinational corporations can locate a production facility in one country but use complex marketing and financial systems to spread

financial assets around the world, again to find cheap tax jurisdictions and hide assets. The speed of transactions makes it near impossible to trace financial transfers.

2. **Taxation Issues.**
S A's Parliament, especially its Finance Portfolio Committee has long battled with obtaining fair taxation from business. Previously, it was accepted that tax evasion was illegal but tax avoidance was permitted. Numerous auditors, accountants and lawyers argued extensively that it was perfectly in order for a professional firm to advise a company on how best to present their accounts to minimise tax liability. One could make claims on travel, and incidentals, to reduce tax, or even manipulate the annual accounts showing a loss by setting aside money for depreciation or capital expenditure, all to minimise tax payments.

   However M P's repeatedly raised concerns about the consequent losses to the fiscus and changes were made to slow down the concealment. This issue of what may be claimed to reduce a tax obligation remains before us, including in the international dimension.

3. The Institute For African Alternatives (IFAA) has been engaged on policy research in the area of interface between mining and manufacturing for several years. Working with the Industrial Development Corporation (IDC) and the United Nations Economic Commission for Africa (UNECA) we have held several conferences at the IDC involving industry, government, economists and Parliament and published the findings in New Agenda, S A Journal of Social and Economic Policy.

In the last year this work has advanced considerably and the National Research Foundation has co-hosted two meetings of experts to investigate more fully how mineral value chains work in S A and who are the beneficiaries. Some of the biggest corporates have cooperated in this work, they have attended these meetings at senior level, and there have been meetings with top executives to get to grips with the issues. The focus of these interactions have been on what the corporations do, how they do it, whether there are any obstacles, and who are the beneficiaries of their activities.

In examining the latter, who are the beneficiaries, we have sought clarity on the scale of operations within South Africa in relation to the total operations, rather than transfer pricing.

Our conclusion from all this work is that these large corporations are not performing at maximum potential. The reasons for this are many and some will be set out below.

But what is most important is that South Africa is not getting the most benefit from these industries which are functioning well below full capacity. This has serious consequences for the economy and society. Employment is below potential, technological advances are limited, our markets are deprived of goods, etc. etc. Most relevant here is that tax revenues are lower than expected.

<u>It is clear that if matters in industry do not improve, this has a serious effect on discussions about how much could be gained in actions on transfer pricing. There may soon be nothing to transfer !</u>

4. Government – industry Relations in the Mineral Value Chain

   In the past two months IFAA has hosted two meetings in this area. The first was in response to a request by Anglo American Platinum for an opportunity to present a project for "fuel cell rural electrification" to a group of experts from government, industry and academia.

The second Experts Meeting on Mineral Value Chains was hosted by the National Research Foundation and IPAA. The proceedings will be published shortly.

At both meetings it became clear that we are not using our natural resources as effectively as we could. In our mixed economy we have advanced mining companies which extract a vast amount of scarce minerals, and these companies have a huge impact on manufacturing, labour and the rest of the economy and society. Some of these are based abroad, but they have a large local presence and some necessary autonomy. They fall under our law and have to comply to the extent that government insists they do so.

We also have large government with many departments. You would expect that the cluster system installed in the days of President Mbeki would create a unified administration, but my experience is that this is not the case. Silo culture is supreme. Frankly, even in Parliament there is insufficient coordination between Portfolio Committees to ensure that a consensus emerges across Committees with respect to policy and legislation.

The conclusion is inescapable that South Africa has not achieved even the first elements of how we should proceed in building a strong fast growing economy, nor is the institutional arrangements in place to make this happen.

People often raise ideological issues with respect to our economic policy. Those who argue that the free market will save us ignore the fact that the very large corporations are highly dependent on state procurement on favourable legislation and in many other ways. Those who argue for nationalisation ignore the fact that we have an inefficient state machine, that our existing state owned enterprises perform badly, and that we have not created those capabilities necessary to run large enterprises.

To sum up:

1. Even if we solve the transfer pricing problem, the poor performance of our economy means that the benefits will be less than optimal.
2. We need far greater cohesion between and within government departments.
3. Input costs for manufacturing are too high in raw materials, government services, compliance with regulations etc.
4. There are uncompetitive pricing levels within the private sector thereby stifling new growth.
5. The poor relations between government and business require investigation and remedy by new institutional arrangements. Let us accept that this is a mixed economy and create the relevant institutions to make it work. In my previous submission to the Committee I argue for a joined up economy, not just joined up government. Joining up requires strong institutional frameworks.
6. Our mixed economy reveals a high level of dependence of even large corporations on government procurement, services and regulation. Let our free marketeers admit this so we can go on with serious consultations and negotiations thereby building sound state- business relations.
7. Those officials who are indifferent towards business need to be weeded out.