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# THE ACCOUNTING FOR TRANSFER PRICING AND PROFIT SHIFTING IN MULTINATIONAL COMPANIES: THE CASE OF EGYPT


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# ABSTRACT

There has been much discussion in the literature concerning the potential conflict over transfer pricing techniques used by MNCs to shift profits outside the borders of a host country. This happens whereby MNCs artificially lower their profits by manipulating transfer prices with their subsidiaries. They can achieve substantial benefits by adopting effective pricing policies. Careful planning of intra-company prices can take full advantages of differences among such things as corporation tax rates, tax incentives and reliefs and customs duties.

The decade of the 1970s produced important economic changes in the Egyptian economy as a result of the economic open door policy. Since then Foreign Direct Investment (FDI) grew rapidly which reflects confidence in the Egyptian economy. Despite initiatives undertaken by the Egyptian government to attract greater inflows of FDI, greater efforts should be devoted to streamline and simplify the rlevant administrative procedures of the government.

Governmental policies and regulations could encourage multinationals to engage in transfer pricing manipulation more often in developing countries than in more develped countries. This is rarely due to the ignorance of the governments of developing countries to transfer pricing issues at the international level. Also, authorities concerned with the the issue are poorly equipped. The purpose of this study has been to investigate transfer pricing and profit shifting practices by MNCs doing business in Egypt. The case study approach has been used in the empirical work, including eleven companies. The investigation involved governmental authorities and an accounting firm that has an interest in the transfer pricing issue.

The empirical study focused on factors influencing transfer pricing strategies which represent a motive to shift more profits from Egypt.

# Acknowledgement

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I am very grateful to my second supervisor Stan Brignall for his comments, extensive suggestions and proof-reading of the final text. I owe a special debt of gratitude to him.

Collecting data for this research required the interviewing of a number of people who must remain anonymous. This comprises executives of MNCs involved in the case studies and Egyptian government officials working at the General Authority for Investment, Tax Authorities, and Customs Departments. Their help and cooperation are highly appreciated and will not be forgotten.

I am heavily indebted to my country, Egypt, and the University of Mansoura for offering me a scholarship to study in England, and supporting me financially. I would like to express my appreciation to the Warwick Business School for a travel grant awarded during my field study in Egypt. A special note of acknowledgement is due to Sue Foxon, the Ph.D programme secretary; Carlos Hemais, who is really a good friend; and the library staff at the University of Warwick for their help.

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## Dedication

*To the memory of my father*

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# Abbreviation

| | | |
|---|---|---|
| AAA | = | American Accounting Association |
| BIC | = | Business International Corporation |
| BIM | = | British Institute of Management |
| CAPMS | = | Central Agency for Public Mobilisation and Statistics |
| E£ | = | Egyptian Pound |
| EC | = | European community |
| EGPA | = | Egyptian General Petroleum Authority |
| FDI | = | Foreign Direct Investment |
| GAFI | = | General Authority for Investment |
| GDP | = | Gross Domestic Product |
| GNP | = | Gross National Product |
| GOD | = | General Organisational for Drugs |
| GVA | = | Gross Value Added |
| ICMA | = | Institute of Cost and Management Accountants |
| IMF | = | International Monetary Fund |
| IRM | = | Institute for Research and Information on Multinational |
| IRS | = | Inland Revenue Services |
| MNCs | = | Multinational Companies |
| OECD | = | Organisation for Economic Co-opertion and Development |
| PATA | = | Pacific Association of Tax Administrators |
| R&D | = | Research and Development |
| ROI | = | Return on Investment |
| SNC | = | Specific National Councils |
| UNCTAD | = | United Nations Conference on Trade and Development |
| UNCTC | = | United Nations Centre on Transnational Corporations |
| UNDESA | = | United Nations Department of Economic and Social Affair |
| UNIDO | = | United Nations Industrial Development Organisation |

# Chapter I

# Introduction

## 1.1 Transfer Pricing Problem

The subject of transfer pricing has been of great interest and has received extensive debate by academics and scholars in different fields of study. Most of this was directly concerned with transfer pricing as a managerial tool to facilitate decentralised operations. These sources mainly treated the topic in two ways: (1) theoretical approaches, and (2) descriptive analyses of problems incurred in the use of transfer pricing. The remaining studies dealt with the intra-company pricing in an international dimension, giving consideration to specific environmental factors. However, the problem has been left without an acceptable solution.

On the domestic level, writers emphasised intra-company pricing as a means of measuring, controlling, and evaluating divisional performance. Different models were illustrated such as economic, accounting, operations research, and behavioural.

On the other hand, the transfer pricing issue from the international view changes significantly from that of the domestic view. The basic changes are: (1) the content of recent works no longer contain theoretical analyses; and (2) the majority of publications perceive the transfer pricing problem from one specific viewpoint, normally taxation.

It should be noticed that a substantial amount of intra-company transfers generated by process-specialisation takes place within Multinational companies, henceforth MNCs. Intra-company transactions in MNCs are important for several reasons:

**First**, raw materials not available or in short supply for a subsidiary in one country can be obtained for sale or further processing by another subsidiary located in another country.

**Second**, production economies are required to minimise total production costs. This can be conducted more efficiently by producing or assembling components in countries where the cost of labour is low. Then production can be exported to headquarters or subsidiaries for distribution. For example, a substantial percentage of car and computer production takes place in this manner.

**Third**, many services are rendered by headquarters or other subsidiaries for the benefit of all members of a MNC. Examples are R&D, advertising campaigns,

management consulting and the like which are often conducted by the headquarters for the whole MNC.

**Finally**, there are many financial flows between members of a MNC. Some are payments related to tangible and/or intangible transactions provided by other units; some are loan repayments; some are dividends; and some are designed to lessen taxes or financial risks.

The term of "transfer pricing" refers generally to the determination of the value of tangible and intangible transactions exchanged among business units that share common ownership either on the domestic or international level. Since intra-company transfers are not subject to competitive market conditions, the pricing of these transfers can be decided and dictated by the headquarters of the company. The transfer pricing issue of MNCs is more sophisticated than those for their domestic counterparts as a result of some environmental factors that influence the Multinational (MN) transfer pricing decision.

MN transfer pricing can be altered to shift profits from one country to another in a clandestine manner for tax and tariff avoidance, foreign exchange control avoidance, competitive issues, or other reasons. The potential for such manipulations is already great and increasing as a result of continued business concentration of MNCs in both developed and developing countries, and the significance of intra-corporate transactions in the total global trade, reflecting the horizontal, vertical and conglomerate nature of MNC activities. In most countries, manipulating transfer prices is kept confidential and is in any case often difficult to prove unambiguously.

While in theory transfer prices facilitate efficient exchange between divisions, in practice they are often the source of tension between host countries and MNCs. This is especially true when the host country is a less developed country. Studies provide empirical evidence that taxes, tariffs, exchange rate volatility, price controls, and profit remittance restrictions all served as inducements for manipulative transfer pricing (Lall, 1983, and Lall and Streeten, 1977, Vaitsos, 1974).

MNCs use artificial transfer prices to shift profits and liquid funds form one country to another if doing so raises net profits. When MN managers are concerned with flows of their funds from one nation to another, they naturally act to minimise the outright costs associated with such movements of funds. Therefore, instead of using solely dividend remittances, MN managers often resort to underinvoicing or overinvoicing the transactions that move from one of their foreign subsidiaries to another or their headquarters. Underlying the declared profits and dividend remittances are a whole

host of arbitrary pricing possibilities relating not only to tangible transfers, but also to the terms of intangible transfers (royalties, technical assistance fees, management fees, payment of interest, overhead charges and the like). Kopits (1976) suggested that MNC subsidiaries in the UK probably pay 30-50 per cent more than they should for such services. Even when the parent company invests in a foreign subsidiary, it often extends such investment under the name of "long term loans" and charges the subsidiary interest on them.

So, transfer pricing is an accounting methodology that makes foreign investment attractive by gaining advantages both in the host and home countries. Of course, abusing transfer prices affects many areas of a national economy: tax and customs revenues, balance of payments, market structures, and domestic capital formulation. It should be also noticed that the practice of transfer pricing not only affects the expected contribution of MNCs and worsens the terms of trade by increasing the costs of imports, but it may also indicate other long term impacts on the developing countries in terms of blocking the dynamics of investment, technology transfer and growth (Lall, 1983, p.130 and p.135).

Conflicts of interest between MNCs and the governments have been frequent in many host countries. The country is basically interested in maximising benefits for its own territory. The MNC, engaged in world-wide manufacturing operations, is interested in maximising benefits for its own international organisation. In this way, it attempts to find a way of achieving the economic efficiencies of world-wide specialization of production and development within the political constraints imposed by national policies. While the country can control its own corporation and strongly influence national private enterprises, it can find it difficult to exert influence over MNCs.

### 1.2 Foreign Direct Investment and MNCs in Egypt

Host countries accept foreign direct investment (FDI) because of the common attitude that considerable benefits and opportunities are available from direct investment operations (Carr, 1979, p.3). Since the early 1970s the Egyptian government has pursued an open door economic policy. Foreign investors are welcome to invest. The government policy in the investment field seeks to encourage investors to transfer capital, technology, and managerial and organisational skills. Law 230 of 1989 which replaced Law 43 of 1974 offers many incentives and numerous guarantees to lure foreign business to take its part in realizing economic development in Egypt.

Consequently, foreign investors, individuals and MNCs set up establishments either in the form of joint ventures with Egyptians or wholly owned. FDI has involved many

activities such as petroleum, pharmaceuticals, textiles, chemicals, construction, beverage and food processing, tourism, and banking.

These establishments, especially subsidiaries of MNCs, transfer a multitude of goods and services to and from Egypt. They transfer also profits and dividends to their parents. The transfer price of exchanged transactions is based on a transfer pricing method. The pricing method chosen, being influenced by a variety of factors, can be used to shift profits from a subsidiary to its parent or another sister company in the group. Accordingly, the host country's benefits are affected negatively, especially taxes and customs duties. This leads also to the distortion of financial information. Joint venture partners and those trading with them may base policy decisions on transfer price sensitive data.

### 1.3 Transfer Pricing Techniques and Profit Shifting in MNCs in Egypt

This study concentrates on the extent of suspicious activities by MNCs to shift profits from Egypt to other countries using transfer pricing techniques. Currently, the Egyptian government is mistakenly unconcerned with MNC practices in shifting profits through transfer pricing techniques. Not to mention, there is a lack of coordination and cooperation among Egyptian authorities interested in controlling transfer pricing, each of which approaches the question from its own standpoint. Customs authorities, for example, are generally not concerned with import prices being higher than they should be, since those result in higher duty payments. Tax departments, on the other hand, are likely to be concerned since such prices lead to an increase in production costs and hence lower profits and tax collection. The extent to which MNCs manipulate transfer prices depends upon the vigour with which controls are applied by the different authorities on the company's overall strategies.

Hence, considered collectively, intra-company transfers are a vitally important issue to most MNCs. However, they are also of considerable importance and concern to most governments. As noted in Rugman and Eden (1985), the chief reason for governments' interest is potential misuse and frequent abuse of transfer pricing by MNCs.

MNCs are in a powerful position when they negotiate with host countries, particularly third world countries, to establish projects. They might stipulate some conditions which could be prejudicial to host nations. For instance, they might stipulate a restrictive clause allowing the purchase of all necessary production requirements (raw materials and intermediate goods) only from the parent or members of the same MNC family.

### 1.4 Control of Transfer Pricing

Abusing transfer pricing presents challenges for the governments of home and host countries. There is growing suspicion among most countries, especially developed ones that by using sophisticated transfer pricing strategies and accounting procedures, large MNCs dissimulate the true profitability of local subsidiaries and deprive host governments of "legitimate" tax revenues. Controls by host governments tend to restrict FDI and, because such investment tends to be in the more dynamic manufacturing sectors, industrial growth as well. Lack of controls can also have adverse effects, permitting excessive profit shifting and royalties, the financial juggling of cost across national boundaries and causing an over-reliance on locally-generated capital.

It is believed that the control of MN transfer pricing manipulations is difficult without co-operation among countries. The effects of such manipulations transcend national frontiers, and information on how the transfer prices have been established is frequently located outside the country wishing to control them.

Empirical evidence relating to the use of transfer pricing is notoriously difficult to obtain. First, the MNC is not very willing to provide the necessary information, and second, the information that is available to the host country is usually scattered in different departments of the government, such as the tax collections, customs, and the central bank. There appears to be no published study relating to the use of transfer pricing in Egypt. However, if transfer pricing is used to shift profits from a subsidiary in Egypt, this decreases profits in the subsidiary and hence value added. Hence, an examination of profit rates of value added as a percentage of sales could indicate the use of profit shifting.

It is probably true that MNC subsidiaries in Egypt have considerable opportunity to use profit shifting transfer pricing, because of the volume of intra-company imports. As indicated from the field study, the great part of production requirements come from the parent company. Therefore, when all or the greatest part of company profits are alleged to disappear abroad, Egypt will not gain any benefits.

The Egyptian government, among other developing countries, should pay attention to the extent to which MNC transfer pricing tends to be unfair to them. Transfer prices of intra-company transactions should be based ideally on an arm's-length basis, i.e., the reasonable and acceptable price in the competitive market. If such arm's-length prices existed and could be identified for all intra-company transactions, or if such prices could easily be arrived at by developing countries in cases where they are not

readily available, then these countries would not be concerned about MNCs and transfer pricing. Unfortunately, this is not the case, and developing countries have real problems related to:

1- assessing arm's-length prices where no comparable market substitute exists (there can be wide variations, at any specific time or over a short period, in the prices of products frequently traded- in similar quantities and on similar terms of sale - nationally or internationally by a number of companies);

2- difficulty in obtaining from companies the data necessary to reconstruct prices on the basis of actual costs.

### 1.5 Objectives of the Study

On the basis of the preceding discussion, this study aims to pinpoint the extent of manipulation of MN transfer pricing in order to shift profits from the host country, Egypt. The study investigates whether MNCs have made negative or positive contributions to world growth and development. The study will be focused on MNCs commencing their activities in Egypt. Also, the study recommends that payments made by MN subsidiaries in Egypt to their parents must be based upon truthful and accurate pricing.

The purpose of the study therefore is to answer four questions:

1) To what extent do MNCs abuse transfer prices in order to shift profits outside the country?

2) What are the factors that induce MNCs to shift profits through transfer pricing strategies?

3) What effect do MNCs have on the Egyptian economy?

4) How may the Egyptian government control MNC's operations in order to prevent or lessen the abuse of transfer pricing?

To answer these questions, an interview guide and questionnaire have been developed to collect the required data. The data have been collected from three groups: (1) MNCs located in Egypt, where 11 case studies have been carried out; (2) government officials dealing with FDI, including General Authority for Investment, tax and customs; and (3) an independent accounting firm.

**1.6 Research Design**

The structure of the study is exhibited in Figure 1.1. It involves four stages: 1- Conceptulisation, 2- Questionnaire design and surveys, 3- Analysis, and 4- Conclusions.

In the first stage, since the research problem has been clearly stated, the relevant literature was reviewed. The purpose of the literature review was to construct a basis for the study and understand the nature of the transfer pricing topic, in both the domestic and international environment.

The second stage involved collecting data from two groups: MNCs working in Egypt; and government authorities dealing with MNCs. The multiple case- study approach was adopted to collect data from companies.

The third stage is concerned with analysing the findings of the study. The last stage is to write up the research work.

**1.7 Structure of the Thesis**

This study deals with the extent of the use of transfer pricing techniques by MNCs to shift profits outside the host country. The study will assess this issue by applying a case study methodology to 11 MNCs in Egypt.

The thesis consists of 9 chapters. The present chapter has described the problem, the significance of the study, and its purposes.

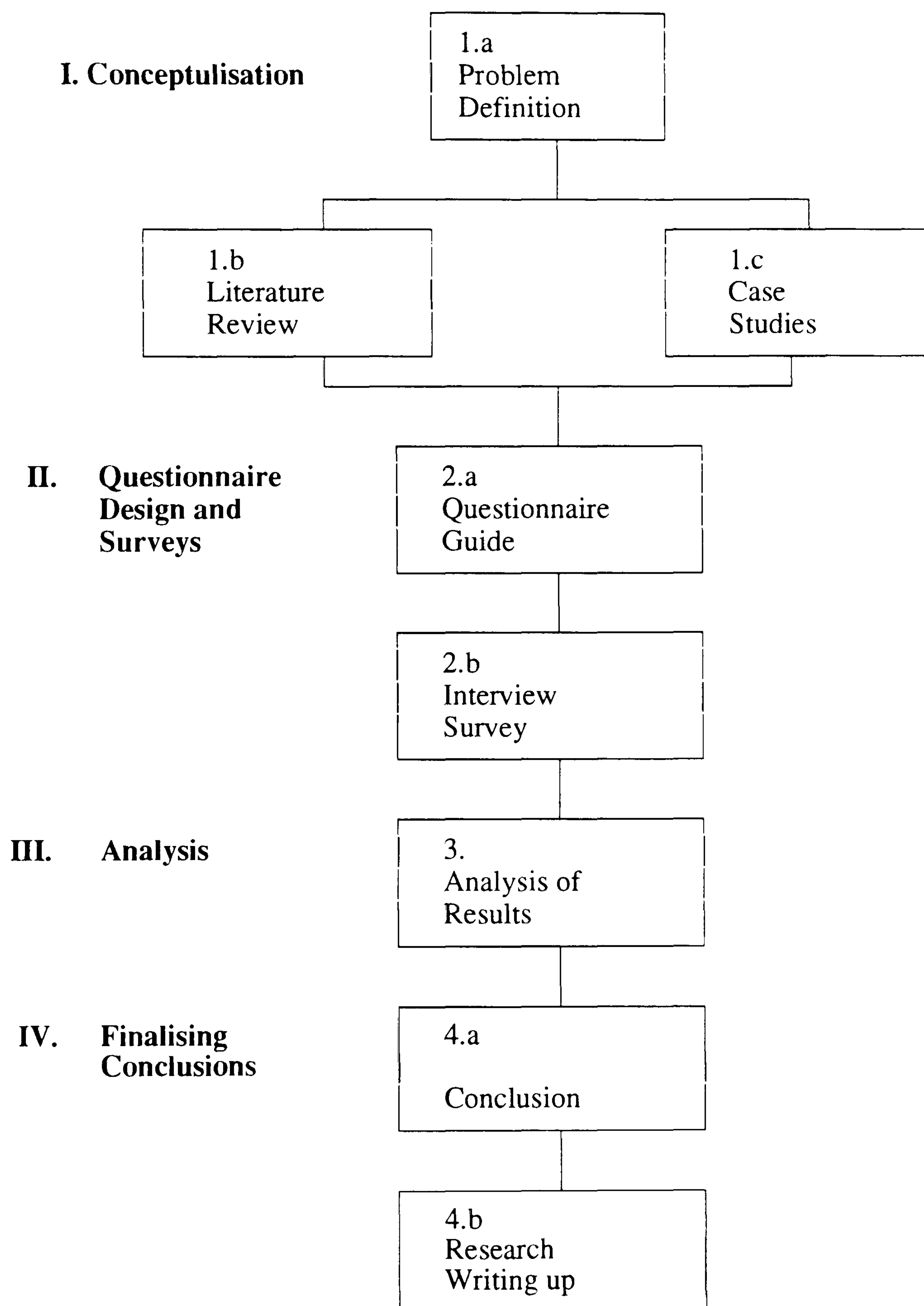
A literature review of transfer pricing approaches is presented in Chapter (2). It also sheds some light on transfer pricing policies which are based on market factors and cost variables.

In order to assess variables that induce MNCs to shift profits via transfer pricing techniques, Chapter (3) focuses on investigating these determinants. This chapter includes a discussion of the nature of MNCs and the significance of intra-company transactions. Sources of transfer pricing information are also discussed at the end of the chapter.

Chapter (4) is devoted entirely to a discussion of the business environment and FDI in Egypt. Attention is given to the major provisions of the Foreign Investment Code. The evaluation and effect of MNCs on different issues of the Egyptian economy are discussed as well.

## Figure 1.1

## The Framework of Research Methodology



Chapter (5) discusses the research methodology and data techniques to be used in the empirical study. The data was collected from two main sources: companies participating in the study and government bodies.

The results of the research findings are presented in details in Chapters (6), (7), and (8). The case study analyses are presented, where each company is discussed individually, in Chapter (6). The overall analysis of the data collected from companies is discussed in Chapter (7).

Chapter (8) analyses data collected from government authorities: tax departments, customs officials, and General Authority for Investment (GAFI). The view of the external auditor regarding examining transfer prices is discussed as well.

The conclusion and recommendations of the study are presented in the final chapter. The chapter suggests additionally further departures for future research.

## 1.8 Limitations of the Study

This study is intended to investigate the extent of transfer pricing manoeuvres by MNCs in order to utilise their returns on the account of host and home country benefits. Among other considerations it deals with the techniques MNCs use to eliminate or neutralise the distorting effects of widely varying national and international business environments, including tax and customs rate differences and political factors. In the case of fluctuating exchange rates, the company could abuse transfer pricing in order to secure a common ground against which to measure the financial performance of its subsidiaries.

This study, like any other empirical study, has its own limitations. Because of the confidentiality and complexity of the transfer pricing issue, response to the study is always uncertain. The uncertainty makes the empirical and statistical approach to studying transfer pricing a high risk in terms of efforts and results. Perhaps this explains why researchers in the past engaged only in descriptive study.

In all case study approaches, the researcher must be aware of the potential problem of the difficulty of generalisation. This research is no exception. As the field work involves eleven MN subsidiaries operating in Egypt, it cannot claim to generalise the results to all MNCs working there. This would need further investigation in order to trace all the effects of MNCs there. However, there is no reason to believe that results from other companies not involved in the study would differ significantly from those involved in the study.

Since most of the MNCs in Egypt direct their sales to the local market, no research was directed toward the transfer pricing strategies from the Egyptian subsidiaries to their parents or other foreign units.

# Chapter 2

## Different Approaches to Transfer Pricing: A Survey of the Literature

### 2.1 Introduction

The transfer pricing issue increases in importance in parallel with the trend towards large firms and with the increased interest of decentralisation and divisionalisation. The need for determining a transfer price arises when goods or services are exchanged between organisational units of the same company. It should be noticed that transfer pricing is a means to an end, not an end in itself. It is an essential part of a decentralised profit control system in any company where divisions buy from and sell to each other. Therefore, the determination of "correct" transfer prices gives division managers both the economic basis and the incentives for "correct" decisions. This involves resource allocation, divisional profitability evaluation, creation of profitability and cost awareness, production-mix decisions, make or buy decisions, etc.

Although the transfer pricing problem became conspicuous more than sixty years ago with the invention of the multidivisional structure (Chandler, 1962), its management is still not well understood (Vancil, 1979; Kaplan, 1982). The transfer pricing problem is a difficult and frustrating one. Although there has been substantial interest in the problem among academics, many managers consider it to be unsolved. The current state of knowledge has been well summarised by Vancil (1979, p.142) as follows:

> "My third disappointment in this study is that I have been unable to say anything definitive- or even mildy useful- on the subject of transfer prices .... The issue remains a perennial puzzle for academicians, while practitioners continue to cope. I wish the best of good fortune to the next researcher to tackle this problem."

When it is desired to classify literature on transfer pricing according to the scientific perspective from which the problem is treated, a variety of approaches have been suggested. Each approach is designed to establish transfer prices that are fair, flexible, acceptable to the divisions, and consistent with corporate objectives. Each approach has its advantages and disadvantages, and no single approach is superior in all situations. Therefore, the purpose of this chapter is to review and appraise the nature and scope of some major models that deal with the problem of transfer pricing. One of the reasons that transfer pricing has remained a dilemma for academics for so long is the numerous of research on how it is actually done in companies. A few surveys

have been conducted that rely on data provided by companies. However, no study based on in-depth research, involving collection of extensive data on the company and its transfer pricing policies from the perspective of both general and functional managers, has ever been conducted. However, a number of descriptive empirical studies will be discussed.

This chapter is devoted to four main points, as follows:

(1) The concept of transfer pricing and its objectives;

(2) Theoretical approaches to transfer pricing;

(3) Practical studies of transfer pricing; and

(4) Different policies for transfer pricing.

## 2.2 The Concept of Transfer Pricing and its Objectives

The term of "transfer pricing"[1] is used to describe the intra-company charge applied to transactions between two or more profit centres of the same company. In another words, transfer pricing is an artificially assigned price which occurs when several units of one firm are involved in non-market transactions. This definition coincides with the description of transfer prices by Horngren and Foster (1991, p.855) and Barfield *et al.* (1991, p.684).

The most important criterion when determining the price is to be true and fair. This could be applied in similar transactions between unrelated parties occurring in the market place; each negotiates the terms and conditions of the transaction and looks after its own interest. The price in this matter is reached by the "arm's- length" principle. Normally, the arm's-length price involves profits because unrelated parties sell at a profit.

Transfer pricing, aside from being a necessary accounting practice, serves important managerial functions. It is generally agreed that the transfer pricing system should accomplish certain objectives simultaneously, including:

1- Assure that the objectives of company units coincide with overall company objectives,

2- Foster operating efficiency,

3- Ensure an efficient allocation of resources,

---

1 There are some terms which are used as synonyms of transfer pricing such as "internal pricing", "accounting prices", and the term of "price of internal consignment", which is used by OECD Guidelines.

4- Evaluate the performance of managers, and

5- Ensure an effective communication within the entire company.

Achieving these objectives may be difficult. So, transfer pricing policies must be constructed to reflect the relative importance of these goals. A manager ideally acts in the best interests of the company as a whole, even at the expense of the reported profits of a division. To effect this ideal behaviour, the system of performance evaluation must reward a manager who chooses company wide goal congruence over divisional performance.

Determining transfer prices is not easy and represents a major issue in integrated business organisation even in a domestic environment. Eccles (1983, p.150) considers transfer pricing a nagging problem as it includes two portions: the sourcing decision and the pricing decision. The divisional manager has to compare the advantages of internal and external sources to decide which is best for his division and for the firm in general. If the manager opts for the first alternative, what price should be charged for the transfers? Consequently, the transfer pricing problem causes serious headaches for the firm and its divisions.

## 2.3 Theoretical Approaches to Transfer Pricing Systems

Approaches to transfer pricing provide an apparatus for the analysis of the behaviour of decentralised firms. All these approaches have focused on two main aspects: "By whom should the prices be set?" and "How should the prices be chosen or calculated?" Usually the discussions concentrate on the second aspect. The question that arises is: *should prices be based on cost, or market value or be decided upon by negotiation?* In the researcher's opinion, these approaches could be divided into four: economic, mathematical, accounting, and behavioural.

### 2.3.1 Economic Approach

The traditional economic answer to the maximisation of a firm's profit is to produce to the point when marginal cost equals marginal revenue. Marginal cost in the economic sense is the additional cost of producing an additional unit, where the cost involves returns to all factors of production, including capital. The problem of transfer pricing within a decentralised firm arises from the conflict between the objectives of each division and those of the firm.

Therefore, the role of transfer pricing, in this situation, is to maximise the total profit of the firm. The problem of transfer pricing was addressed in business literature

as early as 1908/1909 by Eugen Schmalenbach[2] (Drumm, 1983, p.34-35), although most of the works on this issue developed from the middle of the 1950's. The main point raised in the early studies was whether cost or market price should be used for the internal pricing.

The first economic theory which outlined an optimal transfer pricing strategy between divisions of the firm was presented by Jack Hirshleifer (1956,1957). His analysis is considered one of the most important theoretical bases for transfer pricing. As an economist, he developed theoretical models for using a market price as a transfer pricing method as suggested by Cook (1955). Hirshleifer (1956, pp.172-173) presented some general simplifying assumptions for operationalising his model, as follows:

1- The firm has two profit centres: a manufacturing division, and a distribution division, and each division produces only one product which can be sold externally.

2- The output of the manufacturing division is an intermediate good which is used as input for the distribution division. In another words, the manufacturing division is referred to as a seller division and the distribution division as a buying division.

3- The operating costs of each division are independent of the other, i.e., technological independence.

4- The external market's demand for each division's product has no effect on the demand of the other, i.e., demand independence.

It is clear that these assumptions are made in an environment of certainty. In his first paper, Hirshleifer (1956, pp.173-180) suggested solutions for three conditions:

a) There is no external market for the intermediate product, that is, there is no demand and supply of the good other than that generated by the two divisions.

b) The demand for the intermediate product is perfectly competitive.

c) The demand for the intermediate product is imperfectly competitive.

The three conditions will be discussed to show how transfer pricing is set.

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[2] Drumm mentions that Schmalenbach developed transfer pricing as a theoretical concept in his thesis which was published in 1908/1909 and extended in 1947/1948 in two books (in German). Schmalenbach suggested applying circumstances and directions of the market to negotiation between divisions of the firm. He also recommended the marginal cost of each division's product as a base of transfer pricing.

**Condition 1:** When there is no external market for the intermediate product. The transfer pricing should be equal to the marginal cost[3] of the selling division whether the final product is sold in a perfect competitive or imperfectly conditions.

**Condition 2:** In the case of a perfectly competitive market existing for intermediate goods, both divisions could be given the autonomy to trade inside or outside. The transfer price should be equal to the market price for the intermediate product.

**Condition 3:** When the firm is confronted by an imperfectly competitive market for the intermediate good. The optimal transfer price is equal to the marginal cost of the manufacturing division. In most cases, the market price for the intermediate product will be higher than the marginal cost of the manufacturing division.

Hirshleifer (1957, pp.96-108) extended his analysis to include the case of a multiproduct divisionalised firm. He assumed the firm produces a number of final products besides a number of intermediate goods which are used as inputs to the final products. Also, he assumed that the operating cost function for each final product is independent of the others.

For this case, he found that the results do not lend themselves to an easy generalisation. His abandonment/continuation of one or more of the divisions, are involved, the marginal solution must be supplemented by conditions concerned with the company as a whole. He also raised the operational difficulty of an optimal pricing rule where autonomous divisions convey misleading information in order to secure a more beneficial transfer price. To overcome this, he pointed out that in practice divisions should be permitted to resort to the external market if the price demanded by the internal partner is too unfavourable.

Hirshleifer's suggestion, was criticised by some authors. A strong criticism is by Anthony (1973, p.45). He cites:

> "....many economists state that businessmen should act so as to equate marginal costs with marginal revenue. In order for such a precept to be feasible, the businessman must be able to estimate the shape of his demand curve. The economist assumes that this information is obtainable, but the fact is that few businessmen have it. Without this information, structures such as the one Hirshleifer erected, collapse."

Hirshleifer's analysis can be used only when a specified set of conditions exists: It must be possible to estimate the demand curve for the intermediate product; the assumed conditions must remain stable; there can be no alternative uses for the

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[3] The term of marginal cost is used in accounting which is equal to the variable cost of producing an additional unit.

facilities use to make the intermediate product; and the model is applicable only to the situation in which the selling division makes a single intermediate product, which it transfers to a single buying division, which uses that intermediate product in a single final product. Such conditions exist rarely, if at all, in the real world.

#### 2.3.1.1 Limitations of the Economic Approach

Besides constraints in each situation that has been described, the economic approach assumes static conditions. This analysis is concerned only with a particular market situation at one point in time. Also, the models assume a linear production function, i.e., the inputs of each of the buying and selling divisions are considered to be inputs to the final product.

There are many assumptions in the economic approach which make it complicated, even in the simple context. The firm consists of two vertically integrated divisions, with no demand or cost interdependencies, practicing in a perfectly competitive external market.

Moreover, the Hirshleifer and Gould analyses illustrate the existence of transfer pricing along the marginal cost curve, but they fail to suggest an operational method of implementation. Furthermore, the interpretation of marginal cost differs between economics and accounting. Abdel-Khalik and Lusk (1974, p.13) indicates:

> "In summary, Hirshleifer suggests as a transfer pricing rule: price along the marginal cost curve. Hirshleifer has used the term "marginal cost" in the context of economic theory, i.e., the additional cost of producing an additional unit where cost includes returns to all factors of production including capital. In accounting, marginal cost has a different connotation; it is equated with the variable cost of producing one additional unit. Thus, pricing at the accounting marginal cost would not recover investment in fixed assets or returns to capital. Therefore, if the Hirshleifer system is to be implemented, modifications to the information generated by the accounting system become necessary."

Abedl-Khalik and Lusk (1974, pp.14-15) criticised economic models as follows:

1- These models are static, presuming monetary stability,

2- The independence of demand and technology might be difficult to justify,

3- The models assume a linear production function which might not exist in the real world at actual levels of output,

4- Marginal cost pricing might incite dysfunctional behaviour by divisional managers,

5- A division's inefficiency may be moved to another division, which might induce the divisional managers to impose seek by central management. This procedure may vitiate the autonomy of divisions,

6- These models do not include cost-benefit criteria to compare the advantages of establishing marginal cost pricing systems with the cost of producing the appropriate information, and

7- No one of the writers presented a case with more than two divisions.

### 2.3.2 Mathematical Programming Techniques

This approach treats transfer pricing as being analogous to the problem of optimisation under a set of economic constraints.

The value of mathematical programming in setting transfer prices lies mainly in the information extracted from the shadow prices produced by several models. The shadow prices provide a measure of the opportunity cost internal to the organisation and are believed to be the most realistic method of internal pricing. However, if efficient market prices exist for internal transactions, these are the most effective transfer prices. This is due to the fact that such market prices reflect the best opportunity cost and provide ideal conditions for the use of income figures as a control and evaluation tool. The required competitive market is scarce, however, and this unavailability of a suitable market price has prompted the basics of mathematical programming.

The basics of mathematical programming techniques are determining how many resources should be allocated where, in conditions with more than one buying division and with capacity constraints. Therefore, this approach deals with transfer pricing as analogous to the problem of optimisation under a group of economic limitations (Wu and Sharp, 1979, p.71). Most of the assumptions of the economic approach are used in mathematical programming, especially with regard to incentives for managers. But this technique deals with the concept of opportunity cost as mentioned previously instead of marginal cost to determine transfer pricing. The Opportunity cost refers to the benefits foregone by failing to undertake the next best alternative.

The most important models will be mentioned under three subtitles: linear programming technique, opportunity cost technique and decomposition approach

Linear programming may be described as no more than a mathematical technique which is used for solving a particular kind of optimisation. Alternatively, the linear programming technique deals with problems which are characterised by:

a) The objective function is defined which must be maximised or minimised,

b) There are some constraints (scarce resources) to achieving the target,

c) The objective function and constraints are linear, and

d) Variables of the problem can take any real positive value.

The solution in linear programming has two closely related aspects: the primal solution, and the dual solution. The optimal value of the dual variables is called "shadow prices", which reflect the imputed value of scarce resources suggested in the primal problem and with limited outputs. Shadow prices can be used as a basis to compute transfer prices. Shadow prices should not be used directly as transfer prices but must have the variable cost of the intermediate product added to it so as to represent the real transfer price (Dopuch and Drake, 1964, p.16; and Solomons, 1976, p.18).

The opportunity cost transfer pricing was referred to by Cook (1955), as he pointed out:

> "An opportunity cost is probably the best choice, since it reflects the alternatives of the whole company. This would be the actual increase in total cost brought on by filing the order, plus any loss in net revenue to the selling division that resulted from transferring rather than using the material for its own products." (p.91)

In fact, the opportunity cost of the best alternative rejected is rarely incorporated in the formal accounting system, especially for external reporting. The reason for this is the opportunity cost neither represents an incurred cost nor comprises cash flow in the transactions involved.

Onsi (1970, pp.535-543) suggested a system for applying opportunity cost to transfer pricing in the absence of a market price for internal transactions. His analysis is based on linear programming which maximises the total joint profit from the firm-wide view.

Onsi suggested a system for use when actual production costs of the supplying division differ from the plan agreed with the headquarters. The difference between actual and planned divisional profits should be credited as "motivational costs" to the supplying division. The procedure will cope with conflicts between divisional goals and those of the firm. That is, divisional managers will be motivated to establish the

optimal action to maximise the profit of the firm as a whole. This would permit divisions to work as profit centres. Onsi's system, aims to find a means of evaluating the performance of the division as a profit centre.

Benke and Edwards (1980, p.59) pointed out disadvantages of opportunity cost transfer pricing. It might be hard to define the concept of opportunity cost and it is difficult to determine the additional profit foregone or the cost saved. Moreover, the opportunity cost is zero when there is no alternative to be taken into account, but a transfer price of zero is unacceptable. Frankly, if these shortcomings can be overcome, the concept of opportunity cost might generate an appropriate transfer price.

The decomposition technique approach was used to increase the level of the divisional autonomy and improve the linear programming technique, especially to solve large problems.

The basic conception of this technique is that each division calculates its objective function separately in the light of its particular constraints. The top management is not responsible for knowing anything about the internal technological arrangements of the division. However, it should know the requirements of each division for corporate resources.

Conclusions about the mathematical programming approach are far more complex. This approach ends up by top management allocating corporate resources to the various competing divisions. Therefore, it does not maintain a high level of divisional autonomy.

Kaplan (1982) pointed out three problems with mathematical programming approaches to transfer pricing. First, linear approaches yield multiple optimal solutions, only one of which is globally optimal. Second, a great deal of information must be supplied to and analysed by corporate staff, which gives divisional managers the opportunity to manipulate this information to their advantage. Third, the divisional managers have a strong incentive to do so, since shadow prices impute all profits to the scarcest resource, thereby penalising divisions that have adequate or surplus capacity. "This induces a strange set of incentives, encouraging each division to limit capacity so that any profits will be imputed to use of its resources" (Kaplan, 1982, p.496).

The shortcomings of mathematical programming prevent it from being a solution to the transfer pricing problem, even if it is narrowly defined in terms of profit maximisation.

### 2.3.3 Accounting Approach

Accountants have long debated the transfer pricing problem. They have recognised the effects of transfer pricing on major decisions such as make-or-buy, capital budgeting, introducing a new product or dropping an old one, product output level, and final product pricing. They aspired to develop a pricing system that maximises the overall profit of the firm, and at the same time, motivate the divisional managers and provide a fair performance evaluation. Therefore, the transfer pricing system should be designed to reach that objective. They have been concerned with the recognition of the unrealised profits that result from a market-based transfer price. On the other hand, they were not unaware of the allocation problems that accompany a full cost pricing system.

Many accounting writers recommended using market prices as a base for transfer pricing. For example, Solomons (1976) suggested using market prices if there is a competitive market for internal transfers.

Others defended using cost-based transfer pricing. Most of the methods suggested to determine transfer pricing depend on the cost principle, especially if market prices are not easily available. Many methods have been derived from cost concepts to be a base for transfer pricing. The most common method is the actual cost method, which may involve full cost, full cost plus mark-up for profit, variable cost or marginal cost, and variable cost plus profit margin. Standard cost and opportunity cost are also used.

Obviously, the accounting debate about transfer pricing concentrates on whether market price methods or cost methods should be used. Another point of dispute is whether or not the division might be free to decide to deal internally or externally.

### 2.3.4 Behavioural Approach

Prior approaches are criticised as they give high priority to production efficiency, cost minimisation, and profit maximisation. However, they tend to ignore athe human dimension in transfer pricing strategies. The most recent transfer pricing theory offers a behavioural interpretation of transfer pricing as a control device in an organisation. This behavioural approach states that transfer pricing systems simultaneously facilitate an organisation's decentralisation and integration. It is

believed that for transfer pricing to perform the integration process, the evaluation of managers must be based on company profits rather than divisional profits.

Cyert and March (1963) developed a behavioural approach of the firm which concentrates on organisational goals, expectation and choice. The organisation is viewed as a coalition of participants in which conflict is only partially solved. The basics of this coalition include a production plan, sales and inventory policies, market resources and profit policy. The goals of such a coalition are settled by bargaining to avoid uncertainty by, at least, reacting to short-run feedback from the environment. The allocation of resources among divisions requires a kind of bargaining. As transfer pricing is a part of the problem of resource allocation, it is important to the concept of "efficiency" and "fairness". Cyert and March (1963, p.267) considered transfer pricing as part of a long-run bargaining process rather than as economic decisions. Transfer pricing is a result of long-run negotiation, because initial solutions will probably need adjustment. The process of negotiation and re-negotiation of transfer pricing might create conflict between divisions. But presumably divisional managers, in their negotiations, arrive at a satisfactory decision which allows them to give attention to the target of achieving cost reductions.

Cyert and March (1963, p.276) concluded that transfer payments should be made as follows:

> "In general, we should find that transfer payments are made on the basis of a few simple rules that (1) have some crude face validity and (2) have shown some historic viability. We should find that they are the focus of conflict among subunits in the same way as other allocative devices."

Watson and Baumler (1975) investigated transfer pricing in terms organisational conditions (uncertainty, differentiation and integration). They concluded that transfer pricing is regarded as a problem in conflict resolution. They argued that transfer pricing is only one of a number of inputs to a multidimensional process of conflict resolution. In this process they believe that transfer prices are most likely be negotiated as an aid to integration when profit centres are strongly differentiated and highly interdependent. But they did not show the nature of these negotiations. Noting the lack of empirical evidence in this area, they suggested as a hypothesis for further exploration "that accounting data are completely irrelevant or unimportant in the more difficult integrating situations" (p.472).

It might be deduced from the behavioural approach that it is concerned with managerial conflict and fairness. Shillinglaw (1982,) regards fairness as one of three criteria for setting of a transfer pricing system. He mentions: "The transfer pricing

system should be designed so that the divisional managers will regard the transfer prices as fair" (p.819). However, fairness is a relative concept, i.e., it hinges on the personal view of the divisional manager, what he considers as fair may seem absolutely unfair to another manager. Shillinglaw considers this criterion, along with profit maximisation as more important than appraising divisional profitability.

## 2.4 General Comments on Theoretical Approaches

The previous review shows that the economic approach focuses on economic decisions; it does so primarily in terms of outputs levels. Also, it focuses on profit maximisation under the unstated assumption that the other factors are given. As a general rule, a transfer pricing policy should be consistent with the corporate strategy of the company. This approach ignores strategy, since it does not address the question of what business a company chooses to be in or how it chooses to compete in these businesses. It ignores the effect of transfer prices on product pricing for external transactions and on capital investment decisions.

The mathematical approach to the transfer pricing problem requires a less restrictive set of assumptions than the marginal cost analysis of the economic approach. But this approach reduces divisional decsion making autonomy, and ignores strategy and individual fairness through performance evaluation and reward. It focuses only on the economic decision of the divisional output levels.

The accounting approach deals with transfer pricing for two situations: (1) the rational transfer price for decision making, and (2) when no market price exists or the market is imperfectly competitive. In this case, the incremental cost or variable cost is recommended. This will avoid dysfunctional decision making which may arise from using market price, especially, if there is surplus capacity in the supplying division. In the second case, the main contribution of the accounting approach is to fill the gap in the economic approach where full cost plus a profit margin can be used to present transfer prices. The accounting approach pays more attention to the role of transfer prices in measuring and evaluating divisional performance, even if this implies some sacrifice of profit-maximisation.

The behavioural approach focuses on individual fairness and administrative process, and considers managing conflict as the central administrative process. But the approach gives little attention to performance evaluation and reward. Finally, it ignores completely the economic decisions of the company.

As mentioned earlier that the transfer pricing approaches focus on whether cost or market value base should be used, it can be said that using cost methods as a basis for

transfer pricing means shifting profits from the transferor division to the transferee division. This means that market price could represent an arm's-length base for all divisions.

## 2.5 Empirical Research on Transfer Pricing Practices

In the previous sections the theoretical basis for various transfer pricing models was emphasised. The objective of this section is to give a brief account to these studies at the domestic and international levels.

### 2.5.1 Domestic Empirical Studies

There are several practical studies of the domestic transfer pricing problem. Most of these studies depend on questionnaire surveys to collect the required data. It may be noted that few of these studies have shown a disparity between theoretical studies and practice.

Principally, the descriptive studies grade transfer pricing methods into two, cost-based methods and market-based price methods. Some of the studies showed that some companies use more than one method in conformity with a multiplicity of situations. Table 2.1 presents a summary of the major empirical studies:

**Table 2.1**

**A Summary of the Major Domestic Empirical Transfer Pricing Studies**

| Author or Institution | Data Gathering Method | Data Source |
|---|---|---|
| National Industrial Conference Board (1967) | Questionnaire | 190 U.S. industrial companies |
| Mautz (1968) | Questionnaire | 341 U.S. corporations |
| BIM (1971) | Questionnaire | 293 U.K. industrial companies |
| Tomkins (1973) | Questionnaire | 200 U.K. indus. companies |
| Larson (1974) | Interviews | 8 U.S. corporations |
| Vancil (1979) | Questionnaire | 239 U.S. organisations |
| Benke and Edwards (1980) | Interviews | 19 U.S. firms in 10 industries |
| Eccles (1985) | Interviews | 13 U.S. firms in 3 industries |

### 2.5.1.1 National Industrial Conference Board Study (1967)

This study was based on the experience of 190 U.S. companies and demonstrated the various pricing practices of products transferred among divisions of industrial corporations.

Two-third of the firms participating in this study used cost-based transfer prices, especially where divisions are organised as cost centres rather than profit centres. These companies used several methods to determine the cost of transfers, including actual costs, standard costs, and direct or marginal costs. Some executives used cost-plus methods, especially when the price of finished goods is sufficient to give an acceptable return on the firm's investment.

More than 50% of companies participating used market-based transfer prices either as a single pricing basis, or in combination with some forms of cost methods. Market-based methods were used in companies that are divided into profit centres. The most frequently used methods to determine the market price, in this study, were current market price, market price less a discount, and negotiated price.

This study disclosed that chief financial executives of the firm are responsible for establishing transfer prices with the assistance of the corporate controller. Most companies permitted their divisions to buy from outside after approval from the top management.

### 2.5.1.2 Mautz's Study (1968)

Mautz's study on transfer pricing methods was part of a wide study in the field of financial reporting by diversified companies. The required data were collected using questionnaires.

Mautz found that 341 companies responding had internal transactions between their divisions. Of the whole number, 166 firms (48.7%) used only one method of transfer pricing; 175 companies (51.3%) used two methods or more. Mautz found that the negotiated price method was used by 23.6% of corporations, but it is conceivable that respondents considered this method to be synonymous to the market price method. The study showed also that the arm's-length negotiated price method was used by 26.7% of companies, cost-plus markup (21.1%), cost method (19.8%) and other methods (8.8%).

### 2.5.1.3 British Institute of Management Study (BIM), 1971

The main concern of this study was to identify the main transfer pricing methods in 293 companies in the U.K. that replied to the questionnaire sent to them.

Of this number, 193 companies mentioned that they operated a transfer pricing system between their divisions. Companies in this study were divided into three groups according to the number of employees. Two-thirds of the companies mentioned that only one transfer pricing method was used, while the greater number of the companies left used two or three methods. Half of the companies surveyed allowed divisions to obtain intermediate goods from external sources, although top management approval was essential in some cases. Likewise, 109 companies allowed selling divisions to trade outside. The responsible authorities for setting transfer pricing policies ranged between top management; the senior division staff (buying and selling divisions); or a group from the two organisational levels.

With respect to transfer pricing methods in the companies studied, cost-based methods were used by 89 companies (46%), and 104 companies (54%) revealed that they used market-based methods. Out of the 89 firms, 55 firms depended on standard cost methods, while the remaining used actual cost principle. Of the companies that used cost-based prices, 54 companies adjusted the cost by adding a markup, where about 40 companies calculated this addition by a defined amount or a percentage, and 14 companies depended on negotiation between divisions.

Amongst the 104 companies that used market-based methods, 61 firms adjusted the market price to reduce it by the expenses saved in the case of internal transactions. Two methods were used for this adjustment: adjustment by a definite amount or percentage, and adjustment by negotiation.

It is clear that the marginal cost basis was not used by any company in the survey. Also, no company reported that it used mathematical techniques in establishing transfer prices.

### 2.5.1.4 Tomkins' Study (1973)

Tomkins aimed at investigating transfer pricing in very large and important corporations. He carried out a questionnaire survey sent to 200 top companies (groups) in the U.K. listed in the "Times 1000". While fifty one consented to give the required information, the remaining replied on condition that their names and data were not published.

Of the 51 companies, 4 did not transfer goods or services between divisions and 3 indicated that transfer prices were used but did not mention the basis. The findings of this study coincided with prior studies, that cost based and market based transfer prices were the most common in the companies examined.

Table 2.2 displays transfer pricing policies in 44 companies. All companies mentioned that they did not use either mathematical techniques or marginal cost methods, except for three companies. Tomkins concluded the degree of transfer pricing conflict depends on the degree of divisional autonomy, which represents the key aspect of transfer pricing decision making.

**Table 2.2**

**Transfer Pricing Policies in Tomkins Study**

| Method | Number of times referred to by groups |
|---|---|
| **Cost-based Methods** | |
| Direct cost | 3 |
| Direct cost plus | 6 |
| Average total cost | 3 |
| Total cost plus | 8 |
| Sub-total cost-based methods | 20 |
| **Market-Based Methods** | |
| Current market price | 22 |
| Market price less discount | 9 |
| Sub-total market-based methods | 31 |
| Negotiated bases | 14 |
| Other bases | 2 |
| Total | **67** |

*Source:* Tomkins (1973, p.180).

### 2.5.1.5 Larson's Study (1974)

Larson conducted an empirical study in eight U.S. firms, built on in-depth interviews with nine division controllers or assistant controllers and eight top-level managers.

All companies advocated market prices as the best method of pricing intra-company transfers. However, none of them used market price as a base for transfer pricing, but they used instead a price ranging from market-based to cost which was set by a special committee in the top management.

Purchasing from external sources was very restricted in some companies. Also, some divisions had to get central management approval for dealing outside after giving appropriate reasons . Some of these companies preferred to make external purchases centrally to get better prices.

Larson's opinion of the transfer pricing problem was cynical as can be seen from his conclusion:

> "The overall conclusion that emerges here is that the problem of conflict resolution that surrounds transfer pricing and decentralization is of such a complex nature that it is very doubtful that any present method of transfer pricing would be successful. As long as top management ignores profit in evaluating a division, the method of transfer pricing used is largely irrelevant." (1974, p.32)

Of course, this study is limited to a small sample and it could be difficult to generalise these results to the whole community.

### 2.5.1.6 Vancil's Study (1979)

Vancil (1979) studied the management of decentralised firms under the auspices of the Financial Executive Research Foundation. The reported data are based on a mail survey sent to 684 U.S. manufacturing companies. Of the 291 companies which returned the questionnaire, 249 (85%) reported that goods were transferred among profit centres. The amount of transfers varied up to 65% of the total value of goods sold (or manufactured, depending upon whether a profit- or cost-based transfer price was used) by the profit centre. The majority of profit centres were not independent. Meanwhile, 239 companies specified transfer pricing policies, which are displayed in Table 2.3.

Vancil noted that variable cost methods were limited in use, where 4.6% of companies used them. His comment was:

**Table 2.3**

**Transfer Pricing Policies in Vancil Study**

| | No. of companies | | Percentage | |
|---|---|---|---|---|
| | **Partial** | **Total** | **Partial** | **Total** |
| **Cost-based methods** | | | | |
| Standard variable cost | 7 | | 2.9 | |
| Actual Variable cost | 4 | | 1.7 | |
| Standard full cost | 30 | | 12.5 | |
| Actual full cost | 31 | | 13.0 | |
| Full cost plus markup computed on return on sales | 7 | | 2.9 | |
| Full cost plus markup on return on investment | 7 | | 2.9 | |
| Full cost plus a defined profit | 26 | | 10.9 | |
| | —— | 112 | —— | 46.8 |
| Negotiated price method | | 53 | | 22.2 |
| **Market-based methods** | | | | |
| Competitor's price | 28 | | 11.7 | |
| List or bid price | 46 | | 19.3 | |
| | —— | 74 | —— | 31.0 |
| | | **239** | | **100%** |

*Source:* Vancil (1979).

> "From a business perspective, this is not surprising because the profit center managers of supplying divisions would have little incentive to produce if their output were to be transferred on the basis of variable costs." (p.173)

Full cost methods prevailed in 25% of the companies. This study also investigated whether there was a difference in the transfer pricing policy used depending upon

whether the goods were transferred out from a cost or a profit centre. It was found that if a corporate manufacturing function shipped the goods, a cost-based policy was used over 80% of the time. If goods were shipped from one profit centre to another profit centre, a cost-based policy was used less than half the time. When profit centres traded with each other, a market-based policy was used over 30% of the time, and negotiation occurred more than 20% of the time. These results are intuitively appealing. A profit centre would transfer goods out above cost so as to generate some contribution to profit. However, a corporate manufacturing function that generally served several profit centres would not be required to show a profit. There was no uniformity in the way all companies set transfer prices (i.e., each of the policies was used regardless of supplier by some of the companies).

#### 2.5.1.7 Benke and Edwards' Study (1980)

In the past few years, Benke and Edwards have presented a study which provides a wealth of detailed information collected by in depth interviews with controllers and their staffs in nineteen companies in ten different U.S industries. It focused on policies, techniques and problems of transfer pricing.

The study noted that transfer pricing conflicts were often settled by the top management, because "the greater the dollar value of the product involved the higher was the level of resolution" (Benke and Edwards, 1980, p.10). In some cases, conflict was resolved by the company president. Only minor problems, or those which related to lower levels in the organisation, were resolved by the controller's office.

Benke and Edwards (1980, p.29) distinguished between primary and secondary transfer pricing techniques. The techniques are primary if the company uses a single technique for internal transfers. The division may choose another (secondary) technique if the primary technique does not fit the prevailing conditions. The study has disclosed that most of the companies examined were divided into profit centres, i.e., the degree of decentralisation was very high.

Market-based transfer prices were used by 15 firms as a primary technique, while 12 firms used it as a secondary technique. On the other hand, cost-based technique were used by three companies as their primary techniques, while four firms used it as a secondary technique.

Market-based prices were divided into four classes, namely: current market prices, adjusted market price, negotiated price, and contribution margin. The last method involves allocating the difference between the sales price and variables costs between the supplying division and the receiving division.

Cost-based methods were found with either profit centres or cost centres. Actual/standard variable cost and actual/standard full cost methods were prevailing in cost centres. Similarly, these methods were used by profit centres after adding a margin for profit.

#### 2.5.1.8 Eccles' Study (1985)

Eccles presented a study hinged on extensive interviews with general managers of profit centres in 13 firms in three industries: chemicals, electronics, and heavy machinery.

Eccles developed some hypotheses which revolve around the importance of transfer pricing and conditions that govern adjusting transfer pricing policies and their effects on conflict between divisions.

Eccles divided transfer pricing policies used in the companies investigated into four bases: mandated full cost-based; mandated market-based; exchange authority; and dual pricing. Most of the firms used more than one policy at the same time. Only two firms used four methods simultaneously. Eccles considered that vertical integration[4] is the most important reason for establishing transfer pricing policies.

The main conclusion that can be inferred from the empirical studies is that no best transfer pricing method exists. A variety of methods were employed and the particular method chosen was probably based on the primary objective the company was attempting to accomplish through the transfer pricing process.

### 2.5.2 International Empirical Studies

With the tremendous growth of international trade, the transfer pricing issue became a major concern of corporate management in MNCs. Various empirical studies related to international transfer pricing were carried out since the 1960s. Most of these studies have contributed in identifying and analysing the key environmental variables influencing the MN transfer pricing practices. Table 2.4 presents a summary of the major empirical studies on international transfer pricing. These studies will be discussed according to the chronological sequence of their publications.

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[4] Vertical integration means unification of different activities of the business within the boundaries of a single firm. The objectives of vertical integration may be achieving economics of production or securing supply or demand. For more details see Eccles (1985, p.79).

**Table 2.4**

**A Summary of the Major Empirical Studies on MN Dimensions of Transfer Pricing**

| Author or Institution | Data Gathering Method | Data Source |
|---|---|---|
| Greene and Duerrs (1970) | Questionnaire survey | Executives from 130 companies |
| Arpan (1972) | Questionnaire survey | Executives of 60 firms, representing 10 foreign countries |
| BIC (1973) | Interview | International Corporation (number not available |
| Shulman (1975) | Interview | 8 large U.S. industrial companies with considerable overseas operations |
| Milburn (1977) | Questionnaire survey and Interviews | 33 partners from major accounting firms in the U.S. and Canada |
| Tang (1979) | Questionnaire survey | 247 large industrial companies in the U.S. and Japan |
| Yunker (1982) | Questionnaire survey | 52 large corporations in the U.S. |

#### 2.5.2.1 Greene and Duerrs' Study

Greene and Duerrs (1970) examined transfer pricing practices in 130 MNCs. The results showed that transfer prices were usually established on a cost-plus basis, but if the goods could be obtained from outside market, a negotiated transfer price was used between the units involved.

The important factors that influenced transfer pricing decision included tax and customs duties and the desires of domestic divisional executives and local managers abroad to have an effective influence on corporate policy in MN transfer pricing.

#### 2.5.2.2 Arpan's Study

The study by Arpan (1972) focused on transfer pricing practices of non-American MNCs with respect to their wholly owned American subsidiaries. Arpan collected data from 60 companies, representing 10 countries. The purpose of the study was to explore non-American transfer pricing systems and to compare them with those of American MNCs in terms of orientation, variables considered, degree of system complexity, problems encountered and method used.

Among 30 respondents, 17 subsidiaries used market prices (arm's-length negotiated prices), 3 reported a market price less commission method, 4 mentioned a cost plus method, and 6 called theirs a combination system.

Arpan concluded that transfer pricing system was one of the most closely supervised corporate operations and policies determined by parent company executives with minimal participation by subsidiaries.

#### 2.5.2.3 BIC Study

The Business International Corporation's study (BIC), 1973, discussed the problems involved in interdivisional transfers of intangibles such as, technology, services, patents and trademarks.

BIC found that pricing of intangibles is one of the most politically sensitive questions faced by MNCs. It offered two criteria for setting transfer prices on intangibles:

a) Transfer prices for intangibles are based on market value or they are essentially arbitrary.

b) The key external restraint on pricing intangibles is taxes.

#### 2.5.2.4 Shulman's Study

In this study, Shulman (1975) examined environmental determinants affecting MN transfer pricing. These include income taxes, import duties, economic restrictions imposed by host governments, currency fluctuation, competitive positions of foreign subsidiaries, and so on. All the companies interviewed stated the existence of these determinants but not all of them took all these determinants into account in transfer pricing.

Shulman emphasised that a successful MN transfer pricing method should maintain a functional control system to measure, evaluate, and motivate divisional management.

#### 2.5.2.5 Milburn's Study

Milburn's study (1977) was concerned with the measurement of transfer transactions between controlled subsidiaries of MNCs. The focus of the study was the external user of subsidiary financial data in Canada and the U.S. and how the interests of third parties were affected by MN transfer pricing. Milburn found that major Canadian companies were highly sensitive to MN transfer pricing variability.

In another study, Milburn (1977) suggested that Canadian professionals should concentrate on developing disclosure, to help financial statement users make informed decisions as to the impact of MN transfer transactions on company results.

#### 2.5.2.6 Tang's Study

The primary objectives of Tang's study (1979) were to identify, measure and explain the similarities and differences in transfer pricing practices of selected manufacturing companies in the U.S. and Japan.

Tang found that the use of transfer pricing techniques was more widespread among the U.S. companies than the Japanese companies. Of the U.S. companies, 92% used some form of transfer price, but only 73% of Japanese companies did. Full cost-plus was found to be the most popular international transfer pricing method among both the U.S. and the Japanese companies. Tang found that the key objectives for transfer pricing strategies of companies in the two countries were quite similar. Maximising consolidated profits and determining divisional performances were the most important objectives reported by the respondents in both groups.

#### 2.5.2.7 Yunker's Study

In her study, Yunker (1982) showed that subsidiaries have the greatest autonomy with respect to short-run operations not directly related to other units. There was less

freedom with respect to activities directly affecting other subsidiaries that are covered by such variables as price of sales to subsidiaries in other countries.

The most important objective of the transfer pricing decision was to increase overall profit. The market price was the most important transfer pricing basis, followed by standard full cost plus a fixed markup. Establishing the transfer price itself by the parent corporation on a case-by-case basis to benefit the overall corporation was given an intermediate rating by the respondents.

### 2.6 General Comments on Empirical Studies

The previous discussion shows that the empirical studies on domestic transfer pricing focused on transfer pricing methods. These studies disclosed that companies tend to adopt a transfer pricing method which is most relevant to their objectives and in the meantime is consistent with their internal and external conditions.

Meanwhile, the empirical studies on international transfer pricing have contributed to the understanding of the major environmental determinants affecting MN transfer pricing decisions. Shulman's study is a primary example. Arpan's study and Tang's research have also provided some insight into the non-American systems of international transfer pricing systems. The study by Milburn dealt with the financial accounting aspect of transfer pricing. This was a major contribution to financial accounting literature. The study by Yunker focused on the effect of transfer pricing on performance evaluation in MNCs.

There are, however, a number of limitations to the above studies. The common problem with most of these empirical studies is that data obtained from questionnaires and interviews are often unreliable. Anoter limitation is that the samples, used by researchers such as Shulman were too small for his conclusion to be generalised.

### 2.7 Different Policies for Transfer Pricing

Determining the appropriate transfer pricing policy has been a controversial issue in accounting and business literature. As mentioned earlier, most transfer pricing policies in use today are based on either internal cost or external market prices. The following will give a brief discussion of these policies.

#### 2.7.1 Cost-Based Transfer Prices

This approach might be used for pricing internal transfers where the firm is divided into cost centres. Also, if companies are more concerned with determining the

profitability of the individual products than with that of the centres as such, they may prefer to base transfer prices on production costs.

There are two main methods for assessing the cost: prices based on actual costs of production and prices based on standard costs. Each method could be divided into sub-methods such as variable cost, variable cost plus markup, full cost, and full cost plus markup.

Using markups to be added to the cost are determined according to one or more of the following factors:

a) the volume of the operations performed by the intermediary and the risks undertaken,

b) whether the onward sale is affected bby the attachment of any form of intellectual property, such as trad mark,

c) whether the intermediary had the exclusive right to resell the goods, and

d) comparable mark-ups in transactions with unrelated parties.

Cost-based methods of transfer pricing, according to the survey of the National Industrial Conference Board (1967, p.6), are used most in practice, and the reasons for this popularity, also according to the survey were (Ibid, pp.6-7):

1- The selling (transferor) unit is considered a cost centre rather than a profit centre.

2- Emphasis is on the profitability of products rather than on profits earned by operational units. To better evaluate product profitability, executives contend that product costs should reflect, or approximate, actual costs incurred in their production and distribution, undisturbed by the inclusion of interdivisional profits.

3- Management's desire to achieve better utilisation of company facilities to avoid incurring idle plant cost.

4- Sometimes the amounts involved in interdivisional transfers are so insignificant that the company's management does not consider it worthwhile to bother with the complications of market-based transfer prices, regardless of any other considerations.

In fact, cost-based transfer pricing is subject to some criticisms. In the first place, the difficulty of allocating fixed and variable costs to products, because the costs are time- and volume-dependent. In the second place, including contribution margin for profits in the calculations can hide inefficiencies in the transferor centre and this will

be passed on to the receiving centre. A third disadvantage of transfer pricing at cost is neglecting the opportunity cost. A fourth disadvantage, is that receiving centres will not be motivated to use cost plus basis to make rationalisation in the manufacturing process, because they thereby decrease their own profits in absolute terms.

### 2.7.2 Market-Based Transfer Prices

For goods that are traded both internally and externally, the market prices of the external transactions are often the basis of the transfer price. When the selling profit centre can sell internally and externally, outside customers represent the opportunity cost of having to trade with internal customers. The use of market prices is consistent with the concept of operating entities as decentralised profit centres.

Top management and executive managements can be involved in setting transfer prices. Managers of transferor centres and transferee centres more frequently negotiate the transfer price according to some corporate policy guidelines. The role of top management is often low although they may intervene in the case of any disputes between departments.

Market-based prices can be used by internal centres without any adjustments, i.e., the **prevailing price** in the market or so called "arm's-length price". The receiving centre might refuse to accept this price, preferring to buy from external vendors. Therefore, in order to motivate it to buy internally, the market price is adjusted downward by the amount of cost the supplying centre avoids by selling internally. Such costs include selling expenses, freight, advertising, and bad debt expenses. The applied price in this case is called an **adjusted market price**. The advantage of this price is that it encourages internal sales.

When the market is perfectly competitive, the prevailing market price (arm's-length price) represents an ideal basis for setting transfer prices. It allows the transfer of intermediate goods between departments while accurately reflecting the performance of departments and preserving their autonomy.

Moreover, this price is most acceptable to tax authorities and most likely to be the appropriate basis to MN subsidiaries, but this depends upon variables not easily controlled, and market conditions.

Using the market-basis to set transfer prices is not always a simple process, particularly when volumes of intra-company transfers are extremely large or differ in some way from the products sold externally. The amount of internal transfers is often large when a vertical integration strategy exists. When the transferor unit is one of the

largest producers in its industry and the transferee unit is one of its largest customers, there may be no external sales of equivalent volume for comparison.

In short, transfer pricing methods can be partitioned into cost-based and market-based. The cost-based methods are widely used in practice in both domestic and MN companies. They are considered easy to implement and can serve various purposes in most domestic companies. However, objectives such as profit maximisation and optimal resource allocation seem hard to achieve with these transfer pricing policies in the MN context. On the other hand, the market-based method is favoured as it serves different purposes inside and outside the firm. However it is not easy to get arm's-length prices.

### 2.8 Summary

The need for a transfer pricing system arises from the desire to measure where 'the value is being added' in the business process. Transfer pricing is usually a highly contentious issue because it affects the relative profit contribution of various business units and so reflects on the perceived ability of the relevant managers, with managers of profitable business units being thought to be superior to those who are managing less profitable units.

The transfer pricing problem will remain as long as top management seeks to decentralise operations and use a single tool to communicate, motivate, direct, and evaluate. Top management should decide what the transfer pricing mechanism should accomplish and use the method that best fills its needs. However, the transfer pricing mechanism cannot be used effectively for more than one objective. In fact, the transfer price should not be the sole, or even a major, determinant in performance evaluation since so many other factors (i.e., cost efficiency, total product performance, and other subjective measures) are important in determining managerial effectiveness and efficiency.

From the findings of the previous studies one can sense a growing awareness of transfer pricing problems among many researchers. Even though they provide more disagreements than agreements on specific issues, these studies do contribute to a better understanding of transfer pricing policies. The significance of these studies sheds some light on the importance of the transfer pricing problem that exists in most companies.[5]

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[5] In Vancil study (1979), 249 of the 291 companies in his sample (85%) are confronted by the transfer pricing problem. Also, Tang (1979) found that 91% of 121 American companies used transfer pricing.

Some studies regarded a transfer pricing system as a subset of the overall management control system of a company. Therefore, according to this view, for a transfer pricing system to be effective, its purpose should be compatible with corporate objectives, and its operating procedures must be compatible with other control techniques used in the company.

No one method of transfer pricing can effectively satisfy all the informational requirements of a decentralised firm. The "best" transfer price can be defined only as being "best" for a particular purpose.

# Chapter 3

# Dimensions of Transfer Pricing Problems in the International Context

## 3.1 Introduction

International expansion through foreign direct investment (FDI) is an alternative to growth focused on the company's domestic market. As a result of the enlargement of business activities, which has taken place over the last three decades outside their national boundaries through controlled entities in other nations, the term of "Multinational" emerged .

MNCs invest outside their inland borders to take advantage of economic differences, such as taxation differences, financial market differences, differences in product costs, and differences in selling prices in different markets. Also, the firm invests directly in a given country to avoid governmental restrictions on market access such as tariffs and quotas and the problems of currency variation[1]. For instances, the growth in protectionism by the European community (EC) and the rising of Japanese Yen, has been an important factor leading to increased Japanese investment in the EC. By the same token, companies may be able to benefit from the availability of grants and other subsidies given by host governments to encourage inward investment. When the FDI takes place, the MNC can avoid various transaction costs (i.e., the costs of finding suppliers of inputs and distributors and negotiating contracts with them. The main strategy of MNCs is to produce in the lowest cost production countries and sell in the countries where selling prices are highest (AAA, 1973, p.131).

Continuous reciprocal transactions take place between the MNC and its subsidiaries which include tangible and intangible assets, services. The U.S. section 482 regulations partition intra-company transactions into five categories: (1) loans and advances, (2) the performance of services (3) the use of tangible property, (4) the transfer or use of intangible property and (5) the transfer of tangible property.

With the growth of intra-company transactions, transfer pricing issues have become increasingly important to MNCs, and both home and host countries. Generally, developing a transfer pricing system in the international milieu does not vary compared to its domestic counterpart. However, the problem of transfer pricing in the

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1 For more details about reasons that MNCs invest and grow see Levi (1990, pp.392-397).

international context is more sophisticated and an extremely sensitive and confidential issue. Providing a reasonable measure of a subsidiary's economic performance is often irrelevant to the objectives of MN transfer pricing strategy. A MN pricing system must attempt to meet the objectives of the strategic plan, the management control system, and the system of performance evaluation. So, transfer pricing has indeed become a planning issue for all MNCs. Sensitivity to issues raised and the compliance requirements, may produce significant tax savings and reduce administrative burdens. Failure to address these issues, however, may be costly and severely troublesome for the MNC. This is due the existence of external dimensions in two state-nations at least (host and home countries). In addition there is the increasing concern about transfer prices by other parties both inside and outside the MNC.

Many writers have shown that the difference between the MNC and other possible forms of the firm is its unique ability to transfer funds internationally. As Lall (1983, p.111) mentioned:

> The fact that a transaction involving a transfer or sale of goods takes place within a firm, regardless of whether or not the firm spans different countries, and the firm is free within broad limits to assign whatever price it likes to those goods, means that the traditional theory of pricing in competitive, oligopolistic or monopolistic markets ceases to apply to the process of transfer-pricing. The essential difference is simply that in transactions on the open market or between unrelated firms, the buyers and sellers are trying to maximise their profits at each other's expense, while in an intra-firm transaction the price is merely an accounting device and the two parties are trying to maximise joint profits. It is possible that the accounting price may approximate the arm's length price of the goods ......, but certainly adhere is no presumption that this should be so: any other price is equally plausible .....

It will be to the advantage of the MNC to transfer as much income as possible to subsidiaries for whom the law and regulations offer privileged status and who are therefore taxed at lower rates. The flexibility of MNCs to shift resources across national frontiers has increased greatly over the last two decades (Cavanagh and Clairmonte, 1982) This manoeuvrability expands the companies' economic power, as they can move readily to the most profitable areas. Naturally, the principal objective of MNCs is to maximise their world-wide net profits rather than profits of any given subsidiary (Copithorne, 1971; Diewert, 1971; Horst, 1972; and Eden, 1985). Plasschaert (1980, p.1) mentions that the transfer price has acquired bad meaning because it "evokes the idea of systematic manipulation of prices in order to reduce profits artificially cause losses, avoid taxes or duties in a specific country". This means the company prefers to repatriate profits via transfer pricing technique rather than a dividend (Which migh be subject to withholding taxes). Usually, a dispute

emerges between MNCs and fiscal authorities about what transfer prices should be. This chapter devotes to discuss the following points:

1- The significant role of MNCs in the Global Economy.
2- Transfer pricing conflicts.
3- Some evidence of transfer pricing manoeuvres.
4- Factors influencing transfer pricing dermination.
5- The cost of technology and transfer prices.
6- Restrictions on the ability to manipulate transfer prices.
7- International co-operation and exchange of information.

### 3.2 The Significant Role of MNCs in the Global Economy

Once a corporation establishes a production facility abroad, its international operations take on new meaning. The corporation is regarded a Multinational. As the MNC is an important concept in this study, a definition is made here.

For the purpose of this study, a MNC is defined here as a corporation which exerts its activities through wholly or partially owned subsidiaries or affiliated divisions, in at least one foreign country.

One of the most significant features of the contemporary world system has been the tendency towards FDI by MNCs. Generally, the significant role of MNCs has increased in the global economy, notably in developing nations. Jacoby (1973, p.50) regards the MNCs as "the most powerful agency for regional and global economic unity that our century produced". In a sense the successful MNC "acquires more power than any single government on earth" (Evans, 1990 p.237).

Some factors have greatly encouraged MNCs to proliferate and expand. Firstly, there has been a huge expansion in world demand for existing, improved and new goods and services. The second factor that encouraging the rise of MNC activity has been the liberalisation of trade in goods and services (until the late 1970s) and more recently money, mainly between the developed countries but also, to a much lesser extent, between them and developing countries. Thirdly, technological innovation by large enterprises, has greatly reinforced their internationalisation capabilities. In other word, innovation enables some MNCs to expand and utilise advantages of production when costs are lower. The 1980s appear to be witnessing the emergence of new MNCs and the link-ups of existing MNCs, to penetrate and to internationalise R&D in a number of high technology fields.

Perhaps the best way to gain an appreciation for the importance of MNCs is to examine Table 3.1. The table exhibits the 50 largest industrial MNCs ranked by size of sales in 1990. It shows also profits, assets, and number of employees for the same period. Many of the world's largest companies listed in the table are larger economically than most of their host nations. Of the 50 firms listed, 22 are headquartered in Western Europe, 16 in the United States, 9 in Japan, 2 in South Korea, and one in Venezuela.

The size of MNCs has increased greatly over the last three decades. Revenues of the top 500 largest companies totalled $5 trillion, while profits amounted to $178,349 million (Fortune, 1991, p.103). Some MNCs operate in many countries, for instance, General Motor has operations in 46 host countries (over 500 subsidiaries), and IBM operates in 49 nations (Who Owns Whom, 1991). As a matter of fact, MNCs account for roughly a quarter of the gross international production.

Most of these large MNCs are household names: General Motors, Royal Dutch/Shell Group, Exxon, Nestlé, Hitachi, Ford, British Petroleum, Toyota Motor, Toshiba, Peugeot, Hoechst, NEC, Sony, Xerox, and Pepsico. MNCs have achieved their globalisation of production by means of joint ventures, licensing and sub-contracting agreement, and taking advantage of the burgeoning free trade and export processing zones. Industries differ greatly in the extent to which foreign operations are of importance to them. For instance, the oil companies and banks are far more heavily involved overseas than are packaged food companies.

MNCs play a great role in dominating the production sector in many developed countries. For instance, at the end of the seventies they wielded 25% of the industrial sector in the U.K., West Germany, France, and Italy. Even in some developing nations, the percentage was very considerable, for example, it was 44% in Brazil and 43% in Columbia (Heininger, 1987, p.352). This means that MNCs "exude an aura of strength and flexibility" (Vernon, 1971, p.4).

Some questions have being asked concerning the potential costs and benefits of FDI for home and host countries. There is no doubt that MNCs have helped to develop the economic structure and promote the economic growth of the host country. In addition to having contributed to a more integrated world economy. They provide scarce capital, technology and know-how and in some cases they provide the access to export markets. The role of FDI has been seen as technology transfer. Technology transfer involves not only the introduction of new hardware to the market, but also the techniques and skills to operate it. This leads to improving the balance of payments of

the country as a result of increasing exports[2] and declining imports. MNCs have various reasons for becoming more important. A more positive view towards the contribution of MNCs to industrial development has been expressed by Lewis (1955, p.258):

> Domestic income increases because the undertaking pays wages and salaries to local people, buys local supplies, and pays local taxes; and these payments not only increase consumption, thereby stimulating local production, but also make it possible to have larger local savings, and also to spend on schools, medical services, and other permanent improvement. If the choice is between local capital and foreign capital the advantage may be with the former, but if, as is more often the case, the choice lies between foreign capital or leaving resources undeveloped, then there is little doubt that foreign investment plays a most useful role in providing income to pay for higher standards of consumption, of education, and of domestic investment.

Jobs are often the most obvious reason to cheer about FDI. The benefits reach far beyond employment. Salaries paid by MNCs are usually higher than those paid by domestic companies. The creation of Jobs translates also into the training and development of a skilled workforce. In most cases, MN hotel chains have been instrumental in establishing a pool of trained hospitality workers and managers. The size of direct employment by the 500 largest MNCs was 25 million in 1990 (Fortune, 1991, p.103). All MNCs had 65 million workers, which equalled 3% of world employment in 1984. Of this, 65 million, approximately, 43 million are in the home countries and 22 million are employed abroad, (of which almost one third are in developing countries). This share is impressive in view of the fact that only one quarter of the FDI flows go to developing nations[3] (Kreye *et al.* 1988, pp.4-5).

In fact, the role of MNCs might be passive in many practices, notably in transferring technology and in intra-group pricing. With regard to the transfer of technology, MNCs, at least in manufacturing, might transfer older technologies to host developing countries. They might also exaggerate the value of technology in such a way that the host country has to pay higher royalties, technical fees and other costs. Regarding the transfer pricing aspect, the problem seems to be versatile, as companies use various transfer pricing policies in order to maximise global profits.

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2 It is remarkable that a MNC could export more than a national firm. This is due to the former has greater marketing network and can, sometimes, evade protections in other nations more effectively. About 30% of Argentinean manufacturing production came from MNCs in 1983. Also, 70% of manufacturing goods in Zimbabwe came from those companies. (Economist, U.K., 1988, vol. 309 (7578) November, p.103). Several countries also, such as Brazil, have imposed export requirements as a protection for FDI.

3 The size of employment in these sectors might constitute 6% of the World labour force. U.S. MNCs employed nearly 6.5 million employees abroad in 1984, 42% of these in Europe, 32% in developing nations, 14% in Canada, and 5% in Japan. In addition to this, MNCs have created employment in sectors that deal with them such as suppliers. (Economist, U.K. 1988, Vol. 309, No. 7578, November, p.103; Kreye *et al.* 1988, pp.4-5).

Table 3.2 summarizes the considerable positive and negative impacts of MNCs. In summary, arguments for and against FDI are endless. Costs and benefits must be taken into consideration.

Some writers defend MNCs (Pollio *et al.* 1988, p.115) when they use the transfer pricing device to achieve their goals. The dilemma is that the host country is in sovereign power to levy taxes and customs duties and apply restrictive regulations, which companies have to respond to. Therefore, the transfer pricing mechanism is, *inter alia*, a response by MNCs to achieve their targets.

### 3.3 Transfer Pricing Conflict

As mentioned at the outset of the chapter, all transactions taking place between related parties of a MNC fall under the transfer pricing issue. When transfers take place, they must be valued, i.e., transfer prices for these transactions are set. The transfer price is a substitute for the market price.

Logically, it is hypothesized that these prices should be set according to appropriate criteria, which, theoretically, are not prejudiced, to maintain the interests of MNCs on one hand, and the benefits of the host countries on the other hand.

The most important criterion when determining the price is to be true and fair. This could be applied in similar transactions between unrelated parties occurring in the market place; each negotiates the terms and conditions of the transaction to look after its own interests. The price in this case is reached by the "arm's- length" principle which normally involves profits. This price is generally an accepted standard used by fiscal authorities. Therefore, it is assumed that the company deals with its subsidiaries on this basis. From the MNC's point of view, setting transfer prices on an arm's-length basis depends on the dynamics of the market power and the targets which the MNC seeks to achieve (Hogg, 1983, p.54). It seems that transfer pricing manipulations occur most frequently in areas where international market price can not be obtained easily and when vertically integrated MNCs dominate a market. A MNC might prevaricate the transfer price by biasing it in order to shift more earnings, for certain reasons, from the host country to the home country or to another subsidiary located in a more lenient jurisdiction.

The parent, accordingly, will score advantages at the expense of the host country as well as the home country. This means that a MNC can maximise its earnings as much as possible regardless of the interests of the other groups or governments involved.

## Table 3.1
## The Fifty Largest Industrial MNCs, 1990

| Rank 1990 | Company | Nationality | Industry | Sales ($M) | Profits ($M) | Assets ($M) | Employees (Number) |
|---|---|---|---|---|---|---|---|
| 1 | General Motors | U.S. | Motor Vehicles | 125.126 | (1.986) | 180.237 | 761.400 |
| 2 | Royal Dutch/Shell | Neth/U.K. | Oil | 107.204 | 6.442 | 106.349 | 137.000 |
| 3 | Exxon | U.S. | Oil | 105.885 | 5.010 | 87.707 | 104.000 |
| 4 | Ford Motor | U.S. | Motor Vehicles | 98.275 | 860 | 173.663 | 370.400 |
| 5 | INT'L Business | U.S. | Computers* | 69.018 | 6.020 | 87.568 | 373.816 |
| 6 | Toyota Motor | Japan | Motor Vehicles | 64.516 | 2.993 | 55.340 | 96.849 |
| 7 | IRI | Italy | Metals | 61.433 | 927 | NA | 419.500 |
| 8 | British Petroleum | U.K. | Oil | 59.541 | 3.013 | 59.199 | 116.750 |
| 9 | Mobil | U.S. | Oil | 58.770 | 1.929 | 41.665 | 67.300 |
| 10 | General Electric | U.S. | Electronics | 58.414 | 4.303 | 153.884 | 298.000 |
| 11 | Daimler-Benz | Germany | Motor Vehicles | 54.259 | 1.042 | 44.983 | 376.785 |
| 12 | Hitachi | Japan | Electronics | 50.686 | 1.477 | 49.456 | 290.811 |
| 13 | Fiat | Italy | Motor Vehicles | 47.752 | 1.346 | 66.027 | 303.238 |
| 14 | Samsung | South Korea | Electronics | 45,042 | NA | NA | NA |
| 15 | Philip Morris | U.S. | Food | 44.323 | 3.540 | 46.569 | 168.000 |
| 16 | Volkswagen | Germany | Motor Vehicles | 43.710 | 652 | 41.892 | 268.744 |
| 17 | Matsushita | Japan | Electronics | 43.516 | 1.649 | 49.748 | 198.299 |
| 18 | ENI | Italy | Oil | 41.762 | 1.697 | 60.467 | 130.745 |
| 19 | Texaco | U.S. | Oil | 41.235 | 1.450 | 25.975 | 39.199 |
| 20 | Nissan Motor | Japan | Motor Vehicles | 40.217 | 808 | 36.402 | 129.546 |
| 21 | Unilever | UK/Neth | Food | 39.972 | 1,637 | 24.806 | 304.000 |
| 22 | E.I. Du Pont | U.S. | Chemicals | 39.839 | 2.310 | 38.128 | 143.961 |
| 23 | Chevron | U.S. | Oil | 39.262 | 2.157 | 35.089 | 54.208 |
| 24 | Siemens | Germany | Electronics | 39.228 | 913 | 41.148 | 373.000 |
| 25 | Nestlé | Switzerland | Food | 33.359 | 1.635 | 27.859 | 199.021 |
| 26 | Elf Aquitaine | France | Oil | 32.939 | 1.951 | 42.559 | 90.000 |
| 27 | Chrysler | U.S. | Motor Vehicles | 30.868 | 68 | 46.374 | 124.000 |
| 28 | Philips | Neth | Electronics | 30.866 | (2.328) | 30.548 | 272.800 |
| 29 | Toshiba | Japan | Electronics | 30.182 | 923 | 32.830 | 142.000 |

(continued)

## Table 3.1 (concluded)

| Rank 1990 | Company | Nationality | Industry | Sales ($M) | Profits ($M) | Assets ($M) | Employees (Number) |
|---|---|---|---|---|---|---|---|
| 30 | Renault | France | Motor Vehicles | 30,050 | 222 | 23,422 | 157,378 |
| 31 | Peugeot | France | Motor Vehicles | 29,380 | 1,700 | 22,652 | 159,000 |
| 32 | Basf | Germany | Chemicals | 29,184 | 685 | 24,552 | 134,647 |
| 33 | Amoco | U.S. | Oil | 28,277 | 1,913 | 32,209 | 54,524 |
| 34 | Hoechst | Germany | Chemicals | 27,750 | 927 | 22,839 | 172,890 |
| 35 | Asea Brown Boveri | Switzerland | Ind. & Farm Equip | 27,705 | 590 | 30,247 | 215,154 |
| 36 | Boeing | U.S. | Aerospace | 27,595 | 1,385 | 14,591 | 162,700 |
| 37 | Honda Motor | Japan | Motor Vehicles | 27,070 | 572 | 18,019 | 79,200 |
| 38 | Alcatel Alsthom | France | Electronics | 26,456 | 943 | 38,147 | 205,500 |
| 39 | Bayer | Germany | Chemicals | 26,059 | 1,164 | 25,349 | 171,000 |
| 40 | NEC | Japan | Electronics | 24,391 | 597 | 23,343 | 114,599 |
| 41 | Procter & Gamble | U.S. | Soap & Cosmetics | 24,376 | 1,602 | 18,487 | 88,800 |
| 42 | Total | France | Oil | 23,590 | 765 | 20,761 | 55,000 |
| 43 | Petroleos de Venezuela | Venezuela | Oil | 23,469 | 2,405 | 8,130 | 51883 |
| 44 | Imperial Chemical | U.K. | Chemicals | 23,348 | 1,196 | 29,826 | 132,100 |
| 45 | Daewoo | South Korea | Electronics | 22,260 | 122 | 31,555 | 85,831 |
| 46 | Occidental Petrol. | U.S. | Food | 21,947 | (1,695) | 19,743 | 55,400 |
| 47 | United Tech. | U.S. | Aerospace | 21,783 | 751 | 15,918 | 192,600 |
| 48 | Thyssen | Germany | Mining | 21,491 | 451 | 14,604 | 152,078 |
| 49 | Mitsubishi Electric | Japan | Electronics | 21,228 | 538 | 20,108 | 89,113 |
| 50 | Nippon Steel | Japan | Mining | 21,156 | 818 | 26,618 | 72,929 |

* Includes Office Equipment NA: Not available

*Source:* Excerpted from Fortune, July 29, 1991, No. 15.

**Table 3.2**

**Positive and Negative Effects of FDI on Host Countries**

**Positive Effects**

1- Capital formation

2- Technology and management skills

3- Regional and sectoral development

4- Internal competition and entrepreneurship

5- Balance of payments

6- Labour

**Negative Effects**

1- Industrial dominance

2- Technological dependence

3- Disturbance of economic plans

4- Cultural change

5- Interference by home government of MNCs

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*Source:* Czinkota *et al.* (1989).

On the other hand, there is a gradual realisation for home and host nations to protect their national interests. Host countries are becoming aware of the need to monitor and evaluate MNCs within their borders. Manipulting transfer prices has implications for the balance of trade, the balance of payments, and tax payments. The use of transfer pricing also distorts national statistics, in particular those relating to the value of trade flows, corporate profitability, and the value added. Parry (1980, p.193) indicates that: "With increasing realization of losses that occur with transfer pricing, host and home nations tend to scrutinize those intra-family transactions that can provide the means for exercising this and related monopoly power. However, when the MNC is able to set monopoly prices within the host nation, the MNC's share of any gains from foreign investment will be increased at the expense of host-country's gains. If monopoly and/or transfer pricing are coupled with other distortions which lead to inefficiency losses in the level of gains, then there may well be no net benefits for the host country".

Other significant not-governmental groups affected by transfer pricing are creditors, investors and trade unions. The creditors and investors must determine how much of a company's profit may have resulted from deflated transfer prices. Trade unions, on the other hand, need to know whether the profits are understated because of the use of artificial transfer prices. Briefly, many groups are affected by transfer pricing systems, but few have direct access to information about them.

When transfer pricing is used to syphon profits out, the repercussions will affect the national interests and, to some extent, the morale and initiatives of affiliated managers abroad tend to be adversely affected. They not only see their accounting result influenced by considerations beyond their control, but find also that inter-subsidiary performance comparisons are difficult (Nevhawser, 1986, p.181). Even the management of the parent company might find itself in a win situation, because the performance measurement and evaluation will be complex and might create more problems with regard to the efficiency and effectiveness of subsidiaries (Reuber *et al*, 1973, p.147). Despite this, a formidable barrage of incentives spur the MNC to shift earnings through pricing policies.

As a matter of fact, the issue of transfer prices is usually deemed as one of the most pivotal problems fomented by the activities of MNCs. Heininger (1987, p.353) describes the conflict by saying: "the situation is exacerbated by the fact that the corporations, because of their intra-firm production, price, and credit relations and their centralised pattern of decision-making, can effectively use economic instruments, such as transfer prices, to evade fully or at least partially government

control and influence". Therefore, transfer prices are a function of environmental powers.

### 3.4 Some Evidence of Transfer Pricing Manoeuvres

Several empirical studies have found evidence of manipulation of transfer prices. Before discussing the moves in transfer pricing manoeuvres, practical evidence can be shown to give significant importance to transfer pricing in the context of the international milieu.

Frequently, most evidence comes from developing countries "as tax differentials between origin and domestic destination countries are larger and tax administration is much laxer" (Adams and Whally, 1977, p.165). The pharmaceutical sector had the lion's share in manipulating transfer prices.

Some companies might exaggerate transfer prices indirectly by changing the ingredients of goods sent to subsidiaries. For instance, a study done by the Andean Group's commission, declared that U.S. pharmaceutical companies sent chemical ingredients to their subsidiaries in the Andean Group member countries under complex code names and with high values. The specialists in the group discovered that these chemicals were simple ingredients such as salt and ordinary inorganic chemicals which were being shipped for three to seven times their market price.

Another example of abusing transfer prices involves the Ford Motor Company. The company used to export its complete knock-down parts of passenger cars to its subsidiary in Mexico, at first on a full cost plus markup formula. Every time some parts were deleted from the shipping kit, only the variable cost of the deleted parts was deducted from the total cost. This means that the company could have recovered at least the fixed cost of the passenger car merely by shipping empty crates.

Some companies used to discriminate transfer prices between their subsidiaries. For instance, a MNC used to sell products to its subsidiary in Puerto Rico, a tax haven country, at a price of $2.5 per unit, while it sold the same product to another subsidiary in New York at a price of $12.5 per unit (UNCTAD, 1978, p.22). Another example happened in the U.K. in the 1970s,, where the Monopoly Commission discovered that the Hoffmann La Roche, the Siss drugs company, charged its U.K. subsidiary for the active ingaredient supplied in bulk at £370 per kilo for librium and £927 for valium. The Commission found that the same active ingredient could be bought from companies in Italy (where Roche's patents were not protected) for £9 and £20 per kilo respectively. Roche said it was not fair to look at the profitability of

individual drugs rather than the company as a whole, since it needed high profits from successful drugs to finance reserech for new ones. However, it refused to supply data for its worldwide activities. Some inquiries into Roche's pricing policies across Eurpoe were made, and the Inland Revenue re-examined its scrutiny of MN pricing policies. These cases declare that the price disparity takes place not only in developing countries but also in developed nations.

The above cases are now in history, but similar ones could still occur. In all cases there was apparently significant transfer pricing by MNCs, with a consequent transfer actual of returns out of the host country.

Recently, in the middle of 1990, the U.S. Congress has paid great attention to transfer pricing dodges as a means of tax avoidance by MNCs. The Congress asked to protect tax interests and a number of proposals have been submitted to increase taxes paid by those companies. The U.S. tax authorities called on some countries concerned like the U.K. and Germany to cooperate in a joint study (Financial Times, 1990, August, 1, No. 31214).

Briefly, since the volume of intra-company transactions is high world-wide, and the incentive to engage in transfer pricing abuses usually are greater in the developing nations than in the developed nations. And since the risk of detection, generally, is less in the former countries than in the latter ones, it would be an incentive for MNCs to make use of their opportunities to shift profits properly attributable from one jurisdiction to another one. Therefore, however great the problem of transfer pricing abuses is in developed countries, it is an even greater problem in the developing nations.

### 3.5 Factors Influencing Transfer Price Determination

Generally, both host nations and MNCs recognise that freedom from regulations and restraints is a strong inducement to investment. Unequivocal regulations and market freedom are trump cards. This means no discrimination on the basis of foreign investment versus domestic: everyone has the same rate of taxes, no exchange control and can repatriate or export profits. Moreover, if a country suffers from economic and social problems such as unemployment and balance of payments deficit it can subsidise capital grants to foreign investors, albeit indirectly. For example, exemption of foreign investment from income taxes.

The actual picture is different, both host and home countries tend to maximise their welfare from the foreign investment. So, restrictive regulations could be imposed to

maximise their interests and to prevent MNCs from abusing them. By contrast, MNCs are driven by the profit motive, and react to any decision which affects this. In order to augment their benefits, they locate their accounting income either in the home country or in the host country where income burdens are lower.

Therefore, the purpose of this section is to draw attention, in detail, to the factors which have greatest influence in formulating the international transfer prices. There are national differences in the relative importance attached to environmental variables when formulating guidelines for transfer prices. These differences are summarised in Table 3.3. Arpan (1991, pp.502-503) studied the intra-company pricing system of 60 foreign-based MNC and concluded the following:

1- U.S., French, British, and Japanese managements seem to prefer cost-based transfer prices, while Canadian, Italian, and Scandinavian managers prefer market-based transfer prices. German, Belgian, Swiss, and Dutch managements did not have a particular preference for cost or market.

2- U.S., Canadian, French, and Italian MNCs considered income taxes the most important variable affecting transfer pricing methodology, while British firms considered improving the financial appearance of their U.S. subsidiaries as most important. With the exception of Scandinavian managers, inflation was identified as an important variable.

3- In contrast to external influences such as those just mentioned, non-U.S. MNCs reportedly consider only about half as many internal parameters as their American counterparts do. With the exception of the British, most firms under consideration, viewed transfer pricing more as a means of controlling subsidiary operations than as a technique for motivating and evaluating subsidiary performance. This is largely explained by the fact that the profit centre concept is not very widespread among non-U.S. companies. Aside from control, the other major consideration deemed important by all companies was the acceptability of transfer prices to both host and parent governments.

Jane Burns (1983) classified, in her survey, fourteen variables that affect transfer pricing decisions. These variables, in order of mean ranking, are shown in Table 3.4. She also conducted a factor analysis for these variables, and the resulting five most significant groups were as follows:

1- Internal foreign environment (competition and market conditions in the foreign state).

2- Influence on cash flows (management cash flows, exchange controls, floating exchange rates, and U.S. export incentives).

3- Artificial barriers (import restrictions, customs duties, price control, and exchange controls).

## Table 3.3

## National Differences in Relative Importance Given to Variables in Transfer Price Determination

| Aspect | Parent's Nationality | | | | | | |
|---|---|---|---|---|---|---|---|
| | U.K | France | Germany | U.S. | Canada | Scandi-navian | Italy |
| Income tax | 3 | 1 | 3 | 1 | 1 | 3 | 1 |
| Customs duties | 3 | 2 | 3 | 2 | 2 | 3 | 3 |
| Inflation | 2 | 2 | 2 | 1 | 2 | 3 | 2 |
| Floating exchange rates | 2 | 2 | 2 | 3 | 3 | 3 | 3 |
| Competition | 3 | 2 | 3 | 4 | 2 | 3 | 2 |
| Expropriation | 5 | 5 | 5 | 3 | 3 | 5 | 5 |
| Improving financial position of the affiliates | 1 | 3 | 4 | 3 | 3 | 4 | 4 |
| Exchange control | 5 | 5 | 5 | 2 | 3 | 5 | 5 |
| Export incentives & tax credit | 2 | 2 | 4 | 4 | 2 | 4 | 2 |

**Weighting Scales**

**1** = high importance; **2** = medium importance;

3 = low importance; **4** = not mentioned;

5 = mentioned only with respect to non-U.S. operations.

Source: Arpan, Jefery S. (1991, p.101).

Table 3.4

**Rank Order of Influence of 14 Variables in Transfer Pricing Decisions**

| Rank | Variable | Mean Ranking* | Standard Deviation |
|---|---|---|---|
| 1 | Market conditions in the foreign country | 2.15 | .872 |
| 2 | Competition in the foreign country | 2.26 | .964 |
| 3 | Reasonable profit for foreign affiliate | 2.31 | .975 |
| 4 | U.S. federal income taxes | 2.57 | 1.190 |
| 5 | Economic conditions in the foreign country | 2.61 | 1.037 |
| 6 | Import restriction | 2.62 | .986 |
| 7 | Customs duties | 2.70 | .937 |
| 8 | Price control | 2.80 | .997 |
| 9 | Taxation in the foreign country | 2.84 | 1.143 |
| 10 | Exchange controls | 2.92 | .954 |
| 11 | U.S. export incentives | 3.10 | 1.121 |
| 12 | Floating exchange rates | 3.16 | .916 |
| 13 | Management of cash flow | 3.20 | .928 |
| 14 | Other U.S. federal taxes | 3.64 | .876 |

* The mean of each variable is based on a scale of 1= strongly agree through to 5= strongly disagree.

*Source:* Burns, Jane (1983, p.438).

4- Taxes (U.S. federal income taxes, taxation in the foreign nation, and other U.S. federal taxes).

5- Economic structure (economic conditions in the foreign nation, and U.S. export incentives).

It is clear that factors affecting transfer prices could be permanent, such as customs duties and taxes, or transitory like import controls. When a company formulates its transfer prices it must bear in mind permanent variables that prevail in the long-run. If the company gives interest to the short-run factors, transfer prices will not satisfy the objectives that a MNC seeks. Besides, continuous changing of transfer prices may arouse the curiosity of the competent government authorities to scrutinise transfer prices.

Variables that affect MN transfer pricing strategies can be identified under the following groups:

1- Market and economic conditions.

2- Legal and regulatory considerations.

3- Political and social considerations.

4- Other factors relating to covering losses in one centre of business, antidumping laws, augmenting fixed costs, restrictions by host governments, and winning host-country government approval through minimising conflicts with it and being a good corporate citizen.

It should be noticed that it is unlikely that a MNC will be able to accomplish all objectives with a single transfer pricing strategy. Strategies may vary as environmental variables change. Transfer prices may be designed arbitrarily after world-wide priorities have been determined. Priorities usually include minimisation of world-wide income taxes and import duties.

These issues give a fairly adequate account of situations which induce MNCs to indulge in transfer prices. It should be recognised that incentives to abuse transfer prices depend upon the conditions prevailing in each country. Furthermore, when a MNC takes an action to exploit a particular incentive will depend upon what the objective is. For instance, if the company's objective is to reduce taxes and other payments to the host government, the company will abuse transfer prices to raise profits in those nations where tax rates are low. The following will provide a discussion of the most important factors in detail.

### 3.5.1 Market and Economic Considerations

This category involves the extent of the market and competition in the host country, reasonable profits for subsidiaries, the rate of inflation, restrictions on capital flow, repatriation of earnings, and exchange risks.

These determinants are important in so far as they have a critical impact on the overall profitability and the expected return on investment. Hence, they represent a major consideration in making international investment and resource allocation decisions.

#### 3.5.1.1 Market Conditions and Degree of Competition

The ability of any firm to generate revenues and consequently achieving profits depends upon, *inter alia*, the extent that its products dominate in the market and the intensity of competition. When a company sets its strategic targets, it has to bear in mind how to invade the market. This implies that a MNC must develop a global strategy in addition to several national markets in sourcing patterns, pricing strategies, product designs, technology, successful management systems and financing.

Competitive pressures are particularly important where a new product, sales outlet, or pricing strategy is to be employed. If the project is going to have a significant impact on the market, it should be assumed that competitors will react if possible. How they react and how quickly may well be difficult to estimate and quantify. So, this factor must be considered and documented in the investment decision.

Supposing these patterns are equal between similar firms, the strategy of pricing could have a decisive influence in this matter, i.e., if a MNC derives a competitive advantage over existing rivals to discourage potential competitors from entering the market, it may tend to reduce the final prices of its products in a certain consumer market, even if it has to sell at a loss in order to gain access to the market (Hood and Young, 1987, p.107).

Reducing prices could affect the subsidiary's profit. Therefore, the parent could exercise a transfer pricing gambit to underprice inputs to the subsidiary in order to bolster the competitive position of the subsidiary or stab the position of rivals. Research has shown that MNCs regard the competition and market conditions as a very important factor in the use of transfer pricing, even more than income tax (see Table 3.4). If the MNC holds an influential market position, nationally and globally, and at the same time, the size of intra-firm transfers is large, it is probable that the

MNC will adopt policies which aim at maximising net profits rather than those of particular units (UNCTAD, 1978, p.6).

Despite the advantages that might be gained from using a subsidies policy, there are some dangers in this issue. A government may express greater concern over the problem of antidumping by the MNCs to protect the local industry. Local rivals might take a revengeful action against these companies.

### 3.5.1.2 Exchange Risk

A country that suffers from instability of exchange rates or whose monetary system has collapsed as a result of decreasing the value of its currency may tend to devalue its currency to express the real value.

MNCs face exchange risk as a result of the impact of the changes of exchange rates on their operations. In other meaning, exchange risks occur when a MNC has assets in a foreign currency, or, conversely, liabilities which are dominated in foreign currency and "whose values in terms of domestic currency decrease following a shift in the exchange rate between the two countries" (ICMA, 1981, p.13). The holder of a foreign currency asset gains if the local currency devalues under fixed-rate or floating rate systems.

A MNC normally becomes liable to potential gains and losses due to changes in the values of its assets and liabilities that are dominated in foreign currencies. A MNC should manage exchange risk in order to shelter corporate profits from the negative impact of exchange rate fluctuations, also to benefit from exchange exposure management.

Clearly, the problem emerges in the consolidation of the accounts of MNC and its subsidiaries, when the latter accounts are prepared in a local currency. Hence, when they are translated to the parent country's currency, exchange losses can appear. So, the risk here is called an accounting risk because it is derived from attempts to value foreign subsidiary firms in terms of the balance sheet currency of the parent company.

But, what is the role of transfer pricing to diminish risks for the MNC? It should be stressed that a change in the price does not, in itself, affect exchange risks. The role of transfer pricing could be significant if the devaluation or revaluation is expected. For example, when a devaluation is imminent, it is probable that a company will shift profits and cash funds out of a country via transfer pricing devices. If the devaluation tends to be a permanent feature, profits are likely to be kept at a minimum level. If a country revaluates its currency, the company is likely to apply the opposite.

### 3.5.1.3 Inflation Risk

Inflation is a complex phenomenon. The very fact is when inflation befalls a nation, especially within major industrial and trading nations, it tends to spill over and affect other countries. It is the major and stubborn crux for most developing countries as rates of inflation have escalated in the eighties, particularly in Latin American and some African countries.

Inflation is of major significance in FDI planning, control of foreign operations and in the reporting of results and financial position. There are some influences of inflation on investment opportunities and financial aspects of growing firms. This leads to erosion of capital resources.

Eiteman and Stonehill (1983, p.618) point out that a company might moderate the sharpness of inflation through increasing the sales price by "the sum of the increase in replacement cost of the item sold, plus the loss in real value of the monetary profit expected, plus the increased income taxes that result if actual book cost rather than replacement cost must be used in determining income tax liability". That means a company must lift the price, not only to meet the increase of production costs, but also it has to raise it more than the amount of inflation to face income tax computed on a historical basis. The extent that sale prices are lifted depends on the price elasticity.

The problem becomes more sophisticated, as it is likely that the increase of prices will not be met with favour by government authorities charged with the responsibility for lowering the inflation rate. Thus "a company frequently finds itself in the dilemma of having to accept a degree of decapitalization in order not to incur the wrath of the government" (Eiteman and Stonehill, 1983, p.621).

Hence, MNCs will be seeking to repatriate funds to a safer haven country using transfer pricing techniques. A question might arise when a company tends to syphon its funds off in the periods of withering inflation. How could a subsidiary exercise its activities with limited funds? Of course the reputation, name and size of assets of MNCs, may serve to give them easy access to local credit. For instance, in Grosse's study (1986, p.42), 80% of the 32 MNCs questioned, responded that they prefer intra-company loans to equity because loans guarantee repayment that is acceptable to host countries.

### 3.5.1.4 Restriction on Earnings Remittance

When a country invites foreign companies to exercise investment in its territorials, the latter bears in mind the extent of freedom of transformation of returns. Of course, these returns comprise distributed profits (dividends), interest, royalties, licensing fees, and capital. But many host developing nations express restrictions about the repatriation of returns, not to the extent of prohibiting it, but rather controlling it, so that it will not affect the balance of payments ferociously. Constraints on profit repatiation may deter investment.

The main reason for this restriction is to minimise the outflow of funds and to enhance progress towards the balance of payments. For instance, due to drastic economic difficulties facing Latin American countries, most of these countries impose restrictions on the profit extraction. The Andean countries restrict the outflow of income to 20% of net capital invested (Plasschaert, 1985, p.256; IMF, 1985, p.31). Companies rigourously restrict repatriation funds outside a country's boundaries (Grosse, 1986, p.33). In Argentina, the transmission of profit could be suspended during the periods of exchange restrictions and balance of payments deficit (Tang, 1979, p.83; and IMF, 1985, p.30). The restraint of profit movement is applied in Italy, where the profit remitted ceiling is 8% of net invested capital (Tang, Idem). In Egypt, there is no restriction for companies who wish to repatriate profits abroad.

This factor is very important for US-based MNCs, because of the sizable amount of dividends repatriated from their subsidiaries abroad. For instance, these companies earned $30 billion after-foreign-tax profits in 1984. Of this amount, $11.8 billion of dividends were repatriated to home companies (Hines and Hubbard, 1989). Therefore a MNC could infract restrictions imposed on the profit remittance by artificially high prices of goods transferred to the subsidiary, a high charge on services rendered, including overhead costs and fees of intangible assets and low transfer prices on purchasing goods from the subsidiary.

In summary, when MNCs face some problems on how to repatriate funds across national frontiers, the transfer pricing technique will be a back door way to achieve this target. The larger the number of products being shipped between subsidiaries, the greater is the degree of freedom the corporation has in repatriating its earnings abroad and in setting what look like 'reasonable' transfer prices.

### 3.5.2 Political and Social Pressures

Political factors can create a high degree or risk or uncertainty, alter the investment climate, and have a material effect on transfer pricing policies. Moreover, pressures

from trade unions for a larger share of declared profits might lead to using transfer pricing techniques to evade these demands.

### 3.5.2.1 Political Risk

The political risk is referred to as an unfavourable intervention of a host government in the affairs of the enterprises. The change of political events in a host country might affect the ability of corporations to continue their foreign investment. The political environment might make a country unattractive for MNCs and lead to outflow of capital from an unstable state to the perceived stability in other countries. Robock and Simmonds (1983, p.356) noted that the political risk in the international business exists in the following cases: "(1) When discontinuities occur in the business environment, (2) when they are difficult to anticipate, and (3) when they result from political changes". They also made a distinction between macropolitical risks, when politically motivated environmental changes affect foreign corporations, and micropolitical risks, when the changes affect only some foreign companies or industries or only foreign companies with specific characteristics.

No doubt, political instability has a great influence on the economic system of a country, e.g., price stability, interest rate and exchange rates. These in turn affect the operations of the MNC. The result is minimum levels of cash kept in the unstable country.

Scholars have studied MNC-host country conflicts of a non-economic nature. Recently, Fatemi *et al.* (1987) found that the political and social environment of the host country played a major role in the operations of MNCs, with the political aspects being the most important. Likewise, Korbin (1980) identified four prominent areas of potential concerns: political stability, foreign investment climate, profit remittance and exchange controls, and taxation.

Forms of political risk might be differentiated. The simplest form is that a political regime could require the use of local nationals in management positions and require social and economic welfare to be created by the company. The extremest form of political danger is a wealth deprivation (expropriation and nationalisation).

A study prepared for the Financial Executives Research Foundation diagnoses the following 12 political risk factors: radical change in government composition or policy, expropriation, nationalisation, attitude of opposition groups, probability of opposition-group takeover, attitude toward foreign investment, quality of government management, ownership requirements, anti-private sector influence, labour instability,

relationship with the company's home government, and relationship with neighbouring nations (Newman and Czechowicz, 1983, pp.15-16).

Worsening diplomatic relations between a host and home country increases the likelihood of political danger, at least, in the form of a national boycott of the company's products. Also, if the MNC strategy conflicts, to a large extent, with the national interests of the host country, the probability of political intervention by the latter increases.

MNCs need to plan protective steps in advance to minimise the probability of political danger that might be incurred. In this regard, manipulation of transfer prices may allow the MNC to shift profits out of the risky countries while protecting their corporate image. This result runs to the hypotheses that MNCs shift funds out of the unstable developing country to the more stable developed ones (Vaitsos, 1974, p.111).

Royalties and other fees might be inflated as well to diminish the size of funds in the subsidiary. It might be thought that charging high transfer prices on exports to a subsidiary leads to increasing taxable income in the home country, and paying more import duties in the host country. But at least "what remains after taxes is safe from expropriation and other foreign risks" (Shulman, 1967, p.71).

In countries where foreign investors fear nationalisation, they tend to exercise their activities through debt rather than equity; therefore, the loss will be minimum. Also, MNCs have increasingly become interested in projecting an image of a good citizen to protect against expropriation.

The MNC might also reduce risk by sacrificing a percentage of profits through joint ventures with local partners, but these may still be prone to the risk too. Bradley's study (1977) pointed out that, historically, joint ventures with local investors suffered only a 0.2% rate of nationalisation. Seemingly, the reason is that this creates an influential local voice to protest against the government spasm.

### 3.5.2.2 Social Pressures (Trade Unions)

Trade Unions are interested in enhancing the standard of living of employees. The level of wages and salaries, and job security are likely to be a major concern to this interest group.

This factor appears, manifestly, in developed countries more than in developing ones. Unions are politically and economically powerful in Britain and have an extremely adversarial relationship with management. Swedish unions are very powerful, sharing

management responsibility. Italian unions are primarily interested not only in negotiating better working conditions, working pace and hours, and standard of income, but also in the increasing need for improved housing, health transportation and educational opportunities (Simonetti, 1973, p.84). They have the right to scrutinise the accounting books of the firm to confirm whether the company's results support a rise in wages. German unions are more cooperative, but under the doctrine of code determination, have a say in some management decisions.[4]

These differences must be considered by a company prior to its decision whether and to what extent to set up its activity. On the other hand, a company could avoid any claims from trade unions to augment wages when the profit is high, via a transfer pricing device. An artificially low level of profits may be used by the company as a reason for evading these demands, or reduce the pressure from labour. Therefore, a high transfer pricing on intra-company transactions from the parent to its subsidiary, and vice versa, would be beneficial in this respect.

### 3.5.3 Legal and Regulatory Considerations

This set of considerations involves tax rate differentials, customs duties, import-export restrictions, price controls and joint ventures.

#### 3.5.3.1 Tax Considerations

It is frequently alleged that MNCs astutely use their transfer pricing system to maximise profits in low-tax countries and minimise them in high-tax ones. On the other hand, the protection of the domestic tax base is, of course, receiving an increasing amount of attention in many countries around the world.[5]

Differentials in tax rates between countries have an influence in setting transfer pricing strategies. To observe the difference, Table 3.5 identifies particular nations with both low and high rates of taxation. Tax rates on corporate income range from zero to 65%. Intuitively, if the tax rate is high then so will be the incentives for a MNC to evade paying taxes. A MNC could reduce its tax burden by charging higher transfer prices to parts in high-tax jurisdictions and thereby shift earnings to a low-tax environment. It is important to mention that as a result of these manipulations overall group pre-tax profits will remain the same, but net of tax profits will have increased. Such earning shifting may also be used for "dressing up" financial statements by

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4 It is authorised for trade unions in Germany to appoint a representative on the corporate board of directors.

5 A recent investigation for a committee of the House of Representatives in the U.S. has reported that 36 MNCs achieved total sales of $329 billion in 1977-87 but paid only taxes of $5 billion (Economist, 1990, July, vol. 316 (7664)).

increasing reported income in nations where borrowing and other financing are undertaken.

It is a common feature that most MNCs, especially U.S. ones, have over the last two decades become increasingly adept at planning their investment and financing activity in order to reduce tax obligations (Hines, 1987, p.4).

All other things equal, an obvious way to avoid taxes is to locate as much foreign income as possible in tax haven nations. So, it is not surprising to find that most MNCs have subsidiaries which act as tax havens for corporate funds awaiting a decision on re-investment or repatriation.

Tax haven countries are those in which the tax on foreign source income is either very low or nonexistent and the climate is hospitable to business. The governments of tax haven countries are presumably willing to sacrifice some potential tax revenue in return for the employment, technology, and capital that MNCs can provide, and in some case, more favourable access to financing local development.

**Table 3.5**

**Corporate Income Tax Rates for Particular Countries***

| **High tax rates** | | **Low tax rates** | |
|---|---|---|---|
| **Nation** | **Tax Rate(%)** | **Nation** | **Tax Rate (%)** |
| India | 65% | Bahamas | Null |
| Papua New Guinea | 58% | Bolivia | 2.5% |
| Gabon | 50% | Ireland | 10% |
| Germany | 46% | Hong Kong | 16.5% |
| France | 42%** | Norway | 23% |
| Australia | 39% | U.S. | 28% |
| Mexico | 35% | Egypt | 32% |

* The tax rates shown in this table are derived from a "Corporate Tax: A Worldwide Summary" (1990) by Price Waterhouse. They should be considered as indicative only and represent the best information available at the time of writing.

** The tax rate on undistributed profits is 37%.

Of course, levying new taxes has a conspicuous effect on investment flight outside a country's barriers. For instance, when the German government announced that it was to impose a 10% withholding tax on most savings and investments from the beginning

of 1989, the threat of this tax led to an unprecedented flight of capital from Germany, with DM60 billion leaving the country in the first six months of 1988 (Simonian, 1988).

There are three contradictory viewpoints with respect to taxation between the host country, the home country and the MNC. The host country endeavours to maximise its tax revenues to develop its financial resources. The home country's viewpoint as to foreign investment is to acquire earnings after paying foreign taxes equal to the pre-tax earnings at home. But any MNC, as it puts its self-interest to maximise its investment, focuses its efforts on minimising its tax burden, at least by equalising post tax income between the two nations. Hence, it manages its financial flows to maximise after tax global profits. The consequence is a bargaining situation.

Using a transfer pricing device to change the reported profit between the MNC family is possible, particularly, in the absence of comparable market prices and if the transfer pricing modification is not observed by fiscal authorities in the host country. Even in case of regulating transfer prices by law, MNCs are able to abuse them to evade paying income tax. For instance, however the U.S. legislations regulate transfer pricing methods which should be applied for intra-company exchanges, the government alleged that underpayment amounted to approximately $50 billion for the first half year of 1990. The IRS statistics show while the FDI in the U.S. have tripled and income has doubled, tax payments have not been changed. The IRS accused notably Japanese MNCs of abusing transfer prices to avoid taxes (Paul el at. 1990, p.26).

On the other hand, there is a significant disparity between the tax accounting methods adopted by various countries of the world[6]. Therefore, even if tax rates are the same, or not considerably different, the MNC will still be induced to change transfer prices. Also, tax rates variance is not an absolute factor to syphon off income from a high rate country to a low rate country because of the method that each tax authority applies to compute the taxable income. One country may consider an expense or item of income fully acceptable in computing taxable income. However, for one reason or another, the same item of expense or income may not be recognized by another nation in which the MNC is conducting business. For instance, one country agrees to deduct some types of costs from the taxable income such as depreciation allowances, interest and royalty and technical assistance fees, or agrees to deduct some revenues from the taxable income like capital gains. In contrast, legislations in another country may not recognise these expenses for tax purposes.

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6 For more details about these differences, see Nobes and Parker, 1985, ch. 15).

Nevertheless, the tax factor is of significant importance to the MNC in developing transfer pricing system. For example, the tax administration in many countries collected considerable amounts of additional taxes as a result of transfer price scrutiny in the last ten years (Sargent, 1987, p.23). Some empirical studies declared that the transfer price manipulation is "less useful than often believed as a means to avoid taxes" (Brooke and Remmers, 1970, p.176). On delving further into the same consequence, Arpan (1991, p.496) found that the greater vigilance of tax authorities towards transfer pricing scrutiny is less important for tax considerations in establishing intra-company prices. The reasons for this conduct are:

1- Differences in tax rates between countries which the parent and subsidiaries work are not large enough to manipulate transfer prices.
2- The extent to which tax administrations in the host country as well as the home nation audit transfer prices.

Another study carried out by Kim and Miller indicated that in the past, MNCs considered reducing income taxes as the most important objective in setting their transfer prices. Now, tax reduction is only a minor factor among many others, and the company's overall objective rather than income tax liability should be a major concern (1979, p.71).

In brief, differences in tax rates between nations stir MNCs to conduct operations so that high income accrues to firms in low tax countries, and vice versa, through artificial transfer prices. In other words, the more extensive the transfer prices, the smaller the income taxes paid by the company. Therefore, a kind of dispute emerges between MNCs and revenue collecting authorities.

### 3.5.3.2 Customs Duties Considerations

Customs duties or tariffs affect the competitiveness of a company by increasing costs and reducing profit margins[7]. Tariff schedules of imported goods notably vary from country to another, even the application of these schedules often varies within the country of origin of the imported goods.

The customs area usually coincides with national political boundaries. Most countries impose customs duties (mainly on imports) to develop their financial revenues, exercise control over foreign trade, and protect national industries against foreign competition and dumping policies. For this reason, duties seem to be relatively high in developing countries when compared with developed countries.

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7 Two of the better discussion can be found in Horst (1971) and Lall (1983).

Frequently, customs duties are set as a percentage of import values. Therefore, customs authorities benefit when the value of goods imported is high. Of course, tariffs affect the competitiveness of an enterprise by increasing costs and decreasing the accounting profit. Hence, the enterprise would attempt to set as low transfer prices as possible, with the optimal price being zero. This means the company could mitigate the effect of paying high tariffs through underpricing transfers.

If the customs administration reveals that prices of goods are faked, it would insist on charging the tariff on another price. This could be a market price or even a fictitious price which is higher than the invoice price. Hence, a perpetual contest, between the MNC and the customs department, will be focused on what is the fair price to be used to determine customs duties and meet requirements of each party. In most situations, the customs administration succeeds in applying its estimates. The reason might be the company takes into consideration that slow negotiation leads to a delay in the entry of goods and hence production operations might be affected.

There is some evidence of the manipulation of transfer prices for the purpose of decreasing the burden of customs duties and income tax. For instance, a company attempted to reduce these in Belgium, as an importing country, and reduce the income tax in two exporting countries. Hence, it sent the same goods to Belgium at different prices, this however attracted the attention of the two authorities there. The result was a review of price practices, which led to a change in pricing policies and a huge amount of taxes being paid by the company. This procedure drew the attention of other countries that had subsidiaries for the same company and likewise cracked down on some exercises which the company used in pricing. Besides the additional amounts that the company had to pay, it suffered from the populace brunt.(Benke and Edwards, 1980, pp. 116-117)

Customs duties and income taxation often come to different decisions regarding to the value of goods. This is, principally, due to the different time of which the tax is assessed. Of course, customs duties are imposed on the value of goods at the time of their import, whilst the income tax is established at the time of realising net profit on selling goods. Therefore, when a MNC combines income tax and customs duties in order to maximise its profits, it might find a kind of conflict between them, i.e. low transfer prices reduce tariffs, but, on the other hand, raise the taxable income, and vice versa. The company needs to find a balance between charging very high transfer prices to minimise its income tax and charging very low transfer prices to lessen the amount of customs duties.

### 3.5.3.3 Joint Ventures (Existence of Shareholders)

MNCs might prefer to take majority equity stakes and full management control over joint ventures. The reason also for preferring 100% ownership might be based on financial concerns. For instance, the management of IBM believes that by relinquishing a portion of its ownership abroad, it would be setting a precedent for shared control with local partners. This practice would cost more than could possible be gained (Encarnation and Vachani, 1985). In some cases, IBM has withdrawn operations from a nation-state rather than agree to government demands for local ownership.

There is also a great relationship between technology intensity and the type of ownership. Companies exploiting their own technology prefer whole ventures in industries with high R&D spending, but companies acquiring technology prefer joint ownership (Gomes-Casseres, 1990, p.14). Moreover the relative size of the MNC could affect ownership preference.

The existence of local shareholders might also undesirable for a MNC because it could impede the investment policy of the company. Local partners, notably individuals, expect a quick return on their investments. On the other hand, the company might wish to accumulate capital or might not achieve profits in the short-run, for instance, if it works in the construction sector.

In addition to this point, local investors need information about the financial results to get a complete picture of the subsidiary activity. This means legal requirements for financial disclosure tend to be increased in the case of joint ventures. Disclosure of accounting results might harm the company by giving competitors knowledge about a kind of business that the MNC considers secret.

Many countries prohibit outright ownership, making joint ventures virtually the only vehicle for FDI. There is a popular feeling in many developing countries that there should be a national *presence* in all foreign controlled companies in order to exercise some control or to extract larger shares of rent or simply to acquire more information about the operation of the foreign company (Helleiner, 1989, p.1466).

Even when host governments do not impose restriction on foreign ownership, a MNC might prefer joint ownership for its own benefits. Local shareholders could provide the company with valuable information regarding the conditions of local markets and consumers' motives, so the company could easily penetrate the market. Also, local partners could well deal with the government authorities and might contribute useful technology and competent management. Hence, "joint ventures with an agency of the

host government are becoming more common" (Eiteman and Stonehill, 1983, p.322). Moreover, local partners might act with the MNC to "provide funds for accumulation abroad or for resale in the black market" (Lall, 1983, p.114). In view of these considerations, a MNC might bear in mind that it should select carefully the appropriate partner to reduce any trouble (Poynter, 1985, p.17). Also, when a MNC starts business in a new country where there are established rivals, a joint venture may be an effective way to acquire local expertise, but there may be significant costs to shared management.

Beyond the advantages and disadvantages of the joint venture, the existence of local shareholders encourages MNCs to use transfer pricing devices to penalise the joint venture. The MNC could manipulate transfer prices, so that it reaps the larger share of profits on the account of local partners. As the definition of transfer prices refers to payments for services.

In summary, existence of a joint venture as a base for foreign investment is likely to encourage the corporation to manipulate transfer prices to embezzle the greater share of earnings.

### 3.5.3.4 Import-Export Restrictions

Countries could ration imports for several reasons: hard currency shortage, protection of the local production, and in some cases of the balance of payments deficit. Therefore, they might regulate the foreign exchange and the size of imports of goods.

When the balance of payments is affected by a deterioration in economic health, the government could retain imports as a way to fill the gap between inflow and outflow. So, the parent might underprice the affiliate's imports.

On the other hand, if government restrictions on exchange do not give the freedom of the repatriation of monetary funds, a MNC would seek to syphon its funds off from that country to another way through high transfer prices.

### 3.5.3.5 Price Controls

From time to time, many countries might intervene to control final prices to protect its populace, as a whole, from an irksome exploitation. A company might tend to increase its prices, especially when the demand for its products is perfectly inelastic or it represents the only monopolist for a given product.

The government might valorise the price of final products or determine a given margin for profit to be added to the costs of production. In most conditions, the

government control of prices in an industry is relative to the costs and profits experienced by firms in that industry (Lecraw, 1985, p.228). For instance, the Belgian government determines the relationship between the market prices, cost, and hence profit ceilings. In this respect, the import cost must be 85% of the market price. In France, tax administrations determine a certain profit margin added to costs to extract the market prices (BIC, 1973, pp.47-48).

When a company is limited to price ceilings, some measures can be taken by the company to circumvent this restriction. The company could allocate the production to exports since exports are not likely to be subject to the price control. Similarly, import prices may be increased if the subsidiary is able to pass on its cost increases as higher prices. The parent will tend to overinvoice inputs exported to the subsidiary as a way to establish a higher cost basis, and hence, increase the profit margin above the level secured. It should be noted however that the resultant higher import duty payments, when applicable, need to be considered.

### 3.5.4 Some Other Determining Factors

A great number of various transfer pricing determinants could still be mentioned. This group includes winning host country government approval, legal constraints in the host country, and antidumping legislations.

#### 3.5.4.1 Winning Host-Country Government Approval

The manipulation of transfer prices for the purpose of repatriation of profits can be a politically sensitive problem. It is important that host government should not consider the profit rate too high, or else the MNC is likely to face accusation of price gouging and lose favour.

Consequently, a host government would be concerned about intra-company pricing and its effect on reported profits. In an era when a MNC must be concerned about justifying its existence, maintaining positive relations with the host government is a good idea. Continually changing and manipulating transfer prices is not good policy.

Most governments are becoming more sophisticated and aware of the results of using high or low transfer prices. Using unfavourable prices to a country's detriment may result in the loss of goodwill. It is beneficial in the long run to develop transfer pricing policies that satisfy the foreign authorities even though it may mean sacrificing some profits.

It is also possible that due to MNCs' monopoly patent rights, the company is making embarrassingly high profits as compared to the local firms and therefore feels compelled to reduce the book value of its profits by reporting higher costs.

### 3.5.4.2 Antidumping Legislations of Foreign Countries

Dumping occurs when an exporter sells a product in a foreign market at a price lower than that at which it is sold on his home markets. They aim at capturing domestic market shares at the expense of domestic industries. Some countries step up their measures against these companies and charge them with using predatory pricing.

Basically, when a country levies customs duties it aims, not only, at raising its revenues, but also at protecting local industries against the dumping of the excess production of foreign companies. Therefore, if dumping is proven, the firm may face a high tariff on its imports[8] or a fine (or both). The company has to raise prices charged on intermediate goods somewhat to outflank the accusation of dumping.

Anti monopoly legislations act the other way from antidumping. Anti monopoly occurs when one firm or a few firms dominate the market to the extent that final prices might be abused. In terms of the exercise of monopoly power, the MNCs may not wish to minimise apparent returns in the host country, either to avoid taxation of profits or maintain a good corporate image within the host country. Therefore the company has to decrease transfer prices of intermediate products to improve its picture within the host country.

### 3.5.4.3 Management Control and Performance Evaluation

The problem of management control and performance evaluation represents an internal factor when designing a transfer pricing system. The problem that arises is how does a MNC evaluate properly the profit performance of a foreign subsidiary manager whose operations show a loss when in fact it was the parent company executives who decided that the manager must buy at artificially high prices and sell at artificially low prices in order to shift profit to another subsidiary in a low-tax country? And how does a MNC compare the performance of two managers who operate under exactly opposite conditions and instructions?

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8 Some evidence for using this technique to transfer funds is mentioned in Robbins and Stobaugh (1974, pp.88-90). Also, more recently, countries that impose and subject to anti-dumping duties are mentioned in Financial Times, 24 July 1990, No. 31207.

One solution is to evaluate what a manager's performance would have been if the subsidiary had operated as an autonomous profit centre, that is, had all its internal transfers been at arm's-length prices or their equivalents.

MNCs may resort to maintaining a separate set of financial information for the foreign governments and another set for headquarters to use in the management control process and the performance evaluation system. Unfortunately, the information provided to the host government is all too often used to evaluate the performance of a subsidiary that has been programmed to produce a low profit to minimize income taxes. If headquarters overlooks the fact that low profits were due to an unfavourable transfer price, hard feelings between subsidiary managers and headquarters may result. It may also cause subsidiary managers to act undesirably and long-run morale problems could develop, destroying the short-run effect of tax minimisation.

Ideally the objectives of the management control process should be separated from those of MN transfer pricing. Headquarters must realise that the performance evaluation system should provide information that discriminates between subsidiary performance and world-wide corporate performance.

### 3.6 The Cost of Technology and Transfer Prices

The parent company often provides technical, managerial and administrative, and marketing services to its subsidiaries. Hence, not only are transfer prices applied to tangible transactions, but also intangibles. The area of intangible transfers has, in recent years, given rise to perhaps more controversy than any other.

Intangible assets have been considered a fundamental area of concern with respect to the relationship of developing countries with MNCs. The income earned of U.S. MN subsidiaries in developing nations contains nearly 35% of their total income (UNCTC, 1987, p.3). At the same time, investment income from transfers of technology rose by approximately 87% from 1977 to 1980 (Ibid).

As a matter of fact, charging for services and royalties is another sensitive area of intra-family pricing, because these fees are frequently much less acceptable to host governments. However, some writers point out that, in general, host countries stipulate 50% national ownership, but are lenient on transfers through royalty and fee payments for management and technical services. They do not consider such payments as repatriation of earnings, but it is often used as alternative method of profit shifting when other regulations are too restrictive. "Normally, these charges are

determined by the general economic conditions prevailing in the developing country and the attitude of the local government toward economic development" (Kim and Miller, 1979, p.74).

Using transfer pricing and royalty payments are not the only way for profit shifting outside a country, but other ways include using intra-company loans and intra-group services fees. These issues will be presented briefly as follows:

### 3.6.1 Intra-Company Loans

The OECD Report of 1979 determined the term "loan" between related parties is used in a broad sense and involves loans or advances of money. When a subsidiary obtains a loan from its parent company or any member of the group the interest on the loan can be abused to syphon off funds. This happens when there is an overcharge of intra-company interest paid by the subsidiary.

Syphoning funds in this way achieves two objectives, firstly accumulating funds outside the country, and secondly, minimising the taxable income of the subsidiary as the interest is deducted from it. Therefore, tax authorities of the host government are, out of necessity, much concerned with the rate of interest charged to the subsidiary. An arm's-length rate of interest for a loan between associated parties is the rate that would be charged in similar circumstances in a transaction between unrelated parties. Tax authorities might treat the excess amount above this arm's-length rate as a disguised profit distribution which should be subject to taxes generally applicable to dividends paid by the subsidiary to foreign shareholders.

### 3.6.2 Intra-Company Service Fees

These services cover industrial, marketing, administrative and management activities, and the like. When these services are to be carried out by the parent company or a specific subsidiary a search for a fair basis to allocate them is necessary. The considerations relating to the intra-company services present considerable difficulties as far as their evaluation is concerned. MNCs might use a different basis for the allocation of costs. The most frequent method that is used is "cost-sharing arrangement", that is allocating services fees among various subsidiaries in relation to the benefits that each of them may yield from the utilization. But an arbitrary and rough determination might be used by a MNC as a way to shift profits from one country to another. Another serious way to shift profits is through doubling these services by the parent company when it charges the subsidiary. This manoeuvre happens when it includes the cost of the services in the price of goods transferred to the subsidiary and at the same time charges the subsidiary separately.

There is a mutual relationship between charging these services and transfer prices. That is, a charge for intangible assets and management services might be used as a way to move funds from one country to another instead of transfer pricing devices for products. At the same time, if the host country legislations do not recognize services as items of cost which should be deducted from the taxable income, or the regulations prohibit these payments, transfer prices could be inflated to include these services.

The company should compare between shifting profits through transferring dividends or royalties. Some countries allow royalty payments after taxing them at a lower rate than dividends, or vice versa. But tax benefits from using the royalty technique might exceed than benefits from using exaggerated transfer prices (Grosse, 1986, p.37).

It should be noticed that some countries might restrict the level of royalties. Table 3.6 indicates tax restrictions on dividends and royalty payments which were implemented in some Latin American countries during the 1970s. Tax officials in host countries should give attention to the amounts of royalty and management services, ascertain that the subsidiary has benefited from these services and that the amount allocated is not excessive.

Of course, restrictions imposed on transfers of funds and royalties are likely to encourage disguised remittances through artificial transfer prices that would reduce the host country's share of income tax receipts. Also, this could be a major disincentive to new investment. Moreover, dividend remittances are sometimes subject to greater restrictions than interest payments on loans; this may encourage an excessive debt/equity leverage in the subsidiary's capital structure.

## 3.7 Restrictions on the Ability to Manipulate Transfer Prices

The foregoing discussion has reviewed variables that induce a MNC to rig transfer prices to achieve some gain or circumvent the burden of taxation or other regulations. Nevertheless, the ability of a company for such a manoeuvre is limited by a set of constraints. Some of these limitations have been mentioned incidentally in the previous discussion. These limitations might obstruct the control system in the company. Transfer pricing limitations could be internal (by firms themselves) or external (by authorities).

### 3.7.1 Internal Limitations

If transfer prices have been formulated not on an arm's-length principle, management problems could increase, especially with respect to the measurement, evaluation, and motivation of each unit. In order to keep the enterprise's control system useful, there

is likely to be adjustment of some issues to give credit to certain units for their real contribution to the corporation.

There are a number of references in the literature to MNCs maintaining two or more sets of parallel accounting records (Schoenfeld, 1969; Brooke and Remmers, 1970; Shulman, 1975). For example, the latter found that 3 of the 8 MNCs in his survey had some form of dual records, typically one for internal measurement and evaluation and to show real profits; and the other one for tax purposes and public consumption.

But it should be noticed that the cost of maintaining several measuring systems is high. Therefore, most MNCs, instead, attempt to achieve a single price for each transfer transaction that will satisfy all internal and external purposes.

Another internal constraint is technical in nature, the sophistication of internal pricing decisions. The amount of time and effort to determine and evaluate relevant strategies for multiproducts, in a MNC, could be significant. Therefore, a company might direct its efforts to rig transfer prices for some components only.

### 3.7.2 External Limitations

A transfer price manoeuvre can hurt the company and damage corporate-host country relations. Therefore, besides the internal limitations, MNCs must take into consideration the impact of government controls, especially in terms of discovering the manipulation of transfer prices. Some government administrations can be involved, such as customs, tax, exchange control, and restrictive business practice authorities. This means that there is a limit to the adjustment of transfer prices. For instance, Article 482 of the U.S. Internal Revenue Code sets strict guidelines for determining a transfer price.

Authorities that have an active role in this issue are customs and tax authorities and, to some extent, authorities concerned with restrictive business practices. As mentioned previously, customs departments are concerned with detecting the scaling down of imports; hence, the result is less duties being paid. Shulman points out that customs officers may get suspicious if prices are changed very often and by large amounts. Tax administrations are interested in whether the declared profit is less than a reasonable level, because of raised import prices or lowered export prices.

There are some problems confronting the effectiveness of government control over transfer price manipulations. The first problem is obvious, especially in developing countries, where there is a lack of skilled manpower and equipment and a likelihood of misinterpretation of legislations. So, "it is doubtful whether tax officials can

identify and eliminate all profit transfers through transfer pricing" (Reuber *et al.* 1973, p.145) even in developed countries.

The second problem is that arm's-length prices might be difficult to assign when there are no comparable prices to serve as a yardstick. Of course, comparisons require homogeneous products or, at least, a correction for heterogeneity since goods differ in terms of kinds, credit days, shipment size, and possibly other dimensions.

In such a situation, if tax authorities, for instance, insist that transactions must take place on an arm's-length principle for the purpose of taxation, they "may produce a transfer pricing problem where in fact non existed" (Adam and Whalley, 1977, p.164). Transfer pricing guidelines however should focus on setting the price that would prevail in the market-place. That is if the intra-family transactions differ from the arm's-length criterion, then an adjustment which applies the criterion will be appropriate.

Another conflict for defining an arm's-length price is that tax authorities might not agree among themselves on what comprises an arm's-length price. Hence, firms might find themselves "paying tax on more than 100% of their profit" (Idem).

Some developed countries, in particular the U.S., define explicitly the arm's-length price. The U.S. Section 482 prescribes three methods of defining the arm's-length price which must be used for setting transfer prices. These methods are (I) the comparable uncontrolled price, (II) the resale price, and (III) the cost plus a mark-up. All three methods require reference to similar or comparable transactions with unrelated parties. Each method must be used in the order listed. If the requirements for any one of the three pricing methods are met, that method must be adopted unless the tax-payer establishes that an alternative approach to transfer pricing is clearly more appropriate. If none of these methods can be properly applied, some other *appropriate* but undefined transfer pricing method may be used. This has included techniques such as a profit split analysis or a functional analysis.

It should be noticed that U.S. government officials have the authority to adjust non-market based transfer prices to determine the proper tariff and taxes to be assessed. The OECD guidelines of 1979 also adopt these methods to define the arm's-length basis.

**Table 3.6**

**Regulations on Income and Royalties Repatriation for Latin American Countries**

| Country | Constraints on Income Repatriation | Constraints on Capital Remittance | Constraints on Royalties and Fees |
|---|---|---|---|
| Argentina | Tax on dividends greater than 12% of capital | Not allowed for 3 years | 18% tax |
| Brazil | Same as above | Not allowed | Not exceed 5% of sales |
| Chile | None | Not allowed for 3 years | Same as above |
| Colombia | Maximum dividends 20% of capital | None | Prohibited |
| Ecuador | Same as above | Not allowed for 3 years | Prohibited |
| Mexico | Tax on dividends | None | Up to 5-6% of sales |
| Peru | Maximum dividends 20% of capital | None | Prohibited |
| Venezuela | Same as above | None | Prohibited |

*Source:* Grosse, 1986. p.40.

The third problem concerning the effectiveness of transfer pricing legislations is related to the second, but it is logically distinct from it. It is that a government might find it difficult to obtain from firms the information necessary to reconstruct prices on the basis of actual costs. Necessary information might not be available with local authorities for some products, especially in developing countries, hence they have to obtain it from abroad.

It may, therefore, be essential to create a kind of international co-operation for providing information required to pave the way for maintaining the rights of each state. Such co-operation represents a backbone to vanquish , to some extent, prevarication of transfer prices by MNCs.

## 3.8 International Co-operation and Exchange of Information

Developing nations, as mentioned earlier, are usually facing overcharging transfer prices of domestic subsidiaries by foreign parents. Of course, these countries could look for guidance from those developed nations that also consider overcharging as their main risk. International codes also, such as OECD Code, or UN Code may help to reduce the potential issues of conflict.

Control over transfer price manipulation is difficult without the co-operation among countries. So, host countries can seek greater co-operation with other nations in harmonizing and regulating transfer pricing issue. The most effective way to deal with the transfer price issue is to give attention to reasons that lead to the manipulation and economic conditions. Transfer prices are, frequently, set centrally by the parent company. When a jurisdiction needs information on how these prices have been formulated, it has to obtain it across national frontiers. Intuitively, it is not easy to get information, especially since most jurisdictions restrict the promulgation of information. So, the most crucial aspect is the availability of information. The source of this information could be the company itself, developed countries, or other international organisations.

### 3.8.1 The Company Itself

Obtaining information concerning transfer prices from the parent company itself is an important source. There is an arrangement between the European countries themselves in this matter. OECD issued helpful guidelines, especially in the area of taxation and disclosure of information. It points out that the MNC should:

> 1. upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguard and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
>
> 2. refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed (OECD, 1979, p.23).

This guideline also includes the disclosure of transfer pricing information by MNCs. It points out under the heading of "Disclosure of Information" that:

> Enterprises should, having due regard to their nature and relative size in the economic context of their operations and to requirements of business confidentiality and to cost, publish in a form suited to improve public understanding a sufficient body of factual information on the structure, activities and policies of the enterprise

as a whole, as a supplement, in so far as necessary for this purpose, to information to be disclosed under the national law of the individual countries in which they operate. To this end, they should publish within reasonable time limits, on a regular basis, but at least annually, financial statements and other pertinent information relating to the enterprise as a whole, comprising in particular:

1. the structure of the enterprise, showing the name and location of the parent company, its main affiliates, its percentage ownership, direct and indirect, in these affiliates, including shareholding between them;
2. the geographical areas[9] where operations are carried out and the principal activities carried on therein by the parent company and the main affiliates;
3. the operating results and sales by geographical area and the sales in the major lines or business for the enterprise as a whole;
4. significant new capital investment by geographical area and, as far as practicable, by major lines of business for the enterprise as a whole;
5. a statement of the sources and uses of funds by the enterprise as a whole;
6. the average number of employees in each geographical area;
7. research and development expenditure for the enterprise as a whole;
8. the policies followed in respect of intra-group pricing;
9. the accounting policies, including those on consolidation, observed in compiling the published information" (OECD, 1979, p.24).

For the purpose of the study, the most pertinent obligation placed on MNCs by this guideline on disclosure of information is "the policies followed in respect of intra-group pricing". The reference is to pricing policies for financial purposes. The OECD Guidelines (1988, p.24) elucidate that:

> "without some disclosure of the transfer pricing policies adopted by enterprises, the reader of the financial statements cannot be sure of the reliability of the amounts used to measure intra-enterprise transactions. In particular, the disclosure of transfer pricing policies will assist in the understanding of financial statements when segmented information is presented".

Many MNCs are now beginning to publish annual financial statements that purport to follow these guidelines and are containing descriptions of their intra-family pricing policies. It will become important to consider these description to ascertain whether the material contained is specific enough and sufficiently relevant to give the tax authorities information on what is actually involved in the particular prices.

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[9] For the purposes of the guidelines on disclosure of information, the term "geographical area" means groups of countries or individual countries as each enterprise determines is appropriate in its particular circumstances. While no single method of grouping is appropriate for all enterprises of for all purposes, the factors to be considered by an enterprise would include the significance of operations carried out in individual countries or areas as well as the effects on its competitiveness, geographic proximity, economic affinity, similarities in business environments and the nature, scale and degree of inter-relationship of the enterprises' operations in the various countries.

Obviously, the OECD guidelines on taxation in general and transfer pricing in particular give tax authorities the authority to get information on transfer pricing polices from the subsidiary. If it is available, the parent company can provide it, but at least where the national law specifically requires it. Moreover it many be made available under a request from tax authorities having jurisdiction over the subsidiary even though national law may not specifically require the parent itself to provide information.

### 3.8.2 The Developed Countries

Developed countries, generally the nations in which the parents of MNCs are located, may be a source of information for tax authorities in developing nations.

Most developed countries set an audit system linked to their tax authorities. Tax administrations have the authority to scrutinise international transactions between related parts and to reallocate income or disallow costs that are not determined on an arm's-length basis. For example, tax authorities in the U.S. and most OECD member countries have the power to obtain all information linked to the determination of transfer prices. In Australia, special-purpose questionnaires are used to obtain information for the same purpose (OECD, 1987, p.41).

A few countries have adopted a system to deal with the international tax issue, and active steps have been taken to implement it fully. For instance, multilateral treaties are being made between different countries aimed at the exchange of information. These multilateral conventions raise the possibility of participation in simultaneous tax examinations abroad. Also, some countries have been working closely for the purpose of exchanging information. The "Group of Four" (U.S., U.K., France, and Germany) and "PATA" (Pacific Association of Tax Administrators: U.S., Canada, Japan, and Australia) are cases in point. Such treaties help to exchange information and conduct joint audits concerning MN operations.

### 3.8.3 International Organisations

It would be beneficial to developing nations, and to developed nations as well, if an international organisation would consider the task of systematically collecting and organising data on costs, prices and the other basics involved in these allocations, a feasible and useful task. If the answers are concurring, then a decision should be made as to which organisation or group of organisations should attempt to obtain the data. The data would apparently be a valuable resource to tax authorities everywhere.

It must be taken into account that tax authorities should be governed by very strict rules about the confidentiality of information received by them. The disclosure of such information should be prohibited except for tax purposes and other strictly defined circumstances.

So far, without the proposal to flow information these would seem to have been only limited co-operation among certain countries to control the transfer pricing manipulation, especially for supplying information. As the number of MNCs, or at least, the number of subsidiaries is in continuous propagation, and consequently the intra-company transactions between the members of the family expand, an international agreement is becoming necessary to prohibit all forms of transfer pricing manipulation. Corporations and governments should help each other to this end. Moreover, transfer prices between similar industries should be harmonised.

### 3.9 Summary

One of the most remarkable changes in this century has been the mushrooming of the MNCs with a budget greater than that of some countries. Foreign investments by MNCs around the globe have made an important contribution to the international economy and in doing so have brought the nations of the world closer economically and culturally.

The process of arriving at an appropriate transfer price, difficult even in a purely domestic setting, is further complicated in foreign operations. The many potentially distorting effects of international factors must be taken into account in setting transfer pricing policies for foreign units

Most evidence of manipulating transfer prices comes from developing countries. Shifting profits via transfer prices, royalties, interest, dividends, and fees might affect the net flow of direct investments to these countries. This situation has led some economists to comment that poor countries are helping the rich countries financially instead the opposite (Müller, 1973, p.247).

When a MNC designs its transfer pricing system, some environmental variables are taken into consideration to be assured that its objectives can be optimised within the appropriate pricing policies. If a MNC reported high profits in a particular subsidiary it will expect some consequences such as paying more taxes, inducing competitors to enter the market, leading customers to bring pressure for price reduction, and stimulating labour unions to demand higher wages. A MNC uses transfer pricing policies to attain more benefits and evade restrictions imposed by both host countries

and home nations. The employment of transfer pricing to circumvent restrictions must be compatible with the long-range profitability objectives and can not be established or changed in major ways for short-term conditions without risking serious consequences. The advantages of transfer pricing are obvious but a major criticism of this strategy exists. One problem with making a transfer pricing decision is that multiple objectives could conflict with each other. This is owing to the existence of a significant degree of conflict among all these objectives. So, the overall impact of a transfer pricing scheme must be analysed before a firm policy is selected. In other words, the MNC must weigh the gains and losses from using a particular level of prices. However, doing this is not easy.

It is impossible to establish fixed rules for international transfer pricing. Pricing decisions cannot be made in the vacuum of a particular profit centre without measuring offsetting costs and knowing the ultimate effect on the entire system. Transfer pricing decisions require an understanding of the entire system and calculation of the net effects across all international operations. Therefore, the "correct transfer price would depend on the economic and legal circumstances at the time the decision is carried out" (AlHashim, 1980, p.37).

Host governments are devising different tools, techniques, or regulations more and more intensity to minimise the effect of transfer pricing policies of MNCs on their countries. As for the companies themselves, they should take into consideration when transfer prices are set, avoiding conflict with the host country government.

# Chapter 4

## Business Environment for MNCs in Egypt

### 4.1 Introduction

A study of transfer pricing and profit shifting by MNCs in Egypt must take into account some important environmental factors of the Egyptian society. Indeed, the question of the environment looms particularly large in the case of Egypt more perhaps than for other countries because things are changing so rapidly.

The economic environment in Egypt is a complex mixture of government directives and market forces. The aim of this chapter is to summarise important features of this environment, and to identify significant policy issues relevant to FDI.

The business environment in Egypt has undergone many crucial changes since the early 1970s. Since 1974, a new turn in Egyptian political and economic orientation has taken place. From the political perspective, Egypt moved from international confrontation and non-alignment to accommodation and closed alignment with the Western countries. From the economic perspective, the policy of the Egyptian government was to achieve development and progress through Arab oil wealth, Western technology, and abundant Egyptian manpowers and other resources. Here was the basic idea behind the Open Door economic policy that would set the tone of political and economic life in the 1970s.

As part of this new policy, foreign investment was encouraged to participate in business ventures in Egypt, and Law 43 of 1974 was enacted to provide the legislative framework for inviting foreign capital and technology. The government enhanced the investment legislations, and hence, the previous law has been repealed and replaced in December 1989 by new "Investment Law" (Law 230 of 1989.

This means that FDI is governed within a legal framework, including establishing central screening or approving agencies and lay down the procedures for applying for approvals, together with specific benefits and incentives.

This chapter provides an overview of FDI in Egypt by presenting and discussing the available information about FDI. Legislative and regulatory measures in Egypt that affect the activities of FDI and MNCs will be introduced. A critical perspective of the activities of MNCs and their effects on the Egyptian economy will also be studied. Hence, this chapter will discuss the following:

1- Balance of payments and Egyptian foreign trade
2- Other important aspects of the business environment in Egypt
3- Monumental problems facing the Egyptian economy
4- The Egyptian political environment
5- The Open-Door economic policy
6- The growing importance of FDI for economic development in Egypt.
7- The creation of direct investment returns
8- Government policies toward FDI and MNCs.
9- Overview of Investment Law No. 230 of 1989
10- The MNC and economic development: The Advocates and the critics

Many of these areas may have far-reaching implications for MNCs in designing their transfer pricing strategies.

## 4.2 Balance of Payments and Egyptian Foreign Trade

### 4.2.1 Balance of Payments Position

A history of Egypt's balance of payments for the 1970s and 1980s is depicted in Table 4.1. The balance of payments, as shown, is characterised by a wide gap between the two sides of the current trade account, i.e., imports and exports. The table reveals clearly the divergent fluctuations between robustness and recession. Between 1975 and 1988/89, visible imports increased by 115% from $4.7 to $10.1 billion.[1] Visible exports, on the other hand, went up 69% in the same period from $1.6 to $2.7 billion. In fact, the percentage of visible exports to imports has declined every year. Whereas the percentage was 45.6% in 1980, it turned down to 26.7% in 1988/89.

The $2.5 billion current account deficit in 1985/86 was the worst figure since 1975. Imports rose very rapidly from 1971 through 1980 when they exceeded US$9 billion. They stayed at essentially this level until the end of the 1980s. The fall of visible imports in 1986/87 is due to the chronic shortage of foreign exchange. The government has increased restrictions over private sector imports. Imports of public sector commodities were constrained by the availability of foreign exchange in the commercial banks.

On the other hand, exports in the second half of the 1980s were lower than in the first half. The table reveals that the balance of payments in the 1980s was heavily

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1 Imports exclude military and equipment for exploring and developing oil fields brought in by foreign firms.

dependent on petroleum exports. The decline in exports of this item after 1985/86 was a result of the downturn in the international oil market prices comparing to the price after the October War of 1973.[2] The volume of production of crude oil also fell. In January 1986, the government curbed production to about 650,000 barrels per day, just enough to meet domestic consumption requirements, payments to foreign companies and a small volume to fulfil long-term export agreements.

The table shows a consistent pattern for Egypt's balance on invisible items. Not only is petroleum the largest source of visible revenues, other major invisible sources, that is workers' remittances, Suez Canal traffic, and even tourism are closely related to the conditions of world oil markets. The table shows that the country has always had a substantial surplus on invisible trade during the 1980s.

Transfers by Egyptians working temporarily in the Gulf states represented 31% of total visible and invisible revenues in 1983/84. The falls in the period of 1984/85 to 1986/87 have been attributed to changes in the arrangements under which remittances enter the country, and instability in the Gulf area.

Since the reopening of the Suez Canal in 1975, Egypt's revenues experienced a pronounced upward trend. The fall in 1984/85 was attributable to lower oil production in the Gulf.

Capital grants and foreign assistance from Arab countries increased following the 1973 war up to 1979, when Egypt signed the peace treaty with Israel. The U.S., as a partner in the peace treaty, provides Egypt with foreign aid which amounts to $2 billion a year. It is expected that aid flows from Gulf states will rise after the Egyptian forces participating in protecting them against any Iraqi aggression.

For Egypt, the balance of payment for 1990/91 has been affected adversely by the impact of the Gulf war. The Suez Canal lost revenues of US$400 million because of the naval blockade on Iraq. Exports to Iraq have been stopped completely. The outbreak of war has also affected tourism. Workers' remittances have fallen sharply. On the other hand, oil exports achieved a significant increase as they reached US$2.5 billion.

Egypt must make concerted efforts to stimulate growth in agricultural and merchandise exports. Non-oil visible exports (in absolute value) fell from US$1.4 billion in 1975 to US$1.1 in 1980. And again from US$1.7 in 1987/88 to US$1.5 in

2 Between 1974 and 1980, the price rose peaking in January, 1981 at a weighted average of US$38 per barrel. Since then the price has fallen steadily, until it reached about $18 per barrel in 1991. A fall of $20 per barrel over ten years.

1988/89. A major disincentive to exports might arise from Egypt's preference for production for the domestic consumption. Moreover, Egypt's traditional exports, such as cotton, citrus, and potatoes face hard competition.

In summary, Egypt's crucial balance of payments problem is the crucial deficit which must be brought down to levels that can be financed from available sources. There is no escape from adjusting consumption and imports to the reduced level of resources available to the economy. It is imperative to reduce the fiscal and external deficits. In the second half of 1980s, the fiscal deficit has been over 20% of GDP and the current account deficit has exceeded 10%.

Relieving more than 50% of Egyptian debts means reducing the burden of external debt and debt service. By 1990, the government has reduced subsidies on basic commodities and services which could provide the basis of growing improvement in the balance of payments. The steep price increase on energy, consistent with the declared goal of reaching international prices by 1992, could help the fiscal balance. Introducing a sales tax is expected to add about E£1 billion in revenue annually to government coffers.

### 4.2.2 An Overview of Egyptian Foreign Trade

Basically, foreign trade has been of vital importance to the Egyptian economy. The country relies on imports for almost half of its food consumption especially wheat, sugar, and cooking oil, and for a large portion of the raw material and capital goods needed for the industry. Oil, raw cotton and cotton products represent a significant portion of Egyptian exports.

Table 4.2 summarises the commodity composition of Egyptian foreign trade for selected years in the 1980s. On the export side, it is clear that exports of oil have declined dramatically since 1984/85. This was probably caused by the increasing of local consumption combined with a 50% decline in the world price as previously mentioned. The same trend exists in the exports of raw cotton as here too the proportion has fallen, notably in 1987/88. This however is due to different factors, such as the declining of volume of production, the wish to manufacture cotton and export it in the form of yarn and textiles, and the need to furnish investment companies with their requirements. Consequently, the table shows exports of spinning and weaving products have been growing rapidly since 1985/86.

On the import side, the percentage of imported food and beverages in total imports have fallen in 1987/88, as the government rationalised imports due to the shortage of foreign exchange. There has been very little change in the percentage of machinery

and transport equipment category. The percentage of imports of sundry manufactured items has been growing.

The regional composition of Egypt's foreign trade is displayed in Tables 4.3 and 4.4 and several general trends can be observed from these two tables. Most noteworthy is in the increase of the proportion of trade with the EEC countries. The U.S. is the most important exporter market after the EEC countries. Exports have swung in 1986/87 progressively towards Arab nations as a result of military exports to Iraq. On the other hand, imports from these countries have decreased. The proportion of foreign trade with Comecon countries is in continuous decline over the period.

### 4.3 Other Important Aspects of the Egyptian Business Environment

This part will review other important aspects of the Egyptian business environment which may also have some impact on MNCs and transfer pricing practices. These include the exchange system, tax trends, and customs duties legislation.

#### 4.3.1 Egyptian Exchange Control System

The exchange system in Egypt has always been complex. Adopting exchange policies aimed at often regulating the currency of foreign exchange. Until October 1991 there was a multiple exchange rate system involving a number of rates declared by the Central Bank of Egypt. For example, the foreign exchange market was fragmented for the last two decades into three pools, the central bank pool, the commercial bank pool, and the free market pool. This process involved an even larger number of exchange rates. The majority of remittances to Egypt from Egyptians working abroad was used to be exchanged in the free market where it was illegal as the rate was higher than the commercial rate.

The gap between the official and free market rates of exchange was substantial, especially for the US dollar. During the 1980s, many efforts by the Ministry of Economy have been made to regulate the demand for hard currency. In conjunction with these changes, an import licensing system was designed to reduce imports of luxury goods. In May 1987, the government devalued the exchange rate to close the gap with the free market price,[3] as a first step towards the full unification of the exchange rate.

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[3] In that time the commercial rate of US$1 = E£1.35 as opposed to the free market rate of US$1 = E£2.20. The government introduced a new floating rate which it allowed to gradually rise from the first rate announced (US$1 = E£2.17) to eliminate the black market transactions.

## Table 4.1

## Egypt Balance of Payments, 1971-1988/89 (US$ Billions)

| | 1971 | 1975 | 1980 | 1983/84 | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1988/89 |
|---|---|---|---|---|---|---|---|---|---|
| Visible Trade | | | | | | | | | |
| Exports | | | | | | | | | |
| Petroleum Exports | 0.0 | 0.2 | 3.0 | 3.0 | 2.9 | 2.2 | 1.4 | 1.5 | 1.2 |
| Other Exports | 0.9 | 1.4 | 1.1 | 1.4 | 1.3 | 1.2 | 1.4 | 1.7 | 1.5 |
| | 0.9 | 1.6 | 4.1 | 4.4 | 4.2 | 3.4 | 2.8 | 3.2 | 2.7 |
| Imports | 1.2 | 4.7 | 9.0 | 10.3 | 10.5 | 9.5 | 8.0 | 9.8 | 10.1 |
| **Trade balance** | **-0.3** | **-3.1** | **-4.9** | **-5.9** | **-6.3** | **-6.1** | **-5.2** | **-6.6** | **-7.4** |
| Exports/Imports % | 75% | 34% | 45.6% | 42.7% | 40% | 35.8% | 35% | 32.7% | 26.7% |
| **Invisible Receipts** | | | | | | | | | |
| Suez Canal | 0.0 | 0.1 | 0.7 | 1.0 | 0.9 | 1.0 | 1.1 | 1.3 | 1.3 |
| Tourism | 0.1 | 0.4 | 0.7 | 1.0 | 1.2 | 0.8 | 1.2 | 1.6 | 2.0 |
| Worker Remittances | 0.0 | 0.4 | 2.7 | 3.9 | 3.5 | 3.0 | 3.0 | 3.4 | 3.5 |
| Other Receipts | 0.1 | 0.3 | 1.2 | 2.4 | 2.3 | 2.2 | 2.6 | 2.6 | 3.2 |
| **Sub Total** | 0.2 | 1.2 | 5.3 | 8.3 | 7.9 | 7.0 | 7.9 | 8.9 | 10.0 |
| **Invisible Payments** | | | | | | | | | |
| Interest Payments | 0.1 | 0.1 | 0.5 | 1.2 | 1.0 | 1.3 | 1.1 | 0.8 | 1.0 |
| Other Service Payments | 0.3 | 0.6 | 1.6 | 1.9 | 1.8 | 2.1 | 2.0 | 1.8 | 2.2 |
| **Sub Total** | .4 | 0.7 | 2.1 | 3.1 | 2.8 | 3.4 | 3.1 | 2.6 | 3.2 |
| Balance of invisible | -.2 | 0.5 | 3.2 | 5.2 | 5.1 | 3.6 | 4.8 | 6.3 | 6.8 |
| **Current Account Deficit** | **-0.5** | **-2.6** | **-1.7** | **-0.7** | **-1.2** | **-2.5** | **-0.4** | **-0.3** | **-0.6** |

*Source:* Adapted from Carr (1990, p.227).

# Table 4.2

## Commodity Composition of the Egyptian Foreign Trade (in Percentage)

| | 1982 | 1984 | 1985/86 | 1986/87 | 1987/88 | 1988/89 |
|---|---|---|---|---|---|---|
| **Exports** | | | | | | |
| 1- Agricultural Commodities | | | | | | |
| Cotton | 8.5 | 12.0 | 8.9 | 8.9 | 6.6 | 5.6 |
| Food and others | 4.0 | 5.3 | 5.6 | 9.1 | 6.1 | 6.1 |
| 2- Industrial goods | | | | | | |
| Petroleum | 72.0 | 64.5 | 57.7 | 23.4 | 29.0 | 22.0 |
| Spinning & weaving goods | 6.3 | 7.7 | 11.7 | 25.2 | 26.2 | 23.0 |
| Other industries* | 4.7 | 8.0 | 9.3 | 21.5 | 21.1 | 29.6 |
| 3- Miscellaneous | 4.5 | 2.5 | 6.8 | 11.9 | 11.0 | 13.7 |
| **Total** | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| **Imports** | | | | | | |
| Food and beverages | 38.9 | 39.1 | 33.6 | 31.3 | 23.4 | 22.7 |
| Chemicals, rubber & leather | 7.7 | 7.4 | 11.4 | 10.8 | 14.4 | 11.1 |
| Wood, cork, paper, & textiles | 8.3 | 8.6 | 10.1 | 9.2 | 12.1 | 11.0 |
| Machinery & transport equipment | 29.7 | 23.9 | 25.5 | 25.2 | 24.2 | 22.1 |
| Base metals | 8.5 | 7.2 | 7.4 | 7.8 | 9.9 | 10.0 |
| Sundry manufactured articles | 3.8 | 4.3 | 4.3 | 4.7 | 5.3 | 3.7 |
| Miscellaneous | 3.1 | 9.5 | 7.7 | 11.0 | 10.0 | 19.4 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

* These include foodstuffs, chemicals, engineering & metallurgical products and others.

*Source:* The percentage for years 1982 and 1984 are computed by the researcher based on the value of exports and imports extracted from Central Bank of Egypt, Economic Review (1985) vol. 15 (2). Whereas the percentage for the rest of years extracted from Table 4/5, Central Bank of Egypt, Annual Report 1978/88, and 1978/88, Cairo.

## Table 4.3
## Regional Distribution of Egyptian Exports (In Percentage)

| Region | 1985/86 | 1986/87 | 1987/88 | 1988/89 |
|---|---|---|---|---|
| Arab league countries | 7.1 | 12.2 | 10.4 | 12.7 |
| EEC countries | 35.7 | 38.7 | 40.8 | 41.7 |
| Comecon countries | 19.2 | 14.3 | 11.2 | 8.5 |
| Other European countries | 2.9 | 3.4 | 4.7 | 3.0 |
| Afro-Asian countries* | 14.8 | 10.7 | 11.9 | 15.3 |
| United States | 11.5 | 8.1 | 11.5 | 6.4 |
| Australia | 0.1 | 0.1 | 0.1 | 0.1 |
| Other countries | 8.7 | 12.5 | 9.4 | 12.3 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** |

* Excluding Arab countries.

*Source:* Compiled by the researcher based on the value of exports extracted from Central Bank of Egypt, Annual Report 1987/88, and 1988/89, Cairo.

## Table 4.4
## Regional Distribution of Egyptian Imports (In Percentage)

| Region | 1985/86 | 1986/87 | 1987/88 | 1988/89 |
|---|---|---|---|---|
| Arab league countries | 2.7 | 1.4 | 1.3 | 1.4 |
| EEC countries | 41.3 | 41.2 | 41.1 | 37.3 |
| Comecon countries | 8.8 | 8.5 | 7.2 | 5.9 |
| Other European countries | 10.7 | 12.6 | 14.6 | 12.7 |
| Afro-Asian countries* | 11.9 | 10.9 | 12.2 | 10.7 |
| United States | 16.4 | 20.3 | 16.8 | 24.7 |
| Australia | 3.4 | 2.2 | 1.2 | 1.4 |
| Other countries | 4.9 | 3.9 | 5.6 | 5.9 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** |

* Excluding Arab countries

*Source:* Compiled by the researcher based on the value of imports extracted from Central Bank of Egypt, Annual Report 1987/88, and 1988/89, Cairo.

Since that time, various attempts have been made to rationalise the exchange rate, inevitably involving devaluations of the Egyptian pound. At the end of February 1991 the Egyptian government arrived at an agreement with the IMF regarding liberalisation of the Egyptian economy. Under this liberalisation programme, the Egyptian pound has been devalued and action has been taken on introducing a uniform exchange rate.[4] Ceilings on interest rates have been removed so that banks now base decisions on market rates rather than those set by the government. Trading in hard currency has been regulated, and so on.

### 4.3.2 Egyptian Tax Trends

Tax receipts constitute the major percentage of total government current revenues, as they were 76.6% and 72% for 1986/87 and 1987/88 respectively (National Bank of Egypt, 1988). It is expected that with sophisticated methods and a more determined approach, the government should be able to double tax revenues.

Basically, taxes are divided, in Egypt, into two main categories: direct and indirect. Direct taxes are imposed on income and wealth. These taxes are levied on commercial and industrial activities, wages and salaries, professional activities, movable capital assets, buildings and land, and general income. Indirect taxes are expenditure base and designed to guide purchasing power in the desired direction. These taxes are represented mainly in the form of customs duties, sales tax, and stamp duties.

The framework of the income tax system has been established by Law 157 of 1981. The main taxes relevant to business in Egypt, in general, include:

1- Corporate tax at the rate of 42% (includes 2% development duty tax). Corporate tax is applicable to the profits of all enterprises and subsidiaries of foreign companies operating in Egypt, except as follows:
   a) Profits of industrial and export activities - 34% (includes 2% development duty tax).
   b) Profits of oil exploration and production companies - 40.55%.

   The 2% development duty tax applies to enterprises and individuals. There is an exemption on the first E£18,000.

2- Withholding taxes as follows:
   a) Royalty payments. As a rule, royalties are subject to a 42% withholding tax. The level of royalties and similar licence fees are treated as being costs which should be deducted from the taxable income on which tax is levied at

[4] Under the terms of an IMF agreement, Egypt was obliged to unify its exchange rate by February 1992. The government has moved quickly and applied a unified rate in October 1991. This is due to the success of its tight monetary policy in stabilising the value of the Egyptian pound.

32%. Several tax treaties between Egypt and other countries have specific provisions for taxes on royalties, which vary from complete exemption to a tax up to 25%.

b) Interest payments - 34% of amount paid, with the exemption for loans and credit facilities obtained by public sector companies, organisations or government departments. Also, interest on foreign loans obtained by companies formed under the investment law is, exempted from all taxes and dues. The rate applied under double taxation agreements is 15%.

c) Dividends. All dividends are exempted from withholding taxes in both domestic and foreign firms.

3- Stamp Tax. Stamp duties are levied on a wide range of documents including deeds, applications, contracts, company formation, banking transactions, insurance premiums, invoices, lotteries, posters and other advertisements, air tickets, supply of water, gas and electricity.

4- Sales Tax. This tax has been applied since July 1991 after the repealing of consumption tax. It is applied on goods and services, but some exemptions from this tax exist, such as basic food products and basic raw materials.

In order to avoid double taxation, Egypt has signed a number of tax conventions which are based on the principle of taxation at the source (i.e., profits earned and taxed in other countries are not taxable in Egypt). Agreements of this kind are in force with most European countries, Japan, and U.S. Some conventions not only provide for specific mechanisms to eliminate double taxation, normally by way of a credit, but also reduce, and put a ceiling on, the rate of withholding tax that can be imposed on dividends, interest, and royalties.

### 4.3.3 Tariffs Legislation

The Egyptian government employs tariffs for two purposes, either to finance its expenditures or to protect home industries from foreign competition. Duties are always calculated as a percentage of the value of goods being taxed, these are called ad valorem duties.

Tariff revenues represent a substantial source of government income. Custom duties vary from duty free on basic foodstuffs, to 250% on luxury products, like big cars.

## 4.4 Monumental Problems Facing the Egyptian Economy

Despite several positive developments in the Egyptian economy, there remain massive problems to overcome. The vital problems currently facing Egypt are the high rate of inflation, both the balance of payments and budget deficit are

unsustainably large, sizable foreign debts (totalling $50 billion at the end of 1990)[5], and the problem of unemployment.

With respect to the problem of inflation, Table 4.5 illustrates the inflation rate in Egypt during the second half of the 1980s. It is important to differentiate between the actual rate of inflation, for which there is no official assessment, and the governmental rate of inflation. There are some estimates which show the country's actual rate of inflation has reached as high as 30% per annum due to the rapid increase in money supply. The policy of financing the budget deficit by directly increasing the money supply, which led to chronic inflation. However, the latest economic reform programme involved using the money market for residual financing needs.

MNCs working in Egypt face the danger of potential inflation because of incorrect pricing practices. The basic principle for companies is payments received must equal the replacement cost of the item sold plus overhead and normal profit on the day of receipt of funds, rather than on the day of sale. If this axiom is not followed, the company's normal financing cycle will be broken, since the funds from sales will not be sufficient to replace inventory, either through purchases or new production. Therefore, companies must make regular price increase in the hope that they will counter the inflationary factor.

As mentioned before, the country continues to suffer a large balance of payments deficit, and has been witnessing a devastating national population increase. Moreover, the rate of unemployment has been increasing over the last decade and the problem is still unsolved. Official estimates put the unemployment rate at 22% and the rate could rise further if the economic reforms recommended by the IMF were to be implemented.

Another serious problem facing the Egyptian economy is the migration of the most highly educated and trained people Egyptian labour pool to oil-producing Arab countries, the resulting in something of a *brain-drain* malady.

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[5] As a result of the Gulf War and its effect on the Egyptian economy and the significant role of the Egyptian government in supporting allies, the U.S, Saudi Arabia and the four Arab Gulf countries have written off debts of some US$14.5 billion. Additionally, negotiation with members of the Paris Club led to cancelling of the Egyptian government's guaranteed debts of about US$20 based on net present value, applying on three stages from July 1991 till July 1994. Reduction of these debts is firmly tied to Egypt meeting its IMF and World Bank obligations on long overdue economic reforms. Also, the Paris Club has given the right to the Egyptian government to negotiate separately, with credit countries for more reduction of its debts.

**Table 4.5**
**Official Rates of Inflation in Egypt,* (1984/85 - 1989/90)**

| Year | Inflation Rate |
|---|---|
| 1984/85 | 9.6% |
| 1985/86 | 16.4% |
| 1986/87 | 21.6% |
| 1987/88 | 17.9% |
| 1988/89 | 16.7% |
| 1989/90 | 21.4% |

* These figures are built on the change of consumer retail price. For details of Index of consumer and wholesale prices, see CAPMS (1989) Statistical Year Book 1952-1988, Tables 11-16 to 11-20.

*Source:* Data for the first three years are from Khier-El-Din, 1990. 1987/88 Data are computed by the researcher and built on consumer prices. Data for the last two years are excerpted from Central Bank of Egypt, 1990, p.3).

## 4.5 The Egyptian Political Environment

Studying the political aspect is of great importance for MNCs. This is simply because the political stability of the country stimulates these companies to come and invest there. As Farmer and Richman (1964, p.132) pointed out:

> "A firm would hardly invest heavily in a country expected to undergo extensive political change fairly soon, particularly if such changes would lead to potential danger to the investment."

Since the political aspect makes an impact on foreign policy, it is worthwhile examining in brief the prevailing political environment. Prior to 1952, the economic system of Egypt was based mostly on private ownership, as the state encouraged it. But after the revolution of 1952 and a change of the political system from a monarchy to a republic, some important changes took place especially in the ten years following the revolution. The government played a significant role in developing the economy. The economic programme involved land reform, constructing the Aswan Dam, development plans, and investment in heavy industries by the state itself. This programme led to the emergence of public sector companies

During the period of his rule, President Nasser, due to his disputes with the U.S. and the Western block, adopted a socialist ideology. Expropriation and nationalisation

were the most important issues that affected foreign and private investments in Egypt. The government changed its attitude toward private sector investment by both foreigners and nationals. It generally intended to diminish the relative weight of the private sector and to bring the majority of the country's resources under the control of the public sector.

As a consequence of the prevailing atmosphere in Nasser's period, private capital flowed out of the country. Foreign investors stressed the uncertain regional political situation as being among the most important factors for their hesitancy (Carr, 1979, p.93).

The outstanding change in the Egyptian foreign policy took place when President Sadat succeeded Nasser in 1970. The direct results of the 1967 War involved the closure of the Suez Canal, the loss of oil wells in Sinai, an increase in military expenditure, and a sharp decline in the number of tourists. The economy lost foreign exchange resources. Therefore, Sadat's government realised that its existing policy was unable to accomplish the stated objectives.

Moreover, it was apparent from the beginning of his rule that Sadat allied himself to the Western countries, especially the U.S. The relationship with U.S. improved remarkably after the signing of a peace treaty with Israel at Camp David. The importance of this treaty has been mentioned by Lucien Bruggeman, who served as "investment development officer" at the Egyptian Economic Mission in New York. He stated before Camp David: "Without a peace settlement in the Middle East, or at least significant movement in that direction, not many American corporations are going to be seriously interested in investing in Egypt" (Carr, 1979, p.93). President Mubarak, Sadat's successor, continued the same direction, keeping a good relationship with Western countries.

Generally speaking, the political climate of Egypt is described as remarkably stable, at least compared to other countries in the region. This climate should encourage investors to make decisions to invest in the country.

### 4.6 The Open-Door Economic Policy

Since the early 1970s there has been considerable concern in Egypt, as in any developing nation, over the impact of FDI on development and the metamorphosis of the industry and national economy. The government implemented a statute for an Open Door Policy, "*Al-infitah*" in Arabic, for encouraging investment by both

citizens[6] and foreign nationals. This policy depends on three sources: foreign and Arab investment, private national investment, and the important role of the public sector.

When the government adopted this policy it took into consideration that foreign investment and wealth will supplement domestic investment and enable Egypt's economic lag to be overcome. It has also hoped for more positive results from the investment reform process.

In fact, there are some particular objectives that led the Egyptian government to try to attract FDI. These objectives are:

1) Generation of the maximum amount of revenues in order to support the financial requirements of the development objectives, government administration, etc.,
2) Creation of foreign exchange earnings,
3) Creation of a stable source of revenue in order to insulate government finances from the volatility of world markets,
4) Promotion of efficient operation and management and, in the case of natural resources, the optimum exploitation of resources,
5) Acquiring modern technology,
6) Creation of new job opportunities for its citizens, either directly or indirectly (forward and backward linkages), and
7) Endeavour to lessen the frequent deficit in the balance of payments which has existed since the Second World War. (SNC, 1982, p.348 *et seq*)

In June of 1974, the Government promulgated Law No. 43 concerning the Investment of Arab and Foreign Funds and the Free Zones.[7] The government also held bilateral investment treaties with many developed countries to promote and protect FDI. Law 43 was a Magna Carta that aimed at encouraging the inflow of foreign investment and regulating investment entry into the Egyptian market. Because this law had some impediments to foreign investor, the government abolished it and replaced the Law

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5 Recently, the government has focused on what it believes is about US$50-70 billion of Egyptian people held abroad that could be tapped to help finance the deficits in the balance of payments if these amount would be invested in Egypt.

7 Free zones represent areas exempted from: 1) import and export regulations, 2) exchange control regulations and all taxes for an unlimited period. Only, an annual duty (1%) of the value of the goods entering or leaving the free zones. Free zones areas are divided into two types, public and private. For more details: GAFI (1989) Investment Law 230 of 1989, Chapter 3.

230 of 1989. The new law avoided most difficulties in Law 43 of 1974, and provided more incentives to foreign investors.

## 4.7 The Growing Importance of FDI for Economic Development in Egypt

FDI has won more appreciation from developing countries. It has been realised that direct investment helps significantly to increase productive capacity and create employment in these countries- both vital prerequisites for growth. Economic growth has been found to depend largely on private corporate investment. The debt crisis has curtailed private lending to developing countries, and official development assistance has not substantially taken up the slack. Under these circumstances, most developing countries have stepped up their efforts to lure foreign investment, not only for its contributions to their productive capital but also for its technology, training, management and marketing advantages.

Towards the beginning of the 1970s, it was realised that industrialisation at any cost and the policy of import substitution were obsolete policies. The gains to the host economy from FDI arise both from the use of additional factor resources imported from advanced countries and from the generation of improved additional resources within the host country. Egypt is committed to economic growth and technological change both because it wishes to close the gap with the industrialised countries and because it is confronted with a set of concrete challenges. Moreover, inward investment is advantageous to the Egyptian economy, in terms of real income, efficiency, and all other relevant aggregate economic variables.

Data currently published show the total stock of FDI in Egypt has amounted to a significant amount as illustrated in Table 4.6.[8] Table 4.7 also exhibits the gross value added (GVA), labour costs and average of the GVA per employee in each industrial sector for FDI projects. The spinning and weaving sector has had the highest proportion of employees but the average of GVA per worker is low compared to other sectors. The two sectors which have had the highest GVA per employee are food products and chemicals. Table 4.8 reports the distribution of FDI in Egypt by source country and sector up to the middle of 1989. Some features of the distribution of FDI in Egypt are indicated are as follows:

1- Although Arab countries' investments represent an enormous percentage (60%), nearly a half of these investments were directed to finance and service activities.

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8 The vice president of the GAFI has announced that the total amount of investments in Egypt till the end of June 1990 has reached E£10 billion. These investments are distributed according to the nationality as follows: 64% for Egyptians, 19% for Arabs, and 17% for Foreigners (Al Ahram newspaper, November 15 1990)

2- The size of FDI in Egypt is still really far from satisfactory to meet the development requirements and help to decrease the size of unemployments.

3- FDI is biased towards financial and service projects as they accounted 33% of the total investments in inland projects. On the other hand, the agricultural and animal and construction sectors have received a scanty percentage (4.2% and 4.6% respectively of the total investments in inland projects).

4- Finally, the impact of FDI in Egypt up to the middle of 1989 on employment, capital inflow, and on the balance of payments is not encouraging.

**4.8 Achieving Satisfactory Returns on Investment**

There is no doubt that achieving satisfactory returns on investment is the major objective of doing business. This is particularly in the case of conducting business abroad where greater risks are involved.

FDI is undertaken by investors and is accepted by host countries because of the shared belief that substantial returns are available from direct investment operations. According to the new dominant industrial organisation approach to FDI advanced notably by Hymer (1976) and Caves (1971), these returns are attributable to the transfer and exploitation of special assets possessed by foreign investors. This transfer of technology or know-how takes place more efficiently or quickly through direct investment than through such alternative channels as imports licensing, consulting arrangements, or local generation.

From the viewpoint of foreign investors, the returns attributable to the special asset must be high enough to offset the excess cost of production in an alien location, such as adjusting to different economic, social, legal, and cultural conditions. From the viewpoint of the host country, the cost of adapting foreign technology must be less than the local costs of developing similar technology, and the net benefit greater than seeking the technology through the other alternative mechanisms.

The returns to the foreign investor are principally in the form of dividends, technical fees, any unusual profits received from the sale of raw materials and components to local firms, and capital appreciation above the normal rate of inflation. The returns to local firms may comprise higher productive capacities, higher wages, income, and employment, lower prices, more competitive market structure, tax revenues, more exports, a diffusion of skills, improved efficiency of production in foreign companies and throughout industry, and the gradual spread of an enterprising spirit and technical and innovational capacities.

**Table 4.6**

**Total and Value of FDI Projects Approved from July 1974 to December 1988**

| | No. of Projects | Capital E£M* | Investment Costs E£M** | Number of Employees | Wages E£ M |
|---|---|---|---|---|---|
| Inland Projects | 1392 | 7192 | 13707 | 201827 | 383 |
| General Free Zones Projects | 215 | 316 | 429 | 10111 | 23 |
| Private Free Zones Projects | 44 | 746 | 928 | 7012 | 25 |
| **Total** | **1651** | **8254** | **15064** | **218950** | **431** |

* Represents the approved capital and invested in the projects.

** Investment costs represent costs spent for setting up the projects.

*Source:* Compiled from GAFI's Statistics, 1990.

**Table 4.7**

**Sample of Gross Value Added (GVA) per Employee in FDI Projects (Industrial Sector) at the end of 1988**

| Sector | No. of Projects | Labour Number | Labour Costs/GVA E£ M | GVA/ Turnover E£ M | GVA per Employee E£ |
|---|---|---|---|---|---|
| Spinning and Weaving | 58 | 51,509 | 45 | 836 | 16,230 |
| Food Products | 54 | 9,138 | 14 | 636 | 69,600 |
| Chemicals | 87 | 10,673 | 19 | 507 | 47,503 |
| Wood Products | 11 | 2,173 | 3 | 39 | 17,948 |
| Engineering | 33 | 4,138 | 9 | 125 | 30,208 |
| Building Materials | 58 | 7,878 | 14 | 323 | 41,000 |
| Metals | 42 | 8,672 | 27 | 379 | 43,704 |
| Pharmaceuticals | 15 | 2,276 | 7 | 87 | 3,825 |
| Minerals | 3 | 368 | 1 | 5 | 1,387 |
| **Total** | **361** | **96,825** | | | |

GVA = Gross value added.

*Source*: Compiled from GAFI's Statistics, 1990.

## Table 4.8

## FDI in Egypt Distributed by Country and Sector till the middle of 1989* (E£ M)

| | Inland Projects | | | | | Free Zones | Total |
|---|---|---|---|---|---|---|---|
| | Indus. Sector | Financing Sector | Agri. & Animal Sector | Constru-ction Sector | Service Sector | Projects** | |
| Arab Nations | 287.000 | 490.000 | 60.000 | 76.000 | 240.000 | 458.000 | **1611.000** |
| USA | 124.184 | 42.483 | 5.214 | 2.275 | 157.750 | 79.760 | **411.666** |
| Germany | 57.747 | 42.520 | 1.524 | 2.155 | 24.284 | 0.764 | **128.994** |
| Luxembourg | 35.874 | 41.846 | - | 3.839 | 12.342 | 8.176 | **102.077** |
| U.K | 35.194 | 16.631 | 0.225 | 2.853 | 11.086 | 19.622 | **85.611** |
| Japan | 57.135 | 1.300 | 1.090 | - | - | 11.005 | **70.530** |
| France | 21.470 | 25.168 | 4.100 | 0.808 | 12.736 | 2.533 | **66.815** |
| Switzerland | 15.055 | 4.419 | 7.898 | 3.683 | 26.769 | 3.532 | **61.356** |
| Italy | 39.155 | 3.375 | 0.428 | 0.830 | 5.798 | 2.902 | **52.488** |
| Holland | 8.214 | 0.874 | 1.555 | 0.792 | 0.793 | 2.263 | **14.491** |
| Spain | 5.853 | 5.600 | 0.420 | - | - | 2.574 | **14.447** |
| Sweden | 6.310 | - | - | - | 6.370 | 0.550 | **13.230** |
| Denmark | 2.887 | 1.650 | 3.176 | - | 4.062 | 0.175 | **11.950** |
| Greece | 1.988 | 1.500 | 0.400 | - | - | 7.346 | **11.234** |
| Canada | 1.769 | 2.400 | 0.500 | - | - | 0.217 | **4.886** |
| Belgium | 1.042 | - | - | 1.088 | 2.387 | 0.140 | **4.657** |
| Austria | 1.797 | 0.750 | - | - | 0.080 | 0.770 | **3.397** |
| Norway | 1.575 | - | - | - | 0.400 | 0.127 | **2.102** |
| Finland | 0.718 | - | - | - | - | 1.120 | **1.838** |
| Portugal | 0.300 | - | - | - | - | - | **0.300** |
| **Total** | **705.267** | **680.516** | **86.530** | **94.323** | **504.857** | **601.576** | **2673.069** |

* Due to the lack of information, these investments do not involve companies established outside the Investment Law. Also investment from developing countries and investments by the Egyptians are not involved.

** Both general and private free zones projects.

*Source:* Compiled from GAFI's Statistics, 1990.

Despite the advantages of FDI to a host country, it has some drawbacks. Many critics allege that this external dominance may have such costly effects as a possible stifling of the development of special skills and of R&D activity, the use of inappropriate scale technology, excessive importation, and biased transfer pricing. Other possible undesirable features, particularly if there is an oligopolistic market structure or excessive entry inducements, are diseconomies of scale, and high prices.

It is important to note that the Egyptian government has hitherto largely ignored the transfer pricing problem. Consequently, there is no mechanism to deal with it. This might be because, in general, developing countries eagerly seek FDI and are more willing to accept the potential abuse of transfer pricing as a necessary cost of having MNCs (Lall, 1985, p.78). The effects of FDI on the host country are illustrated in figure 4.1.

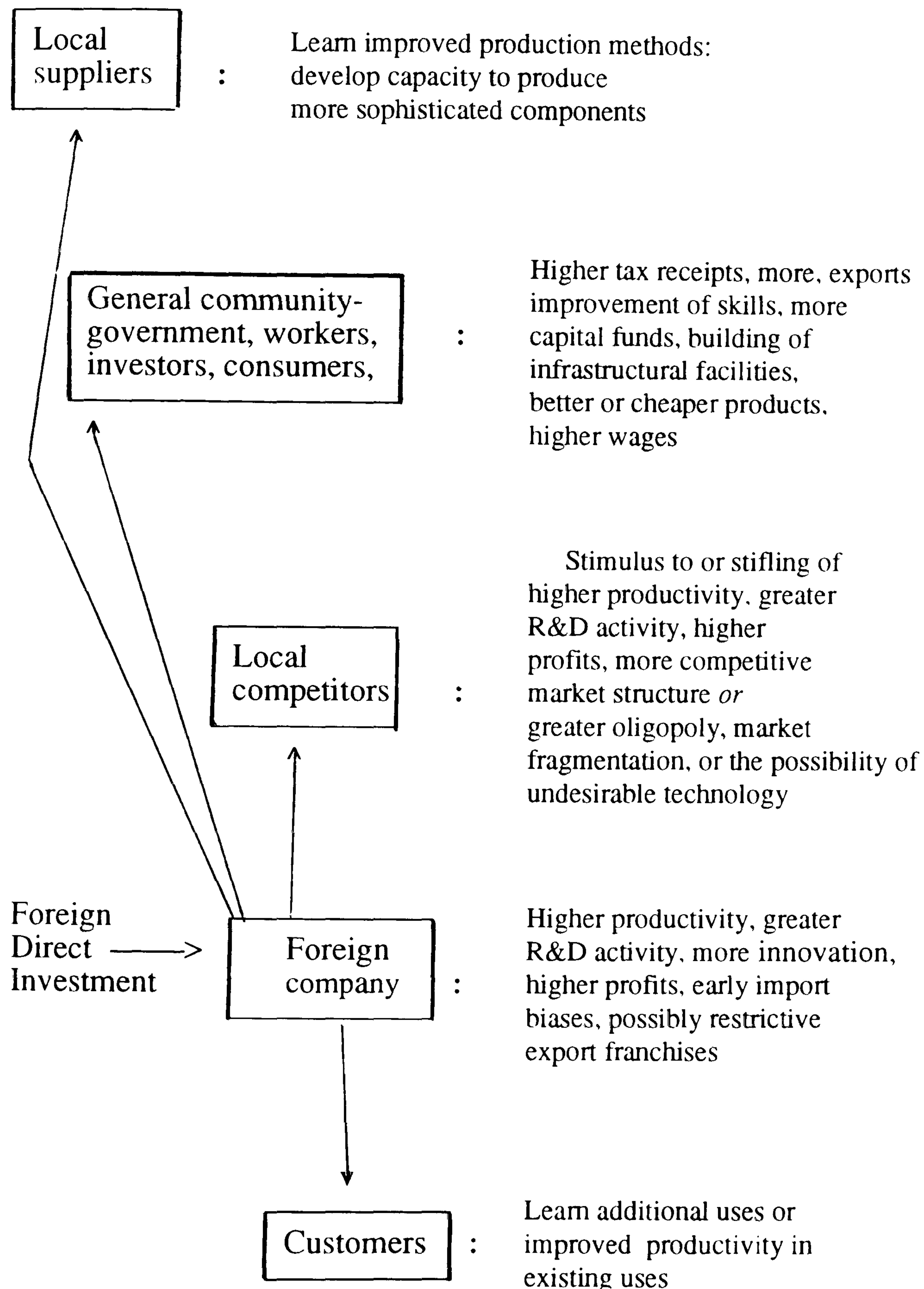
### 4.9 Government Policies Toward FDI and MNCs

Generally, the investment proposal is judged by the Egyptian government on the extent to which it contributes to the attainment of, and conforms with, national development policy objectives. The Investment Law No. 43 of 1974 has been built on a series of historical steps to assure protection for foreign investors. This history encourages the belief that the recent liberalisation measures of law 230 of 1989 are not merely a momentary swing of the pendulum.

Since 1974 the Egyptian government has introduced a package of incentives to attract investment in Egypt. Most incentives and protections included in the law aim at making investment opportunities more attractive to foreign investors. The most significant aspect of investment law was a guaranteed protection against nationalisation, confiscation, or sequestration of the assets by judicial procedure. Further, it exempted approved investment projects from many restrictive laws which would otherwise have applied to private sector companies. According to the investment law, companies are permitted to hire workers without going through the employment offices, to define their own arrangements for involving workers, to distribute any amount of profits to workers, to import and export without licences, and to set rentals in new buildings free of rent control. Generally, incentives could be divided into two main groups, as follows:

**Figure 4.1**

**Effects of FDI on the Host country**

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*Source:* Carr, David W (1979) *The Impact of Foreign Direct Investment on the Economic Development of Australia*, Ph.D. diss., New York University.

### 4.9.1 Non-Financial Measures

These are represented in the provision of infrastructure and business services. The government spent significant amounts, notably in the 1980s, in order to renew and develop the infrastructure (telephone, water, roads, electricity, etc) especially in the new industrial sites. The government also built houses in these areas as a way to attract a work force via internal migration.

### 4.9.2 Fiscal Incentives

Law 43 of 1974 offered a variety of instruments in pursuing the objectives set for investment in Egypt. These include assurance against expropriation, tax concessions, import/export regulations, and foreign exchange control.

In addition to fiscal incentives, there are other advantages from investing in Egypt. For instance, Egypt is a growing market with substantial growth in power generation and transportation. Also, it has the largest pool of trained labour among Arab countries, the broadest agricultural and industrial base in the Arab Region, and a stable and popular government.

Notwithstanding the incentives of the Law 43, some shortcomings were encountered and these prevented the Egyptian government from reaching the required level of investment to meet the development programmes. These obstacles created investment costs and risks that in turn decreased the expected return.[9] The government has repealed Law 43 and replaced it by Law No. 230 of 1989 which reformed foreign investment legislation. The purpose of Law 230 was to enhance the objectives of the previous law and to remove the difficulties and uncertainties inhibiting foreign investment. The new law added additional incentives to lure foreign investment which other countries enjoy, so that Egypt can be competitive. It offers certain guarantees, privileges, and exemptions to foreign investors. The investment privileges fall into five categories:

- guarantees against expropriation;

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[9] Obstacles that led initial investor response to be lower than anticipated could be insufficient incentives, bureaucratic difficulties, shortage of foreign exchange, public sector problems, and poor infrastructure (underdeveloped sources of communication, transportation, and energy). For details see (Bishop, 1985, pp.552-558). But it should be noticed in addition to changing the investment law, the Egyptian government renovated and updated all means of transport and it improved sources of communications.

- exemptions from certain labour, business, and other laws;
- privileges with respect to exchange controls and repatriation of funds;
- exemption from taxation and customs duties; and
- special procedures for the settlement of investment disputes.

To be entitled to these incentives, a foreign investment has to be in an "approved project", that is, approved by the General Authority for Investment (GAFI).[10] This screening function is designed to guarantee that a given project fits into the country's economic development programme, thus reducing the chances of a costly conflict at a later date.

Law 230 has made changes in these particular areas and in the overall framework for foreign investment in general. It is helpful to begin with a brief review of the major characteristics of Law 230.

### 4.10 Overview of Investment Law No. 230 of 1989

As mentioned earlier the purpose of the new Law 230 of 1989 was to introduce considerable liberalisation of policies and procedures relating to FDI. The law determines the principal aspects of investment in Egypt. These could be outlined as:
- Fields of authorised investment,
- Joint ventures with locals,
- Foreign Exchange Requirements and repatriation of profits and funds, and
- Incentives and guarantees of investment.

These issues will be dealt with in detail in the following discussion.

#### 4.10.1 Fields of Authorised Investment

Law 230 states that investment activities should be within the framework of the general policy of the country and the aims and priorities of the national plan for economic and social development. Hence, the law refers to some priority areas in which foreign investment is invited. It highlights clearly land reclamation, industry, tourism and housing as activities for FDI. However, other fields may be added according to the requirements of the country, on the initiative of the GAFI.

Unlike Law 43, banks, investment companies, reinsurance companies, transportation companies, construction companies and technical consultancy companies may no

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10 For facilitating routine procedures for investment, the government issued in June 1991 a "negative statement" which involves projects to be approved by the GAFI. All other projects not included in the statement will not require any approval.

longer be established under the new law. It is clear, for instance, that the authorities consider that there are enough banks in the country.

### 4.10.2 Joint Ventures with Locals

Generally, joint ventures in developing nations entail at least three chief parties: MNCs, national partners and the governments of the host countries. Law 43 contained a clear statement of principle; that projects under the law, other than Free Zone, projects should have participation by Egyptian capital. In three cases, the minimum Egyptian participation was specified: joint venture banks (51%), construction contracting companies (50%), technical consultancy companies (49%). These activities are in any case omitted in the new investment law. Joint ventures undertaken in conjunction with local enterprises and individuals are more highly favoured by the Egyptian government than those with state-owned companies.

Unlike Law 43, Law 230 involves no such declaration of principle and no specified minimums. Hence the law permits approved projects to be full foreign ownership whatever the activity of the project. This obviously is a liberal attitude to foreign investment, compared with many other developing countries.

### 4.10.3 The Repatriation Guarantees on Invested Resources as a Safeguard to FDI

The legal regulation governing the repatriation of invested funds is of considerable significance to the FDI decision. This being so, attention should be paid to two problem areas, namely, the exchange regulations on the one hand, and repatriation of income and company capital on the other hand.

The freedom to acquire foreign currency is essential to the operation of FDI. For instance, Law 230 gives projects a general right to operate a foreign currency account. Guaranteed rights to repatriate invested capital on the liquidation of a corporation and to remit profits and capital are extended to foreign investors by Law 230.

Law 230 mentions that the remittance of profits shall be within the credit balance of the foreign currency account of the company. This means that if a company earns sufficient foreign exchange, its profits will be transferred with no limitations. But if the foreign currency are not sufficient, the company may acquire foreign exchange from the free market in order to fully transfer its profits.

As far as FDI is concerned, companies under the investment law are permitted to maintain foreign currency accounts in Egypt in the form of working capital, foreign loans, proceeds of sales and other remittances from abroad. There are no exchange

control restrictions imposed on transactions with these accounts, but quarterly reports must be submitted to the GAFI regarding the operation of the accounts.

Apart from companies, banks are also permitted to execute foreign exchange transactions within the framework of a general authorisation, without need to obtain specific exchange control approval.

To get the foreign currency needed for imported inputs to their production process, the great majority of companies in this study purchased dollars from the free market. Another group met its foreign exchange needs from exports. A third group got foreign exchange allocations from the official pool, but since these allocations were insufficient or delayed, they also had recourse to the free market. A financial executive of a pharmaceutical company reported during the field study that the company obtains its imports, sometimes, through a credit from U.S. Aid Commission. In this case the documentary credit is valid for 6 months.

### 4.10.4 Pricing and Profits

Generally, a foreign investor looks for profitability, safety, and a market. Egypt can offer all of these. On the profitability count, products of investment companies are not subject to compulsory pricing or profit ceilings since they pay world prices for inputs. However, some basic products may be excluded from these exemptions for the public interest, such as pharmaceuticals.

### 4.10.5 Protection Accorded by the Law

Article 8 of Law 230 stipulates and guarantees the safeguarding of FDI. These guarantees involve: (1) guarantees against confiscation or nationalisation of investment projects; (2) guarantees against seizure, requisition, blocking, sequestration or custody of project assets and funds; and (3) no expropriation of real estate or property, either partial or full. The new investment law states that, in case of acquisition for reasons of public interest, fair compensation is payable based upon the market value of such property. Companies established in the free zones may not be nationalised or confiscated.

Aside from the law, bilateral agreements for the protection of private investments have been signed with some countries.

### 4.10.6 Import/Export Regulations

A large number of developing countries restrict, or require importers to obtain a licence for, imports across their borders. The licence is usually a prerequisite for

obtaining the foreign exchange necessary to pay for the imports. In Egypt, there is no control system on imports by MNCs. Law 230 gives companies the right to import their production requirements: materials, equipment and machinery, and in quantities which are necessary for their activity or an expansion thereof, without any being subject to the procedures relating to importation in general. Similarly, to help implement an export strategy, the law provides that companies may export without a licence.

Apart from the law, it should be noted that if there are substitutes produced locally imports would be restricted. However MNC subsidiaries often argue that local substitutes differ in quality and do not meet their production standards. Therefore, they seem to create artificial reasons to obtain their requirements from their parent group. Also, the technology transfer contract enables the licensee firm to buy materials, components and parts from the technology supplier, which could be the MNC in most cases.

### 4.10.7 Investment Incentives as a Criterion for Encouraging FDI in Egypt

Fiscal instruments affecting the formation of subsidiary companies belong to the most important category of investment criteria. Apart from attracting direct investment, both domestic and foreign, incentives are usually designed to achieve specific development goals, such as the development of particular sectors of production or services, regional development, export promotion, technology transfer, stimulation of employment of nationals, stimulation of training and R&D, and the increased use of domestic inputs in the production process. These incentives take a multitude of forms, such as tax holidays and exemption from other kinds of taxes, applying a low rate of tariffs. A further investment criterion for foreign companies is the possibility of transferring profits and capital.

Meanwhile, there are some incentives which could be used to achieve economic and social objectives rather than simply as mechanisms to attract foreign investment. This is clearly seen in the case of the location of enterprise in free zones to encourage exports, or in new cities; and in the use of local content in the manufacture.

#### 4.10.7.1 Tax Concessions

The Egyptian government provides fiscal incentives to stimulate investment in basic industries and other industrial sectors of special importance, as well as in various geographically-disadvantaged regions of Egypt. Such fiscal policy measures provide tax exemptions for a period of time. Under Law 230, several tax incentives have been offered to FDI as follows:

1. A corporate income tax exemption is granted for a period of five years from the first fiscal year following the start of production or commencement of activity as determined by the GAFI. This period may be extended for a further five years if necessitated by reasons of "public interest" taking into consideration project's activities, its location and its contribution to exports, employment and social and economic development.

2. Promotion for regional areas. All investment companies are exempted from the payment of income tax for fifteen years where projects are established in new industrial regions, new urban communities, and remote regions.

3. Promotion of sectors of the economy. The sectoral incentives relate primarily to projects of land reclamation, real estate development, establishment of new cities and industrial zones. The tax holidays for these sectors are similar to those that are embodied in the regional incentive scheme. To encourage investment in medium or low housing, the law gives tax exemption for 20 years.

4. In all cases, the tax reliefs will be increased by another two years if the percentage of the local component in equipment, machinery and outfits exceeds 60%. It is noticed that funds invested in lands and buildings are not counted in the calculation of the percentage. Additionally, an approved expansion of a project will benefit from a further five years exemption.

5. Exemption from stamp duty: Firms established under the investment law are exempted from stamp duties and notarisation fees.

Under the provision of the law, companies operating in free zones are exempted from income taxation as well as complete customs exemption on capital assets and working capital for the life of the firm. The idea of such exemptions is to encourage these companies to export their production and to enhance the balance of payments.

In general, the tax exemptions and extensions available are greater than those under Law 43. They now stretch from five years for the basic exemption to 20 years in the case of medium or low cost housing.

#### 4.10.7.2 The Taxation of Distributed Profits

All dividends from an investment which are remitted to entrepreneurs or undertakings not residing in Egypt are exempted from the general tax on income to the extent of 10% of the original value of the tax-payer's share in project capital. This exemption is raised to 20% for a joint-stock company which offers its shares for public subscription and where at least 40% of its capital has been subscribed.

Profits from invested foreign capital can also be re-invested and benefit from a similar tax holiday.

#### 4.10.7.3 Customs Duties

Law 230 of 1989 offers "special tariff rates" on imports by investment companies. Capital assets are exempted from customs duties. All investment projects qualify for a flat 5% customs rate on their requirements. Companies working in free trade zones are outside the customs territory of Egypt, on the condition that they export their production. This gives rise to a different status to merchandise placed within the zone.

On the other hand, exemption from customs duties encourages foreign company to get their production requirements from abroad under the pretence that local requirements are not of the same quality. So it is not surprising that the rate of local inputs reaches only 22% in the beverage industry, 24% in the car industry and only 4% in a pharmaceutical company (Issa, 1989, p.39). Therefore tariffs impetuses should be restricted to induce MNCs to buy raw materials as much as possible from the local market. This will help to raise the efficiency of different industries.

The same problem occurs with equipment and machinery as they are completely exempted from customs duties. Foreign companies import all capital goods from their parent companies or other sources abroad. Only 8% of these assets were local components. Law 230 encourages foreign companies to depend on local components. It gives projects tax exemptions for an additional two years if the local component in machinery, equipment and outfits exceed 60%.

It should be noticed that the incentives mentioned above have contributed to an expansion of investment activities in Egypt. The accumulative volume of inward stocks of FDI were 7.0 and 14.9 billion of dollars from the period 1974-1979 and 1974-1984 respectively (UNCTC, 1988, p.381). Investment in services took up a remarkable share in Egypt, accounting for 45% of total investments, from 1974 to 1984. Table 4.9 shows the value of inflows for the period of 1975 to 1985.

### 4.10.8 Critical Comments on Law 230

There are some drawbacks in Law 230 which could be summarised as follows:

1) The law restricted FDI to five main fields for investment. This restriction should be revamped, leaving the decision to the investor. Only banned activities should have been explicitly mentioned.

**Table 4.9**
**The Value of Inflows to Egypt 1975-1985**

| Year | Inflows ($M) | OER | E£M | GDPD | Inflows (E£M real terms) |
|---|---|---|---|---|---|
| 1975 | 8.5 | 0.39 | 3.32 | 47.3 | 7.02 |
| 1980 | 547.9 | 0.70 | 383.53 | 91.6 | 418.70 |
| 1981 | 752.3 | 0.70 | 526.61 | 100.0 | 526.61 |
| 1982 | 293.9 | 0.70 | 205.10 | 107.7 | 190.44 |
| 1983 | 489.6 | 0.70 | 342.70 | 119.7 | 286.30 |
| 1984 | 728.8 | 0.70 | 509.60 | 130.9 | 389.30 |
| 1985 | 1177.8 | 0.70 | 823.90 | 144.6 | 569.78 |

**OER** = Official Exchange rate, **GDPD** = Gross Domestic Product Deflator.

*Source:* Inflow in U.S. dollars from UNCTC (1988a, p.504); Official Exchange Rate from The Central Bank of Egypt, *Economic Review*, various issue; and the Gross Domestic Product Deflator from Khier-El-Din (1990).

2) Because the law is full of exemptions and requires exceptional powers to grant privileges this could mislead the investor about his legal rights and obligations.

3) The role of the GAFI is criticised because of long and bureaucratic procedures for any approval. The investor has to get an approval for most decisions, such as setting up the business, transferring profits abroad and so on. Some people have called for the abolishment of the GAFI. It is believed that the existence of this organisation is important to control investing companies. But any delays should be overcome and the procedures simplified.

### 4.10.9 Are Regulations alone Sufficient to Attract FDI into Egypt?

The Egyptian government changed policies and regulations affecting MNCs in an attempt to spur greater amounts of FDI. Despite these changes, however, flows of FDI have only increased slightly. Thus, policy changes alone may have a limited impact. In developing countries that possess a large and growing internal market or substantial productive resources, changes in policies and regulations can prove instrumental in helping attract greater amounts of FDI. At the same time, the experiences of developing countries with policy changes suggests that blanket liberalisations may be less effective than changing or adopting specific regulations or elements of policy towards MNCs. In addition, some policy changes may be effective

in certain economic conditions, and not effective in others. This means regulations and changing policies are not sufficient to attract FDI.

In many cases, the investment decisions of MNCs are influenced by two factors:

1) Business climate and government's favourable attitude and confidence towards foreign investors. Relating to this point, while the overall regulatory framework had been liberalised, the administrative apparatus continued to be combersome and time consuming which could impede and give a bad impression about the buiness climate in Egypt.
2) The rate of return on investment. When an investment decision is undertaken by a MNC, the corporation puts forward the capital, technology and management, bears the risk and receives the returns. In this regard, the ROI should be sufficient to cover all risks.

Therefore the Egyptian government should focus on these two factors as a way to attract FDI into the country.

### 4.10.10 The Effect of World Transformations on FDI Flows into Egypt

The Egyptian government should take into account the effect of political and economic transformations on FDI in Egypt. In other meaning the establishment of the single internal market within the Western European countries at the beginning of 1993 has already attracted substantial increase in FDI into these countries in anticipation of higher external barriers. The increase of FDI into these countries may occur at the expense of FDI into developing countries. The more frequently MNCs select investment locations within EC, the more likely they will refrain from selecting locations in developing countries.

The ongoing changes in the Central and Eastern European countries, and their encouraging linkages with MNCs may also come at the expense of FDI in developing countries.

It is possible that some developing countries may ultimately benefit from the single international market. To the extent that increased FDI in the EC leads to an intensification of competition, lower-cost offshore production locations within developing countries may become more important. Also, if the larger internal market leads to an enhanced competitive position among European MNCs, they may increase their FDI in developing countries in order to compete within U.S. and Japanese MNCs on a global basis

## 4.11 The MNC and Economic Development: The Advocates and Critics

The activities of the MNC have naturally become a focus for countries interested in development and economic transformation and they are considered the most powerful motivation within developing states. Such a commitment is embodied in the United Nations General Assembly Declaration on the Establishment of a New International Economic order embraced by Arab nations and other third world countries:

> "All efforts should be made ..... to encourage the industrialization of the developing countries ..... and win a view to bringing about a new international economic structure which should increase the share of the developing countries in world industrial production."[11]

Such a concern in host nations with growth and development, followed the disappointment with the unrealized expectations of the First Development Decade. There was an inadequacy of aid in the form of an investment-domain in which MNCs play an extremely important role (Pearson, 1970). This shift has highlighted and added significance to concern about the relationship of the MNC to the process of development.

## 4.12 The Effect of MNCs on the Egyptian Economy

In determining the effect of MNCs on the Egyptian economy, three issues should be taken into account. These issues can be summarized as follows:

**First:** It is essential to determine the yardsticks by which one should assess the contribution of FDI. The criterion to evaluate MNCs activities in host countries should relate basically to the country's welfare, which differs from one country to another.

**Second:** It is necessary to ask how one can assess and measure the impact of MNCs in host countries in the absence of research which would show how host country's resources would be used if MNCs were operating elsewhere. In other words, the opportunity cost approach will be useful to evaluate the effect of MNCs on using the resources of the host country.

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11 U.N. General Assembly Resolutions 3201 (S-VI) and 3202 (S-VI), "Declaration and Action Program on the Establishment of a New International Economic Order", May 1, 1974, reprinted in Guy F. Erb and Valeriana Kallab (eds), 1975, *Beyond Dependency: The Developing World Speaks Out*, New York Overseas Development Council, pp.185-202.

**Third:** It is very important to assess the effect of MNCs to special issues, such as employment.

The impact of MNC activities on the Egyptian economy will be discussed around some elements including:

a) The effect of MNCs on the balance of payment,
b) The effect of MNCs on tax revenues,
c) The effect of MNCs on profit extraction,
d) Royalty payments by subsidiaries in Egypt,
e) Return on investments,
f) The effect of MNCs on providing employment,
g) Social welfare and MNCs,
i) The impact of technology transfer and R&D activities,
j) Marketing, trade marks and names, and
k) Transfer pricing manoeuvres.

### 4.12.1 The Effect of MNC Activities on the Balance of Payment Flows

Generally, in estimating effects of MNCs on the balance of payments, it would be essential to gather information relating to financial flows and outflows between the host country and other countries. Information of inflows might be easy to determine. Outflows information which involve intra-company imports, profits repatriated, payments of royalties, interest charges, and management fees are not easy to depict as there is no full disclosure neither by companies nor the Egyptian government.

Even if we take only the values of exports and imports as an example to assess the effect of foreign companies on the balance of payments, the picture will be gloomy. Available data for 1982 declared that the value of production was E£663.9 million while the value of exports amounted to E£17 million. The value of imports amounted to E£558.8 million (Issa, 1989, p.20). The comparison between imports and exports shows that foreign companies added a deficit of E£541.8 million to the balance of payments.

In fact, this condition contradicts with aims of Investment policy in Egypt, from the point of the host country. In other words, the project should be self sufficient in its hard currency requirements so that the value of its exports cover all imports and transferring profits.

However, in judging the effect of the operations of MNCs on the balance of payments of a developing country, it should be realised that although currency saving might be achieved in terms of the alternative cost of direct imports of finished goods from the same suppliers, the actual outflow of funds from these operations is most likely to outbalance the inflow.

### 4.12.2 The Effect of Foreign Companies on Tax Revenues

As mentioned previously, tax revenues are very important as they represent a substantial proportion of income for financing the expenditure of the state. Therefore, the contribution of foreign investment companies should be viewed in terms of the country's total tax receipts. As the investment law gives these companies tax facilities, this could have adverse effect on tax receipts and the balance of payment simultaneously. In fact, when investment companies are eligible to pay taxes, i.e. after expiring the tax holiday period, most of the MNCs might evade taxation, easily, by such techniques as transfer pricing, royalties and service fees, and/or submitting unfrank statements showing low profits or even losses. This is evidenced by the very low level of tax receipts from these companies shown in Table 4.10.

It is believed that an ineffective tax system and lack of legislation to prevent tax evasion, besides financial and economic incentives which the government offered resulted in no considerable tax accruing to the country from foreign companies, notably those of the big MNCs. Evidence of this is extracted from Table 4.10 as the average of taxes paid by those companies over that period was 3% of total taxes. Though, the amount of taxes increased until 1984/85, reaching E£317.2 million, i.e. 4.6% of total tax receipts. Tax receipts declined in the following two years to E£269.5 million, i.e. 3.5%.

The absence of effective control to scrutinise transfer prices, arbitrary allocation of administrative expenses and high royalties contributed to minimising the taxes paid by MNCs.

The problem of administrative corruption of tax authorities in Egypt might be added to factors that induced MNCs to evade paying fair taxes. Therefore, the Egyptian tax system is inadequate in terms of its control capacity.

In summary, according to a statement made by a servant in the GAFI: *"MNCs look for profit, and they produce goods that are profitable for themselves"*. For instance, General Motors of Egypt announced that the net income posted a 141% jump in 1989 comparing to the year earlier, in spite of the fact it absorbed only 35% of its capacity. It should be noted that the company is still in the tax holiday period.

**Table 4.10**
**Tax receipts from Foreign Companies and its Relative Importance to the Total Tax Receipts 1981-87 (E£ M)**

| Year | Total Tax Receipt of the Country | Total Tax Receipt from Foreign firms | Relative Importance (%) |
|---|---|---|---|
| 1980/81 | 4181.0 | 48.2 | 1.2% |
| 1981/82 | 5479.7 | 59.2 | 1.1% |
| 1982/83 | 5923.5 | 156.6 | 2.6% |
| 1983/84 | 6148.1 | 219.9 | 3.6% |
| 1984/85 | 6966.9 | 317.2 | 4.6% |
| 1985/86 | 7593.6 | 269.5 | 3.5% |
| 1986/87 | 7909.7 | 273.7 | 3.5% |

*Source:* Tax Administration (1988) Unpublished Data, Cairo.

### 4.12.3 The Effect of MNCs on Profit Extraction

The frequent tendency of the MNCs working in Egypt is to transfer profits abroad. Not surprisingly the amount of profits transferred by six MNCs exceed more than the half of total profits transferred by all MNCs between 1975 to 1986. These companies transferred E£20 million which equals 54% of the total profit transferred abroad. Table 4.11 indicates the development of profits transferred by industry sector. The table indicates that the relative importance of these transfers has been increasing since 1984.

### 4.12.4 Royalty Payments by Subsidiaries in Egypt

Royalty payments for technology and services depend on the terms of the contract regarding know-how, technical information, use of licences, patents, trademarks, or trade names. These payments usually take the form of a given percentage of sales and/or a lump sum.

As far as Egypt's case is concerned, Table 4.12 illustrates these payments made to MNCs in different industries. The rate of payment ranges between 1.5% and 5% of net sales depending on the technology package provided, the bargaining power of technology negotiators, and whether or not royalties are supplemented by other technology payments. Despite the fact that these amounts are comparatively acceptable judging by international standards, what really counts is the worthiness of transferred technologies for the royalty rates agreed upon. Also, what is remarkable,

as shown in the table is the high incidence of lump sum payments and there is no limited time for such payments in some cases.

Although many find that transfer pricing is difficult to predict for tangible transactions, as data is not easily available for many reasons, the problem with intangible transfers are particularly striking. This is because of the often unquantifiable, amorphous nature of intangibles and the very large adjustments that are associated with them. However, a government may, for example, find that a MNC who licenses a patent to its subsidiary might have similar licensing agreements with unrelated parties in countries where there is no patent protection and where several competitors exist. Although the patent would be less valuable in the latter case, it might still be used as a "comparable situation" for the related party transactions, taking into account all the facts and circumstances.

To summarise, payments of royalties and fees by Egyptian subsidiaries to their foreign parents are growing more rapidly. Thus, these payments might be used as a way to shift profits abroad, especially as the government pays little attention to the duration of technology transfer agreements. They may last from 5 years to 10 years, renewable year after year, until terminated by either of the parties.

**4.12.5 Return On Investments**

The analysis of income statements for some MNCs for the period of 1984-1987 showed high return on investment. This return ranged between 100% and 175% in three companies working in the production of dry batteries, shaving cream and the assembling of Xerox-machines; between 50% and 90% in 4 companies producing welding wires, pipes, plastic and other chemicals; and between 25% and 40% in 6 corporations producing car batteries, pesticides, and metallic products. (GAFI's Follow-up Reports, 1984-1987).

The reason for achieving high levels of profit can be imputed to, as mentioned earlier, the wideness of the local market and the nonexistence of governmental control over final price. Not to mention, royalties, licences, technical assistance fees, trade marks, and profits from abusing transfer prices. (Sakr, 1989, p.20)

**Table 4.11**

**Value of Profits Transferred Abroad and Relative Importance of Giant MNC Transfers, till 1986 by Industry Sector (E£ M) (**)**

| Year | Engineering | | | Chemicals | | | Metal | Pharma | Food-process | Total Sectors | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | MNCs | % | Total | MNCs | % | (*) | (*) | (*) | Total | MNCs | % |
| 1975-79 | 0.119 | 0.112 | 94 | - | - | - | 0.102 | - | - | 0.221 | 0.112 | 51 |
| 1980 | 0.679 | - | - | - | - | - | 0.315 | - | 0.024 | 1.000 | - | - |
| 1981 | 1.309 | 0.112 | 9 | 0.018 | - | - | 0.504 | - | 0.070 | 1.900 | 0.112 | 6 |
| 1982 | 1.4 | - | - | - | - | - | 1.100 | - | 0.070 | 2.600 | - | - |
| 1983 | 2.6 | 1.6 | 61 | 0.129 | 0.093 | 72 | 1.000 | - | 0.075 | 3.800 | 1.700 | 44 |
| 1984 | 3.0 | 2.0 | 65 | 0.837 | 0.756 | 90 | 1.300 | - | 0.084 | 5.300 | 2.700 | 51 |
| 1985 | 4.6 | 4.1 | 90 | 2.500 | 2.400 | 97 | 1.500 | 0.318 | 0.407 | 8.900 | 6.500 | 74 |
| 1986 | 4.1 | 3.6 | 89 | 5.200 | 5.000 | 97 | 2.400 | 0.636 | 0.072 | 12.400 | 8.700 | 70 |
| TOTAL | 17.8 | 11.5 | 65 | 8.600 | 8.300 | 96 | 8.300 | 1.000 | 0.800 | 36.500 | 19.800 | 54 |
| Percentage of Transferred Profits to Registered Capital | 62 | 92 | - | 32 | 68 | - | 86 | 2 | 23 | 31 | 80 | - |

(**) Other foreign companies in Egypt transferred profits, but they are not shown in the table because they are not MNCs. These companies concentrate in spinning and weaving industries, construction materials, and thermal industries.

(*) No profits transferred for MNCs.

*Source:* Sakr (1989, p.33).

## Table 4.12
## Royalty Payments by Subsidiaries in Egypt to their Parents, 1988

| Name of MNC | Main Product | Annual Sales (E£000) | Royalty Payments % of net sales | Royalty Payments Lump Sum | Royalty Payments Other |
|---|---|---|---|---|---|
| **American Companies** | | | | | |
| Chemical Production for Construction (CPC) | Plasticizer, water proofing compounds, bonding agents | 1410 | | | $71000 p.a. |
| Crush Int. | Soft-drinks | 18000 | | $50000 | |
| Dr. Pepper Co. | Soft-drinks | 8800 | | $502000 | |
| Gillette | Shaving blades | 1400 | 1.35% | | |
| Guardian Industrial | Flat glass | 53416 | 3% for 7 years | | |
| Combustion Engineering Pioneer Hi-bred Int. | Hybrid corn seeds | 8400 | | $609000 | |
| Reynolds Int. | Aluminium products | 4899 | 2% | $300000 | |
| Royal Crown Cola Int. | Soft-drinks | 5700 | | | Restricted imports of material from the parent co. at a value of E£744000 |
| Warner Lambert Co. | Biscuits, Chocolates | 2452 | 2.5% | | |
| **French Companies** | | | | | |
| Bonna | Concrete pipes | 5000 | | | E£50000 p.a. |
| Chambon Engineering | Wood products (Wooden doors) | 1332 | | F.F.450000 | |
| Equipments Mecaniques Specialisés | High-Pressure hoses and other rubber products | 500 | | F.F.3138000 | |
| Evian Source Cachet Badoit | Mineral water | 7800 | 3% | | |
| Giordano S.A. | Solar heating | Min. 400<br>1000 & over | 4% if min. sales (400.000)<br>3% if sales 1 M<br>2% if more than 1 million | | |
| Soeiété des Tuyau Bonna | Pipe wrapping | 5000 | | $50000 | |
| Vittour (Société General des Eaux Minerales) | Natural spring water | 3940 | 5% for 5 years min. fees equal of E£100000 | | |

(continued)

## Table 4.12 (concluded)



| Name of MNC | Main Product | Annual Sales (E£000) | Royalty Payments | | |
|---|---|---|---|---|---|
| | | | % of net sales | Lump Sum | Other |
| **Italian Companies** | | | | | |
| Ariston | Refrigerators | 3450 | | | $518000 p.a. |
| Instituto Bio-chémico Italiana | Pharmaceuticals | 1080 | | $270000 | |
| Marzotto Co. | Ready made garments | 1763 | | $712000 | |
| **Japanese Companies** | | | | | |
| Maruhon Kohsan Co. | Metal spare parts & tools | 2735 | | E£51180 | 10% of profit 10 year |
| Yoshida Kogyo K. | Metal & plastic zippers | 735 | | $224000 | |
| **UK Companies** | | | | | |
| Guiness Peat Int. | Flat glass | 3375 | 1.5% | | |
| S. Silka | Ready made garments | 1 M (piece) | $400000p.a. | | |
| **German Companies** | | | | | |
| Bavaria Feuer-Loscher | Fir extinguishers | 568 | | DM102000 p.a. | |
| Pieher Maschinen und Schraubenwerke AG | Cranes | DM 9 M | | 5% | |
| VDM Aluminium GMBH | Solar heaters | 900 | | Capitalisation of know-how (max. 27% of total equity) with min. fees E£135000 | |
| **Other Companies** | | | | | |
| Altex (Sweden) | Painting (Surface casting) | 916 | 2.5% if net profit > 20 of equity | $114000 | |
| Associated Capsules PVT Ltd. (India) | Pharmaceuticals (Gelatine capsules) | 12000 | | $400000 | |
| Ditta Benedetto/ Globe Trotters (Italy/France) | Men clothing | 43670 | | | $415000 p.a. |

*Source:* Compiled from the GAFI's records.

### 4.12.6 The Effect of MNCs on Providing Employment Opportunities

One of the main objectives of economic development plans in Egypt, is to create new jobs to meet the expected labour supply. As the government is responsible for creating jobs, it was believed that FDI would alleviate the burden shouldered by the government in this respect. Therefore, the government requires the MNCs to employ Egyptians and train them to acquire new skills. The criterion applied by the government is that the number of Egyptian employees in any project should be at least 80% of the total and their remuneration not less than 70% of all wages and salaries.

When evaluating the contribution of MNCs to specific problems such as employment the vital question would be whether the role of MNCs to this problem is a good contribution or not? Despite the existence of MNCs in Egypt creating new employment opportunities and developing skills, their number was few. This is due to the fact that these companies tend to be highly capital and skill intensive with little employment implications. MNCs are concentrated in industries such as pharmaceuticals, chemicals and to a lesser extent engineering. In the first two industries, according to UNIDO (1969, p.43), the potential for substitution of labour for capital is limited to about 5 to 10%.

In some industries, MNCs have had negative effects on the labour market. This can be seen when analysing the employment structure in these companies and their policies used to attract skilled labour from national companies and not from the new labour force. This means that MNCs do not add, in reality, new job opportunities but they take advantage of using skilled labours which has accumulated experience and training. Table 4.13 illustrates the distribution of labour force recruitment by years of experience, in of the some giant MNCs.

On the other hand, it should be noticed that MNCs in Egypt continue to operate without or with only a skeleton expatriate staff. The adequate selection and training of Egyptian personnel are in a better position to ride the storm.

In short, MNCs have not created new real job opportunities, but have chosen to draw upon the human skills of the country.

**Table 4.13**

**The Framework of Labour Force in some MNCs, 1986**

| A. Labour Framework according to the Length of Experience Period (Average of 9 projects) | | B. Framework of Production Labour (8 projects) | | | |
|---|---|---|---|---|---|
| **Period of Experience** | **Percentage of Labour Force** | **Projects** | **Skilled Labour** | **Unskilled Labour** | **Percentage of Skilled Labour** |
| Less than 1 year (new) | 9% | P1 | 22 | 21 | 105% |
| 1 to < 5 years | 43% | P2 | 37 | 30 | 123% |
| 5 to < 10 years | 32% | P3 | 25 | 18 | 139% |
| 10 years and more | 16% | P4 | 36 | 20 | 180% |
| | | P5 | 30 | 23 | 130% |
| | | P6 | 47 | 44 | 107% |
| | | P7 | 85 | 120 | 71% |
| | | P8 | 14 | 12 | 117% |

*Source:* Sakr (1989, p.54).

### 4.12.7 Social Welfare and MNCs

It should be noticed that the price levels in Egypt have been affected by several factors such as inflation and the appearance a new class of people working in rich Arab countries who are prepared to pay high prices, especially for imported goods. Also, MNCs increased their prices sharply despite the fact that they have been enjoying a long concession period, free from taxation and customs duties and other advantages. The government has no right to control prices of foreign companies, or even to encourage them to reduce their prices, or to keep them to a reasonable level.

A frequently heard criticism of MNCs is that they promote consumption of inappropriate products through heavy advertising in low income countries (Jenkins, 1988)

To judge the role of MNCs in achieving social welfare in Egypt, one should look at the type and nature of products manufactured by these companies in Egypt. It is easy to notice that a large proportion of these products are similar to those designed for advanced country consumers. These goods are considered luxuries and are therefore ill-suited to cater for the basic requirements of the middle and lower classes of the society.

For instance, aluminium products such as aluminium frames, windows, doors, and curtains tend to predominate the metallic industry; and these products are basically made to satisfy the housing requirements of wealthy groups as well as office and hotel requisites of businessmen and tourist, not the poor's need for shelter. Likewise, the principal products of the chemical industries are those primarily consumed by high-income groups, such as cosmetics, detergents, floor waxes, etc. The same applies to engineering industries, where most products are produced for the luxury market: motor-vehicles, elevators, TV screens, cassette tapes, air-conditioners, washing machines, refrigerators, fan-heaters and other electrical household appliances. By their nature, only pharmaceutical companies direct their products to all different classes.

Because of the over-elaborate characteristics of these products and because their price is far above what the poor can afford to pay, none of them has been suitable for satisfying the basic requirements of nutrition, clothing and shelter of the majority of the population. So clearly, from the social welfare standpoint, MNCs have involved themselves to a large extent in the production of the wrong products.

Even products available for the majority of people are oriented for consumption. An example of these commodities is beverages and mineral water which are not

important, at least, for a developing country which suffers from massive economic problems. It is likely that national investment will be affected as a consequence of lowering the marginal propensity of savings.

It is likely that MNCs prefer selling domestically in Egypt to exporting, because the profit margins are so high. But the government should offer long-term opportunities for foreign companies to open export markets, at least in Arab neighbour countries. This would help the country as well as companies themselves to generate dollars to finance imports of raw materials and capital goods.

### 4.12.8 The Effect of MNCs on the Transfer of New Technology

One of the government objectives of inviting FDI is to raise existing technological know-how. The way this objective is achieved is by requiring that foreign projects should introduce advanced technology and production techniques.

As FDI is, at present, one of the principal vehicles for technology transfer to Egypt, the bulk of foreign technology and know-how transmitted through this direct investment is very significant. According to the GAFI's statistics, there are 110 foreign companies acting as technology transferors to Egypt. The list furnished is, however, far from complete, as it does not cover all means of technology flows.[12] It should be noted that most of the industrial MNCs in Egypt are engaged in technological-advanced, capital intensive and faster-growing industries, notably those characterised by high product differentiation and intensive advertising. MNCs transfer usually the same sort of technology used in developed markets and produce the same or similar lines of production. In addition, such transactions tend to be in the form of comprehensive packages.

All MNCs working in Egypt, frequently, hold agreements for the provision of various services by them especially when joint ventures take place. This means that the extent of technology transfer is influenced by the degree of ownership. Such agreements stipulate that the MNC provides technology, know-how and trademarks. The transfer of these resources becomes an essential element for the establishment of a joint venture manufacturing operation. Even when the subsidiary is wholly-owned, MNCs commonly have know-how agreements to obtain income on their technological contributions.

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12 Technology flows involve, according to Derakhshani's definition (1983), the acquisition, development and utilisation of technical knowledge by a country other than that in which this knowledge originated.

Table 4.14 illustrates the different types of technology provided under joint venture (with and without foreign equity participation) and technical assistance and licensing agreements.

In summary, the cost of imported technology is relatively high, particularly if the transfer pricing and restrictive business practices are taken into consideration. Alongside this, the country tends not to utilise, to a large extent, the technology transferred for the following reasons:

a. the limited learning of training and technical programs provided by MNCs which do not help much in increasing the nationals' knowledge on how to absorb, master, and adapt technology to local conditions;

b. the reluctance of technology suppliers to transfer technology information outside the borders of the recipient company. Kim and Kim (1985) note that MNCs are becoming more hesitant toward technology transfer. Some speculated reasons include the emergence of the so-called 'newly industrialised countries' as exporting nations. This increases competition in the international and local markets;

c. the weak technological linkage developed with the rest of the economy, especially with scientific research institutions and the capital goods industry;

d. the centralisation of decision making process at parent headquarters;

e. as indicated above that capital-intensive rather than labour-intensive technologies are often transferred to Egypt by MNCs. Consequently it does not absorb sufficient labour; and,

f. MNCs are often blamed for not facilitating the transfer process, as technology agreements include binding provisions. These legal Clauses reduce the willingness of the country to produce the same technology.

**Table 4.14**
**Type of Technology Transferred, by Economic Sector**

| Type of Technology | Food Prod. & Beverage | | Textiles & Clothing | | Wood & Wood Products | | Metals | | Building Materials | | Engineering | | Chemicals | | Pharmaceu. | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (1) | (2) | (1) | (2) | (1) | (2) | (1) | (2) | (1) | (2) | (1) | (2) | (1) | (2) | (1) | (2) |
| TA | 1 | 3 | - | 2 | 2 | 1 | 5 | 2 | 6 | 2 | 10 | 3 | 6 | 6 | 2 | - |
| TA + TM | 1 | 5 | - | 1 | - | - | - | - | - | - | 8 | - | 1 | 1 | 1 | - |
| TA + MT | - | - | 1 | - | 1 | - | - | - | - | - | 1 | 1 | 1 | - | - | - |
| TA + CS | - | - | - | - | - | - | - | - | - | - | 1 | - | - | - | - | - |
| TA + KH | 1 | - | - | - | - | - | - | - | - | - | - | - | 2 | 5 | - | - |
| TA + WS + MT | - | - | 1 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| KH | - | - | 1 | 1 | - | - | - | - | 1 | 1 | - | - | 4 | 4 | - | - |
| KH + MT | - | - | - | - | 1 | - | 2 | - | 1 | - | - | - | - | - | - | - |
| KH + CS | - | - | - | - | - | - | - | - | - | - | - | - | - | 1 | - | - |
| KH + TM | - | - | - | - | - | 1 | - | - | - | - | 1 | 4 | 2 | - | - | - |
| TM | - | 1 | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| **TOTAL** | **3** | **9** | **3** | **4** | **4** | **2** | **7** | **2** | **8** | **3** | **21** | **8** | **16** | **17** | **3** | **-** |

**Notes:** **(1)** With foreign equity participation; **(2)** Without foreign equity participation

**TA** = Technical Assistance; **TM** = Trade Marks; **MT** = Manpower Training;

**CS** = Consultancy Services **KH** = Know-how; **WS** = Work Supervision

*Source:* Compiled from The GAFI's Records.

### 4.12.9 Research and Development (R&D) Activities

R&D activities are usually centralised in the parent company and institutions in developed countries where prevailing market and institutional conditions stimulate technological development. In this regard some authors criticise MNCs in Egypt as they do not locate R&D activities locally. For example in the pharmaceutical sector, "foreign subsidiaries ... have proven to be as poor channels for technology transfer as their parent multinational companies. No research and development capabilities to speak of are being prepared locally .... Despite the fact that some agreements had R&D Clauses, only one drug assessment supplemental to a parent company programme was initiated and no R&D contribution is expected from all these sources". (Galal, 1983, p.240)

In effect, as will be discussed in Chapters 6 and 7, none of the companies covered by the study did establish laboratories for basic scientific or development research. What was available at best in some companies was simply a division or a department for technical service and quality control. To try and set up a separate research division was considered a too early commitment and a very costly and risky gesture, given the nature and requirements of R&D activities and the features of host developing countries.

In fact, MNCs' behaviour to concentrate their R&D facilities in the headquarters countries might be an attempt to tighten control over the subsidiaries. In addition, it is argued that MNCs invest abroad to spread their R&D costs over more markets. So, they can not be expected to re-incur similar costs just in the interests of the host country.

### 4.12.10 Marketing Arrangement, Trade Marks and Trade Names

The foreign investor was assumed to play a significant part in promoting exports and opening up new outlets through export commitments, promotional aid, advertising techniques, use of trade marks and trade names, and so on. But unfortunately in most cases reviewed, the marketing policy was heavily directed towards the domestic market with very few exports. Suffice to emphasise that actual exports of already established companies do not surpass at best 5% of total output, which is far below what they had originally projected. Only 4 companies reported that they have started to export since 1988. The percentage of exports was not significant in comparison with the total revenue. Exports were chiefly confined to liquid (car) batteries, shaving blades, and pharmaceutical products. The main reason for this is found in the relative attractiveness of the domestic market in which they enjoy quasi-monopoly power and/or exert price leadership practices. One can also add the reluctancy of foreign

investors to expand sales across the borders of the host country, especially in areas where they already carry out similar activities or have granted export rights to someone else. Frankly speaking, none of the companies seems interested in promoting manufactured exports, at least not to their source country or traditional markets. The trade marks and names of companies enjoying market recognition, such as Xerox, Gillette, Squibb, General Motors, Colgate, Vittal, are widely used simply to expand the local market by ensuring high quality control. As shown in Table 4.14 over one-fifth of technology suppliers are making such trade marks and names available to joint-venture companies most of which are engaged in the production of consumption goods, particularly cosmetics, beverage and consumer durables. And to make matters worse, a significant number of free zone projects are applying to the GAFI for transfer into inland projects.

### 4.12.11 Transfer Pricing Manoeuvres

Transfer pricing, as indicated in Chapter 3, can be abused by overpricing of imports, underpricing exports, over-evaluation of foreign investor's contribution (e.g., overpricing of technical equipment imported), capitalisation of know-how and so on. It is very difficult to calculate how much is the overcharge or undercharge, as they require full information of transfer prices charged and their arm's-length prices in the free market.

Transfer pricing tends to be, to a large extent, in the form of overpricing of imported materials and capital goods, especially if technology suppliers are directly involved in the procurement of the inputs and machinery. The sparse information gathered in this respect indicates a price differential ranging between 15% and 30%.

For machinery and equipment which represent about 95% of total assets (Sakr, 1989, p.46), MNCs tend to import all equipments required for production lines as a package deal. At the same time, they do not admit domestic substitution, except in small-range cases, which could be 5% of the total assets at most. This issue is clear in projects that depend mainly on advanced technology and produce marked commodities for the local market. Also, in the case of joint-ventures, the percentage of foreign contribution is high, especially for the American contribution. The reason for MNCs insisting to import all their equipments is to utilise the exemption from customs duties and profits achieved abroad from supplying machineries. Also, the ability of these companies to save foreign currencies, required for imports through suppliers facilities, and bank loans and guarantees.

In fact, MNCs are more integrated in their home economies for their requirements for inputs of components and raw materials. One study concluded that U.S corporations tend to import most of their inputs from the U.S. or Europe. In the meantime local enterprises have the proclivities to diversify their sources of inputs, including home markets (Mason, 1973, p.353).

With regards to MNCs in Egypt, the field study illustrates that MNCs depend on imports of these goods for assembly and production operations. The percentage of imported products amounts to 95% of total value of production requirements in some industries as shown in Table 4.15.

As mentioned previously, MNCs argue that they prefer to get their material requirements from abroad because of either the nonexistence of the local counterpart or its quality is low. In fact there are some hidden inducements for preferring the production requirements importation. They achieve, in most occasions, additional significant profits in the form of supplying commissions in return for contracting with foreign suppliers. Over and above, they could abuse transfer prices, hence shifting profits abroad for tax evasion. Also, imported materials might infiltrate to be sold at high prices in the local market instead of using them in the production. This extreme case could happen in the absence or weakness of the host government's control (Sakr, 1989, p.48).

**Table 4.15**

**Percentage of Production Materials Imported by MNCs in Egypt**

| Economic Sector | Ratio of materials imported to the total value of materials (%) |
|---|---|
| Pharmaceutical Industries | 90 - 95 |
| Mineral Industries | 85 - 95 |
| Engineering Industries | 70 - 92 |
| Chemical Industries | 65 - 88 |
| Beverage Industries | 70 - 851 |
| Food Industries | 60 - 72 |

*Source:* Sakr (1989, p.47).

### 4.13 Summary

This chapter has reviewed some of the more important aspects of the Egyptian environment including the balance of payments, external trade, exchange system, tax system, and customs duties. The Egyptian political system and inflation effect have also been discussed at some length.

The last two decades have witnessed many significant changes in the Egyptian environment. Since 1974, the government has taken steps to attract FDI. As FDI is now governed by Law 230 of 1989, the main aspects of the law have been discussed.

The general climate for FDI in Egypt is relatively favourable. The Egyptian government has sought to create and maintain a business environment that encourages inward investment. With regard to incentives of investment, the country can find itself in competition with other developing countries as potential locations for FDI and feel it must offer incentives to remain competitive. In such situation, MNCs may benefit from the incentives without changing their location decisions.

The existence of MNCs, as well as the widespread nature of the FDI policy has been seen to contribute some vital socio-economic consequences to the Egyptian society since the adoption of the open door policy in 1974.

Most of MNCs prefer joint venture investment with national partner, especially public sector companies, as they can benefit from their experience to dominate the local market at the lowest cost. This involves, for example, accumulated experience and knowledge of marketing and a well trained workforce.

At the same time, MNCs prefer to acquire the majority of capital to enable them to control the company. For instance, when the UK Chloride Group has established its subsidiary in Egypt with local investors, the basic agreement for the project was that if the share of capital of the parent company becomes 50% or less the subsidiary must change its name and will not have the right to use the patent at all.

Whilst the government encourage investment companies to use local components by extending the tax holiday, it seems this incentive is not enough. The government should necessitate the use of local materials and production components by other ways such as low prices or subsidies to complying companies.

# Chapter 5

# Research Design and Methodology

## 5.1 Introduction

A review of the literature reveals that much of the discussion about MN transfer pricing is still based on conjecture and speculation. The basic reason for this is that much of the writing is theoretical and lacks an empirical investigation. Hopefully, this study will result in the formulation of a refined set of propositions that may be further tested in future research.

The methodology adopted in this study is a multiple case-study approach. It is hoped the study will produce some useful suggestions relating to manipulating transfer pricing techniques and profit shifting in MNCs. The research goals include identifying variables that influence transfer pricing decision, determining the relationship among these variables and examining the strength of these relationships, and clarifying why such relationships between variables exist. Katz (1965), Simon (1969), and Kerlinger (1973) all pointed out the suitability of the case study methodology in similar research settings.

The case study approach represents the fulcrum point of this research, data was collected from 11 MN subsidiaries in Egypt; in-depth interviews with financial executives and other staff were performed; and data from governmental sources and an accounting firm was collected.

This chapter focuses on the research methodology and design of the study. A significant amount of the discussion will be devoted to the case study approach. The chapter is segregated into 7 parts. Section 1 deals with the research methodology and design. Section 2 presents questions of the research. Section 3 illustrates propositions that have been tested in the case study. Section 4 is concerned with the questionnaire that was used for collecting data. Section 5 focuses upon the case study approach, seeing as it represents the cornerstone of this research. Section 6 discusses the sources of data of the field study. The last section discusses the reason of focusing the study on pharmaceutical companies.

## 5.2 Research Methodology and Design

The collection of data through a case study approach is guided by a protocol, which should include: (1) an overview of the project, including a statement of the research issue; (2) field procedures, including the specification of sources of information; (3) case study questions, including 'shells ' for the data to be collected; and (4) a guide for the case study report, including its outline and format (Yin, 1987). Therefore, the protocol is designed to increase the reliability of the research process.

Where the study involves more than a single case, a replication, as opposed to a sampling logic, is suggested (Yin, 1987). Each case is considered equivalent to a single experiment, and analysis follows a cross-experiment, rather than a within-experiment, design and logic (Figure 5.1). Replication may be either literal or theoretical, and is dictated by the theoretical framework, which mentions the conditions under which case findings should be the same (literal replication) and different (theoretical replication).

The overall research design was adopting a multiple-case study approach to collect data from companies. This research strategy is recognised as strong with respect to realism of context, but relatively weak with respect to generalisability and to precision in control and measurement of variables (McGrath, 1982). Some factors influencing the choice of this approach were as follows:

1- The sensitivity and complexity of transfer pricing issues in MNCs makes it difficult to collect data from a large number of companies. Using the case study approach is appropriate when the sample is limited. This approach could provide the breadth and richness of information necessary for the research.

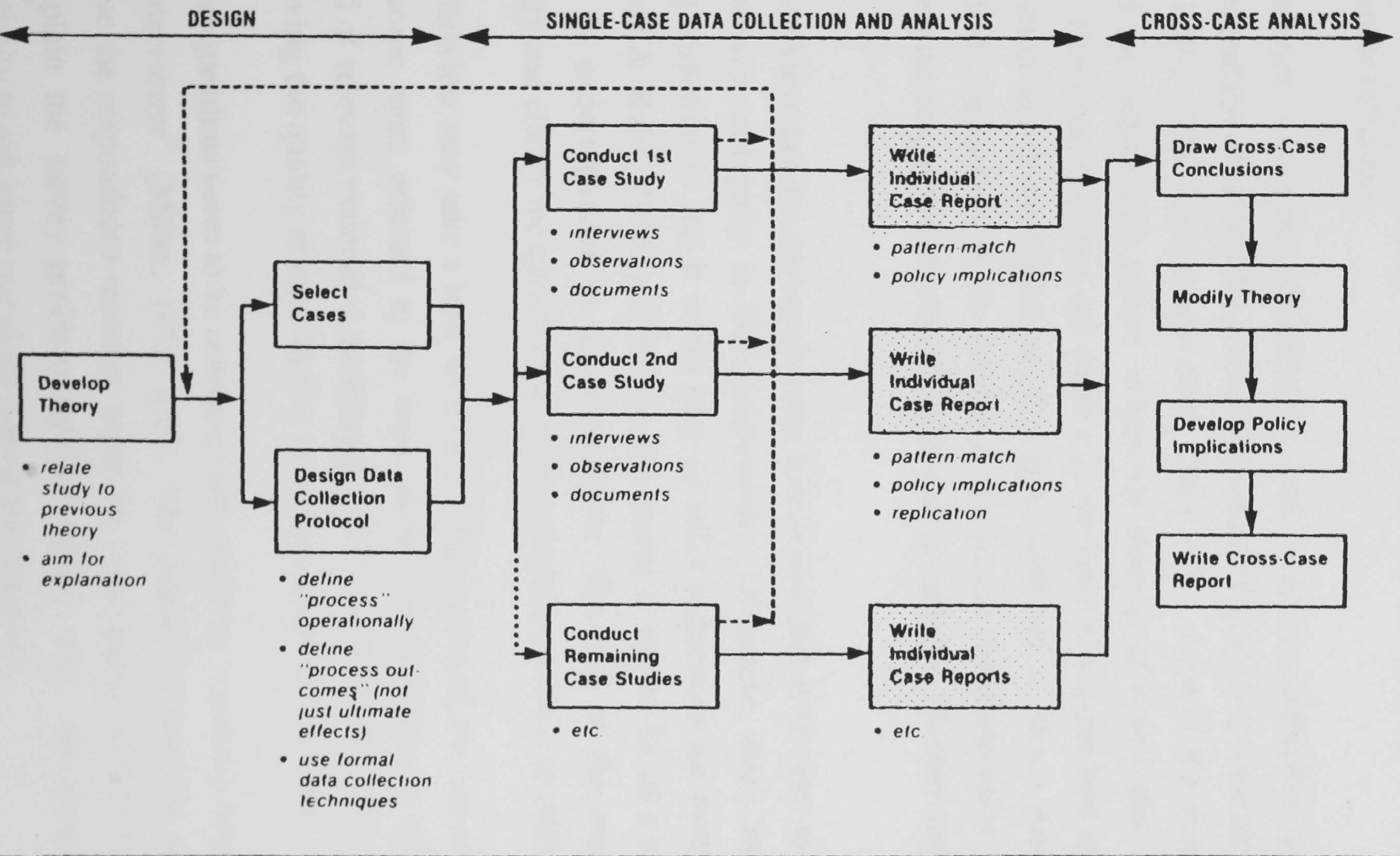
2- The case study approach is particularly suited for 'why' and 'how' questions. It is these kinds of questions which are considered in this field study.

A questionnaire was used to collect the required information from each company. By using questionnaires in case studies to investigate the problem, two significant merits would be achieved. Firstly, findings could be interpreted more rationally. Secondly, hypotheses used could be more adequately tested (Katz, 1965, pp.58-59).

In addition, another questionnaire was administered by interview to government staff, to pinpoint how the Egyptian government authorities deal with the transfer pricing problem. The authorities involved were GAFI, customs officials and tax authorities.

**Figure 5.1**

**The Case Study Method**




*Source:* Yin (1987, p.51)

The major objective of this research is to investigate the relationship between transfer pricing techniques and profit shifting in MNCs working in Egypt. The transfer pricing, as mentioned earlier, is not only extremely complex but also very secretive.

The chosen methodology achieves the following objectives:

1- Acquiring observations from a high ranking persons (general, financial, manufacturing, and marketing executives in companies investigated; and government officials).

2- The interview, as a means of collecting data, is often an effective way to yield a high percentage of returns for most respondents willing to co-operate (Kidder and Judd, 1986, p.225, Gorton and Carr, 1983, p.37), even if the required data is beyond the individual's power to provide directly (Cannell and Kahn, 1965, p.330). However, this does not mean that the interview is the best instrument for observation in all circumstances. But it is preferred to direct questions to the individuals themselves, in the absence of barriers to communication. This might " motivate the respondent to answer fully and accurately" (Kidder and Judd, 1986, p.225).

3- The interview can be managed more effectively and it is easy to explain and indicate any ambiguity in the questionnaire. Of course, there are differences among respondents and it is not easy to tailor a question for every respondent (Cannell & Kahn, 1965, p.358). So, the question should be in a standard form which is understandable to all respondents. The role of the researcher is to simplify and clarify the questions to avoid misinterpretations or misleading.

4- The interview may take a long time, as a consequence of the respondent needing to become more oriented to the topic under investigation. In this matter, the "recall of relevant material is facilitated" (Miller, 1970, p.87). This could lead to improving the quality of data, hence, securing acceptable findings.

5- If some questions seem to be sensitive, they could be "carefully sandwiched in by the interviewer" (Miller, 1970, p.87). The researcher has the opportunity to observe the respondent's reaction, hence he "can change the subject if necessary or explain the survey problem further" (Ibid). Also, the researcher has the opportunity to ask more questions during the interview.

The development of research design is very important for carrying out case studies. It guides the researcher in the process of collecting, analyzing, and interpreting data. Hence, it enables him "to draw inferences concerning causal relations among the

variables under investigation" (Nachmias and Nachmias, 1976, pp.77-78). A research design comprises of four components, (1) a study's questions, (2) propositions, (3) units of analysis, (4) data analysis and interpretation of the findings.

## 5.3 Key Research Questions

Defining the research questions is the most important step to be taken in a research study (Yin, 1987, p.19). The research questions represent a basic framework for the required data. They could produce propositions to be tested. Since the objective of this study is to examine the extent of shifting profits through transfer pricing technique in MNCs working in Egypt, a number of key research questions were formulated:

(1) To what extent do MNCs working in Egypt use transfer pricing techniques to inflate their profit on account of the interests of the host country and their home country?

(2) What are the important factors taken into consideration when setting transfer prices in MNCs?

(3) What are the perceived and actual effects of MNCs on host countries in the area of profit shifting?

(4) How do tax authorities and customs administration deal with the transfer pricing problem in MNCs?

(5) Do the Egyptian authorities involved issue regulations for the calculation of an arm's-length price on intra-group transactions?

In order to answer these questions, some propositions were developed to be tested in the field study.

## 5.4 Research Propositions

The formulation of usable propositions is of central importance as it pinpoints the relationship between two or more variables. Determining the content of the required data depends upon the research propositions. Good and acceptable propositions should have some the following characteristics:

i. Propositions must be specific, conceptually clear, and represent relations between variables.

ii. Propositions should have clear and available implications for testing these relations (Kerlinger, 1973, p.15).

Propositions of this study are based on a theoretical development of the literature. The propositions about transfer pricing behaviour are straightforward, i.e., MNCs set transfer pricing policies that differ from their arm's-length prices when they have an incentive and ability to do so. As shown in Chapter 3, there are some factors that are likely to affect the process of setting transfer prices. Taking these variables into consideration means a MNC attempts to shift more income at the expense of the host country's interests as well as the home country's benefits. Most of these variables were investigated by authors in developed countries.[1] Nine propositions were tested in this study as follows:

(1) The more environmental factors that confront and limit the ability of a MNC to reap benefits, the greater is the desire of the company to manipulate transfer prices and, to a large extent, to restore their financial mobility.

(2) The larger the amount of intra-company transactions between a subsidiary and constituent part of a MNC, the greater the opportunity to shift profits by manoeuvring transfer prices.

(3) The more that a monopoly is employed by the MNC, the greater the manoeuvre of transfer prices.

(4) MNCs might use more than one method of transfer pricing policy.

(5) MNCs confront the same environmental problems in regard to international transfer pricing.

(6) The greater the risk, either political or economic, in the host country, the larger the transfer prices of imports by the subsidiary from the parent or other subsidiaries in the same group, and vice versa, and therefore the more profits are shifted out of the risky countries.

(7) MNCs take market conditions and competition into account as an important factor when designing transfer pricing policies.

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1 See for example Shulman (1975) for US companies, Tang (1979) for comparison between US and Japanese firms, and Arpan (1991) for several developed nations.

(8) MNCs inflate their royalties paid by Egyptian subsidiaries as a way to shift more profits

The next proposition is related to Kopits (1975):

(9) If the host country's income and dividend withholding tax rates are greater than the home country's income tax rate, the MNC may inflate royalty payments to the parent company so that the company's worldwide tax burden is reduced.

## 5.5 Questionnaire Structure

An extensive literature review provided the framework for the development of the questionnaires. The review enabled the researcher to identify specific problem areas and provided insight as to the identification of key variables. The analysis of contents of the company questionnaire and the government officials questionnaires[2] appears in following two sub-sections.

### 5.5.1 Analysis of the Company Questionnaire

Despite the fact that a case study approach does not require, necessarily, designing a questionnaire to obtain data required for investigating the research propositions, a questionnaire was used to ensure consistency and completeness in the interview process, especially where a tape recorder method was unwelcome by the respondents. A cover letter accompanied each questionnaire (Appendix A). During the interview specific questions and relevant points which were touched on or were insufficiently covered in the questionnaire were discussed with respondents.

The questionnaire aims at finding the method(s) used in setting transfer prices and testing a number of environmental factors which might be taken into account in this respect. Also, assessing to what extent the Egyptian authorities are concerned with the transfer pricing aspect.

An effort was made to ensure that the items included in the questionnaire were relevant and easily understood. Therefore, the questionnaire was pretested even after already having had several revisions. The researcher was interested in the potential respondent's evaluation of the study (all were very enthusiastic), such as whether or not the questions were clear and readable, and what questions should be omitted or added to the questionnaire. The pretesting study was carried out in two ways:

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[2] As Arabic versions of questionnaires were used in collecting data, a copy of each questionnaire in Arabic and English language appears in the Appendix.

1- After translating the questionnaires from English to Arabic it was typed by a Management lecturer at the University of Mansoura. A former professor in the U.S. for more than 10 years, and a current general executive of research and information division at the GAFI read both English and Arabic versions.

2- In a five-hour session with two directors of the accounting division of a MNC in Egypt, the company questionnaire was examined, and critically evaluated. The directors were asked to answer the questions according to the instructions and then to carefully review all the items from a critical perspective to seek out problems, such as ambiguity or redundancy.

The results of the pre-test suggested that there was little need for revision. In addition, none of the respondents involved in the pre-test indicated any degree of difficulty in interpreting the items as presented.

The tool used in this study may have some limitations in terms of validity and reliability, but procedures were used to check these, as reliability is a necessary prerequisite of validity; unless measurement is reliable, it cannot be valid. Consequently, if the researcher can demonstrate the validity of his instrument, he presumes that it is reliable (Suchman, 1967, p.320). To check reliability, the precision and accuracy of items related to transfer pricing aspect, is not easy since any change in opinions expressed might reflect a real change. Therefore, in order to ensure validity in the questionnaire and the interview, items are repeated in different forms, without destroying the conceptual meaning of the variable to be tested. Thus, in order to determine the reliability of an item, for example concerning transfer pricing determinants, one can check the answer of other items which are also intended to determine investment obstacles in Egypt. This method of cross-examination was also followed in the pre-testing and in the main questionnaire. On the other hand, concerning the question of validity of items, that is, whether the items were really measuring what they had to measure, this was established on the basis that the measure had been used previously by other researchers (Tang, 1979; and Burns, 1983).

The questionnaire (see Appendix A) was divided into five sections to obtain data regarding general company characteristics, transfer pricing policies, environmental determinants of international transfer pricing policies, the importance of transfer pricing from the Egyptian authorities' point of view, and the allocation of intangible assets and joint expenditures between the MNC group.

It should be noticed that the subjective-judgements were coded as numerical values, a higher number indicating a higher level of the specified criteria. A standardised 5 point scale was used. For example 5 for "most important", 4 for "very important", 3 for "important", 2 "fairly important", and 1 for "not at all important"

**I- General Company Characteristics**

The first section of the questionnaire requests general information to provide knowledge about the companies participating. Specifically, information was sought on the name and nationality of the firm, the age of the company, industry, method of investment, currency used in management accounts, and the name of the person responsible for completing the questionnaire.

**II- Transfer Pricing Policies**

Section II of the questionnaire contains questions aimed at finding the percentage of intra-company transactions, and how frequently cost-based and market-based transfer prices were used to price transactions. Participants were asked in 5-point scale fo determine how frequently each method of transfer pricing is used. The scale was 1 for "Never used", 2 for "Rarely used", 3 for "Sometimes used", 4 for "Frequently used", and 5 for "Usually used".

Data provided by the participating companies was used to test proposition 5. Participants were also asked to indicate their role in establishing and reviewing transfer prices. Table 5.1 provides a list of the variables and corresponding questions from Section II of the questionnaire.

**III- Environmental Determinants of Transfer Pricing**

As the key purpose of this research was to investigate the extent of shifting profits through transfer pricing, it was essential to study motives that induce MNCs of doing so. By analysing these factors, one could judge, to a great extent, if profits are trasferred outside the country or not.

Therefore, section III of the questionnaire is concerned with these factors that have greatest influence on formulating transfer prices. A list of 24 factors was developed after an extensive review on MN transfer pricing. Although the list is not exhaustive, but includes most of the important factors mentioned in the literature. The respondents were asked to indicate the purpose of designing transfer pricing policies, ranked by order of importance. The responses were scored as 1= not at all important; 2= fairly important; 3= important; 4= very important and 5= most important. These

variables appear in Table 5.2. In the same section, participants were asked to rank the five most important variables.

This Section also includes questions about the importance of MNCs to the Egyptian economy and the obstacles that MNCs face in improving their investment in Egypt. The rest of the questions from this part are shown in Table 5.3

**IV- The Importance of Transfer Pricing to the Egyptian Authorities**

This section aims to throw light on the importance of the transfer pricing issue from the perspective of the Egyptian authorities. A pattern emerged from the questionnaire item which requested managers to indicate the importance of MNCs to the Egyptian economy. Table 5.4 corresponds to the list of questions of part IV in the questionnaire.

**V- Intangible Assets and Allocating Headquarters Expenditures**

This sections deals with the allocation of intangible assets and joint expenditures between the subsidiaries of the MNC. As discussed in Chapter 3 transfer prices involve all kinds of transactions, for example, goods, services, know-how, loans and a like. Table 5.5 provides a list of the variables and corresponding questions from Section IV of the questionnaire.

### 5.5.2 Analysis of the Governmental Authority Questionnaire

The second group of questionnaires was directed to government authorities including GAFI, tax and customs authorities. The GAFI questionnaire aimed to obtain information about the degree to which MNCs help the host country's government in solving its severe economic difficulties. The questionnaire also sought to determine the importance of the transfer pricing issue to the Egyptian authorities and assess any restrictions imposed on capital outflow.

The aim of the questionnaire directed to the tax and customs authorities was to pinpoint the possibility of scrutinising transfer pricing and the extent of applying an arm's-length basis on intra-company transactions if there is any doubt. Problems that face tax and customs authorities over the transfer pricing issue were also included in these questionnaires.

Tables 5.6, 5.7, and 5.8 list the variables and corresponding questions on the questionnaires directed to GAFI, Tax Authorities, and Customs Department respectively.

**Table 5.1**
**Survey Source of Transfer Pricing Policies**

| | Factor | Information Source (Section, Question) |
|---|---|---|
| 1. | Percentage of intra-group purchases | II (1) |
| 2. | Percentage of intra-group sales | II (2) |
| 3. | Transfer pricing policies | II (4, 5, 6) |
| 4. | Extent of existence of external market price | II (6, 7) |
| 5. | Sources of subsidiary sales distributed between domestic market and overseas market | II (8) |
| 6. | Restrictions imposed by the Egyptian government on the imports and exports of the subsidiary | II (9, 10, 11, 12) |
| 7. | Responsibility for setting up and reviewing transfer pricing policies | II (13, 14, 15) |
| 8. | Frequency of reviewing transfer pricing policies | II (16) |
| 9. | Extent of buying production requirement from outside market | II (17, 18) |
| 10. | The extent of using dual accounting books for the purpose of financial statement and income tax | II (19) |
| 11. | The extent of relating the reported profit to the subsidiary performance | II (20, 21) |

**Table 5.2**

**Variables Considered for Transfer Pricing Policies ***

1. Maximisation of the group's overall profit
2. Differentials in income tax rates and income tax legislation among countries
3. Rates of customs duties and customs legislation in Egypt
4. Anti-dumping and Anti-trust legislation in Egypt
5. Compliance with tax and customs regulations of home country
6. Restrictions imposed by the Egyptian law on the repatriation of profits and capital
7. Restrictions imposed on the amount of R&D, royalties and other overhead costs charged against the subsidiary
8. Maintenance of adequate cash flow in the subsidiary
9. The need of the subsidiary to seek local funds
10. Shifting profits to another subsidiary to cover part of its losses
11. Level of inflation in Egypt
12. Multiple exchange rates
13. Existence of price controls in Egypt
14. Existence of export subsidies and tax holidays in Egypt
15. Market conditions and competition in Egypt
16. Risk of expropriation and nationalisation in Egypt
17. Existence of local shareholders
18. Performance evaluation of each subsidiary
19. Divisional autonomy
20. Maintenance of good relations with the host government
21. The bureaucratic system to deal with Egyptian authorities
22. Ambivalence of regulations in Egypt
23. Rules and requirements of financial reporting for the subsidiary
24. Simplicity and ease of application of transfer prices
25. Others (to be specified)

* [illegible] 1, 2, and 3 of the company questionnaire.

**Table 5.3**
**Survey Source of Investment Information**

| | Factor | Information Source (Section, Question) |
|---|---|---|
| 1. | The importance of MNCs to the Egyptian economy | III (4) |
| 2. | Factors influencing the company decision to invest in Egypt | III (5) |
| 3. | Major obstacles to investment in Egypt | III (6) |
| 4. | The crucial factors that influence investments in Egypt | III (7) |
| 5. | Sources of subsidiary finance in order to expand investment in Egypt | III (9) |

**Table 5.4**
**Survey Source of Transfer Pricing Importance from the Egyptian Authorities Perspective**

| | Factor | Information Source (Section, Question) |
|---|---|---|
| 1. | The extent of legislating transfer prices by the Egyptian government | IV (1, 2) |
| 2. | The extent of re-computing intra-group transfers arbitrarily by customs departments | VI (3, 4, 5) |
| 3. | The extent of changing net profits by the tax authority | VI (6, 7, 8) |
| 4. | Testing transfer pricing policies by external auditor | VI (9) |
| 5. | Requirement of financial reporting regarding the disclosure of transfer pricing policies | VI (10) |

**Table 5.5**

**Survey Source of Intangible Assets and Allocating Headquarters' Expenditures**

| | Factor | Information Source (Section, Question) |
|---|---|---|
| 1. | The extent of allocation of loan interest and other funds | V (1) |
| 2. | Rates of allocation of loan interest | V (2) |
| 3. | Criteria for allocating intangibles assets | V (3, 4) |

**Table 5.6**

**Survey Source of Questions Directed to General Authority for Investment**

| | Factor | Question Number |
|---|---|---|
| 1. | Factors attracting MNCs to invest in Egypt | 1 |
| 2. | The extent of involving the Egyptian government in determining transfer prices for MNCs working in Egypt | 2 |
| 3. | The extent of adopting transfer pricing policies by MNCs to avoid restrictions imposed by the host government | 3, 4, 12 |
| 4. | The extent of exaggerating royalties paid by the Egyptian subsidiaries to their parent companies | 5 |
| 5. | The disclosure requirements of transfer pricing policies in the financial reporting in Egypt | 6, 7 |
| 6. | Restrictions imposed by the Egyptian authorities on transferring profits by MNCs | 8, 9 |
| 7. | The economic environment in Egypt and its affect on MNCs to move capital funds out of the country | 10, 11 |
| 8. | The importance of MNCs for the Egyptian economy | 1, 13 |
| 9. | Difficulties of collecting required information from MNCs | 14, 15, 16, 17 |

**Table 5.7**

**Survey Source of Questions Directed to Tax Authorities**

| | Factor | Question Number |
|---|---|---|
| 1. | Problems that face tax authorities in assessing the taxable income of MNCs | 1 |
| 2. | The extent of changing reported profit by MNCs to decrease the tax burden | 2 |
| 3. | Scrutinising transfer prices by tax authorities | 3, 4, 5 |
| 4. | Criteria for treating intangible assets when assessing taxable income | 6 |

**Table 5.8**

**Survey Source of Questions Directed to Customs Officials**

| | Factor | Question Number |
|---|---|---|
| 1. | Problems that face customs officials when determining customs duties on imports by MNCs in Egypt | 1 |
| 2. | The extent of underinvoicing of imports by MNCs in order to lessen customs duties burdens | 2, 3 |
| 3. | The extent of using guidelines by customs departments to describe the arm's-length price | 4,5 |
| 4. | The extent of negotiating customs duties with MNCs | 6, 7, 8 |
| 5. | The average of customs duties rate applied on imports | 9 |

## 5.6 The Case Study as a Research Strategy

The term "case study" refers to a fairly intensive observation of an individual unit (rather than the total population) through discussion and observation in order to throw some light on any particular set of questions. In so doing, it describes a situation or a sequence of events, leading up to some particular behaviour. The case study method is to be contrasted with statistical methods which yield averages and in which departures from average in one direction tend to be offset by departures in the opposite direction. The key characteristics of case study method are portrayed in Table 5.9.

**Table 5.9**
**Key Characteristics of Case Study Approach**

1. Phenomeonon is examined in a natural setting.
2. Data are collected by multiple ways.
3. One or few entities are examined.
4. Complexity of the entity is studied intensively.
5. Experimental controls and manipulations are not involved.
6. Exploration, classification, and hypothesis development are features.
7. Results depend heavily on the integrative powers of the investigator.
8. Changes in site selection and data collection methods may take place during the research.
9. 'Why' and 'how' questions may be addressed through operational links traced over time.
10. Focus is on contemporary events.

*Source:* Adapted from Benbasat *et al.* (1987).

Commonly, one purpose of the case study technique is to obtain "a better knowledge of the significant variables rather than the final testing of a well-formulated theory" (Katz, 1965, p.65). This instrument provides for flexibility in approach, allows scope and apparent freedom to the investigator regarding the quantity of data to be collected, the procedure adopted in collecting it, and the sources of information to be tapped. So, it is preferred in examining contemporary events (Yin, 1987, p.19).

The case study approach has greater depth and more intensity compared to other methodologies. The reason is that the investigator focuses study on a small scale, That is, a single community or a single group according to its social structure. Hence, the interrelation and interaction are more obvious and the process of observation is on-going. More details and more perspectives will also be available in the case study (Katz, 1965, p.58).

Case studies are useful in exploratory research. Selltiz *et al.* (1962) designate it as a "stimulating insight" maintaining that the intensive case study approach is particularly

useful in unformulated areas, where it might suggest hypotheses for further research. Yin (1987) emphasises the importance of the case study as a research strategy in the field of social sciences. The purpose of the case study here is to explore more information representing real life and to gain a better understanding of the relationships between variables. Katz (1965, p.75) indicated that the main advantage of the case study is its "inductive procedure, its potentiality for discovering significant variables and basic relations that would never be found if .... research [was] dictated by a hypothetical-deductive model". It is well known that case studies have a number of strengths and weaknesses. These strengths and weaknesses matters will be discussed after determining the validity and reliablity of case-study approach.

### 5.6.1 Validity and Reliability of the Field Study

The Validity of the method of data collection is concerned with the question "Does the researcher measure what should be measured"? This requires to gather some sort of evidence to give confidence that a measuring tool does in fact measure what it appears to measure. The reliability refers to the ability of the analysis to reproduce the same parameter values from subsequent sets of preference judgement. The validity and reliability of this study can be assured as follows:

1) The use of different sources of data (interview and questionnaire) is important in contributing to the overall data validity and reliability, as is well recognised (Mitchell, 1985). Method variance was thereby reduced.

2) The generalisability, i.e., external validity, of multiple case study data was assessed where comparable data on a reference population are also available.

3) The composition of case narratives also served an important data validation function. Storytelling made sense, so to speak. Internal validity was enhanced in that gaps and inconsistencies were exposed and subjected to resolution. External validity was tested by the believability of the story to the outsider.

4) Multiple case studies are not inexpensive to conduct. However, efficiency may be achieved where the work is guided by a conceptual framework and set of proceudres that focus the data collection effort.

5) Access to companies investigated was not so difficult as is sometimes portrayed. Privacy and confidentiality must be respected.

### 5.6.2 Strength of the Case Study Approach

Kerlinger (1973) considers the case study approach is strong in realism, significance, strength of variables, theory orientation, and heuristic quality. The realism of the case study is obvious because it reflects real life. Generally, "the more realistic the research situation, the stronger the variables" (Kerlinger, 1973, p.402). The realism similarly increases the external validity, hence generalisation made from the study to other situations becomes more valid. Heuristic quality is very highly in this field because the researcher can use experience and practical efforts to find answers to questions or improve the performance. Therefore, this field is "rich in discovery potentially" (Kerlinger, 1973, pp.407-405)

As the case study has unique merits, the investigator could expect more information. The reason being that "people involved in communication activities maintain many contacts and often have information which does not appear in their official reports" (Katz, 1965, p.69). Stake (1981, p.32) has emphasised that a good case study could "provide different and better knowledge /than statistical generalisations by/ providing more valid portrayals, better bases for personal understanding of what is going on, and solid grounds for considering action".

It is most likely that some information obtained from various respondents would be discrepant, which requires additional exploration. The researcher might find, by extra investigations, whether these differences "are a function of idiosyncratic perception and experience or a reflection of group membership and role differences" (Katz, 1965, p.70). Advantages of case studies could be dilated as follows:

1- The case study tends to continue over a period of time, so it is likely to maintain continued observation. The usually prolonged involvement of the researcher means that interconnections of events can be traced over time, so that processes can be inferred. This allows the cross-checking of data and findings.

2- Observation techniques can be employed directly, so it is easy to obtain a description of the same sets of data described by interview respondents (Bower, 1970, p.28, Gorton and Carr, 1983, p.37).

3- The case study technique allows interdependent reactions and mutual perception to be obtained from various individuals whose behaviours are interrelated to make up the social structure.

4- Case studies are unique in enabling the researcher to observe events of the study in its natural occurrence. They can also give depth of understanding to survey

findings. The researcher can have more rich insights and hypotheses for more rigourous experimentation.

5- The case studies can furnish the essential information, hence increasing the chance of the study being more successful. Also, case studies allow the researcher to utilise a the whole series of methods of data collection (Bryman, 1989, p.172).

### 5.6.3 Limitations of the Case Study Approach

As a technique of research, the case study approach has a number of weakness and limitations. Katz (1965); Bloom and Fischer (1982); and Yin (1987) mention some aspects that weaken the case study approach. These weakness could be summarised in the following points:

1- The lack of rigour, because of either the dubiousness of evidence or biased views, influence the direction of findings and conclusions. The investigator must take these issues into consideration and work hard in order to overcome these problems.

2- Like all exploratory research, findings of a single case study should be seen as tentative. However, a number of insights can be gained and hypotheses suggested for future research. It is believed that a single case study can not be representative of the whole population, although within multiple case studies there is a conscious attempt to increase the range of generalisation. It is proposed by many writers that findings of any case study could be considered as a part of the theoretical framework and a guide for generalising to similar studies in the future (Yin, 1987; Zikmund, 1984). Furthermore, case studies should be evaluated in terms of the adequacy of the theoretical inferences that are generated (Yin, 1987).

Some methodologists however are suspicious of generalisation based on statistical deduction at a single point in time. Findings based of samples, however large, are often stripped on their context when generalised across time and space. Cronbach *et al.* (1980, pp.231-235) have suggested the term of extrapolation to solve the dilemma of generalisations. Unlike the usual meaning of the term "generalisation", an extrapolation obviously signifies that one has gone beyond the narrow boundaries of the study to consider other applications for the findings. Extrapolations are modest conjectures on the likely applicability of findings to other situations under similar, but not identical, conditions. Extrapolations are logical, thoughtful, and problem-oriented rather than purely empirical, and

probabilistic. Extrapolations are helpful when based on information-rich samples and designs.

3- Data collection procedures are not routinised. This means data could not be conducted by a researcher assistant. Skills required for collecting case study data are much more demanding than in experiments and surveys. In this situation, there is a little room for the traditional research assistant. The required skills might be represented in:

   a) The researcher should be able to ask good questions and secure valid and reliable answers. Questions should be carefully worded and presented to facilitate obtaining answers which give useful information to the objectives of the survey (Chisnall, 1986, p.137).

   b) The researcher must be a good listener to assimilate large amounts of new information without bias.

   c) The researcher must be adaptive and flexible, so that newly encountered situations could be seen as opportunities, not threats.

   d) The researcher should be unbiased from preconceived notions, including those derived from theory. This means that he should be sensitive and responsive to contradictory evidences.

4- Another problem facing the case study approach is the likelihood of the lack of co-operation by respondents. This problem is related to the time required for investigation. The case study requires much time on the parts of both the investigator and the interviewee to obtain the required information. A respondent might make excuses not to meet the researcher under the pretence that he is busy on important work. The respondent often takes a special interest in the problems at issue; he becomes more knowledgeable and more critical and, to that extent, less representative. Also, he might change his behaviour as a result of the greater awareness produced by repeated questioning. This could have an affect upon the research objectives. Nevertheless, successful case studies can make unique contributions.

5- The investigator should indicate the nature of the study and its objectives and give information interviewees. The problem that emerges here is the amount of information that has to be given. This problem is also connected with the time allowed for the study. Of course, this obstacle is clear if the study is wide in its coverage.

To ensure that the interview is effective, the researcher has to take into consideration the following aspects during the interview:

a) The main objective of the study should be clear to the respondent.

b) The researcher must work through the specific areas for investigation.

c) The researcher's third task is to help the respondent once he has begun to perceive his problem in a new way, to envisage a constructive approach and to be fully acceptable to the respondent. The new approach involves the creation of a new attitude in the respondent towards the problem. However, the interviewer should remain as neutral as possible and avoid interjecting any personal views.

d) Appropriate questions and behaviour should be used during the interview. Here, the questionnaire administration needs to be clearly understood, with the application of standard procedures and instructions. The researcher might define the main objective of the study and investigate all areas relevant to the problem situation. If he is unable to decide what questions are germane and accurate and express them in easily understood language to the respondent, he will not be able to accomplish his study effectively.

e) The researcher should be able to deal with the occasional aggressive, suspicious or difficult respondent. This requires the researcher to remain interested in and enthusiastic about the study even when he faces some difficulties. A rapport can be established between researcher and respondent to create a good climate. Hence, the researcher must be able to advance the cooperation without being coercive, in order to avoid the resentment of the respondent (Hoinville *et al.* 1987, p.106).

6- The observer might pry into different aspects of the study and attempt to gain access to records in order to obtain sufficient information. This behaviour might be seen unwelcome by the respondents. However, this problem might be overcome, depending on the researcher directing the interview.

In summary, it is only by means of good planning and thorough preparation before a case study is carried out, that problems to be faced can be satisfactorily overcome. In such a situation, the knowledge in case studies is more concrete, and more contextual compared to other methodological techniques.

### 5.6.4 The Choice of Sample for the Field Study

The present study focuses on practices of MNCs in Egypt to shift profits through transfer pricing devices. Hence, four objectives are realised in the study. The first is to investigate the current state of transfer pricing practices in MN subsidiaries in Egypt. The second is to identify the order of importance (ranking) of factors that affect the design of transfer pricing systems. The third is to determine the conflict between the company and the revenue collection authorities as regards transfer pricing issue. The last is to propose an optimal solution for settling the problem.

As aforementioned, the empirical investigation undertaken, in this study, involved 11 foreign companies located in Egypt.[3] Multiple in-depth interviews were generally with the directors having financial management responsibility, such as the financial manager, cost accountant, and financial analyst. Personal interviews were also conducted with manufacturing, marketing and planning officers. Standardised questionnaires were employed to collect data in order to increase reliability and comparability.

Several interviews were held with interested government agencies to record different views on the transfer pricing problem. This group involved officers in the GAFI, Customs Departments, Tax Administration. An interview also took place with officers from an Auditing firm.

Companies were chosen from four industries, pharmaceutical (4), chemical products (3), engineering and metal products (3), and textiles (1). These sectors were chosen because they have several common characteristics. There is a high degree of commitment to foreign operations in Egypt. They depend on parent companies for importing production requirements, i.e., the percentage of inward transfers is significant, especially for the first three sectors. These characteristics are important because the study was to determine the extent of transfer pricing and profit shifting in MNCs.

Meanwhile, these companies are categorised, according to the legal system, into three groups: three companies working under company law (Law 159 of 1981 which it replaced Law 26 of 1954), seven joint venture companies according to Investment Law 230 of 1989 which replaced Law 43 of 1974, and one foreign wholly-owned company working under the latter law. Table 5.10 furnishes a break-down of these

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[3] The case study approach can be conducted on one company. Some advantages can be gained from multiple case-study approaches. These merits include increasing the confidence in the generalisation of the results, especially for MN transfer pricing topic that is too complex. Likewise, comparisons, through multiple case studies, allow the special features of cases to be identified much more readily.

companies by country of origin and industrial branch. The interview pursued the same general questions, in a flexible style that permitted the inclusion of interesting experiences, and were conducted by one or two of the participants in this study.

The companies were selected from two sources: (1) a guide (*The Situation of Economic Opening in Arab Republic of Egypt, 1988*) prepared by the Central Agency for Public Mobilisation and Statistics (CAPMS) in Egypt, and (2) an "*Investor's Guide, 1985*", published by the GAFI. Some criteria have been taken into account in selecting the sample:

1- The researcher intended to focus the field study on the petroleum and pharmaceutical industries. The initial list of company names included 4 joint venture companies and a further 5 foreign concession companies in the petroleum sector. The researcher had interviews with managers of four companies besides an interview with a financial manager of the Egyptian General Petroleum Authority (EGPA) which controls all oil activities in Egypt. After discussion, the petroleum sector was excluded from the field study. The reason for this is the agreements between the national partners (public sector) or the government represented in EGPA, and the foreign investors based on production-sharing schemes. Under this system, Egypt represented by the EGPA does not bear any initial risks or costs of exploration, or any at all if no oil is found. The foreign investor recovers all costs and expenses in respect of all exploration, development and related operations under the agreement, to the extent of 40% of all crude oil produced. Such crude oil is referred to as "cost recovery crude oil". The remaining quantity 60% of the crude oil is shared between the national side and foreign investors. In the production-sharing system, payments of royalties are generally included in the government share of production. According to the agreement, the government is entitled to 10% royalties on the total quantity of the petroleum produced.

   Therefore, MNCs do not set transfer prices for the transactions with the parent or any part of the group. But the question emerges: *What is the price that should be used by the company when it pays income taxes to the Egyptian tax authorities?* To answer this question, it should be noticed that Egypt adopts a flexible pricing policy according to the international prices. So, this price is used when the MNC pays taxes.

**Table 5.10**

**Distribution of Sample MNCs Undertaking in the Study, By Country of Origin & Economic Sector**

| Country of Origin | Economic Sector | | | | Total |
|---|---|---|---|---|---|
| | Pharmaceuticals | Chemicals | Engineering & Metals | Textiles & Clothing | |
| U.S | 2 | 2 | 1 | - | 5 |
| U.K | - | 1 | 1 | - | 2 |
| West Germany | 1 | - | - | - | 1 |
| Japan | - | - | 1 | - | 1 |
| Switzerland | 1 | - | - | - | 1 |
| France | - | - | - | 1 | 1 |
| **Total** | **4** | **3** | **3** | **1** | **11** |

2- The researcher had to prepare another list and got the approval from the GAPMS. He intended the sample to represent the four industries mentioned earlier, especially the list included 20 companies, where 9 of them refused to participate in the research.

3- Among the firms participating in the study, 45.5% were U.S. nationality. This is due to the fact that the U.S. is considered the hub of MNCs' activity to the extent that the words American and MNC became synonymous especially in 1960s and 1970s. The size of U.S. investments in Egypt is considerable[4], despite its fluctuation, compared to other countries. Table 5.11 depicts the amount of investments, income and capital outflows by U.S. companies in Egypt till 1989. The nationality of the other companies participating in the study was 45.5% European MNCs and 9% Japanese MNCs.

**Table 5.11**

**U.S. Direct Investment in Egypt ($ millions)**

| | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|
| Direct Investments | 1,926 | 1,807 | 1,669 | 1,670 | 1,802 |
| Income | 494 | 85 | 219 | 208 | 315 |
| Capital Outflows | 378 | -113 | -150 | -86 | 77 |

*Source:* U.S. Direct Investment Abroad, *Survey of Current Business*, vol. 70 (8), 1990.

### 5.6.5 Obstacles of Carrying out the Field Study

The field work took three months during the period of the beginning of December 1989 till the end of February 1990. In the course of the fieldwork, some difficulties were encountered. The field work required obtaining two approvals from Egyptian authorities before going there. After contacting the Egyptian Cultural Bureau in London, a copy of questionnaires was sent by them to the Mission Department in Cairo in May 1989. The first approval, from the Security Department of the Ministry of Education, was not difficult to obtain before going to Egypt. The other approval

[4] The large size of US investments was concentrated in the petroleum sector, as it totalled $1,447 million in 1989.

was from the CAPMS in Egypt. The procedure of getting this approval was long and complicated. It took nearly seven months and even required personal contact.

Two copies of questionnaires (Arabic versions) and a list of company names were presented to the CAPMS. After getting the approval, the researcher had to get a letter from the Mission Department, the Ministry of Education directed these to each company involved in the study. Hence, the letter and a copy of the approval of the CAPMS were presented to each company.

The availability, proximity and willingness of companies to participate was found to be substantial. As the case study methodology required the co-operation of these companies, therefore a willingness to participate was an essential element for the successful completion of this study. The researcher contacted each company by telephone to have the first appointment with the company representative.

Given the possibility of non-response, nine companies indicated unwillingness to participate in the survey, either because of the information confidentiality from their point of view or because of the corporate policies against such reporting. These companies cover three sectors: Engineering (4), Chemicals (3), and Textiles and Clothing (2). More efforts were made with these companies to encourage their cooperation, but these efforts did not produce any positive response. Hence, they inclined to provide this type of information.

A financial manager of a MN subsidiary that produce photocopying equipments pointed out that the information requested is confidential. He said:

> *"This issue is very confidential, and I am reluctant to discuss it with you."*

Another manager of a company that produces dry batteries commented that the policy of the headquarters in the U.S. is not to give any information to researchers. It was known that the parent company stipulated that the Egyptian government did not establish other projects producing the same product for 5 years. Moreover the parent company exported finished goods to market them in Egypt for two years before constituting the joint venture company, as a way to study the Egyptian market.

Another manager of a computer corporation emphasised that he has to get an approval from the U.S. parent company before participating in the project which is difficult. He said:

> *"We do not give information to any researcher without an approval from the parent company in the U.S. I doubt they will agree to participate in this work."*

The same unwillingness was from a U.S. auto company. Despite two appointments with the financial manager to discuss the issue, the Vice Chairman (French) did not agree because of the confidentiality of transfer pricing aspects.

Another company declared that the year-end closing (here officials were engaged in preparing annual financial statements) precluded its participation in the study.

Despite these problems, it was possible in the end to collect data for the case study which may give some indications about abusing the transfer pricing by MNCs to coincide with their interests, hence meagre or even negative net flow for Egypt as a host country.

Some of the required data was difficult to obtain from the surveyed companies or the Egyptian authorities concerned. Such data included the cost of production, value added in Egypt, cost of intra-company exchanges and so forth.

## 5.7 Data Collection Sources

As mentioned earlier, the data required for this research was collected from three groups: MN subsidiaries, government officials, and an auditing firm. Questionnaires were designed to collect the data and were administered to respondents during the interviews conducted in Egypt (beginning of December 1989 - end of February 1990). This section provides a description of these groups, and the number and position of persons from each group participated in the research.

### 5.7.1 Population and Sample of MNCs

For the purpose of this research a MNC is defined as a manufacturing company operating under Egypt's Foreign Investment Code and wholly or partially owned by foreign investors. The data for the survey were obtained through case-study approach of 11 MNCs in Egypt. The researcher chose these companies that are likely to give an access to the somewhat extnesive volume of information contained in the survey. Names of these companies have been omitted because of the sensitive and confidential nature of the information. Hence, disguised names A,B,C,D,E,F,G,H,I,J, and K will be referred to companies participating in the study. The names of Manager interviewed also are anonymous.

It should be noticed that the empirical investigation might be seen as a preliminary test not yielding conclusive evidence but aiding the identification of the motives of

transfer pricing manoeuvres by MNCs in Egypt. As this has not been investigated in this country previously, some further explanation will be demanded.

Professional contacts with the general manager were used in each company to develop a short list of candidates for participation. Data gleaned through in-depth interviews with executive officers in the financial departments and other functional departments at the subsidiaries were of the utmost significant for the case reports and the data analysis and interpretation. The interviews were based on structured questionnaires. The interviews have been begun with a pre-arranged sequence of semi open-ended questions, then continued with more and more structure as the knowledge about specific characteristics of the investigated companies gradually increased.

Table 5.12 lists the companies and number of persons interviewed, according to function. The number of persons interviewed varied between 2 and 8 with mean of 6. A total of 63 managers were interviewed during the period. The number of visits at each company ranged from two to five. The interviews lasted from one hour to three hours.

As shown in Table 5.12, interviews were held with company executives because of the confidentiality and sensitivity of the transfer pricing issue. The letter from the Mission Department, Ministry of Education and the letter attached to the questionnaire were directed to the financial executive in each company. The financial executive identified the executive identity to be interviewed. Financial managers in two companies authorised one of their assistants to deal with the researcher. Financial executives' opinion were to hold interviews with senior executives for some reasons:

1- They have more knowledge and are involved with transfer pricing aspect more than low level staff.

2- The confidentiality and sensitivity of the transfer pricing issue. Therefore, senior managers are often reluctant to reveal any information which is likely to cause problems to the company.

All interviews were held on a completely confidential basis, with neither the interviewees nor their firms being identified in any way.

A tape recorder was carried with the researcher during the interviews. All interviewees conditioned not to use it during the interviews because of the sensitive nature of transfer pricing topic. They stated that they can talk freely without recording. Therefore, writing-up was the only means to record the interview with

respondents. It should be noticed that it was impossible to obtain any document relating to intra-company transactions.

Some managers preferred to fill the questionnaire by themselves and they kept a copy after completing it. Others preferred to talk freely whilst the questionnaire was filled in by the researcher.

Despite foreign investors prefer to have their business run by Egyptian managers, it has been realised some positions were run by foreigner.[5] The reason for preference the Egyptian manager seems to be that he is useful for the administration of the firm with regard to national business and commercial rules and regulations. Consequently, the questionnaire was prepared both in Arabic and English languages in order to overcome problems for both local and foreign co-operators. All interviews also were conducted in Arabic except one as the financial manager was not Egyptian. Hence, the interview was administered in English, and the English copy of the questionnaire was used.

Besides using the questionnaire to glean information, additional notes were recorded using writing up as mentioned above. As the knowledge about transfer pricing techniques increased from the practical viewpoint, it was possible to test tentative hypotheses. The approach used was very similar to the to the approach used by Walton (1983, pp.30-31):

> In the field, I try to develop rich description of the situation. I search for comparative data between organizations or between different time periods in the same organization. During the early stages of making sense out of the data, I rely primarily on inductive processes. I immerse myself in the data, let it soak, and then gradually organize it, searching for themes, contrasts, and causal relationships among aspects of the situation studied.

This approach does not lend itself to structured interviews, since it is designed to identify the relevant variables and suggest hypotheses about relationships between them, rather than to test hypotheses that have already been formulated. As the multiple case-study approach is used to glean information, the companies investigated will be discussed case-by-case.

Generally, many of the respondents declared that when the parent company sets transfer prices it takes into consideration what suits the organisation to show its profits, and how the prices of transactions would contribute to the group profits, rather than from calculations based on market prices. The respondents doubtless intended to

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[5] Top management and technical posts were to a large extent occupied by foreigners, at least from the home company country. As a consequence, in 10 out of the 11 companies, the managing director was nominated by the foreign investor.

argue that arm's-length pricing was not available, as is so often the case, or perhaps irrelevant; but the effect of such contention is simply to establish that pricing methods do shift profits- and by design.

**Table 5.12**

**Summary of Data Collection Effort**

| Company | Number of Interviews | | | | |
|---|---|---|---|---|---|
| | General Managers | Financial Managers | Other Managers* | Total | Number of Visits |
| A | 2 | 3 | 2 | 7 | 4 |
| B | 1 | 4 | 3 | 8 | 5 |
| C | 2 | 4 | 1 | 7 | 2 |
| D | 0 | 3 | 2 | 5 | 3 |
| E | 0 | 5 | 0 | 5 | 4 |
| F | 1 | 3 | 0 | 4 | 2 |
| G | 0 | 5 | 2 | 7 | 5 |
| H | 1 | 4 | 0 | 5 | 3 |
| I | 1 | 3 | 0 | 4 | 2 |
| J | 0 | 5 | 2 | 7 | 5 |
| K | 0 | 4 | 0 | 4 | 2 |
| **Total** | **8** | **43** | **12** | **63** | **37** |

* Primarily in manufacturing, marketing and planning.

The greater centralisation of the internal control of MNCs has clearly reinforced such tendencies. It is well known that this tendency has gone much further among American MNCs, than among European ones. When MN subsidiaries are largely autonomous, transfer pricing which would reduce the subsidiary's declared profit in favour of another part of the group is apt to be resisted by local management. Centralisation impairs such resistance, and when profit plans are drawn up on a

divisional basis, transfer prices are less likely to allow for the susceptibilities of local management.

Generally speaking, there was little evidence of deliberate, large deviations from arm's-length pricing, but arm's length prices tended not to enter into the calculations.

### 5.7.2 Population and Sample of GAFI's Officers

During the field work, an initial meeting was held with the staff of both the Research and Information and the Administrative Affairs divisions of the GAFI. The meeting was aimed at:

1- specifying the main functions undertaken by each section within the structure of the GAFI; and

2- identifying the name and position of the people responsible for carrying out these functions.

This helped in specifying those people with whom the subject could be discussed and from whom the required data might be collected.

Officers were interviewed from different divisions as follows:

- Members of the GAFI's Board of Directors.
- Industrial projects division.
- Follow up and Auditing division.
- Agricultural and Construction projects division.
- Investors Relation division
- Promotion division
- Legal Affairs division
- Research and Information division

The main function of the first three divisions is to evaluate foreign manufacturing investment proposals, follow up their actual operations, and submit recommendations to the Board of Directors. Therefore, it was decided to meet as many of the Board members and the officers working at these divisions as possible.

Although the last four divisions are not involved directly in investment decision-making they were expected to provide valuable information for the research. The Investors Relation, and Promotion divisions were expected to provide information about the major problems facing foreign investors, and the factors influencing their

decision to invest in Egypt. The Legal Affairs division was expected to provide information about the legal conditions within which foreign investments take place in Egypt. Finally, the Research and Information division was expected to provide some quantitative data which might help in supporting the research's results and findings. Table 5.13 shows the number and position of the GAFI officers who participated in the research.

Regarding Tax Departments and Customs Departments, the researcher interviewed 19 people in the former, and 16 in the latter. In the accounting firm, 2 people were interviewed and gave information relating to the study.

### *5.8 Why Focusing on Pharmaceutical Companies?*

The pharmaceutical sector is one of the most heavily represented by MNCs in both developed and developing countries. These companies dominate approximately 50 to 60% of the world production (IRM, 1985).

This sector is one of the most successful industrial sectors in Egypt. Investment in the drug industry was one of the main objectives of the first plan for industrialisation in Egypt in 1957. In fact, the industry has relied on FDI in a prior stage of opening policy in Egypt. Hence, by 1958 the Egyptian Higher Organisation for Drugs strived to encourage foreign companies to enter into license agreements with local investors to set up subsidiaries in Egypt.

As a consequence, four drug MNCs commenced their activities in Egypt in the forefront early in the 1960s after long negotiations with the government over the extent of ownership. The agreement was reached giving those companies 60% of share capital, and hence effective control of the joint venture. Domestic pharmaceutical companies also held numerous licence agreements with international firms for the acquisition of technology and know-how.

In fact, MNCs which have been aware of the implications of a developing country's decision to put restrictions on imports and have accepted to take the risk in setting up operations inside Egypt are now reaping the advantages. These are represented in great opportunities in terms of substantial increases in sales as well as the benefits of a secure and stable market for which production programmes can be well planned in advance and safely executed. As regards the Egyptian market for pharmaceutical MNCs, it has held many attractions because the population is relatively large (about 57 million people in 1991) and partly because of the ease to get any kind of medicines without a prescription. The pharmaceutical sector has been chosen for four reasons:

**Table 5.13**

**Number and Position of GAFI's Officers Participated in the Study**

| | Board's Member | Head of Division | Head of Dept. | Managing Director of Dept. | Resear-chers | Total |
|---|---|---|---|---|---|---|
| Board of Directors | 2 | | | | | 2 |
| Industrial Project Division | | 1 | 1 | 2 | 2 | 6 |
| Agricul. & Const. Project Division | | 1 | 1 | 2 | 1 | 5 |
| Follow-up & Audt. Division | | 1 | 2 | 2 | 2 | 7 |
| Investors Relation Division | | 1 | - | 1 | - | 2 |
| Legal Affairs Division | | 1 | - | - | - | 1 |
| Promotion Division | | - | 1 | - | - | 1 |
| Research & Inform-ation Division | | 1 | 1 | - | - | 2 |
| **Total** | **2** | **6** | **6** | **7** | **5** | **26** |

1- The pharmaceutical industry, as mentioned above, represents a major set of industries in which Egypt is host to inward FDI. Six foreign joint venture companies and one wholly-owned subsidiary play a significant role in the production of medicines.[6] Those companies accounted for 46.7% of the total number of drug companies in 1986 with total sales £E186.6 million (35%). Table 5.14 outlines some facts of the Foreign companies compared to national ones.

2- Because the most over-pricing was found in this industry.[7] Pharmaceutical companies inflate prices of components sent to their subsidiaries in order to gain more benefits at the expense of other parties. It is also possible that due to monopoly rights which will be discussed below, potential profits of foreign subsidiaries are high as compared to the local companies.[8] Subsidiaries therefore feel compelled to reduce the book value of its profits by reporting high costs.

In this matter, all pharmaceutical subsidiaries in Egypt buy their requirements of effective materials from the parent company or any subsidiary in the group at exaggerative prices (Issa, 1987, p.274). Overpricing of raw materials can be observed by comparing the percentage of raw materials imported in both foreign and national companies in Egypt. The percentage in the former ranges between 60% and 90%, whereas in the latter was 48.3% (GOD, 1987, pp.45-52).

It has been realised during an informal interview with officials in the GAFI that pharmaceuticals companies stipulated some restrictive conditions in their agreements. These conditions stipulated that intermediate products must be purchased from within the parent company group. Companies argued that the importation from that source guarantees obtaining raw materials easily and with high quality control. The Code of Foreign Investment agreed to this, in return companies provide enough information about import transactions to the GAFI.

In fact, it is difficult for the GAFI to compare transfer prices with competitive prices, especially as the number of patented names and kinds of chemicals and raw materials exceed 22000. So, the control over transfer pricing is very limited by the GAFI.

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6 Some leading MNCs have been set up after carrying out the case study, e.g., Glaxo.

7 As detailed in Chapter 3, most evidence comes from pharmaceutical industry in developing countries. For instance, Vaitsos (1974) found that in the Columbian industry, income flows was a major motive for overpricing intra-company transactions.

8 It is generally the case that the prices of subsidiary products are all higher than their domestically produced equivalents, particularly the former brands are generally accepted as superior. So, it is not surprising to find foreign subsidiaries achieve high profits.

Table 5.14

**Foreign and National Pharmaceutical Companies in Egypt up to 1986**

| Project | 1st Year of Production | Number of Employees | Capital £E.M | Sales £E.M |
|---|---|---|---|---|
| **Public Sector** | | | | |
| Misr | 1937 | 2320 | 14.2 | 42.5 |
| Memphis | 1940 | 1900 | 13.1 | 36.5 |
| CID | 1950 | 3000 | 15.2 | 57.3 |
| Alexandria | 1963 | 782 | 8.0 | 29.7 |
| Nile | 1963 | 2800 | 15.9 | 63.5 |
| El-Kahira | 1963 | 2050 | 15.7 | 51.7 |
| El-Nasr | 1964 | 2097 | 13.0 | 43.5 |
| | | 16492 | 100.9 | 347.3 |
| **Private Sector** | | | | |
| Hoechst-Orient | 1962 | 502 | 5.7 | 45.1 |
| Pfizer-Misr | 1962 | 466 | 8.2 | 27.3 |
| Swiss Pharma | 1965 | 497 | 10.5 | 63.2 |
| Squibb Egypt* | 1979 | 316 | 17.0 | 40.8 |
| Ibico | 1986 | 221 | 9.5 | 10.2 |
| ABI | 1987 | 95 | 6.7 | - |
| Farco | 1987 | 105 | 5.4 | - |
| | | 2202 | 63.0 | 186.6 |
| **Total** | | **18694** | **163.9** | **533.9** |

* The parent company has merged with Bristol-Myers company in 1990. The latter had a scientific bureau in Egypt for marketing its pharmaceutical products. Hence, after this merger the name of the subsidiary became Bristol-Myers Squibb Egypt.

*Source:* The General Organisation of Drugs

Hndoussa (1974), in her research on the pharmaceutical industry in Egypt, pointed out that a subsidiary used transfer pricing mechanisms so that the difference between the local value paid by the subsidiary and the arms-length price of imported inputs exceeded the value of royalties and profit repatriated to the parent company in the same year (1965).[9] These practices happened in spite of the existence of a central agency to monitor imports of drugs and their manufacturing requirements. Unfortunately, there is no role for the government to control transfer prices and compare them with competitive international prices.

3- The overcharging on payments for royalties, technical know-how, overhead allocations, commission fees by foreign subsidiaries to their parents are likely to be used as an alternative device to shift profits outside the country. Patent cover is an important source of monopoly profits in pharmaceutical industry. Although the percentage of royalties is not high[10] (the maximum limit is 5% by law), some companies obtain these payments for a long period, even after the production know-how becomes expired.

4- With regard to commission fees, the agreements between subsidiaries and parent companies always include the payment of such fees for the purchase and installation of machinery (which often originates from the parent company). But the more crucial, continuous and questionable payments which is included in most agreements between Egyptian companies and MNCs is the allocation of a fixed percentage of the sales of licensed products towards the advertising expenses of the publicity office of the parent company in Egypt, payable in local currency.

Moreover, with regards to production, it has become painfully apparent that MNCs are far better able to ride the crisis than national companies. Hence the structure of local markets is changing in favour of greater MNC shares in most places.

### 5.8.1 Royalty Payments in the Pharmaceutical Sector

Proprietary technology and trademarks are major determinants of the success of the pharmaceutical industry, and the strategy of companies is to maintain close control over technology, as well as over marketing variables having to do with quality and reputation (especially among the medical profession) such as brand name, image, sales force recruitment, training, and relations with government health authorities.

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9 The overpricing amounted 159% of competitive prices. For more details see Handoussa (1974, pp.116-118).

10 The percentage of royalties on modern drugs in some countries might equal 20% or more. (Mainhardt, 1971)

This sector is one of the most active fields for licensing in Egypt. It should be noted that most of products are manufactured under licences of the parent's know-how. Licensing contracts are concluded between a MNC and its subsidiary which implements the contract, under general principles laid down by the supervisory organisation. These principles stipulate a maximum royalty of 5% payable on net factory price, for a period of five to ten years. In addition, the licensor may demand payment for various technical assistance services it provides, so long as the amounts are within the range in effect in similar cases.

### 5.8.2 R&D in Pharmaceutical Companies

An interesting facet of the pharmaceutical industry is that accounting profit rates are higher than the average for all manufacturing industries. In some years the rate was double of the average because of increasing R&D. The sector is also unusual in having the lowest proportion of purchase as a percentage of turnover. Moreover, pharmaceutical MNCs gain royalties in return for giving licences and selling know-how to national companies.

There is no doubt that the pharmaceuticals industry is highly research-intensive. The cost of R&D is very high compared to other industries, as it is a fundamental characteristic of the drug industry. Drug companies spend an average 8-12% of their turnover in R&D with some going as high as 15% (IRM, 1985, p.14). It is noticed that R&D is usually centralised activity in the home country. This is due to the dramatic increase of the cost of innovation. It is estimated that funding and developing a new drug cost approximately $100 million (IRM, 1985, p.4). The related question to this study is should the prices of drugs produced in Egypt among developing counties include contribution towards the R&D outlays of the MNC group (even though R&D is undertaken in the home country). There is an argument that R&D costs are not applicable to foreign subsidiaries just because the product was primarily developed for the domestic market. Again, this is a question of an equitable distribution of costs and the allotment of corporate resources. Some MNCs that conduct R&D abroad have formed R&D pool accounts, and the world-wide cost of R&D is spread over all sales by all subsidiaries on the basis of sales volume by product.

## 5.9 Summary

This chapter has been devoted to discussing and presenting the main elements of the research method, in an effort to shed light on the eleven MNCs participating in this study. A case study approach was followed and a questionnaire was used for

collecting data. Data from government authorities including GAFI, tax departments, and customs officials.

Pros and cons of the case study approach have been presented. A major problem for the case study approach is the accusation of limited generalisation. It is not difficult to overcome this problem, since the purpose of case studies is to generate or test a theory, not represent a wider population. Although, using multiple case studies can enhance the degree of generalisation.

The result of the data collection process was a dossier of materials: completed questionnaires; organisational documents; and interview notes.

# Chapter 6

# Research Findings I: Case Study Analyses

## 6.1 Introduction

Chapter 3 has focused on variables that affect MN transfer pricing strategies. This chapter is devoted to analysing the case studies which involve 11 MNCs undertaking their activities in Egypt. The findings of the field research will be presented which have bearing upon the projected argument. Each company involved in the field study will be discussed separately.

It is necessary to mention that the empirical study depends on different means for collecting required information from investigated companies. These tools include in-depth/free interview, questionnaire and direct observation as well as using information and statistics from other sources.

Several issues will be discussed in each case study. The first part of the case study defines the company and discusses the important sources of data, the ownership and capital structure, intra-company trade, annual sales, and so on. The second part documents transfer pricing strategies used by the company. The third part examines factors that affect transfer prices. The study will extend to cover other issues such as technology transfer, how intangibles are allocated, performance evaluation, and so forth. The fourth part will provide additional information on the motives and obstacles of investment in Egypt.

Chapters 7 and 8 will continue the analysis where necessary to further the plan.

## 6.2 Company A

### 6.2.1 Facts About the Company

Company A was established in 1962 and commenced manufacturing in 1965. The subsidiary is a consortium, three Swiss MNCs own 60% of the share capital whereas local private sector and individuals own the rest. The registered capital was E£11.2 million and it has been duplicated in 1990. With 570 employees, the company produced more than 100 items of pharmaceuticals and sold them locally in 1989. The volume of production and sales was E£92 million which covers 12.2% of the local market.

For the production, high quality-control standards are applied in the company. Generally raw materials in pharmaceutical companies are divided into two kinds, called *effective* materials and *auxiliary* materials like bottles used to fill medicines. It has been found in all drug companies that effective materials are supplied through the parent company or any part of the MNC if it is not produced locally. For company A, the effective materials represent 85% of imports from parent companies.

The herald financial results of foreign drug companies in Egypt showed net losses since 1986. These losses are due to the increasing costs of raw materials, especially those of basic ingredients. Wages and energy costs have been rising as well.

Pharmaceutical companies argue that the principal reason for losses is due to the price controls implemented by the Egyptian authorities[1], and at the same time costs of production have risen.

It is not surprising since the public interest aims at protecting the consumer and keep the supply of medicines at reasonable prices. Of course, consumer protection limits the manager's freedom to control his marketing decision variables. However, prices of medicines have been increased sharply during 1990 and 1991. The continuous increase in prices of medicines will help companies to improve their operating rates and consequently enjoy higher profitability.

Losses could also be due to the higher rates of inflation and domestic currency fluctuations in Egypt. Moreover, profit/loss margins may differ because of various intra-company payments, such as management charges for services performed by the parent company and royalties. However, differences in profit/loss margins which persist over long periods are consistent with the use of "profit shifting" transfer pricing.

### 6.2.2 Technology Transfer

Pharmaceutical companies, often, acquire the technology from their parents. A contract for know-how is signed between the parent company and the subsidiary. The common rate and duration of royalties are: 5% of net turnover for the first ten years, 3% for the next five years, and 2% for the last five years.

Generally speaking, royalty payments represent a heavy burden on pharmaceutical subsidiaries. In Company A, the amount of royalties paid to parent companies for the

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[1] Since 1970 nearly all drug companies in the world suffered from declining profitability. This is due to the fact that costs have risen faster than prices and suggested profit margins. There are regulations in most countries either developed or developing countries extending to prices and margin of drugs. For more details, see IRM (1985) pp.21-32.

period of 1966 until 1979 amounted 366% of the issued capital. The amount in 1979 only was E£464,438 which represents 148% of the subsidiary capital.

Likewise, all pharmaceutical companies in Egypt establish a scientific office to be responsible for the promotion of medicines. These offices get fees from the subsidiary which represent significant amounts. For instance, Company A paid E£1,346,000 in 1979 to its scientific office. But whatever the role of scientific offices, they are, in fact, a legal way to shift funds outside the country. Table 6.1 summarizes facts about the amounts of royalties and fees paid by the Company A. The inflated rate of royalties and fees leave no room for doubt that the cost of technology is a source for the repatriation of profits from Egypt to abroad.

**Table 6.1**

**Value and Percentage of Royalties and Fees Paid for the Period 1966-79 (Amounts in E£)**

| | Amount and Rate |
|---|---|
| Capital in 1967-68 | 313,000 |
| Sales 1966-79 | 77,360,354 |
| Royalties paid 1966-79 | 1,146,643 |
| Fees paid to the Scientific Office | 8,146,643 |
| Percentage of royalties and fees to sales | 12% |
| Percentage of royalties and fees to capital (Annual Average) | 216.6% |

*Source:* Case study survey and calculated by the author.

### 6.2.3 Transfer Pricing Strategies

The determination of transfer pricing strategies is the responsibility of the parent company. Usually transfer prices are calculated according to a standard variable cost-plus formula, including production costs, marketing costs, and profit. Although pharmaceutical MNCs accept the principle that transfer prices should be at arm's length basis, they argue that arm's length prices must entirely cover R&D and other costs which should be spread over the whole product range, and not historically identified on a product-by-product basis. As might be expected, this can bring them

into conflict with government authorities. e.g., customs and tax authorities (IRM. 1985, p.30).

### 6.2.4 Analysing Factors Determining Transfer Pricing

One of the most important factors in recent years which has had an impact on transfer pricing is the exchange rate fluctuation. Very large swings have taken place, in particular in the value of US dollar against the Egyptian pound.

> *"When the company confronts environmental obstacles it should be vigilant to take them into account when transfer pricing is formulated."*

The vice president of the company feels that this policy is valid for all companies practicing their activities under uncertainty conditions.

### 6.2.5 Motives for Investment in Egypt

The enormous local market and satisfying the high demand for pharmaceuticals in the Egyptian market were main factors leading to investment in Egypt. Most of the company's production is absorbed by the domestic market. During the interview with the executive manager of marketing division, he quoted:

> *"Egypt has an enormous market that grows at an increasing rate with developed and varied requirements. We want to see our various products in the top quadrille of market shares, if the market share is too low the company will be whipsawed by the competition".*

The availability of a highly productive labour force constituted a strong reason for investing in Egypt, especially as the level of wages is reasonable compared to other countries.

### 6.2.6 The obstacles to Investment in Egypt

On the other hand, Interviewees were asked to point out problems that affect the climate for investment in Egypt. A list of the most common problems was prepared in advance to help interviewees. In all interviews this list was shown at a later time so that the interviewee would not be limited by problems mentioned in the list.

For Company A, four type of problems were identified:

1- Economic instability, as it affects profit margins.

2- Price ceilings by the government have a direct effect on the profitability of the company. And sometimes the final price does not cover even direct costs of the product.

3- The difficulty of obtaining the required foreign exchange from the banks to pay imports, because of its shortage. The company had to get a part of the foreign exchange from the black market.

4- The bureaucratic and formal procedures when dealing with government authorities might affect the production plan.

### 6.2.7 Allocation of Intangible Assets and General Services Fees

Generally speaking, all companies investigated in the study emphasised that administrative and management service fees rendered by the parent company are charged on an actual basis. On the other hand, parent companies do not charge them for interest on excess cash supplied. However, if they obtained loans from the parent company or any part of the MN family, the interest rate is determined according to the market. As indicated during the interviews, all companies usually depend, for borrowing, on local sources.

With regard to R&D costs, the two parent companies allocate them on a world-wide basis, so they are added as a given percentage to the cost of imports by Company A. Transportation costs and technical assistance fees are charged at actual basis. It has been found that royalties are charged as a percentage of production for a period of twenty years as follows: 5% for 10 years, 3% for 5 years, and 2% for other 5 years. With regard to the tax authorities, these ratios are acceptable as there is an agreement between the subsidiary and the parent company. However, from the tax authorities' view, the period of charging royalties is too long and it could be a way to minimise the taxable income.

## 6.3 Company B

### 6.3.1 Company Background

Company B was founded in Egypt in 1961 as a joint venture subsidiary for a West German MNC and started production in the following year. The parent company has 60% of equity while the rest is owned by individuals and private sector. Company B is specified in producing drugs (69%) and chemicals (31%). The annual sales (local market) amounted E£93 million in 1989. By the end of that year the company had 850 employees. Its issued capital is E£5.7 million.

Generally speaking, the MNC is the largest company in terms of world drug sales (IRM, 1985, p.2). The financial manager stated that although the MNC had opportunities to set up plants in Mexico or Argentina, where it could obtain much more favourable terms as compared to Egypt at the time (1958). The choice of Egypt was based on the awareness that the opportunity might not be available for long.

The policy of the company, as revealed by one of the top managers, often coincides exactly with the country in which it is doing business. This means the company prefers to minimise any conflict with the Egyptian government and be a good corporate citizen.

As far the company is dependent on the parent company for supplying the effective materials, the amount of intra-company purchases has amounted to 60% of inputs in 1989.

### 6.3.2 Performance Evaluation and Management Reporting

The parent company designed an evaluation system tailored to the company's goals, organisational structure, products and markets. Each subsidiary prepares regular management reports to be presented to the headquarters' controller. These reports are oriented heavily toward products and performance of the subsidiary. It also examines financial issues such as cash flows, assets, receivables, inventories, and capital purchases on a quarterly basis.

On a monthly basis, reports of production and sales quantity and value are sent to the headquarters. Some other items are also sent such as cost of sales, and selling expenses. All statements are translated into the home-currency through a monthly accounting rate. It should be noted that exchange gains and losses are considered to be the responsibility of the parent company treasury and not of the subsidiary.

The headquarters' top management examines these reports regularly to measure the performance of each subsidiary. The parent company believes in management by objectives; operations managers list their objectives at the beginning of each year, both financial and other, such as staff development and maintenance of good relations with the host government. In fact, the financial performance is the most significant factor in making an evaluation, but the company feels that other, more subjectives elements, such as staff training, leadership abilities, appearing as a goods citizen and maintaining a safe working environment, must be considered.

### 6.3.3 Transfer Pricing Strategies

The basic policy relating to establishing and reviewing transfer pricing policies is determined at the top executive level of the parent headquarters, but it is the pricing department that has full world-wide responsibility for implementing company pricing policy.

The standard variable cost plus a margin method, is frequently used for intra-company pricing. On the other hand, while tax regulations are recognised as a basic parameter in determining transfer pricing strategy, the company finds that certain competitive factors play inevitably a very crucial role. For example, several of Company B's rivals are themselves MNCs who coordinate pricing and sourcing on a world-wide basis and every company likes to take the lion's share in the market. Therefore, transfer prices must be consistent with current market conditions.

### 6.3.4 Analysing Factors Determining Transfer Pricing

In determining a suitable transfer prices, one of the basic considerations must be the spread between the final sales price to the customer and the costs incurred by the company. In certain circumstances, pharmaceutical companies have taken losses to penetrate a market that has a long-range profit potential. The theory is that the losses are an investment in the future of the market, and that they are a necessary cost of future business.

In working forward, from costs plus an acceptable margin to a transfer price, there is the danger that the product will then be priced out of the market. Company B, therefore, examines this factor in setting the price.

Like other companies, company B had been affected by the acceleration of the high rate of inflation and government price controls.

### 6.3.5 Difficulties Encountered

The company faces government regulation over the final prices of medicines. Other problems had risen from the inflationary situation which had made it hard for the company to depend on borrowing locally. Interest rates had been running upwards of 20 percent per annum.

### 6.3.6 Technology Transfers

Generally, the parent company provides the technical equipment and training. Getting a maximum return on amounts invested in R&D activities is a touchstone of most MNCs, especially pharmaceutical ones. This is represented in royalties for licence and patents used. The percentage of royalties paid by Company B to parent companies was 296% of capital for the period of 1963-79. Table 6.2 shows royalties and fees paid as a value and percentage of capital and revenues.

**Table 6.2**

**Value and Percentage of Royalties and Fees Paid for the Period 1963-79 (Amounts in E£)**

| | Amount and Rate |
|---|---|
| Capital in 1967-68 | 624,000 |
| Sales 1963-79 | 33,428,259 |
| Royalties paid 1966-79 | 1,832,975 |
| Fees paid to the Scientific Office | 2,006,531 |
| Percentage of royalties and fees to sales | 11.5% |
| Percentage of royalties and fees to capital | |
| (Annual Average) | 36.2% |

*Source:* Case study survey and calculated by the author.

## 6.4 Company C

### 6.4.1 Facts About the Company

The company C was founded in 1962 to produce and market pharmaceuticals in Egypt. The company is based on a joint venture between a U.S. MNC, which acquires 60% of shares, and individuals and private sector. The MNC is one of the strongest companies in the drug industry and investors consider it a leader in the international pharmaceutical industry (Sammon & Geman, 1987, pp.59-61).

The company employed an average of 494 workers in 1989. The capital has amounted approximately E£8 million, whereas the sales turnover was E£52 million in that year. As many MNCs in Egypt produce for the local market, there is no outflow of intra-company transactions. It is important to note that the percentage of intra-company purchases amounted 70% of inputs in 1989. In an interview, a senior manager in the company mentioned that:

> *"The parent company is recommending the specifications of raw material to produce the same products as in the home country. This is why we are purchasing the raw materials from the same source that provides them in the home country."*

The company has achieved no profits in the 1980s. However it continued its expansions without resorting to government subsidies. It relied on local sources to finance heavy investment in new machinery and plant. This shows that pharmaceutical companies can be forced, fundamentally with profit levels, to rethink their financial strategies (IRM, 1985, p.31).

### 6.4.2 Performance Appraisal

The parent company evaluates performance basically on the basis of financial results and achieving the plan. The subsidiary managers report to their board of directors which is composed of senior headquarters executives. The parent controls its subsidiaries through the board structure.

The most important measure of performance is comparing actual profit before taxes against budget. Other criteria are sales, gross margin, capital tied up in stocks, trade debt and overhead. The company is currently placing a strong emphasis on market share, but this is not reported monthly or quarterly because of the difficulty in getting data.

### 6.4.3 Transfer Pricing Strategies

The determining and reviewing of transfer prices is done by the tax department in the parent headquarters and subsidiary executives. Of course, the tax division tries to minimise the total tax to the extent possible within the tax rules and regulations of host countries. Usually, via the intra-company price for any product or component, the negotiated based and arm's-length based-methods are frequently used. Changes in the methods used for pricing are taken into account in the strategy. Auditing transfer pricing policies are done on a flexible basis. The company reviews these policies when some external factors affect the strategy, e.g., the effect on final price of the product.

Intuitively, the subsidiary decision-making should be proportional or nearly proportional to its contribution to the overall goal achievement, i.e. the more the subsidiary contributes to the fulfilment of goals of the parent company and the entire corporation, the higher its decision-making should be.

### 6.4.4 Analysing Factors Determining Transfer Pricing

Data available for the assistant production components (auxiliary materials) imported from the parent company showed that prices have escalated between the period of 1980 and 1982. For example, the price of Bottle L30 rose 291%, Liquid Petroleum 216%, Apple Flavour 301% (in 1981 compared to 1980). The price of Vilas 5CC increased 313% in 1982 compared to 1981. The same thing for the rest of auxiliary materials (10 items) where the increase in prices ranged between 199% and 218%.

It has been concluded during the interview with the financial executive that government-enforced price controls have an important effect in formulating transfer pricing strategies.

Also, drug companies are confronted by the degree of competition in the local market as each of them tries to acquire the greater share of it.

### 6.4.5 Royalties and Fees Paid

The total amount of royalties paid to the parent company amounted E£1,993,341 between the period of 1963 and 1979. The amount of royalties represented 166% of the project capital (E£1,200,000). Table 6.3 shows royalties and fees as a value and percentage of capital and revenue.

Table 6.3

**Value and Percentage of Royalties and Fees Paid for the Period 1963-79 (Amounts in E£)**

| | Amount and Rate |
|---|---|
| Capital in 1967-68 | 1,200,000 |
| Revenue 1963-79 | 51,129,500 |
| Royalties paid 1966-79 | 1,993,341 |
| Fees paid to the Scientific Office | 3,358,493 |
| Percentage of royalties and fees to sales | 10.5% |
| Percentage of royalties and fees to capital | |
| (Annual Average) | 26.2% |

*Source:* Case study survey and calculated by the author.

## 6.5 Company D

### 6.5.1 Facts About the Company

Company D operates in the pharmaceutical industry and is 100% owned by its U.S. parent company registered in Panama for tax and tariffs purposes. Its main objectives in Egypt are to produce medicines for local and foreign markets, especially after the abolition of its Lebanon subsidiary. Other objectives are to develop drugs and demand for its products.

The MNC represents an interesting example of merger with other pharmaceutical companies to undertake major strides and become a global competitor in all markets it serves. For example, it merged with Beech-Nut life Savers in 1968. One of the company's most recent and potentially most successful joint ventures is that with Bristol-Myers company for approximately $11.5 billion stock swap. After this acquisition, it was considered to be the second world's biggest drugs company. In fact, this joint ventures will enable them to have drug sales of $4.5 billion and to invest $600 million a year on R&D[2] which is second only on research to Merck company. Nevertheless, the company still commits itself towards massive investment in product R&D and efficient production for its own purposes.

Company D was established in Egypt in December 1974 under the Investment Law 43 of 1974 and started its production in 1979. In 1989 the number of employees was 239 whereas its capital was $27.5 million. It has been realised that the proportion of highly skilled and semi-skilled personnel were greater than labourers. Hence, the number of labour decreases because of adopting high technology in production. The annual sales has amounted to E£66 million.

### 6.5.2 Organisational Structure and Reporting System

The financial executive stated during the interview that the position of the company as a wholly-owned subsidiary permits a greater degree of action and total control within the system of the parent company. The administrative structure of the MNC well fits the so-called mother-daughter structure, i.e., foreign subsidiaries report directly and exclusively to the parent company. The parent always makes strategic decisions about the management operations and human resource functions of the

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2 Many of the big pharmaceutical companies have been keen to thrive on partnership, co-production and joint ventures with different foreign companies to gain economies of scale in R&D and marketing. Costs in both these areas have been escalating due to more stringent government safety rules.

subsidiary as well as its financing. The subsidiary's top management, which consists of the foreign general manager and six Egyptian executives, reports to both parent and Egyptian government officials regarding problems of planning, control, and evaluation.

The reporting system is highly formalised and standardised and divided into different items. Needless to say, monthly and quarterly reports differ in both form and contents. The monthly reports include information on sales turnover and other key figures, whereas the quarterly reports are more diverse and detailed, including information on the income statement and balance sheet statement, etc. The subsidiary also formulates its annual budget and forward it to headquarters for the purpose of preparing the preliminary budget of the MNC. This annual budget is considered as a co-ordination tool rather than a control mechanism, whereby the performance of the subsidiary is evaluated in accordance with the degree to which budget figures are achieved.

### 6.5.3 Importation of Raw Materials

As far as the degree of interdependence is concerned, the volume of intra-company transaction has amounted 85% to 90% percent of purchases in 1989. The financial manager has reported, during an interview, that the high ratio of production components imported from within the group is due to the fact that chemicals used in production are not available locally and the fact that high quality control is required for producing drugs. To quote: "

> *"All medicine manufacturing processes in the subsidiary must be based on the research of the parent company and products must carry the trade mark of the MNC. As a consequence, all active raw materials of drugs should be imported from the MNC's group. This is because active components are measured in thousandths of a gram and should be tested according to high standards of quality control".*

The financial manager claimed that they do not employ transfer prices as a mechanism to shift profits or achieve advantages on the account of the host government's interests. As he declared:

> *"We do not use transfer pricing mechanisms to shift profits outside the country. If someone likes to be a confident that the transfer pricing technique is not used, he can check the intra-company transactions through the financial statements. The income statement showed losses since the company commenced its activities in Egypt in 1979. The main reasons of these losses are high production costs and price controls imposed by the Egyptian government".*

On the other hand, an example for abusing transfer pricing by the company was mentioned in a report by the GOD in 1985. An Italian exporter offered to supply an active material for Decacilien at $360 per kilogram, while the parent company's price was $780 per kilogram. When the subsidiary's management was asked by the GOD to reduce its transfer prices the head office argued that the Italian offer was of doubtful quality and hence not comparable for negotiation. The overpricing in this ingredient is 217%.

The parent company prices intra-company transfers at levels determined at the annual budget meeting except under special circumstances, such as unexpectedly higher volume or a complex tax situation. In the former case, the subsidiary manager is expected to negotiate a price. In the latter case, management in the U.S. may set the price.

### 6.5.4 Transfer Pricing Policies

From the financial manager's point of view, transfer prices should be legally acceptable but should maximise company profits. Transfer price setting is concentrated at the parent headquarters' level. And they can not be made by the company's subsidiaries, especially in the complex market where customs duties and different tax rates influence marketing decisions. Transfer prices are determined according to standard variable cost plus a margin basis. The parent company policy permitted transfers at other than standard variable cost plus if some critical conditions occurred.

As the economic environment in Egypt is complicated, particularly the level of inflation, special accounting and control procedures have been adopted by the company. For instance, using monthly average cost figures for charging inventory into costs of goods sold, the quarterly or even monthly revision of standard costs, and using the "current assets" method for translating balance sheets from local currencies into dollars. By this method of translation, current assets and liabilities in local currency terms were translated by dollar exchange rate prevailing at the time of translation, while long-term assets and liabilities were translated by dollar exchange rates prevailing at the time of their acquisition, that is, by "historical rates". In the budgeting process, a "best guess" estimate of the likely rate of inflation was incorporated by the financial manager in the budget prepared by his staff.

### 6.5.5 Technology Transfers

As mentioned above, the company operates as a wholly-owned subsidiary, the financial manager commented that most U.S. companies apparently prefer to exercise

an equity interest in the use of their intangible assets and proprietary knowledge in order to protect their competitive positions. The company is strengthening its representation in Egypt, especially with respect to licensing technology into the country. It has a dominant, fairly stable position in the local market.

The technical services of the parent company took in hand not only the construction but also the preliminary studies and the execution of various stages of the project. Production Operations demand a permanent presence of several foreign experts as well as several visits by specialists from the parent company to do certain specific jobs. Parallel to this, the financial management and administration must be organised, staff have to be recruited and technical supervision must be set up. Naturally, technical assistance by the parent company does not stop on the first day of production. It must continue to ensure regular and high-quality production, to maintain or replace equipment, to make plans for expansion, to launch new medicines required for the market, to maintain efficient management and train personnel, etc.

The technology used is very sophisticated, some of machinery and equipment are very complicated. No training takes place in the parent company, local resources are being adequate for the required technical level. If the production requires very sophisticated knowledge, technicians from the parent company come on the spot and bring complementary know-how.

When the Egyptian subsidiary started operations, it signed a contract with the parent company, according to which royalties would be 5% of net turnover during the first ten years, 3% for the following five years, then 2% for other five years.

The technical fees allocated to the subsidiary account for about 10% of net sales. These fees are not monitored by either GAFI or GOD, as they do not appear in the financial statements of the subsidiary and partly due to the lack of experience to deal with these types of expenses. The agreement of establishing the subsidiary includes also paying to the parent company 10% of net sales for advertising costs.

### 6.5.6 Analysing Factors Determining Transfer Pricing

The primary issue in designing a transfer pricing system for the company is determining its business objectives. The evaluation of managers is conducted according to the extent of achieving specific objectives assigned by the MN management. It can be concluded that the most important variables of designing transfer pricing system from the point of the company are hyper-inflation and multiple exchange rates in Egypt.

The other three factors considered very important by the company were maximisation of overall corporate profit, minimisation of overall corporate income taxes, and price controls on drugs by the GOD.

Other factors deemed to be important were maintaining good relations with the host country, simplicity and ease of applications, maintenance of adequate cash flow, and existence of competition among pharmaceutical MNCs in Egypt.

Factors rated by the company as fairly important include maximisation of the group overall profit, differentials in income tax rates and legislations, the bureaucracy of dealing with the Egyptian authorities, and performance evaluation of the company.

The remaining factors, including the political and cultural, rates of customs duties and stern customs legislations, anti-dumping and anti-trust legislations, restrictions on profit and capital repatriated abroad, requirements of financial reporting, and divisional autonomy, were judged by the company as being not at all important.

## 6.6 Company E

### 6.6.1 Facts About the Company

Company E was founded in Egypt in 1987 to be a manufacturer and marketer of cosmetics, professional, pharmaceutical and health products. The American parent company holds 80% of equities, whereas the remaining (20%) is allocated to different nationalities. The MNC has world-wide subsidiaries in 176 countries with consolidated corporate sales having reached $15 billion in 1989. The parent company has placed great emphasis on marketing. Advertising, selling and administrative expenses came to a significant proportion of net sales.

The registered capital of the Egyptian subsidiary amounted to E£4 million. The annual sales were E£6 million, whereas human resources were 50 workers in 1989. As the MNC has subsidiaries mostly all over the world, sales of the Company E cover only the local market.

The parent company supplies the Egyptian company with raw materials which accounted for 40% of production requirements in 1989 and supplies it with machinery and equipment.

### 6.6.2 Marketing Strategy

Despite the young age of the company, it has acquired a significant position in the Egyptian market. As the target of the company is to dominate a great share of the market and to maximise the return on shareholders' investment. So the policy of the company depends on making an enormous progress in introducing new products to create the perfect business opportunity.

The policy of the company is also to develop a corporate marketing strategy built on an appreciation of its standing, in terms of market-share, technical and market strengths and weakness, competitors' strengths and weakness and overall market trends. The company responds to the problems of managing its products' life-cycles and adopts the most appropriate marketing strategies.

### 6.6.3 Measure of Performance and Budgeting and Reporting System

The administrative structure of the MNC is similar to its counterpart of company D, that has been discussed earlier, i.e., mother-daughter structure. It should be noticed that the subsidiary is run as an investment centre. "Return on assets employed" based

on local currency calculations, is used as the primary basis for evaluating subsidiary executives.

Because of the recent establishment of the firm, a complete activity report has to be sent to the parent company every month. The management reporting system is highly conclusive and standardised as it is a powerful tool for communication, rigourous control of the business and approval of business decision. The major aim of the reporting system in the company as it has been revealed by the financial manager

> *"is to keep a tight lid on costs. It is our prime method of implementing cost reduction".*

This provides a motivation for managers to work towards targets that accord with business strategies. Reports include precise descriptions of all improvements in production and marketing.

The evaluation of each manager is done by the level above. The focus is on planning, results and most recent estimates. This provides the company management with an opportunity to determine whether short-term actions are being taken at the expense of the long-range targets.

The system of budgeting and forecasting extends three years into the future. The first year of the long-range forecast becomes a preliminary budget for the year ahead. A year later, the budget is reforecasted, a comparison is made between it and the original forecast, and changes are accounted for.

This means that the annual budget should comprise data for three years, i.e., present year data, estimates of the following year and forecasts for the year after. This medium-term plan with a horizon of two years has to be strategic as it is a consideration of major operational decisions, such as to expand certain activities or to curtail others.

Monthly and quarterly reports are prepared and sent to the parent company. The monthly reports involve information on the quantity and value of sales, production costs and inventory. The quarterly reports are more specific and comprise information on the income statement and balance sheet statement, etc.

The Measurement of performance is related to the objectives of the whole strategic plan and annual budgets that are derived from the plan. The primary financial measure is the success in achieving the subsidiary's net income. Other measurements

include Return on investment (ROI), net income to sales ratio, market share, inventory and receivable turnover rates, and currency exposure.

But ROI is a key measure of performance for the company. The ROI for the company's products is measured at least once a year, which results in careful management of inventories and receivables. The evaluation of the subsidiary's manager himself encompasses other measurements. These involve how well he has dealt with government relations, the progress he has made toward achieving certain targets such as increasing market share and his success in maintaining good employee relations.

As a result, the company has very sophisticated measures of financial performance. In summary, when Company E sets its budgets, it shows three categories of forecasting:

- Forecasts for the present year.
- Forecasts for the next year.
- Forecasts for the year after next year showing what is expected.

### 6.6.4 Transfer Pricing Strategies

The company uses a standard variable cost-plus formula for determining transfer prices. The prices are formulated by group headquarters. The percentage added to the cost of overhead and profit incurred by the transferor. The way used to evaluate intra-company transactions differs from that which is used for other sister subsidiaries in the parent country as the market price is based on four components (cost of goods, sales expenses, advertising and promotion, and general and administrative expenses). Only two of which should be loaded into the intra-company price (cost of goods plus advertising and promotion expenses).

The final price is decided upon by the parent controller working in conjunction with the executive vice president, financial manager, and marketing manager of the subsidiary. The committee have the authority to adjust the transfer price. The point to note is that transfer prices are determined in dollars, so the burden of exposure management is shifted to the subsidiary. However transfer prices are reviewed continuously according to the economic conditions in Egypt. In the area of taxes there is some world-wide co-ordination in order to maintain close scrutiny on all tax matters.

### 6.6.5 Analysis of Factors Affecting Transfer Pricing System

Contributing corporate cash flow to the Egyptian subsidiary is high on the list of priorities. Tax minimisation is a part of the game but this factor is not important as the company still enjoys the tax holiday exemption. The company is concerned about the drastic upturn in inflation as it affects its potential for growth.

Because of the economic destability in Egypt the company treats all capital expenses as current expenses. As a result, company profits would be lower but it would keep the capital of the company. This procedure per se is a sign that the company tends to shift profits abroad.

The main problems facing the company are the level of inflation and the rate of exchange. Of course the company is concerned to keep the real value of money. Therefore these two factors are very important when transfer pricing strategies are formulated.

The company pays too much attention to the competition factor as it affects its strategy. To quote the financial manager of the company:

> *"In our business, we deal with mass markets where competitive pressures are the dominant feature of our pricing. We closely watch the competitors and ensure that we watch them in terms of marketing and cost control. Our major controllable is our sales mix and I want to ensure we keep a tight control on this."*

### 6.6.6 Allocation of Intangible Assets

Because it is so difficult to determine objectively the price of many intangibles, the pricing of intangibles is one of the most politically sensitive questions faced by the MNC. Basically, royalties for R&D costs and technical services fees are allocated in accordance with the profitability of each subsidiary. Despite the fact this technique is subjective it helps, particularly, new projects in the start-up period where the profit is low or negative.

### 6.6.7 Incentives for Investment in Egypt

When this point was discussed with managers during the interview, all of them pointed out that taking part in the local market represents the main target for investment in Egypt. The marketing manager in Company E mentioned that:

> *"Egypt has an enormous market that grows at an increasing rate with developed and varied requirements and tastes."*

Another objective for the investment in Egypt is the possibility of exporting to neighbour countries, especially Arab nations. If this purpose is successfully achieved, the parent company could gain more profits through reducing costs of shipping from other subsidiaries in Europe and U.S.

### 6.6.8 Technology Transfer

The main forms of technology inflows to the Egyptian company come from the parent company. The type of technology applied in the company is especially capital intensive in production for the following reasons:

1- to save time and increase the productivity of labour and develop new skills;

2- to improve the quality of production, hence to increase it and increase the size of exports; and

3- to adopt an approach which is more profitable and more suitable to both local and international markets with regard to the competition factor.

## 6.7 Company F

### 6.7.1 Facts About the Company

Company F entered Egypt in 1978 according to the Investment Law 43 in joint venture with Egyptian shareholders and a U.K. corporation. Company F is involved in the manufacture of electrical elevators. The English parent company has 51% of shares. The headquarters of the parent company is in Finland. The registered capital is E£1 million. In terms of annual sales, it has accounted for E£4 million in 1989. The number of labour force reached 180 in the same year.

Company F operates in the engineering industry and is characterised by a low degree of product diversification. It sells in the local market whereas its product serves special customers like hotels, investment hospitals, and the construction sector. The company is mainly supplied by various divisions of the parent corporation. About 70% of inputs were being imported from the parent company and another subsidiary in Belgium, and this called for extra effort on the part of the home office to ensure that the key items were continuously expedited. The remainder of production components were being bought from the local market.

The technology employed in the manufacturing process cannot be judged as sophisticated even though the parent company invests considerable amounts in R&D in order to keep abreast of actual and potential changes in the use and design of its products. R&D is centrally performed in the parent company.

The structure of competition is characterised as oligopolistic since two companies including company F, dominate the domestic market.

### 6.7.2 Performance Appraisal

The parent company believes in giving more autonomy to local management than is typical of many US MNCs. At the group headquarters, the emphasis is on strategic planning. Though it is informed of the progress and problems of subsidiaries on a regular basis, the headquarters is predisposed not to interfere with the day-to-day operational problems.

In evaluating the performance of the subsidiary, the parent company is working toward standards that will hold good for a number of years, yet recognise the current position of the business in its life cycle, and reflect the requirements of shareholders.

### 6.7.3 Transfer Pricing Strategies

The assessment of transfer pricing policies are done by the participation of the subsidiary and headquarters of the parent company. A committee including the international controller, domestic controller and vice president of the subsidiary, are responsible for designing these prices. The final decision should be approved by the head office.

It should be noted that the company calculated its sale prices differently, since most of its sales are on a contract basis. The first step is to estimate the original contract price by adding the replacement cost of inventory items on the day of sale, and a normal sales markup. Then, on the day of payment, the standard escalator clause is applied to the mark-up value of the goods as of the day of purchase, and this price adjustment is added to the original contract price. This results in an apparent profit spread that is quite high, but the higher replacement cost of inventory works out to be the same as the spread in the original contract estimate.

Company F prefers to use independent price indices for its elevator clauses, but where these are not available or not accurate, the company computes its own index. This is done by adjusting the portion of the contract related to materials on the bases of the prices of steel, copper, and other basic materials whose costs are generally known; and when adjusting the labour cost portion of the contract either on the basis of a general labour index or an average company cost in certain labour categories that can be certified by a local independent accountant. The point is to construct the index in such a way that and customer can reconstruct it to see that it is fair.

The company experiences suggest strongly that a deeper analysis of pricing practices by firms operating in inflationary economies is necessary to improve profit performance. Even in such stable countries, the replacement cost principle should be used because of the effect that labour contract changes and price increases in basic industrial materials and raw materials can have over the course of a contract sale with long delivery and credit terms.

### 6.7.4 Analysing Factors Determining Transfer Pricing

In an attempt to explain factors affecting transfer price formulation, the financial manager pointed out economic conditions have a great effect. The high rate of inflation and currency devaluation were the most important determinants in designing transfer prices. Also, the market share is highly considered in such conditions. The financial manager revealed that a devaluation of the Egyptian pound against hard

currency, especially the U.S. dollar, lead to sharp increases in the prices of imported raw materials.

On the other hand, it has been observed that overall profits of the company and performance evaluation have only a moderate degree of importance on exercising transfer pricing policies.

The company does not give any account to political aspects. The financial executive commented:

> *"The political situation in Egypt is more stable, and at the same time the investment law guarantees projects against any confiscation. Hence, were not bothered at all for the political risk ."*

### 6.7.5 Incentives for Investment in Egypt

The executive manager of the company pointed out that there are enormous advantages for the company to invest in Egypt. Peaceful trade unions, new development in infrastructure and communication, cheap and well trained labour were the most important issues from the manager's viewpoint. The lower import tariffs guaranteed to investment companies have been mentioned to be a stimulus to invest in Egypt. Also, the company captures a large share of the local market, as the company is in a oligopolistic position with another company.

Additionally, the flow of foreign capital into Egypt looked to the manager as a gesture of confidence. He pinpointed that the freedom to remit abroad 100% of profits and unlimited royalties are very important issues for the investor and stimulate him to investment in the country.

## 6.8 Company G

### 6.8.1 Facts About the Company

Company G is the youngest subsidiary in this study, as it was established in 1989. It is based on a joint venture between a Japanese MNC and individual shareholders. The MNC is one of four big Japanese companies which have come to dominate the world market for motorcycles.

Table 6.4 exhibits the percentage of equity for investors. The subscribed capital is E£15 million. After steadily improving for its position through 1989, the company produces light trucks, especially pick-ups and minivans. From the beginning of 1992, the company will start the production of vehicles after it has got the approval of the ministry of industry in Egypt.

**Table 6.4**

**Type of Joint Venture and Percentage of Capital in Company G**

| Investor | Equity Percentage |
|---|---|
| Private sector and Individuals | 51% |
| Foreign investor | 29% |
| Parent company | 20% |

The company is paying particular concern to management skills such as team building, motivation, delegation, staff communication and performance appraisal. It is known that all the leading Japanese manufacturers are in a position to build their auto factories all over the world especially in Europe. According to the financial manager during the interview:

> *"We established in a number of important niche markets and we have been growing as fast as if not faster than some subsidiaries of our parent company abroad".*

As a result of demand in the overall new vehicle market, the value of annual sales has amounted to E£2 million. The human force was 100 workers. Company G assembles

road cars as it imports intermediates from the parent company. The percentage of intra-company purchases amounts to 80% of inputs. Despite the fact that the company has started its operation recently it has started to export a part of its production to Arab countries (an estimated 10% of its outputs).

### 6.8.2 Performance Appraisal

Results are basically reported to headquarters based on how the subsidiary is managed. The evaluation of the performance of the subsidiary and manager is based mostly on financial results, but managers are also appraised more judgementally. Like most Japanese companies, the parent company has been successful because it makes investments which do not appear to have a return in the short term, as the financial executive stated.

The policy of the parent company is to have managers with very high standards. Managers must not only identify events that may make it difficult for them to reach their budgets but must also describe the contingency plans they would follow should such events occur. If descriptive events take place, the manager must convince headquarters management that the appropriate steps were taken in line with a contingency plan to minimise the negative impact of these events. Failure to do so may lead to corrective action.

Like several Japanese firms, the company has successfully improved its competitive position by adopting a management style that emphasise the quality control, encourages worker loyalty, and requires an inordinate devotion to details.

### 6.8.3 Transfer Pricing Strategies

The parent company has a considerable influence over setting transfer prices. The financial manager revealed that the headquarters often formulates transfer pricing policies on the basis of standard full cost plus fixed margin.

As a general rule, the parent company does not maintain any controls in the area of intra-company pricing, as each situation is treated on an individual basis. Each subsidiary is responsible for its own profit and tax situation; as long as the profit picture remains satisfactory, company headquarters does not interfere. Although the parent headquarters design a transfer pricing system, every subsidiary has the authority to review prices in the light of its conditions.

### 6.8.4 Analysing Factors Determining Transfer Pricing

The policy of the company is to take political aspects of risk and the company's ability to operate in a country into account. The parent company ranks countries in categories, and it expects a higher return from countries in which the risk is higher. The method is subjective, but it is a step towards incorporating country risks into performance evaluation system. The company regards political conditions in Egypt as stable and does not pay any attention to the headquarters.

The strategy of the company is to keep costs as low as possible. One of the most perplexing problems that the company faces is the impact of local currency fluctuations notably on performance evaluation.

The financial manager pointed out that the parent company, like most Japanese firms, take into account income taxes and tax rate differences in order to maximise their profits. Nevertheless the company enjoys tax concessions for 15 years according to the Investment law in Egypt, the manager emphasised that the corporate tax rate is high (32%). Therefore, this could motivate the company to abuse transfer pricing.

It has been realised also that the decision of transfer pricing is influenced to a fairly large extent by the volume of transfers. The manager stressed that MNCs often make their decisions according to costs/benefits analysis. If the quantity and value of intra-company transactions are significant, the probability of manoeuvring transfer pricing increases.

### 6.8.5 Technology Transfer

The parent company provides assistance in training personnel which takes place in the subsidiary in Egypt. The company pointed out that the scale of operations in Egypt is similar to that in Japan and this is part of the reason why parent company policy is to provide assistance for these training exercises.

## 6.9 Company H

### 6.9.1 Facts About the Company

Company H is of American nationality and specialises in producing detergent and floor cleaning goods. The MNC is considered a leader in each of its business categories and its main objective is to expand world-wide into emerging countries. The approval of establishing the company was 1978, whereas it commenced its production in the early of 1982. It is based on a joint venture with an Egyptian public sector company and investors from Saudi Arabia. The percentage of capital for each investor is shown in Table 6.5. The company is quite capital intensive and has high fixed costs. The productive workforce was 48 workers, whereas the production has amounted E£1.3 million in 1989. The subsidiary is very profitable and enjoys a great deal of autonomy from the parent company. Therefore the parent treats the subsidiary as a profit centre for the purpose of managerial control and evaluation. It sets annual budgets in terms of pre-tax profit and judges local managers largely on their ability to meet or beat the targeted figures.

**Table 6.5**

**Type of Joint Venture and Percentage of Capital in Company H**

| Investor | Equity Percentage |
|---|---|
| Parent company | 55% |
| Public sector | 35% |
| Foreign investors | 10% |

### 6.9.2 Marketing Strategic Policy

The MNC follows a creative marketing policy and focuses on new product development efforts in order to be a world-wide marketer with above-average profitability. Additionally, the company has specific long-term corporate objectives or goals that it is dedicated to achieving:

1- The company wants to remain a privately owned company. In order to do so, it needs to continue as a financially sound company. Therefore it cannot allow its

debt ratio to get out of control, and so its borrowing capacity is not unlimited. Also, it needs to achieve significant profit margin and return on investment.

2- It wants to maintain its world-wide initiative by expanding into emerging countries. The company is in various stages of negotiations in a number of countries around the world because it wants to establish a presence in these countries for long-term growth.

3- The company wants to be a leader in each of its business categories.

4- It wants to maintain a highly competent, effective management team, and increasingly productive work force.

5- It wants to continue as an outstanding corporate citizen wherever it operates.

The policy of the company before introducing a new business is based on some criteria as follows:

1. Products should be characterised by high standards of quality and safety, the company has built the goodwill of its customers world-wide. In new business planning, it avoids markets that could damage this goodwill. The lack of government regulations in some countries can lead to markets being created based on false, misleading claims and inferior products.

2. The new product should have potential for growth and profits. The potential return on operating assets should be greater than the ongoing return, and high marketing and administrative costs must be taken into account. It is also necessary to achieve a positive cash flow within a reasonable time on which, the degree of risk, anticipated growth rate, profit potential, and working capital required for the estimated life of the business, will be based.

3. To achieve the previous criteria, there should be an opportunity for the new product to expand into many overseas markets. Labour and capital will be of average or lower intensity relative to national industrial norms. The products also can be a building block for multi-product lines or business.

The above criteria should help the company to distinguish between different opportunities and to establish priorities for new product investigations.

Relating to the Egyptian subsidiary, the volume of intra-company purchases and sales have amounted 20% and 10% respectively in 1989. Goods that were bought from the parent constitute effective materials which are very expensive and cannot be supplied domestically. The rest of raw materials used in production were purchased locally

from indigenous manufacturers. Apparently, the subsidiary decision-making power involves the degree of its influence over purchasing raw materials elsewhere. But, the purchasing executive mentioned that the foreign partner should test such materials in order to be sure that they are consistent with the quality control standards required by the parent firm.

### 6.9.3 Performance Appraisal

The measurement of the subsidiary's performance is done in both local currency and dollars because of inflation and currency fluctuations. However, as the subsidiary will ultimately have to return dollars to the US parent company there is more focus on dollar results.

Local currency sales and operating expenses are monitored closely in evaluating both the subsidiary and the management.

### 6.9.4 Transfer Pricing Strategies

Company H arrives its transfer prices by a standard variable cost-plus formula. The determination of transfer pricing is done by both the parent headquarters group; consisting of the corporate controller, director of taxes, and legal counsel; and vice president of finance of the subsidiary. Once the formula is determined, it is the responsibility of the MNC controller to see that it is implemented on a world-wide basis. The parent company did not attempt to allocate variances to the subsidiary. Standard variable cost-plus transfer prices were established on an annual basis and were not adjusted if market prices moved below this basis.

The audit of transfer pricing is made on a periodic basis by the parent internal audit department. From time to time, there is a review of the entire transfer price structure by the tax department to determine if the cost-plus formula falls within the range of general US tax guidelines.

The general manager of the company believed that communication was the key to making a transfer pricing policy work, since constantly changing conditions necessitated changes in transfer prices. He commented:

> *"Any company never makes enough adjustments in the system if it does not have enough communication with its entities. A company always has changing conditions. Situations never develop exactly as it is predicted."*

### 6.9.5 Analysis of Factors Affecting Transfer Pricing Strategy

It is increasingly important that the subsidiary looks to the future and has strategies which anticipate changes. Strategic decisions are based upon a complex set of factors, many of which, given sufficient lead time, can be influenced by the astute subsidiary general manager.

Concentrating the attention to maximise the subsidiary's profit performance and contribution to the MNC, the scope of the company is to dominate local market share, as a key measure of success. This allows the company not only to enjoy the local cost advantages related to scale of manufacture and generate high returns, but also it can benefit from the sharing of production technology and improvements with the parent company. The policy of the company is to be aware of local competitors with a more flexible production process offering a wider variety of products to the local market. Faced with problematic competition, the subsidiary was able to enhance its position and expand production by drawing upon the MNC technological expertise, as well as being aware of market opportunities and the capacity situation.

The company turns cautious about the rate of inflation in Egypt. An even greater fear is that the sales will be affected by the rate of inflation in Egypt. With the sharp increase in inflation in most countries, inflation-adjusted data are gaining increasing acceptance as a more realistic measurement of performance. The MNC modifies its results for inflation, internally as part of the evaluation process of subsidiaries.

### 6.9.6 Contribution of the Company to the Egyptian Economy

The parent company was involved in production in Egypt to satisfy the local market requirements and passing the tariff barriers. The general manager emphasised that the Egyptian subsidiary will contribute to the economic life of Egypt through taxes paid after the concession period. The firm has never shown any losses, thus taxes on profits will be considerable. Not to mention, the company policy is to show positive face and behave as good corporate citizens. As the general manager said laconically:

> *"People have to see you and know you as a friend"*

### 6.9.7 Technology Transfer

The transfer of technology from the parent company to its daughter in Egypt consists fundamentally in applications of basic research carried out in research centres of the parent company.

A challenge facing the subsidiary's managers is the location of development and innovative activities. There is a natural tendency for development activities like new product or process research, or the development of new business to be performed by the parent company. Generally the role of the Egyptian subsidiary is to pick up on these developments and translate them into the local environment.

## 6.10 Company I

### 6.10.1 Facts About the Company

Company I was founded in 1982 to produce razor blades. It is a joint venture between a US. MNC and Egyptian individuals. The MNC acquires 70% of capital, whereas the remainder is allocated to local shareholders. The registered capital is E£9 million, whereas the labour forces reached 180 workers in 1989. The annual sales of the company have reached E£2.5 million, 60% of them in the local market and 40% for exporting to countries in Africa and Europe. The percentage of intra-company purchases amounted 50% of the total of production requirements.

The policy of the parent company is to convince subsidiaries' managers that they are responsible for world-wide operations. Thus, a part of every manager's job is to make his business grow inside and outside.

The financial manager declared during the interview that the company buys its requirements from constituent firms for strategic or huge cost reduction reasons.

The structure of the market for the company appears to be oligopolistic as it captures the lion's shares of the local market. When the company entered the local market there were two rivals producing similar products, one of them which was a public sector company became unable to compete. So the market is now oligopolistised by two MNCs.

The parent company uses international planning and control systems with long-range strategic focus. The corporate planning process involves deciding: (1) the corporation's objectives, (2) how these objectives will change over time, (3) the resources used to attain these objectives, and the policies that govern acquisition, use and disposition of the resources. For the company, planning involves incorporating the economic, social, legal, and political characteristics of each operating environment into the company's overall master plan.

### 6.10.2 Performance Appraisal

The parent company divides its performance measures into two groups, long-term (at least one year) performance measures and short-term measures. The basic long-term measures are cash flow generation by product and return on investment. In its cash flow measure the company seeks to determine whether a product will earn enough

money for its plant replacement, its share of corporate costs and have some excess profit to finance a level of growth that the head office feels it is realistic.

### 6.10.3 Transfer Pricing Strategies

Basically, transfer pricing decisions originate and come to the attention of the head of international operations at the headquarters, if insoluble difficulties arise. However designing and reviewing transfer pricing policies are to be co-ordinated between the headquarters and subsidiary managers. The parent company uses standard full cost transfer prices and allocates all variances in an attempt to measure the total financial responsibility of the subsidiary.

Some problems might arise, since the cost manager of the subsidiary often felt the subsidiary is being charged for variances that they were beyond his control. At the root of this problem was the manner in which standard full costs were set. The problem was exacerbated by the lack of criteria for performance measurement, evaluation, and rewards, which largely based on financial results.

### 6.10.4 The Problem of Transfer Pricing

Several interviews have taken place at different levels within the company. The cost manager of the company believes that the subsidiary should operate independently and realise the best possible performance in each country. The apparent business policy is based on three facets:

1- The company is in business to serve customer requirements and consider its profitability.

2- Through a profit-centre orientation, the company wants to optimise the returns on its individual business on a 'stand alone' basis.

3- The company looks at capital investment on the basis of incentives provided by the government particularly in the area of taxes.

The cost manager's point of view is based on the fact that conflict will exist when adjustment in transfer prices negatively affect performance measures and financial rewards.

The marketing manager of the company doubts the wisdom of trying to optimise returns on a stand-alone basis. In his view, the transfer pricing problem "is only a symptom of a more deep-seated problem related to the definition and operating of profit centres. Transfer pricing can be viewed as a mechanism for allocating profit between profit centres.

Properly used, it should motivate autonomous units to take independent decisions that lead to an optimum result for the corporation.

### 6.10.5 Analysing Factors Determining Transfer Pricing

The decision of transfer pricing is influenced by cash flow advantages and greater profits. Income tax consideration was given high ratings. This is because corporate profits may be affected by differentials in income tax rates and income tax legislation.

The financial executive stated during the interview that the company is concerned about economic difficulties prevailing in Egypt. These involve the hyperinflation and decreasing purchasing power of the Egyptian pound.

Determining the subsidiary's performance was mentioned by the manager to be one of other criteria to the promotion of corporate effectiveness. The other requirements are measurement and motivation. But, performance evaluation takes a low degree of importance when designing transfer prices.

It was understood that the parent company balances between the manipulation of transfer price and performance evaluation to prevent any contradiction.

### 6.10.6 Incentives and Disincentives for Investment in Egypt

In general, there is a desire for any investor to expand investment abroad in order to benefit form comparative advantages. Requiring higher returns has a priority over other issues when the investment decision is made. Guarantee programmes were useful for the investment decision.

The proximity of Egypt to the Arab region was stressed to be an important factor for investing in Egypt, as quoted by the marketing executive:

> *"Our objective to operate in Egypt is not just for marketing locally, our whole approach is to produce and export to near countries even to Europe and Africa. Manufacturing in Egypt is more profitable to our parent as the costs of production are lower in comparison the parent's costs."*

Relating flaws of investment, it was mentioned that the transfer of earnings is subject to the approval of GAFI. The authorisation for such remittances often takes long procedures to be granted.

### 6.10.7 Technology Transfer

The main form of technology mechanism received is engineering technology, documents, and various forms of media. The parent company supplies the subsidiary with machinery. There is also exchange of personnel for the purpose of training.

A production manager has expressed that the subsidiary has acquired the same technological operations used by the parent company and other subsidiaries in developed countries. He said:

> *"Of course, this help us to produce the same standard quality and export to European and African countries."*

### 6.11 Company J

#### 6.11.1 Facts About the Company

Company J is a minority-owned French corporation with a majority of equity held by an Egyptian public sector company. The subsidiary was established in 1980 and started its first production in November 1981. The company is engaged primarily in the textile industry, as it produces in mass ready suits and sells them in the local market and exports a part of its production. The parent is a holding company owns seven subsidiaries in France and other overseas subsidiaries in U.S. and Egypt.

It should be noticed that before the company was established as a joint venture with the public sector company, the latter had an idea for the constitution of a new company in the garment industry. The company failed to realise the idea prior to adoption of the open door policy in 1974, as a result of a number of financial, technical, institutional, and administrative determinants.

The total investment capital of the company when it was established was about E£1.2 shared between three groups. Table 6.6 shows the percentage of equity for each partner involved in the joint ownership. The joint venture in this company has a time-limit on its duration which is 25 years. Of course, this period must be sufficient to allow the foreign investor to recover the capital invested with a fair and reasonable profit for his contribution, taking into account any risks that may be entailed in the future. As the textile industry is rather labour intensive, at least as compared with other industries in Egypt, the labour force was 600 workers in 1989. The amount of annual production was E£11 million in the same year.

The factory has a daily production capacity of 750 jackets, 1,250 pairs of trousers and 260 vests. The company distributes its production through its own retail stores and also in many public and private shops in the rest of the country. A part of the production, also, is exported, notably to the Middle East countries. Since 1985 the company introduced a peculiar service to individuals who want their suits tailored using their own fabrics.

The relationship between the Egyptian company and its parent is very beneficial. From the viewpoint of objectives, it is clear that this joint venture has been a success. The Egyptian partner had to find a partner willing to manufacture a new product in Egypt which required, at the time of start-up, an advanced technology. This means the

contribution of real technology seems obvious, for simple reason that without an association with the MNC, products of the company will not satisfy consumers' requirements. For the foreign investor, the objectives were two-fold: first of all to sell technology, and secondly to make a profitable investment. As the financial executive said:

> *"We have put in a lot of hard work over the last nine years building an infrastructure for the future. The most important goal for us is to produce garments for different fashions. Thus in a few years we must be able to build up a solid history of sales and profits that allow us to be quoted as one of the best in the market. Then we can obtain capital to really allow us to expand."*

From the viewpoint of economic results and effects, the company has shown the traditional effects of a firm which works well and whose activities are a credit to the history of progressive industrialisation in Egypt. It created new jobs, improved the standard of living, increased professional training, substituted for imports and brought about confidence in the competence and seriousness of the local partner.

The main objectives of the company start with buying raw materials or piece goods. The purchase of fabrics is made in large lots from the manufacturer which is the Egyptian investor (public sector company). This purchase constitutes 60%, whereas 10% of production requirements are supplied locally and the remainder from the parent company (30%). The manufacture process includes cutting and sewing fabrics to be ready garments and clothes. Finished products are marketed in both local and foreign markets, where the former represents 85% and the latter is 15%.

**Table 6.6**

**Type of Joint Venture and Percentage of Capital in Company J**

| Investor | Equity Percentage |
|---|---|
| Public sector company | 55% |
| Parent company (French) | 25% |
| Foreign investor (Arab Investment bank) | 20% |

The company pays attention to customer service, marketing and sales skills. The planning period is one season, i.e. a half year. The reason is production and sales are made up by the autumn/winter, and spring/summer season. The management of the company does set transfer prices in collaboration with the parent company's headquarters.

### 6.11.2 How the Minority Parent Company Controls the Subsidiary

As the French parent company is in a minority position (25%), an important question is to arise which is whether the minority ownership gives the company undue influence on the control of the Egyptian subsidiary?. The answer to the question can be understood by considering the organisation of the subsidiary's board of directors. The board involves a French manager who is a specialist and has more technical knowledge and skills in garment industry. The board gives him full authority for decision making with the co-operation of the marketing manager who has more information about markets and public tastes.

In this type of joint venture with shared-management according to Killing's classification (1983, p.54), both partners have an active role in the management of the joint venture.

It should be noticed that the distribution of ownership of joint ownership may be thought of as primarily aimed at clarifying the joint objectives of partners. In many cases in developing nations "the question of majority or minority participation is essentially a symbol rather than a reflection of the actual degree of control exercised over the operations of the enterprise" (Friedmann & Béguin, 1983, p.15). This thus makes it likely that the control of policy in joint partnership, even where there is minority participation by the foreign company, may be decided in relation to the parent company's strategy. As one manager of a parent company explained his enterprise's philosophy:

> We do not like to put too much capital in a developing country, so 20-25 per cent of a joint venture's equity is ideal for us. But whether we own 10 per cent or 51 there are three things we must control - product quality, the decision to expand the company's equity base and any design directly related to the product's design or manufacture. This means that we always have a few of our own people in management positions in the venture. (Killing, 1983, p.72)

This statement shows many analogies to the ownership pattern and the proportion held by the parent company in its subsidiary venture. The French manager essentially

controls the processes of the product's quality, product design and manufacture, as the vice chairman of the subsidiary indicated.

### 6.11.3 Technology Transfer

Generally speaking, the textile industry stood at the technical heart of the industrialisation process in Egypt since the 1930s, as a result of constructing two big mills.

One of the main incentives which stimulated the Egyptian partner to enter into a joint venture was because the French company had more experience, skill and familiarity with technology, as well as a brand name tied to the French design in the garment industry.

So, the subsidiary uses highly advanced technology acquired from the parent company. A production manager indicated during the interview that the company uses the same types of technology, both product and process, which are already applied in the parent and other subsidiaries in France and West Germany. He cited:

> *"We are proud that we are in the forefront of using the latest advanced technology in our company. You imagine! There is no difference between what we use and what is used in the parent country and other subsidiaries in France."*

The company uses this advanced technology, especially in the first stage of production, design and cutting and in the finishing stages. It has been indicated that the type of technology applied required a labour intensive approach in most of the production process stages. As a result, the company employed a reasonable size labour force (600)[3] and created new jobs in the region.

The Egyptian firm depends on R&D activities of the parent company in France, where very advanced R&D is available to continuously develop production. These facilities comprise introducing new methods of production to deal with competition in both local and international markets.

The contract of know-how and technical assistance between the Egyptian subsidiary and the parent company concluded that the inputs of required technology would be such that the production of the local partner would be rendered possible, and that this new technology would be quickly assimilated. The services furnished by the parent company can be summarised in the following manner:

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[3] The number of work force when the company started its production in 1981 was 300 employees. So, it means the number has doubled in 9 years.

1- All the available know-how, knowledge and process in all firms in the developed countries which belong to the ready garments division of the parent company are at the disposal of the Egyptian partner.

2- The results of ongoing research as well as all new processes or industrial machinery developed by the firms of the group are also brought to the attention of the Egyptian subsidiary.

3- The same goes for other services such as organisation, programming, maintenance of machines, marketing, etc.

**6.11.4 Transfer Pricing Policy Applied**

In general, the financial executive has a certain opinion about foreign companies. This view is based on the correct position for MNCs which should comply with the national intent and spirit of the law in the country.

It has been mentioned above that the company depends heavily on local sources for suppling raw materials especially from the Egyptian partner. At the same time the company is dependent upon imported machines and other essential components bought from abroad (France, Germany and Brazil).

The market transfer pricing system that would prevail in an arm's-length transaction is applied in the company. The policy offers a number of advantages to the company as follows:

1- The accounting practices of many MNCs today have come under increased scrutiny by host governments, which often view them as mechanisms to achieve some benefits on the account of the host country. Consequently, a sound, consistent, straightforward transfer pricing policy would put the company in a good light with the fiscal authorities of the country.

2- Market transfer pricing supports the decentralised profit centre concept and allows the company to be consistent with the competitive environment in the country.

3- It encourages the subsidiary's management to re-price products in the market place on a consistent and competitive basis, while aiming at making an acceptable return.

The process of formulating transfer pricing is done by the headquarters of the parent company. Transfer prices are set on an annual basis during budget preparation and

usually do not change during the year. Typically, these prices are agreed upon by subsidiary executives.

### 6.11.5 Analysing Factors Determining Transfer Pricing

The financial manager revealed that the volume of intra-company transactions is not too large (30%). He believes that even if the parent company manipulates transfer prices, the effect will be very limited. This is because of the small amount of transfers. However, the company is concerned basically with profit consideration and rate of income taxes in Egypt. These two variables received the highest rating by the manager. Other variables to which high ratings were given by the executive were the competitive position in the local market and maintaining good relationships with the Egyptian government.

Several variables were given very low rankings. These involved risk of expropriation and nationalisation, strict capital control and shifting profits to other subsidiaries in order to cover some losses.

### 6.11.6 Contribution of the Company to the Egyptian Economy

The parent company was concerned to invest in Egypt for several reasons. The cost structure representing cheap labour and raw materials availability within different markets as well as local marketing policy makes it considerably cheaper comparing it to other subsidiaries. The possibility of opening more markets in other Arab states or in the Middle East countries can absorb the firm's production.

The parent company was also induced to invest in Egypt as the competition from other companies was low, except for one public company. Moreover the parent firm has more privileges than local companies. Concessions in the investment law especially tax holiday (15 years) also had an influence on the decision to invest in Egypt.

The financial executive considers, under current conditions and in the market economy of Egypt, the company's presence contributes to the development of the country. The company absorbed technology capable of generating its own up to date technology in order to develop its products.

Concerning factors influencing the investment decision, it has been indicated that geographical proximity, investment climate, availability of raw materials, and labour forces, were the main incentives to the foreign investor to enter into a joint venture with the public sector company.

## 6.12 Company K

### 6.12.1 Facts About the Company

Company K was formed by a UK MNC in 1980 and commenced its production in 1982 on the basis of a joint venture as indicated in Table 6.7. The MNC is widespread geographically which is perceived as one of its main strengths.

Concerning Company K, the amount of capital is E£9 million, and about 450 persons were employed in 1989. The invoiced sales amounted to E£60 million. Of total sales, 20% was for export to Europe, Arab countries and Nigeria. It is worth nothing that in 1989 only 10% of inputs represents intra-company transactions from the parent company. The reason for the low percentage of transfers was that raw materials are available in Egypt. Even intra-company materials supplied can be obtained locally, but the company was under pressure to obtain them from the parent company.

**Table 6.7**

**Type of Joint Venture and Percentage of Capital in Company K**

| Investor | Equity Percentage |
|---|---|
| Parent company | 50% |
| Public sector | 38% |
| Private sector and Individuals | 10% |
| Foreign investor (Commercial bank) | 2% |

The contract of establishing the joint venture company stipulated that the General Company for Batteries (the national investor) should close down its production. Not to mention the Egyptian government has guaranteed neither to permit or constitute other similar projects under the Investment Law nor local projects, even expansion of existing projects. Naturally, Company K has got concessions to the extent that it is in a monopolistic position.

The basic agreement of establishing the company stipulated the parent company should supply all machinery and equipment. Also, technical and management assistance; patent; licence; and loans should be through the parent itself. On the other

hand, the national partner contributed its share of capital in cash by borrowing the amount from the Ministry of Finance at annual interest rate of 11%.

The company has manufacturing as well as marketing operations as it benefited from the experience of the public sector investor in this respect.[4] It produces four kinds of batteries, electrical, industrial, automotive and lid acid. Automotive and industrial batteries contribute 80% of turnover. The demand for automotive batteries, for example, is heavily dependent on the number and range of motor vehicles operated. Using the number of motor vehicles operated in the host country, one is able to estimate the growth rates of the demand for the product of the company. As regards the market for the power generation apparatus the competitive conditions are undoubtedly oligopolistic since it dominates the output and distribution of this product.[5] The growth rates of the demand for this product are in increase during the last 8 years.

### 6.12.2 Management Appraisal

The subsidiary reports directly to its headquarters. The reporting system takes a highly standardised format and comprises monthly and quarterly data. Monthly reports, as a rule, include data on preliminary turnover, orders received, orders invoiced and inventory. Quarterly reports contain the balance sheet and income statement, stock and sales analyses and gross profit in each product line.

Evaluation and control of performance and behaviour of sales are heavily based on the degree to which budget figures have been achieved. The subsidiary sets its own sales forecasts for the future after having received important targets and general information from company headquarters. The corporate and subsidiary top executives meet at headquarters to discuss and formulate the final annual budget.

Therefore, the basic standards of performance evaluation are (1) budget, which includes projections of financial issues, vs actual and (2) the present year's performance vs last years'. In setting up the budget, the company tries to incorporate expected economic conditions for the coming year. But as the economic conditions change, updated forecasts are made once a month, and further adjustments to the forecasts are made twice a month to reflect current conditions. The budget itself is not

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4 The basic agreement for establishing the Company conditions that officers of the joint company have the right to scrutinise records of the public company with regards to producing and marketing batteries to ease establishing the joint company.

5 When the company F started its activity in Egypt it dumped the domestic market with imported batteries as a way to study it. One can deduct that the company trampled the local industry. The agreement between the MNC and the national public company to stop producing and selling electrical batteries which achieved a great profit in the past. Of course this agreement constrained the national partner by liquidating a successful project that had a great share in the market.

revised, only the forecasts. If managers do not meet their budgets because of uncontrollable events, they are still held accountable for an explanation. They can explain why an objective was not met, but they must also explain what actions they took to overcome conditions that had not been anticipated in the plan.

Furthermore the subsidiary is obliged to prepare verbal annual plans specifying action programmes by which budget figures are to be achieved and commenting on and clarifying different aspects of its respective budget. Since the company started its production in Egypt, it has achieved annual profits except in the years of 1984/85 and 1985/86.

### 6.12.3 Transfer Pricing Strategies

The subsidiary holds a considerably high degree of decision-making over transfer pricing design. Because of the practice of trying to maximise the return of sales in the market, Company K has been allowed to formulate transfer prices according to the prevailing conditions in the Egyptian context. As a result, the executive vice-president and the divisional managers have in fact ultimate authority in determining specific transfer prices. A guideline is established at company headquarters and transfer prices are determined at the subsidiary level in accordance with this guideline. The controller of the subsidiary reviews periodically the transfer prices to see that they fall within the broad framework of corporate guidelines.

Intra-company transactions are computed on the equation of standard variable cost plus mark-up (15%). This method is usually used by the company.

When discussing other transfer pricing policies that can be used by the company such as market price, the financial analysis manager emphasised market prices would be used if the company really gained something. It is a big pain to set market prices as they are prone to fluctuation.

It has been concluded from an interview with the cost manager that the local price of plastic containers used in assembling car batteries was less than the parent price by 40%. The subsidiary does not import these containers, but depends on local supplies as the strength and quality of the containers is similar.

### 6.12.4 Analysing Factors Determining Transfer Pricing

Concern was expressed about the effect of transfer prices on performance measurement, evaluation, rewards, but the economic decision had priority over these concerns.

Keeping good relations with customers is an important factor when transfer pricing polices are set. The sales manager mentioned:

> *"We have products but the key to our success is in targeting large customers and offering them a complete service which precludes them from ever contacting our competitors. Sure we lose money on some products, but that is a cost of cementing the customer relationship".*

The UK MNCs are, in general, ahead in most countries when they come to incorporating inflation into their financial analysis. The parent company makes allowances for price-level increase in both internal and external reporting. It recognises the importance of inflation in the financial management of its business, both in performance appraisal and in project evaluation.

### 6.12.5 Royalties Paid to the Parent Company

Royalties paid are 4% of total sales. Of course this percentage is high, not least because the technical know-how is presented by the national partner (public sector).

## 6.13 Summary

This chapter has presented comprehensive findings about 11 case studies of MNCs practicing their activities in Egypt. The characteristics of companies and their transfer pricing practices were discussed. It has been found that companies often obtain their requirements of raw materials from the parent company. Purchasing outside the domestic market was allowed in some cases especially the chemical company.

Table 6.8 summarises some facts about companies investigated in the case studies. It should be noticed that all data in the table is for the year of 1989 except the capital of company A which has been replicated in 1990.

Of the environmental factors of MN transfer pricing, it was found that overall company profits and maximising consolidated-after-tax profits were the two most important objective of most companies.

All MNCs exerting their business in Egypt are confronting a particularly complex array of economic variables that affect their profitability and investment.

Motives and perplexities of investment in Egypt, technology transfer, royalty payments and other issues were discussed as well.

The next chapter will present the overall findings of the case studies. Surveys of government authorities that have an interest in transfer pricing will be discussed in Chapter 8.

**Table 6.8**

**Some Facts of Companies Surveyed in Case Studies**

| Company | Industry | Nationality | Year of Start-up | Capital | Type of Investment | Parent's Equity | Workforce | Sales (E£M) | Inward Transfer (% of inputs) |
|---|---|---|---|---|---|---|---|---|---|
| A | Pharmaceutical | Switzerland | 1965 | E£22.0 | JV | 60% | 570 | 92.0 | 85% |
| B | Pharmaceutical | Germany | 1962 | E£ 5.7 | JV | 60% | 850 | 93.0 | 60% |
| C | Pharmaceutical | U.S | 1962 | E£ 8.0 | JV | 60% | 494 | 52.0 | 70% |
| D | Pharmaceutical | U.S | 1974 | $27.5 | WO | 100% | 239 | 66.0 | 90% |
| E | Chemicals | U.S | 1987 | E£ 4.0 | JV | 80% | 50 | 6.0 | 40% |
| F | Engineering | U.K | 1978 | E£ 1.0 | JV | 51% | 180 | 4.0 | 70% |
| G | Engineering | Japan | 1989 | E£15.0 | JV | 29% | 100 | 2.0 | 80% |
| bH | Chemicals | U.S | 1982 | E£ 4.1 | JV | 10% | 48 | 1.3 | 20% |
| I | Engineering | U.S | 1982 | E£ 9.0 | JV | 70% | 180 | 2.5 | 50% |
| J | Textiles | France | 1981 | E£ 1.2 | JV | 25% | 600 | 11.0 | 30% |
| K | Chemicals | U.K | 1982 | E£ 9.0 | JV | 50% | 450 | 60.0 | 10% |

The data is for 1989 JV = Joint Venture WO = Wholly Owned

*Source*: Case Study Results.

# Chapter 7

## Research Findings II: Overall Analysis of Case Studies

### 7.1 Introduction

The analysis in this chapter attempts to provide overall comparisons of findings on the basis of interviews with executives of the companies investigated.

Different issues will be discussed in this chapter, including the characteristics of companies investigated, materials transfers, and transfer pricing policies. As discussed in Chapter 3, MN transfer pricing systems are markedly affected by a group of environmental variables, this chapter is designed to identify these variables.

Incentives and disincentives for investment in Egypt are discussed at the end of the chapter.

### 7.2 Ownership Structure

The field study involved 11 MN subsidiaries, whose names were anonymous. Some useful empirical findings have been indicated by the study. The joint venture was the most common type of business. The findings of this study suggest that companies with wholly foreign companies and majority foreign companies are concentrated in industries such as pharmaceutical, chemical, and engineering. On the other hand, the two companies with minority foreign companies were concentrated in the fields of textiles and engineering, where the foreign shares were 25% and 20% respectively.

It has been noticed in most surveyed cases that MNCs tend to concentrate the control over their subsidiaries in their own hands, even in a minority ownership case. This is through the management board as they exercise control firmly over the critical decisions. In general, it has been found that foreign managers in these companies are mainly responsible for:

a- choice of technology, feasibility studies, product design and other related activities such as quality control, and

b- establishing detailed plans for operation.

Therefore maintaining the control over subsidiaries is vital for organising MNCs' operations in a harmonised way. In this vain, it may be useful to note that, the U.S. Chemical Marketing Association in its advice to its members recommended:

"If you have the necessary balance of resources, a wholly owned subsidiary is preferable to a joint-venture: If you use a joint-venture secure control, but any share of ownership is better than a licensing agreement" (Balasubramanyam, 1984, p.730).

## 7.3 The Financial Structure

For the companies investigated, it was found that the capital per project differs considerably from industry to industry and from one project to another. While some companies were found to have a fixed capital of some millions, others have about a million Egyptian pounds. In addition, companies with sizeable fixed capital were found to be mainly concentrated in chemicals, pharmaceutical, and engineering.

The other feature that characterises the financial structure is the source of finance. It was found, contrary to the premise that ownership structure is usually coincident with the source of finance, that there is no straightforward connection between the two in Egypt. Some companies with a majority foreign ownership, raised the largest part of their capital in the local market, mostly via loans. Such a source represented in some cases 90% of the total capital of such companies. This is due to the fact that MNCs often have privileged access to local capital giving them a competitive advantage over local firms.

## 7.4 Sources of Raw Materials and Production Requirements

It was demonstrated that all companies in the survey obtain their requirements of raw materials and intermediate products from their parent companies. The senior manager of a pharmaceutical company which obtain the lion's share of its requirements from abroad commented:

*"Our parent company is recommending the specifications of materials to produce the same product as in (the home country). This is why we are purchasing raw materials from the same source."*

As the main issue of the research is to investigate the extent of manipulating transfer prices as a means to shift profits outside the host country, it was important to assess the source and authority of purchasing production goods (raw materials, intermediate goods, and so on).

Basically, all companies in the study import their requirements through their parents either directly or from other subsidiaries. Even, if they are not available from the group, the headquarters recommends the source of purchasing which is often the mother country. In some cases, special permission would have to be obtained from the parent company if imports from other sources were found to be necessary. Not only

had permission to be obtained for the import of some quality of raw materials, but the quality had to be checked and closely controlled.

The foreign partner, as it is demonstrated in table 7.1 was alone responsible for production goods sources in 55% of the cases. Meanwhile, about 18% was left to both foreign and local partners together, and in 27% of the total cases the choice was concentrated in the local partner's hands only.

Meanwhile, it was found that purchases of raw materials in the local market are concentrated in the textile industry.

**Table 7.1**
**Representation of Choice of Sources of Production Goods**

| | Number | % |
|---|---|---|
| Parent Company | 6 | 55% |
| Local Partner | 2 | 18% |
| Both Foreign and Local Partner | 3 | 27% |
| **Total** | **11** | **100%** |

*Source:* Case Study Results.

Nevertheless, further insight into the 27% of co-operatives, reveals that such co-operation is a myth rather than a reality. In the three companies indicated in Table 7.1, it was apparent that the local partner was a public sector company. Hence, in such a situation, the representation of the local side becomes a necessary formality. But the final decision was left to the foreign partner.

## 7.5 Corporate Transfer Pricing Approaches

The forty three financial executives interviewed were asked to indicate the frequency of use of the various transfer pricing methods. As discussed in Chapter 1, these methods could be based on cost or market. Cost-based methods range between actual or standard, variable or full, added a markup or not, marginal cost, negotiated price, and dual price. Market-based prices are dichotomised into two methods: arm's-length and adjusted market price. Interviewees were asked if other methods were used, such prices were assessed by the host government.

The results of these methods were tested statistically using the Minitab Package to extract both the mean and standard deviation.

The mean for each method was calculated on the basis of giving a scale for each response. For example, observations of arm's-length price method were: (2) never used, (7) rarely used, (3) sometimes used, (11) frequently used, (20) usually used. The mean response would be 33.80 {=((2x1) + (7x2) + (3x3) + (11x4) + (20 x 5)) / 5}. The standard deviation (s) is the square root of the sum of squared deviation from the mean divided by the number of observations less one. Algebraically this can be shown as:

$$s: \sqrt{\{\Sigma(x-\bar{x})^2/(n-1)\}}$$

The higher the mean, the greater the relative importance of the methods to the respondents in the sample. The higher the standard deviation, the greater the dispersion of judgements concerning relative importance. The standard deviation explains to what extent the respondents agree on the rating of the individual methods.

Table 7.2 displays the empirical results pertinent to the frequency of use of transfer pricing methods. In Table 7.2 the mean score, standard deviation, and rank for each pricing method are shown.

The most popular transfer pricing method used by MNCs operating in Egypt was standard full cost plus fixed markup method. The second, third, and fourth most widely used methods by companies were, negotiated price, actual full cost plus fixed markup, and prevailing market price, respectively.

The theoretical transfer pricing methods, such as incremental cost, opportunity cost (including the mathematical programming techniques) were not used by the companies investigated.

No company acknowledged using the dual price method. When asked if the transfer pricing method used for external reporting purposes differs from that used for internal purpose, all respondents indicated using the same basis. However, prices could change from one transaction to another in order to achieve the goals of the company. These findings do not support the contention occasionally voiced by government tax agencies that the majority of MNCs often use dual transfer pricing methods. Thus, in

most cases, the transfer pricing used for performance evaluation is a price that is acceptable to tax authorities.

The findings coincide with other studies such as Shulman (1975) and Brook and Remmers (1970) that MNCs consider the costs of maintaining several records are too high.

For the three chemical companies in this study, the standard variable cost plus fixed markup method was the most widely used in pricing intra-company transactions. On the other hand the standard full cost plus fixed markup was most frequently used by the motor vehicle company.

The adjusted market price was the most frequently employed method by two pharmaceutical companies.

Meanwhile, as the field study involved 5 U.S. companies, two of them set their transfer prices according to negotiated prices and prices determined at corporate headquarters.

Table 7.3 shows how the transfer pricing basis is selected in the surveyed companies. It might be concluded that the subsidiary normally has little direct participation in the setting of transfer prices, even in the most decentralised of parent/subsidiary relationships. The main reason for this is the perceived necessity to evaluate and integrate international factors which may influence overall profitability (including tax, foreign exchange, and financing factors). Of course, these factors cannot be fully appraised at the subsidiary level. But this does not mean that the local management does not have any influence on transfer prices. The rational headquarters takes into account the subsidiary reaction to its pricing practices. This, however, is only an issue that parent and subsidiary objections might overcome without modifying transfer prices.

### 7.6 Analysis of Variables Affecting Transfer Pricing Strategies

A basic objective of the study was to assess the extent of manipulating MN transfer prices in order to shift profits outside Egypt. As mentioned in Chapter 3, there are various variables that induce a MNC to function transfer prices for this purpose.

**Table 7.2**

**Rank Order of Usage of Various Transfer Pricing Methods**

| Rank | Method | Never Used (1) | Rarely Used (2) | Sometimes Used (3) | Frequently Used (4) | Usually Used (5) | Mean Rank-ing* | Standard Devia-tion |
|---|---|---|---|---|---|---|---|---|
| 1 | Standard full cost plus markup | - | 3 | 7 | 8 | 25 | 36.80 | 50.90 |
| 2 | Negotiated price | 2 | 7 | 3 | 11 | 20 | 33.80 | 40.30 |
| 3 | Actual full cost plus markup | 4 | 4 | 4 | 16 | 15 | 32.60 | 34.00 |
| 4 | Arm's-length price (prevailing price) | 5 | 6 | 5 | 18 | 9 | 29.80 | 28.10 |
| 5 | Actual variable cost | 6 | 6 | 13 | 7 | 11 | 28.00 | 19.94 |
| 6 | Actual variable cost plus markup | 5 | 8 | 9 | 13 | 8 | 28.00 | 18.67 |
| 7 | Standard variable cost | 7 | 3 | 12 | 14 | 7 | 28.00 | 21.34 |
| 8 | Standard variable cost plus markup | 8 | 5 | 7 | 15 | 8 | 27.80 | 22.03 |
| 9 | Standard full cost | 8 | 7 | 8 | 10 | 10 | 27.20 | 17.58 |
| 10 | Actual full cost | 7 | 5 | 15 | 10 | 6 | 26.40 | 17.24 |
| 11 | Adjusted market price | 7 | 10 | 16 | 5 | 5 | 24.00 | 14.98 |
| 12 | Marginal cost (long-run) | 10 | 26 | 7 | - | - | 16.60 | 21.61 |
| 13 | Dual price | 33 | 10 | - | - | - | 10.60 | 15.22 |

* The mean of each method is based on multiplying the number of observations by the scale given for each response.

Environmental variables can pose a problem if they have not been taken into account when developing transfer pricing systems were discussed with interviewees. The sixty three executives were asked to indicate the extent of importance of variables that prove troublesome for a transfer pricing system. The weighting of the variables is based on a five point scale ranging from 1= not at all important to 5= most important.

Table 7.4 presents the ranking of the average importance and the standard deviation of importance for each of the 24 factors. The standard deviation describes to what extent the respondents agree on the rating of the individual factors.

**Table 7.3**
**How the Transfer Pricing Basis is Selected**

| | **Formulating** | | **Reviewing** | |
|---|---|---|---|---|
| | **Number** | **%** | **Number** | **%** |
| By Parent Headquarters | 8 | 73% | 6 | 66% |
| By Subsidiary Managers | 1 | 99% | 2 | 18% |
| Both Parent & Subsidiary | 2 | 18% | 3 | 28% |
| **Total** | 11 | 100% | 11 | 100% |

*Source*: Case Study Results.

It can be seen that "competitive and market conditions" received the highest rating by respondents closely followed by "Level of inflation in Egypt", and "multiple exchange rates".

The two corporate factors of transfer pricing policies "maximisation of the group's overall profit" and "performance evaluation of the subsidiary" were considered to be the most important factors. The financial controller of one company pointed out:

> *"It is no good buying a business and sitting on it- I might as well put the money in the stock market, at least then I can get hold of the money again quickly. If I am going to buy a business I have to be able to see an opportunity to add to the value of the business."*

## Table 7.4

## Rank Order of Variables Affecting Setting Transfer Prices

| Rank | Variable | Not Important (1) | Fairly Important at all (2) | Important (3) | Very Important (4) | Most Important (5) | Mean Ranking | Standard Deviation |
|---|---|---|---|---|---|---|---|---|
| 1- | Market conditions and competition in Egypt | 2 | 5 | 10 | 15 | 31 | 51.40 | 62.10 |
| 2- | Level of inflation in Egypt | 2 | 5 | 15 | 26 | 15 | 47.20 | 43.10 |
| 3- | Multiple exchange rates | 2 | 8 | 21 | 17 | 15 | 44.80 | 33.30 |
| 4- | Maximisation of overall profits | - | 9 | 29 | 12 | 13 | 43.60 | 35.10 |
| 5- | Performance evaluation of the subsidiary | 3 | 8 | 27 | 14 | 11 | 42.20 | 31.90 |
| 6- | Maintenance of good relations with the host government | 8 | 13 | 15 | 15 | 12 | 39.80 | 22.60 |
| 7- | Differentials in income tax rates and income tax legislation | 27 | 14 | 16 | 6 | - | 25.40 | 17.08 |
| 8- | Existence of export subsidies and tax holidays in Egypt | 8 | 11 | 23 | 13 | 8 | 38.20 | 24.10 |
| 9- | The bureaucratic system to deal with Egyptian authorities | 8 | 12 | 22 | 11 | 10 | 38.40 | 22.70 |
| 10- | Simplicity and ease of application of transfer prices | 15 | 13 | 17 | 13 | 5 | 33.80 | 16.72 |
| 11- | Existence of local shareholders | 4 | 20 | 21 | 12 | 6 | 37.00 | 22.05 |
| 12- | Maintenance of adequate cash flow in the subsidiary | 2 | 12 | 38 | 11 | - | 36.80 | 46.70 |
| 13- | The need of the subsidiary to seek local funds | 12 | 18 | 9 | 16 | 8 | 35.80 | 19.08 |
| 14- | Ambivalence of regulations in Egypt | 12 | 14 | 24 | 9 | 4 | 33.60 | 23.30 |
| 15- | Compliance with tax and customs regulations of home country | 12 | 21 | 16 | 8 | 6 | 32.80 | 13.75 |
| 16- | Restrictions imposed by the Egyptian law on the repatriation of profits and capital | 15 | 18 | 18 | 7 | 5 | 31.60 | 14.60 |
| 17- | Divisional autonomy | 18 | 18 | 13 | 10 | 4 | 30.60 | 10.71 |
| 18- | Existence of price controls in Egypt | 30 | 5 | 5 | 20 | 3 | 30.00 | 28.90 |
| 19- | Rates of customs duties and customs legislation in Egypt | 29 | 11 | 12 | 11 | - | 26.20 | 16.77 |
| 20- | Rules and requirements of financial reporting for your subsidiary | 21 | 24 | 16 | 2 | - | 25.00 | 22.29 |
| 21- | Shifting profits to another subsidiary to cover part of its losses | 26 | 23 | 9 | 5 | - | 23.80 | 16.50 |
| 22- | Anti-dumping and Anti-trust legislation in Egypt | 30 | 17 | 11 | 5 | - | 23.40 | 14.21 |
| 23- | Restrictions imposed on the amount of R&D, royalties and other overhead costs charged against the subsidiary | 32 | 19 | 12 | - | - | 21.20 | 19.47 |
| 24- | Political risk in Egypt | 28 | 27 | 8 | - | - | 21.20 | 22.50 |

* The mean of each variable is based on multiplying the number of observations by the scale given for each response.

During an informal interview with a manager of an investment bank (Misr Iran Development Bank), he stated that the foreign investor is concerned with the profit contribution, and the decision of establishing the enterprise depends basically on this factor.

These factors will be discussed briefly as follows:

### 7.6.1 Market Conditions and Competition

Marketing and competitive consideration was investigated as a determinant to transfer pricing strategy. Table 7.4 shows that the competitive position determinant has received very high ratings. According to the financial executive of a chemical company:

> *"the MNC might want to penetrate a market with a product that is made elsewhere. In such cases, the company tends to decrease the transfer price of manufacturer even below an arm's-length price to make it more competitive."*

The results of the study supports those reported by Burns (1983) and Tang (1979) that market conditions and competition was a major determinant of MN transfer pricing policies.

### 7.6.2 Inflation Rate

Inflation is a problem worldwide, most countries suffer from its effects particularly developing ones. As mentioned in Chapter 4 the rate of inflation in Egypt is soaring, especially during the 1980s.

Faced with a persistently high level of inflation in Egypt, the investigated companies gave this factor a high degree of importance when they designed their transfer pricing system. As shown in Table 7.4 the inflation is the most important factor that influences setting transfer pricing policies in Egypt. This result is consistent with those found by Tang (1979) and Yunker (1982) that inflation played very important role in affecting the transfer pricing strategies in MNCs.

### 7.6.3 Local Currency and Exchange Rate Fluctuations

All companies involved in the study employ a host-currency perspective for preparing management accounts and evaluating both the subsidiary and its manager. However, financial reports sent to the parent company are translated into the parent-currency perspective.

The continued increase in the value of the hard currency, notably the U.S. dollar relative to the Egyptian pound causes profits calculated in terms of the Egyptian currency and translated into dollars to decrease. The reduction in the transferred profits would affect the "overall profit maximisation" objective.

In the opinion of foreign investors, the shortage of foreign exchange hinders the smooth flow of their investment into Egypt. It is important, when considering investment in Egypt, to have assurance that foreign exchange will be available in adequate quantities within the foreseeable future in order to meet the demand for the import of raw or semi-finished materials, to service external debt, and to repatriate dividends.

In addition, executives indicate that the availability of foreign exchange is equally important for projects designed to export their products. Foreign exchange is needed during the critical start-up phases of such projects in order to import production requirements and working capital. Such expenditures must take place before the project is able to generate export earnings.

The scarcity of foreign exchange in Egypt compels companies to seek exports to third markets, even though they are essentially import-substitution projects. This poses a vexing problem for large MNCs which must integrate the output of their Egyptian plants in a global marketing strategy, thus competing in markets served by other subsidiaries of the same MNC.

The results shown in Table 7.4 indicates the importance of this factor relative to transfer pricing policies. And the results substantiate those found by Tang and Yunker that currency fluctuations played a slightly important role in affecting the transfer pricing policies in MNCs.

### 7.6.4 Profit Maximisation

Table 7.4 concludes that maximisation of overall corporate profits was one of the most important determinants of MN transfer pricing policies

The result of this study confirms the findings of Tang (1970, pp.80-81), Wu & Sharp (1979, p.78) and Yunker (1982, p.112) that maximisation of overall corporate profit was one of the most influential factors of transfer pricing policies by U.S MNCs. Furthermore, the result was found with respect to insurance of reasonable profits for subsidiaries to be consistent with that reported by Burns (1983, p.25).

### 7.6.5 Performance Evaluation

The impact of performance evaluation on MN transfer pricing strategies was examined. When asked to assess if the transfer pricing policy used may distort the subsidiary evaluation, executives responded No in most cases. As shown in Table 7.4 this factor is important for transfer pricing bases. However, some interviewed managers indicated that when MNCs give a primary importance to corporate profit maximisation they do not use divisional profits solely for performance evaluation purpose. This result coincides with a survey of 52 MNCs reported by Yunker (1982).

The issue of whether MNCs use the same transfer pricing for both tax and internal purposes was also considered during the interview. All financial and cost accounting executives reported that they use the same transfer pricing method for such purposes as the cost of establishing different transfer pricing methods for different purposes represents significant factor in this matter.

This result coincides with a study done by Czechowicz et al. (1982). They report that 89% of U.S-based MNCs use the same transfer pricing method for both purposes despite a potential resource misallocation from doing so. The reason for this is explained in the following quotation from a manager of a U.S MNC:

> We've talked about developing a system that would (use) dual (transfer) prices- one for the tax authorities and one for internal control. But the cost and time needed to set up and administer such a system would be substantial. Furthermore, if the tax authorities find out that we are using a dual pricing system, we might encounter some difficulties. So we probably won't make any modifications in our system (Czechowicz el al. 1982, p.61)

On the other hand, executives were asked to indicate the extent that the reported results of the subsidiary reflect precisely their performance. Their responses are shown in Table 7.5

The results exhibited in Table 7.5 indicates that 55% of executives are satisfied or totally satisfied with the criteria by the parent company for evaluating their performance. Of the 63 respondents 8% have no idea about the measurement criteria applied by the parent company, and thus their response was simply "do not know". The remaining 37% are not satisfied with the reported profits for the performance evaluation. The nature of the response of the last group is attributed to one or more of the following reasons:

1) Price controls by the Egyptian government. This might be true as the majority of respondents that were not satisfied belonged to pharmaceutical companies.

2) Economic instability in Egypt and foreign exchange fluctuations affected the reported results.

**Table 7.5**

**Executives' Responses as to whether they are Satisfied with Reported Results to Evaluate the Company Performance**

| Totally satisfied | | Satisfied | | Do not know | | Unsatis-fied | | Totally satisfied | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| No. | % | No. | % | No. | % | No. | % | No. | % | No. | % |
| 9 | 14% | 26 | 41% | 5 | 8% | 23 | 37% | - | - | 63 | 100% |

*Source:* Case Study Results.

### 7.6.6 Maintenance Good Relations with the Host Government

Table 7.4 shows the importance to MNCs of keeping goodwill with host countries. In fact, MNCs and a host government should recognise each other objectives and develop policies which lead to greater cooperation between them for their mutual benefit. For example, the Egyptian government is working to provide a favourable business environment for FDI and MNCs conducting their activities in Egypt.

MNCs, when dealing with their foreign investment, are now pursuing long term objectives and have to have good relations with the host government. They recognise the effect of the strong economy in the host country on the position of their subsidiaries operating there. Therefore, instead of profit maximisation at any expense, MNCs are now concerned with the economic stability of the host country because this economic stability has a great influence on the performance of the subsidiary and its profits

### 7.6.7 Corporate Taxes

Table 7.4 shows four issues related to the impact of corporate taxes on MN transfer pricing strategies. These issues are differentials in income tax rates, income tax legislations among countries, compliance with tax regulations of home country, and existence of export subsidies and tax holidays in the host country.

Companies reported that the first factor is the most important in designing transfer pricing policies. Companies tend to report higher costs of production, other than wages and salaries, to reduce their reported profits for tax purposes. For the following two factors, they played a fairly important role in determining transfer prices. The results suggest that export subsidies and tax holidays played an important role in the development of transfer pricing policies. The result is understandable since export subsidies are widely granted in the less developed nations, where hard currency are in short supply. The results coincide with of those reported by Tang (1979, pp.80-81) and Yunker (1982, pp.114-115) that minimisation of corporate income taxes was a key factor of transfer pricing policies of MNCs.

### 7.6.8 Bureaucratic System to deal with Government Authorities

Interviewees mentioned bureaucratic procedures dealing with the government authorities. For example, when they intend to transfer their profits and other funds abroad, long procedures are required to obtain approval. Table 7.4 shows that the companies investigated gave only a slight degree of importance to this factor relative to transfer pricing policies.

### 7.6.9 Simplicity and Ease of Application

The result of the study is consistent with the findings of Yunker (1982) that simplicity and ease of application was considered by MNCs as an important factor of transfer pricing policies.

### 7.6.10 Existence of Joint Ownership

The study declared the existence of local partners does not affect formulating transfer pricing policies to a great extent. The results of the study are consistent with those shown by Tang (1979) and Wu and Sharp (1979). On the other hand, the study and results with respect to joint ventures are inconsistent with those by Kim and Miller (1979).

### 7.6.11 The Effect of Tariffs on Transfer Pricing

Theoretically, customs duties should be of great importance in designing transfer pricing policies especially for MNCs operating in developing nations. This is because of the much higher levels of ad valorem tariff rates. As it is mentioned in Chapter 3 there is a contradiction between the minimisation of income tax from one hand and import duties from the other hand.

Some empirical studies mentioned that the lessening of customs duties influence transfer pricing policies to a fairly large extent (Kim and Miller, 1979; Tang, 1979,

Yunker, 1982; Burns, 1983). Table 7.4 shows the same degree of importance to this factor. The reason is that foreign companies practising their activities under the investment law are exempted from ad valorem tariffs for capital goods and a reduced rate (5%) is applied on production requirements.

In summary, tariffs are of little consequence to MNCs in Egypt. Rates are low and do not, generally, represent serious problems. However, companies pay attention to the amount of duties as it is influenced by exchange rate fluctuations. On the other hand, non tariffs restrictions are of much greater importance. Prior authorisation to import is required.

### 7.6.12 Government Restrictions on the Repatriation of Profits

Despite the fact that the Egyptian Investment Code does not impose restrictions on the transferability of profits, some barriers might defer such transfers. The Investment Code mentioned that the approval of GAFI is required it is the responsibility of a company to find out a source of foreign exchange. However, these issues do not represent significant problems at all. It is expected that this factor does not influence transfer pricing manipulation by MNCs in Egypt.

### 7.6.13 Subsidisation of Subsidiaries

This factor has a special importance in pharmaceutical companies. The result elucidates that strength of competitive position and increasing market shares have formidable degree of importance according to designing transfer pricing policies. This due to the existence of a fairly large domestic market with increased needs for industrial and consumer products, resulting from the increase in number and the enhancement of the standard of living of the population. The results of the study concur with Tang's study (1979).

### 7.6.14 Price Controls

This factor is applied on pharmaceutical companies in nearly all countries, to the extent that it can be a rule rather than an exception in the industry.

All drug companies involved in the field study revealed that government controls limit their ability to operate with a reasonable amount of independence. Of course their output and profitability are affected by prices.

### 7.6.15 Political Factors

The political stability means that the host government does not face political turmoil, civil wars, racial policies, human rights violation, and so on. The continued political

stability within Egypt encouraged foreign investors to seek profitable investment opportunities.

Table 7.4 indicates that political factors have a little degree of importance relative to transfer pricing policies. Respondents added that the policy of MNCs is to keep investments as low as operations permit if the political system is unstable, hoping thus to minimise the cost of confiscation. This result is consistent with Shulman's contention (1975) that a firm operating in a nation with unstable political environment might resort to transfer pricing strategies in order to keep as little cash as possible in that nation.

As was discussed in Chapter 4, the Investment Law 132 of 1989 guarantees the legal protection of foreign investors against the occurrence of expropriation action or any violation by the government. In case of confiscation the government guarantees the investor adequate compensation for a loss sustained as a result of such actions. At the same time, the political conditions are characterised to be stable in Egypt, at least compared to other countries in the region.

So, political determinants are unimportant in setting MN transfer pricing policies. A vice president of a company commented that:

> *"These factors affect the company investment decisions more than its transfer pricing system."*

### 7.7 Overstating Transfer Pricing by Pharmaceutical Companies

Noteworthy, pharmaceutical companies overstate transfer prices not only to divert profits outside the country, but also as a gimmick to circumvent the price controls by the government. Every company has to submit a detailed statement of production costs for each product to the GOD, in order to set the final price of drugs. Therefore, it is the benefit of a company to inflate its transfer prices as the final price will be higher in this case.

### 7.8 Capital Goods Are supplied through the Parent Company

Managers interviewed revealed that machinery and equipment are often supplied by the parent company. Even in the case of joint venture with a local public firm producing the same products, the MNC did not acquire machinery and equipment, under the pretence that old capital goods are not technologically advanced. In an interview, an executive declared that:

*"It is easier and safer to purchase plant and machinery from abroad. Since we come back locally produced ancillary products may or may not fit equipments."*

Executives interviewed were asked to pinpoint to what extent they can get machinery and equipment from outside sources. Table 7.6 summarises company executives' responses to this question.

As the above Table shows, only 12% of responding executives mentioned that they can purchase capital goods from outside markets without the parent company approval. Meanwhile, 26% revealed that the approval of the parent company is required to buy these goods, and they have to clarify the reasons for not buying these goods through the parent company. The majority of respondents (62%) stated that capital goods are bought through the parent company for the reason of producing the same quality of products.

**Table 7.6**

**Executives' Responses as to the Extent to which they buy Capital Goods outside the MNC**

| Allowed with Complete Freedom | | Allowed but Subject to the Approval of Parent Company | | Not Allowed | | Total* | |
|---|---|---|---|---|---|---|---|
| No. | % | No. | % | No. | % | No. | % |
| 7 | 12% | 15 | 26% | 36 | 62% | 58 | 100% |

* Only 58 executives gave their responses to the question.

*Source:* Case Study Results.

The issue was discussed briefly with the executives that mentioned they are allowed to buy capital goods from outside sources. It was found that the permission applies only on spare parts and auxiliary units.

Certainly the parent company, in many occasions, practices some restrictive business over the subsidiary. For example the U.S. Goodyear Company stipulated that its subsidiary in Egypt should get machinery and equipment from it. The company charged the subsidiary for the price of capital goods and 2% as a commission .

An example shows the extent of manoeuvring transfer prices of capital goods, a parent company offered to supply machinery and equipment to its subsidiary in Egypt

for E£58 million. At the same time, it offered to provide the same goods to an independent company (public sector) for E£38 million (cited by Issa, 1987, pp.283-284). This means that the transfer price is exceeding the arm's-length price by 53%.

So, the final word for technology choice decisions always rests with the foreign partner. Even the decision of acquiring capital goods was made by both local and foreign partner, the latter often recommends some alternative sources from which purchases should be made. In the end, the chosen source was a company from the home country. According to one manager:

> *"We accept this situation as a way for advanced technology transfer. And frankly they are more competent than us in this regard."*

Table 7.7 shows the parent company has the lion's share of choosing capital goods in the investigated companies.

Additionally, it was acknowledged from the executives interviewed that the parent company was responsible for feasibility studies, product design, plant construction (its technology, and its supervision), and the accounting system. Thus, the more technology, the more the MNCs is concerned and the less is the role of the local partner, and vice versa.

**Table 7.7**
**Representation for Acquiring Capital Goods**

| | Number | % |
|---|---|---|
| Parent Company | 7 | 64% |
| Local Partner | 1 | 9% |
| Both Foreign and Local Partner | 3 | 27% |
| Total | 11 | 100% |

*Source:* Case Study Results.

## 7.9 Supply and Installation of Machinery

Machinery suppliers are often in charge of most technical services relating to the procurement of machinery and equipment, which comprise installation, start-up,

maintenance, and testing operations. To ensure effective operation and maintenance of production facilities, parent companies normally provide their Egyptian subsidiaries with all technical information and assistance. These include detailed manuals and operating instructions, a list of recommended plant spares, material specifications, quality control, manpower requirements and safety procedures.

It was concluded that the contribution of the foreign investor was great in this issue. In all cases, his role was quite obvious, as the bulk of machinery was furnished by him either directly as a share of the company's capital or by placing orders to the manufacturing facilities of the parent company, or indirectly by recommending certain manufacturers specialised in the field and with whom he had already done business. During negotiations, the foreign investor insisted on being involved in one way or another to make sure that all machinery and equipment are adequately capable of meeting production requirements and in accordance with the highest specifications of quality production. The consent of the local partner was given in most cases on the ground that it is desirable to make the foreign investor legally responsible for this task. This is because the foreign investor has more knowledge to judge the adequacy of machinery and equipment and to make sure that suppliers furnish the necessary guarantees and certificates of fitness. This phenomenon was noted not only in relatively small concerns where local partners do lack technical capability, but also in large undertakings where technological requirements appear to be too sophisticated or complex.

### 7.10 Technology Transfer

One of the vital benefits of foreign investment or of MNCs practicing in host nations is the technology transfer. This involves transmitting knowledge including secret technical know-how, new systems of production and skills, and utilizing and servicing this technology in the host country.

It was found that the MNCs working in Egypt have an international reputation for their technology. As a matter of fact, all respondent managers were proud of using high advanced technology similar to that used in the parent country. In almost all cases studied, respondents showed that production operations and techniques were solely chosen by foreign investors. The investigation of the field study showed that the parent company restricts its Egyptian subsidiary indirectly to buy capital goods and production components from it. This behaviour could be interpreted in the light that MNCs tend to transfer more or less the same sort of technology used in the advanced markets without significant adaptation. So, the sort of technology provided requires a high quality and particular inputs that might not exist in the local market.

Moreover, MNCs might provide technological services in a given stage of production, for example, operation technology, or product design. In this case the subsidiary has to seek the parent as a source for its requirements.

Of equal importance, all the main technological services related to the investment process (design and construct of the project, head office in Egypt, marketing, etc.) are done by the foreign investor.

In brief, the bargaining power of MNCs increases with the level of technology introduced into host countries. The more advanced the technology, the stronger the position these companies have. In addition, the MNCs position gets stronger, the more the host countries' dependence on them for such elements as technology, marketing, and advertising increases (Lecraw, 1984, pp.30-41).

### 7.11 Cost of Technology Transfer

The findings of the study proved that Egypt has experienced different kinds of technology costs. To start with direct costs, it was found that they take the form of royalties, equity, lump sums or a combination of some of these. It was found that royalties (as shown in Table 7.8) represent the dominant form of payment for the surveyed companies. In this respect, 90% of companies' payments for technology took the form of royalties either separately or in combination with other forms. This was followed by lump sum and equity forms for 36% and 9% of the companies, respectively.

**Table 7.8**

**Distribution of Payments for Technology**

| Form | Number | % |
|---|---|---|
| Royalty | 10 | 90% |
| Lump Sum | 4 | 39% |
| Equity | 1 | 9% |

*Source:* Case Study Results.

N.B. The sum of these companies is more than the total surveyed, because there are some companies which mentioned more than one form of payment.

Hence, it is clear that the surveyed companies prefer payments in a form of royalties. It was, also, observed from information provided by GAFI, that this form is more common in the pharmaceuticals, chemicals, and engineering industries. Not only that, but also its level was higher in these industries compared to other industries, whilst it was 5% in average for the former[1], it was 2% for the latter.

However, it was noted that the level of royalty payments in Egypt, in general, is low compared to the international levels. While the rate in Egypt is around 1.5 to 5%, it was estimated to be round 10 to 30% in most developing nations (Patel, 1974, p.10).

There is some evidence that transfer pricing in fees and royalties is now more actively used to shift profits than the pricing of goods. A financial manager of a subsidiary whom I interviewed expressed the opinion that in his industry (pharmaceutical), MNCs were now avoiding tax in Egypt to a far greater extent by payments of fees and royalties than manipulation of product prices.

As mentioned, when discussing case studies in Chapter 6, most of the pharmaceutical MNCs set up scientific offices in Egypt. The purpose of establishing such offices could be compensating the low percentage of royalties paid by the Egyptian subsidiary. Accordingly, parent companies held a separate marketing agreement stipulating the payments by licensee to licensor of 10% of net sales as a contribution to these offices. Additionally, as mentioned erstwhile, a certain percentage of sales is allocated to Egyptian subsidiaries to meet advertising costs by their parent companies.

As far as the analysis is concerned, however, the percentage contribution to scientific offices for advertising can be treated identically to the percentage of royalty payments. If fact, the objective of all these ways is to shift more profits outside the Egyptian borders.

### 7.12 Allocation Methods for Headquarters Services

General costs or certain corporate services that are traceable to foreign units should be allocated to the benefited subsidiaries according to the concept of matching cost and revenue. This concept is fair to measure the profitability of each subsidiary. However, the basis for allocating general expenses may be more or less complex depending on the structure of MNCs and the extent to which various costs are common to the group as a whole, or pertain only to certain subsidiaries.

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1 As indicated in chapter 6, pharmaceutical companies pay royalties with certain rates and duration period as follows: 5% for 10 years, 3% for the next 5 years, and 2% for the last 5 years.

It is difficult to come up with a method of allocation that is not arbitrary to some extent. MNCs might employ a variety of allocation techniques, such as a percentage of sales or production, direct usage, parent-subsidiary negotiation or some other reasonable and systematic basis.

As mentioned in Chapter 3, general expenses involve costs of R&D, management and overhead, technical assistance, transportation and advertising, interest on loans, and so on. It is likely that subsidiaries in less developed countries are more dependent on headquarters' services than those in developed countries.

To assess current practices of the Egyptian subsidiaries in utilising these services, interviewees were asked to indicate whether these expenses are allocated to their subsidiaries.

In the case of R&D, all companies participating in the study would in all probability seek to undertake these activities in their parent countries. This is because of the high costs and large uncertainties of these activities.

It has been found that R&D expenses are allocated to subsidiaries on different bases. These bases are an actual (4 companies), a percentage of sales (2 companies), a percentage of production (one company) and an estimated rate added to the cost of imports (2 companies). Two companies showed that R&D expenses are not allocated to them.

With regard to the transportation cost of imports, it is added to the cost of imports in 6 companies, and allocated on an actual principle in 5 companies. Technical assistance fees are not allocated in 2 subsidiaries. The remaining are allocated on an actual basis in 7 companies; a percentage of sales in one company; and according to the profitability of each subsidiary (one company).

Management expenses are allocated only in 3 subsidiaries either as a percentage of sales in 2 companies or a percentage of production in one company. The cost of loans from the parent companies are allocated according to the rate of interest in Egypt. The results of allocation of general services are summarised in Table 7.9, as it shows, the majority of subsidiaries admitted that the cost of headquarters' services are allocated to them.

**Table 7.9**

**Intra-Company Allocation of General Expenses**

| Item | Allocated | Not Allocated |
|---|---|---|
| R&D | 9 | 2 |
| Management Expenses | 3 | 8 |
| Transportation Costs | 11 | - |
| Technical Fees | 9 | 2 |

*Source:* Case Study Results.

### 7.13 The Exaggeration of Technical Fees

Technical assistance fees represent a significant part of the costs in joint venture companies. For instance, in a study by the United Nations for projects in African countries, it was found that salaries paid to foreign consultants represent 50 times the salaries paid to nationals (Issa, 1987, p.276).

In Egypt, a report by the General Organisation for Industrialisation stated that salaries paid to foreign experts and technicians are very amplified, being on average 9 times their Egyptian counterparts (Issa, 1987, p.276). The findings of case studies declare the differentials in salaries are due to additional costs such as cost of living differentials, the expense of moving families, annual vacations back home at company expense, and children's educational expenses.

With regard to surveyed companies, it has been noticed that salaries of foreign consultants exceed by several times, (without specification to figures as they were not accessible either from companies or the GAFI), those paid to their local counterparts undertaking similar work.

### 7.14 A Proposed Role of the Government to Control Licenses

As investigated, subsidiaries paid inflated royalties and services fees as a result of abusing the cost of technology transferred by parent companies.

The government can control license fees. from an unrelated and potential licensee to a license for similar patents. Such control is based on one of the factors to be considered in the absence of an arm's-length basis. So, suppose royalties have been

adjusted by the authorities for the purpose of income tax, the next step is to compare financial statements of the subsidiary, calculated by decreasing royalty expense, with the profitability of unrelated manufacturing company. Such a way relies on an economic theory as the commensurate-with income standard. This theory assumes that each company in an industry should earn a similar profit rate (Bonney and Sherwood, 1989, p.95). Of course it is not easy to apply this method and considerable problems are anticipated. And some issues must be taken into account when determining comparison such as:

- "Whether the license is exclusive or nonexclusive;
- The extent of trademark and patent rights;
- Terms of the agreement;
- Termination rights of the parties;
- Whether there is any transfer of know-how through the exchange of technical drawings and other documents, or through the loan of personnel by a company to its affiliate;
- Quality standards imposed by the licensor;
- Control exerted by the licensor in manufacturing and marketing the licensed product;
- Ownership of any improvements made to the intangible; and
- Requirements to purchase materials from the licensor (tie-ins)." (Bonney and Sherwood, 1989, p.96)

Besides the above factors, in order to get a fair comparison, the key question is whether the companies would earn "substantially similar profits from substantially similar transactions" (Bonney and Sherwood, 1989, p.97). Some other factors should be considered, such as the similarity of the existence of collateral transactions or ongoing relationships, the size and economic development of the market, and the level of economic risk.

### 7.15 Audit Process of Egyptian Subsidiaries

Like any company, MN subsidiaries carry out two types of auditing, internal and external. The aim of the internal auditing is to ensure that all financial transactions are

precisely recorded. It has be found that this sort of auditing is implemented by both the internal auditing department of the subsidiary and the department of auditing of the headquarters.

The second type is the external auditing which is executed by an independent accounting firm to examine the subsidiary's accounts and prepare a report on the fairness of the financial statements. This audit is done according to general accepted auditing standards.

Naturally, tax administration has the right to access the subsidiary's books and investigate its reports in order to determine the taxable income. The GAFI also have the same right, but only over companies established according to the investment law, in order to evaluate the company performance and determine profits transferred abroad. In the meantime the General Organisation for Drugs (GOD) has access to pharmaceutical companies' books for the purpose of controlling selling prices.

### 7.16 Flow of Transfer Pricing Information to Government Authorities

Executives were asked if the information prepared for the government authorities, i.e. GAFI and Tax Authorities, involve transfer pricing policies. Financial executives (43 interviewees) indicated that the financial reports required by the GAFI include the balance sheet, income statement, inflow and outflow of foreign currency, and follow-up reports. Tax Authorities required only the first two reports. None of the companies involved transfer pricing policies in their reports because there are no regulations in this respect.

Having identified the reports prepared and submitted by MNCs, executives were asked to state the extent to which they would accept providing transfer pricing information and disclose it in their financial reports. Executives' responses were on a 5-point scale ranging from "totally acceptable" to "totally unacceptable" and are presented in Table 7.10

Table 7.10 indicates that the majority of executives (79%) are not willing to disclose transfer pricing information. This was attributed to the general feeling prevailing among executives that transfer pricing disclosure might affect their competitive position in the market. These results indicate that almost all executives regard the confidentiality of transfer pricing information as very important in running their business.

Table 7.10

**Executives' Responses as to the Extent to which they would Accept Disclosing Transfer Pricing Information**

| Totally accept | | Accept | | Accept to some extent | | Unaccept | | Totally unaccept | | Total* | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| No. | % | No. | % | No. | % | No. | % | No. | % | No. | % |
| 1 | 2% | 3 | 7% | 5 | 12% | 11 | 26% | 23 | 53% | 43 | 100% |

* The question was directed only to financial executives as they are responsible for providing financial reports to competent authorities.

*Source:* Case Study Results.

## 7.17 Motives for Investment in Egypt

There are some factors that influence a company's decision to invest abroad. Foreign companies might be attracted to invest in Egypt for several considerations. For example, the Egyptian market structure, the opportunity to maximise profits over world-wide operations, and political stability might represent principal determinants for investment there. The Egyptian Investment Code, as mentioned in Chapter 5, provides a number of incentives that attract FDI to take part.

To assess these determinants in the filed study, the research intended to derive company executives' perceptions of the motives for MNCs to establish operations in Egypt. During the interviews, companies' Executives were asked to pinpoint their views as to the factors that attracted their parent company to set up its activities in Egypt. The effect of each factor was on a 3-point scale to show high, medium and low.

To indicate the positive factors that affevt the flow of FDI into Egypt, each of the factors are ranked according to the relative effect of each facto on such flow. This is done as follows:

1) Since the effect of each factor is measured on a 3-point scale to show the degree of importance, a numerical value of 1, 2, and 3 is used to calculate the overall effect of each factor. This is calculated (for each factor) by multiplying the number of respondents selecting each response by 1, 2, and 3 respectively.

2) The summation of the above calculation could be used to rank the factors, but the problem was that not all respondent (63 executives) provided response to all factors. The total number of respondents ranged from 45 to 60. Therefore the ranking order based on the absolute number would be misleading. To avoid this problem the summation of the above calculation (for each factor) is divided by the total number of respondents producing the mean value. Based on the mean values, factors are ranked in descending order.

Table 7.11 shows executives' responses to the factors that influence the decision making of MNCs to invest in Egypt. The Table draws the frequency and percentage of respondents and the numerical mean response.

It can be observed from Table 7.11 that the most important factors for investment in Egypt are (1) Government policy towards FDI, (2) dominating the local markets, and (3) political and social stability. Foreign companies find Egypt a potentially attractive market, especially as it has an estimated population of 57 million (in the middle of 1991). The results of the study are consistent with a similar study of 33 foreign companies in Egypt (El-Haddad, 1988) which found political stability to rank quite high as an influence on FDI decision.

The result of this study, relating to the market factor, coincides with a study carried on 22 joint venture companies and 3 wholly-owned companies in Egypt, where 80% of answers mentioned that the basic incentive of direct investment is to dominate the large domestic market (cited by Essa, 1989, p.22).

This issue was known to both the local partner and the government authorities responsible for foreign investment in Egypt. For instance, some companies got concessions to import finished goods and market them in the domestic market before starting production. The purpose of this is to get advantages over the domestic market and by providing it with imported products, especially where there is a growing respect for whatever is foreign and a disdain for everything national.

Other reasons for the investment decision in Egypt were the political stability, freedom of profits and capital repatriation, circumventing trade restrictions, secure access to raw materials, and a cheap and well-trained labour force. Egypt is the most industrialised country in the Arab world. So, it has an encouraging potential to export products to these countries' markets. The latter factor was accorded somewhat less important than preceding ones. Tax credits were an important incentive for US MNCs to invest abroad. These tax credits provide an additional benefit to U.S. MNCs in allowing that taxes paid directly to foreign governments on income and dividends

received from abroad will be credited against their tax liability to the U.S. government.

The ability of a foreign firm to transfer its profits represents one of the most important factors considered in a company's decision to establish an overseas operation. Such an ability depends largely upon the host government's regulations. The Egyptian Investment Code grants the right of foreign investors to transfer their profits.

Interviewees in textile and engineering industries pointed out that the availability of raw materials for these two industries was an important impulse for the investment decision in Egypt. But it was found that the availability of raw materials has some limited importance in the other companies. Cheap labour was a very important incentive for the investment decision, as it was mentioned above that foreign experts command high salaries compared to their local counterparts.

The issue of export by Egyptian subsidiaries was a less important incentive for investment in Egypt. Some MNCs even practice restrictions on export market to prevent the discrepancy among their subsidiaries.

In summary, the results revealed that MNCs set up their activities in Egypt for a number of factors as follows:

(1) Government policy towards FDI.

(2) Political and social stability.

(3) The large domestic market

(4) Repatriation of profits and capital).

(5) Maximising return on investment.

(6) Tax holiday and other tax exemptions.

(7) Attractive growth prospects of Arab markets.

(8) Cost advantages (raw materials and labour force)

Factors 6 to 8 represent the government policies aimed at pursuing foreign investment. Factors 1 to 5 represent those factors which are related to the Egyptian economy, political and social conditions and which may have a positive impact upon the flow of foreign investment into Egypt.

**Table 7.11**

**Company Executive' Perceptions to Determinants of Investment in Egypt**

| Determinants | Frequency and Percentage of Response | | | | | | Total No. of Respon-dents | Mean |
|---|---|---|---|---|---|---|---|---|
| | Low Effect (1)* | | Medium Effect (2)* | | High Effect (3)* | | | |
| | No. | % | No. | % | No. | % | | |
| 1) Government policy towards FDI | 5 | 8% | 16 | 27% | 39 | 65% | 60 | 2.567 |
| 2) Access to new markets | 7 | 12% | 12 | 21% | 39 | 67% | 58 | 2.552 |
| 3) Political and social stability | 10 | 16% | 20 | 33% | 31 | 51% | 61 | 2.262 |
| 4) Repatriation of profits and capital | 7 | 13% | 19 | 34% | 29 | 53% | 55 | 2.400 |
| 5) Maximising return on investment | 9 | 18% | 17 | 35% | 23 | 47% | 49 | 2.286 |
| 6) Tax holidays and other incentives | 4 | 8% | 16 | 32% | 30 | 60% | 50 | 2.520 |
| 7) Attractive growth of Arab markets | 17 | 38% | 16 | 36% | 12 | 26% | 45 | 1.889 |
| 8) Cost advantages (raw materials and labour force) | 28 | 54% | 17 | 33% | 7 | 13% | 52 | 1.596 |

* 1, 2, and 3 are numerical values used to calculate the overall effect of each factor, which is then divided by the total number of respondents to calculate the mean values.

## 7.18 Identifying Companies' Problems

To identify the major problems facing MNCs, executives were asked to give their perceptions of the factors causing problems to their operations. The major problems might be summarised as follows:

1- The bureaucracy and formal procedures when dealing with government officials. Dealing with various government bodies represents one of the major factors causing problems for MNCs.

   The bureaucracy in Egypt seems to be the result of overstaffed government offices, and the change of government policy toward investment happening without educating and training the civil servants in how to deal with foreign investors. Bureaucracy is also the result of civil servants lacking the ability and efficiency to deal with investors. These feelings were expressed by company executives in many ways. One executive stated that:

   > *"The main problem is that we have to deal with civil officers who lack the ability to take a decision either because they are not qualified, or because they are not willing to take responsibility."*

   Another executive expressed the situation by saying that: *"the civil officer hesitate to undertake decision"*. In his view, this is due to two main reasons: first, the fear that their decision might be wrong; and second, the fear that they may be accused of being bribed. Consequently, he further said:

   > *"civil officers tend to have several signatures on a document in support of their own which implicity means more time is required."*

2- The government discriminates between local companies and those established under the investment law either foreigners or nationals. For example, the government subsidises energy costs supplied to local firms, whereas it sells it to investment companies at the actual price. However, it should be noticed that the government controls the final price of products of the former group.

3- Local inputs with the appropriate quality are not available easily. So, if a project used the local alternative of raw materials it is likely to lose its competitive advantage especially in the foreign market.

4- Related to the preceding point, when the project depends on imported production requirements it should have an approval from the GAFI. Import procedures requires the government approvals which are always too long. Also, there are the fluctuation in exchange rate affects and the shortage of foreign exchange.

5- The exchange rate is one that has steadily worsened. MNCs have to face rapid fluctuation in exchange rate as well as soaring inflation in Egypt. The problem was further accentuated by the fact that a high proportion, much higher than usual, of the total cost was in equipment and materials imported.

6- Instability of economic measures was considered by the responding executives as a factor negatively affecting their profit margins.

7- The responding executives complained about the different and conflicting regulations applied by the government authorities they have to deal with. An example was given by one executive who mentioned:

> *"To transfer profits you have to get an approval from the GAFI. The GAFI tries to reduce the transferable profits by negotiating with the investor as to the amount of fixed assets depreciation. The GAFI usually argues that depreciation is underestimated., and thus it should be increased. If we look at the Tax Authority we will find completely opposite tendency. In its own interest, the Tax Authority tries to increase the taxable profits as much as possible. The way in which it does that is to decrease the operating costs. Again the main element negotiated by the Tax Authority is the fixed assets' depreciation". He further explained that "in both cases (i.e. decreasing the transferable profits or increasing the taxable profits) the investors will not be able to get his authorised benefits. The investor also may lose the expected return for which he established his investment."*

8- Executives in two companies complained that the GAFI does not meet some of its previous undertakings, for instance on market protection. One executive stated that:

> *"despite the fact that there is an agreement with the GAFI not to give licenses to new investors for five years from production start-up, a production license was given to a foreign company."*

Another executive revealed that:

> *"two Egyptian firms are known to be negotiating with foreign companies to form joint venture to produce similar products". He added that "this contradicts the agreement with the GAFI not to approve new investment projects for four years of starting up our production."*

It was understood that approving new projects affect the available production capacity of the existing companies.

Of course, it is more naiveté from the government as it has had an obligation not to approve establishing similar projects either foreign or national. More interestingly, existing projects of the same industry are not allowed to expand their activities. These examples emphasise that MNCs preferred to be in a monopolistic condition.

## 7.19 The Effect of Operating Problems on Investment Decisions in Egypt

Given the problems facing MNCs, interviewees were asked to give their perception as to the possibility of undertaking new investment projects in Egypt. Table 7.12 summarises executives' responses.

In case of expanding the subsidiary's activities in Egypt respondents were asked to determine the source of finance. Executives' responses are displayed in Table 7.13.

**Table 7.12**

**Executives' Responses to the Effect of Operating Problems on the Investment Decision in Egypt**

| Investing | | Reluctant | | Do not Invest | | Total* | |
|---|---|---|---|---|---|---|---|
| No. | % | No. | % | No. | % | No. | % |
| 14 | 25% | 23 | 42% | 18 | 33% | 55 | 100% |

* Only 55 of 63 executives gave their views on the question.

*Source:* Case Study Results.

**Table 7.13**

**Executives' Responses to the Source of Finance in Case of Expansion the Firm's Activities in Egypt**

| Perception | Executives' Response* | |
|---|---|---|
| | No. | % |
| Self-finance either internally or through the parent company | 21 | 32% |
| Borrowing from financial institutions | 44 | 68% |
| Total | 65** | 100% |

* Only 48 executives have given response to the question.

** 17 executives mentioned that they would depend on the two ways of finance.

*Source:* Case Study Results.

These results indicate that 69% of responding executive perceived that foreign projects depend on borrowing from domestic financial institutions. Interviews pointed out that the reason for preferring this way of finance is due to the ease of getting loans. It is believed that the economic instability in Egypt, especially foreign exchange did not induce subsidiaries to depend on self finance, neither reinvesting profits or borrowing from the parent company.

### 7.20 Summary

This chapter presented findings and results of the case studies. Data analysis was based on responses of 64 executives interviewed during the field study.

Different issues were discussed in this chapter. These involved the characteristics of companies, transfer pricing policies, environmental factors affecting transfer prices, the extent of overestimating royalties paid by the Egyptian subsidiaries to their parents, incentives for investment in Egypt and other issues.

This chapter concluded by analysing the results of this study in relation to various propositions concerning transfer pricing practices and profit shifting in MNCs. In many cases the results were consistent with the theory. On the whole, the study's findings were consistent with those of previous surveys which examined the transfer pricing practices of MNCs.

# Chapter 8

# Research Findings III: Perceptions and Attitudes of Government Officials in Egypt

## 8.1 Introduction

The preceding two chapters identified and examined transfer pricing strategies in 11 MNCs. To complete the picture, this chapter identifies and discusses government authorities' perceptions and attitudes towards transfer pricing practices by these companies. The opinion of the external auditor is discussed also.

The data upon which the identification and discussion tasks are based was collected from a survey questionnaire administered by interview to parties interested in MN transfer pricing topic. These parties consisted of tax authorities, customs departments, GAFI, and the external auditor.

## 8.2 The Attitude of Tax Authorities

For the purpose of this research data have been collected from tax administrations in both Cairo and Alexandria cities. Interviews took place with 19 officials to collect the required data. A questionnaire was used as a guide which was administered to them during the interviews (see Appendix C). The purpose of the interviews with tax officials was to determine the extent of scrutinising transfer prices, and if they do, does it result in conflict with MNCs? On the other hand, can national tax policy take into account transfer pricing response in a way that satisfies national objectives?

The first question directed to tax officials was to state problems that face the Tax Authority in determining the taxable income in MNCs. These problems might be summarised as follows:

1) Bookkeeping methods are sometimes different from the common methods. Also, a foreign language is used in the majority of MNCs for recording accounts. Hence, tax officers might find it difficult to understand financial reports and accounts.

2) Overestimating amounts paid to the headquarters for technical and administrative services. Officers were asked to determine exactly how they judge that the items of these expenses are overvalued. Most answers mentioned that these expenses were higher than those in the national companies.

3) In some cases, MNCs do not provide the tax authority with the required data and documents that support some items in the financial reports and accounts.

Regarding scrutinising transfer prices by Tax officials, it has been found that they accept prices on the import invoices provided by MNCs. The reason for this is that they rely on the fact that the prices were checked by Customs Authorities.

The general manager of tax department at Alexandria pointed out, during an interview, that investment companies seek to minimise their tax burdens through many ways, such as inflating royalties and other expenses payments to their parent companies. With regard to the artificial prices of imports, the tax authority does not adjust them. This is because the tax authority often accepts the price mentioned in invoices submitted by the company. He added also that there is no instructions to adjust the price. The lack of experience of taxation staff to deal with issues such as transfer pricing and intangibles is a problem for the tax authorities.

The general manager has emphasised that for tax purposes, steps must be taken to scrutinise and compare these payments with arm's-length transactions. Tax staff should be well trained to deal with the MNCs. The government should re-evaluate and tighten the existing financial control process of determining the transferred profits and income tax of foreign companies.

Unfortunately, there are no rules in Egypt requiring foreign companies to provide the tax authorities with transfer pricing information. Some tax officials expressed that some foreign companies are very aggressive tax-payers. Officials built their opinions upon the fact that tax liabilities for those companies are disproportionate with their gross receipts. Of course there is tax revenue lost. Some officials see that MNCs might take into consideration taxes as an element of production costs.

In general, tax authorities face difficulties to assess transfer prices for two reasons:

1) because, by their nature, MN transfer prices are beyond the direct scrutiny of any one taxing jurisdiction; and

2) because of the immensity of the auditing effort that may be necessary to be in a position to challenge management. In this matter, it has been found that most of tax officials do not understand, precisely, how the transfer pricing affects financial results of the company. Potentially, the absence of transfer pricing regulations is the main reason for this misunderstanding.

### 8.2.1 Fees for Centralised Administrative, Management and Other Services

Central management or administration expenses by the parent company might be categorised as follow:

(a) Expenses that are incurred by the parent company in its "custodial" capacity, i.e., as a shareholder managing its investment in subsidiaries rather than in the provision of services to its subsidiaries (these expenses should be borne by the parent and applied against its income from investment);

(b) Expenses incurred for the benefit of a subsidiary in the group and are associated with the provision of specific identifiable services to that subsidiary. An example of these expenses, technical assistance costs that are clearly incurred for the benefit of a single subsidiary or more in the group;

(c) Expenses that are incurred for the benefit of a number of subsidiaries of the group as a whole and are shared services and facilities, such as marketing and advertising costs if they are centralised for convenience or economy.

Of course, the basis of recognition expenses and charges to be deducted from the taxable income must be supported by documents.

A preliminary issue where fees for centralised management, administrative and similar services are charged to an Egyptian subsidiary is whether any portion of the fee is subject to Egyptian tax. These charges can be abused against Egyptian subsidiaries by parent companies. Under the general rules of Egyptian tax law, these fees and charges must be incurred for the purpose of earning income in order to be deductible from taxable income.

In summary, there are no regulations to monitor transfer pricing for MNCs. The government should propose regulations for this issue to enable tax authorities to get the required information. Of course, this is not easy, as the government may lack sufficient relevant data and expertise and due to the ability of the tax-payer to comply.

## 8.3 Interviews with Customs Officers

The objective of the questionnaire directed to customs officials was to appraise the role they practice over transfer prices. The interviews took place in two customs departments in Cairo and Alexandria. The former deals only with investment companies and the latter is a general one.

Because of the importance of customs duties as a source of government revenue, there is growing recognition to establish accurate market prices and trends so that regulatory controls can be applied more effectively.

Officers were asked to state the extent to which they find themselves in dispute with MNCs regarding the value of imported goods. Officers' responses to that question are presented in Table 8.1

**Table 8.1**

**Customs Officers' Responses to the Extent to which they find themselves in Dispute with MNCs about the Valuation of Imported Goods**

| Never | | Sometimes | | Always | | Total | |
|---|---|---|---|---|---|---|---|
| No | % | No | % | No | % | No | % |
| 3 | 19% | 8 | 50% | 31 | 36% | 16 | 100% |

The results presented in Table 8.1 indicate that the majority of responding officers have found themselves in dispute with MNCs in this respect. The response of officers could be explained by the fact that MNCs might attempt to underestimate the value of goods to reduce the value of customs duties. As mentioned during the interviews almost all disputes are successfully settled during negotiation between the Customs Authority and MNC's management.

Respondents were asked to state the basis of calculating customs duties in cases of not relying on the invoice. It was found that one of the following bases might be used:

1) Price guidelines prepared by the Ministry of Economy,

2) Prevailing market prices,

3) Otherwise, estimated prices might be used such as approved prices for previous similar cases. Contacting the suppliers is used as well to arrive to reasonable prices.

Officers were asked about the ad valorem rate that applied on MNCs' imports. It has been found that they apply the GAFI's regulations, i.e. full exemption of duties for capital goods and 5% for production requirements.

Officers were asked if there is any kind of co-ordination between them and Tax Authorities to provide the latter with information related to the reasonable prices of imported goods. All interviewees pointed out Tax officers never asked them for this kind of information.

It has been investigated during the field study that customs authorities suffer from many administrative deficiencies. Officials can not get correct information about MNCs' behaviour internally or internationally. This is in addition to the difficulties of evaluating such information, supposing they obtain it. Authorities are not equipped with an efficient administrative apparatus capable of coping with MNCs practices.

### 8.4 The Attitudes of GAFI

As the GAFI is responsible for evaluating and following-up the performance of foreign investment companies in Egypt, interviews with 26 officers took place during the period of the field study (December 1989 to February 1990). The purpose of the interviews was to investigate if the GAFI is concerned to scrutinise transfer pricing policies as they affect disclosed profits of the company.

Interviews were conducted, separately, with the head of each division, and the head of each department within each division of the GAFI. A free discussion and a questionnaire were used to collect the data required. The questionnaire (see Appendix B) was administered to them during the interviews as it happened with other government authorities.

Some questions were similar to those discussed with company executives. These involved the importance of MNCs for the national economy and advantages and obstacles of investment in Egypt. Other questions were about abusing transfer pricing by MNCs and the role of the GAFI in this matter, the extent of controlling royalties and other fees transferred abroad, and the requirements of foreign investment companies to improve the investment environment in Egypt. Hence, these matters will be discussed briefly as follows:

#### 8.4.1 Abusing Transfer Pricing

The problem of transfer pricing was the main issue during several interviews with officials in the GAFI. The question discussed with GAFI's officers was to what extent is the Egyptian government involved in determining transfer prices for MNCs working in Egypt? Generally, the Authority does not pay attention to transfer pricing technique's of either overestimation or underestimation of the value of imported inputs. However, an GAFI's staff member said:

*"If the GAFI is in doubt about the investor's data, it will seek information about the project's import requirements in the international market and use it as a basis for comparison."*

It was explained that since it was established in 1974, the GAFI has not checked the prices provided by investors in any case.

Officers were asked if the parent companies stipulate Egyptian subsidiaries to import production inputs from them. Table 8.2 summarises officers' responses to this question.

**Table 8.2**

**Executives' Responses to the Question of Whether the Parent companies Stipulate Subsidiaries to import their requirements from them**

| Never | | Sometimes | | Always | | Total* | |
|---|---|---|---|---|---|---|---|
| No | % | No | % | No | % | No | % |
| 4 | 17% | 6 | 25% | 12 | 58% | 24 | 100% |

* Among the 26 responding officers, only 24 of them have given a response to this question.

It is clear that the majority of responding officers perceived that MNCs condition their subsidiaries in Egypt to obtain their production requirements through them.

Some officials indicated that, often, the foreign partner dictates conditions to his local counterpart, even in cases with minority foreign ownership. Raw materials are to be imported from the parent company or through it. A senior official mentioned one case which clarifies the extent of abusing transfer pricing, as the foreign partner obliged the subsidiary to purchase raw materials at 150% over its market price. In some cases, it is not allowed to assemble parts produced locally except after written approval by the parent company.

### 8.4.2 Inflating Royalty Payments

The issue of inflating royalties paid to the parent companies was discussed with the GAFI's officials . As Table 8.3 shows, 57% of respondents agreed or strongly agreed that royalty payments could be used to shift profits from subsidiaries in Egypt. Meanwhile, 31% disagree or strongly disagree that these payments are inflated. The remaining respondents (i.e. 12%) agreed to some extent.

**Table 8.3**

**Officers' Responses to the Question of Inflating Royalty Payments to Parent Companies**

| Strongly Agree | | Agree | | Agree to some Extent | | Disagree | | Strongly Disagree | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| No | % | No | % | No | % | No | % | No | % | No | % |
| 5 | 19% | 10 | 38% | 3 | 12% | 3 | 12% | 5 | 19% | 26 | 100% |

Relating to the above question, two issues were discussed with officers. These were: (1) if it is believed that MNCs shift more profits outside Egypt, and (2) whether or not the Egyptian government play any role in preventing such undesirable transfers, i.e. through transfer pricing techniques. The results of the officers' responses for the first issue are presented in Table 8.4. All respondents indicated that the Egyptian government has no role over MNCs to prevent them to shift profits.

During an interview with an executive at the GAFI, it was mentioned that know-how contracts are considered a main channel to shift profits as the government does not oppose on conditions of the contract held between the subsidiary and its foreign company that transfers the technology (which is most cases the parent company itself). For instance, an executive quoted:

> *"Foreign companies often use know-how contracts to shift profits outside Egypt. This because there is no legislation to monitor these fees. The government therefore should pay more attention and regulate the technology transfer".*

Another officer has revealed that there is a programme with the UNIDO to standardise the percentage of royalties, which will be used as a guideline for MNCs in Egypt.

The officials stressed that the Egyptian government should mandate a law dealing with technology transfer by foreign companies. A government approval for all technology agreements should also take place. Moreover, it should motivate these companies to provide their technology to local firms in order to participate in the local market.

### 8.4.3 The Role of GAFI in Performance Evaluation of FDI

The process of evaluating company performance by the GAFI starts with collecting the data required for evaluation purposes. Such data are basically extracted from three financial reports submitted by the companies: the follow-up report: the balance sheet ; and the income statement.

**Table 8.4**

**Officers' Responses to the Extent that MNCs Shift their Profits outside Egypt**

| Never | | Sometimes | | Always | | Total* | |
|---|---|---|---|---|---|---|---|
| No | % | No | % | No | % | No | % |
| 5 | 22% | 7 | 30% | 11 | 48% | 23 | 100% |

* Only twenty three officers have given their views.

The first report is prepared by the FDI, and includes the following data:

1- Capital structure: sources of capital (shareholders' equity, long-term loans, and short-term loans) classified into foreign and local capital.

2- Output: volume and value classified into local sales, exports, and inventory (opening and closing balances).

3- Employment: number of employees grouped according to nationality (nationals, and foreigners), and wage payments for each group.

As for the balance sheet and income statement, there is no designed form to be used to collect the items in these two reports. Companies are left free to submit them according to their own accounting system.

Based on the data extracted from financial reports, company operations are evaluated for the purposes of:

1- Ascertaining that the company is conducting the same business activity as approved by the Authority's Board of Directors.

2- Measuring the company's ability to meet its financial obligations, generate profits, and efficiently utilize its available resources.

The first objective is simply achieved by comparing type of product(s) currently produced by the company and those mentioned in its feasibility study. If a company is found to be producing other products(s) or conducting another business activity, the general action undertaken by the GAFI is to tax the profits generated from this activity even if the company is still enjoying a tax holiday.

To achieve the second objective the GAFI applies financial ratio analysis techniques. These ratios are classified according to their purposes into four categories:

1) Financial Ratios: long-term debt/equity ratio, and total debt/equity ratio.

2) Liquidity Ratios: current ratio and quick ratio.

3) Profitability Ratios: return on investment ratio, and return of equity ratio.

4) Turnover (Efficiency) Ratios: inventory turnover ratio, total assets turnover ratio, and working capital turnover ratio.

Given the data about a company's operations over a number of years, the above financial ratios are calculated and the company's performance is evaluated. Time series analysis of a crude type is used.

It was realised during the interviews with GAFI's officials that the Authority relies on the company's external auditor's report which includes the expression of an opinion as to the fairness of the financial statement presentation. In addition, an auditing office at the GAFI reviews and audits the company reports to ascertain that:

a) the company has submitted its tax declaration and discharged all taxes as well as other obligations due to the State.

b) relevant depreciation rates on fixed assets have been applied.

c) a relevant method has been applied to evaluate inventory, and this method does not change from one year to another.

d) accrued revenues are generated from the company's activity, and this activity has been approved by the GAFI's Board.

e) reserves, especially those for bad debts, are sufficient to meet the purposes for which they have been set aside.

Officers were asked what would happed if a company exerted transfer pricing techniques to shift its profits. In answering this question it was mentioned that if the GAFI was in doubt about the value of the company's import and export transactions, then world prices are taken as the main price trend in reevaluating these transactions and thus in recalculating the company's declared profits. When officials were asked how often this happens, no specific answer was given. It was further stated that the range of profit/equity rates which is considered reasonable for foreign manufacturing companies is 15 to 30% . This range is sometimes compared with the actual (reported) rate of return. If the actual rate was more or less than 30% this may be taken as an indication of the use of transfer pricing techniques by the company concerned.

### 8.4.4 Comment

The process of performance evaluation by GAFI relying on a company's external auditor's report has shortcomings for three reasons:

1) the difficulty of ensuring the independence of an external auditor who is paid by the company being audited.

2) the limited interest of external auditors. They are basically concerned with the fairness of financial reports. Issues such as transfer pricing and management fees paid to the parent company have very little interest or no interest at all. This is particularly true in Egypt where the private sector accountants have no great deal of experience with these issues. This is due to the ignorance of international business studies in accounting departments of universities, and the absence of foreign business operations during the two decades that followed the 1952 revolution.

3) The process ignores the possibility of transfer pricing techniques to distort a company's reported profits. The range of profits/equity used by the GAFI to judge if the company employed transfer pricing techniques is not enough. Most companies are still enjoying the tax holiday (i.e. the fifteen years of tax free production according the Law 230 of 1989). After this period foreign companies are likely to distort their reported profits.

Therefore, the government is particularly recommended to:

1) perform its own auditing and investigation functions and not rely heavily on the company's external auditor's reports. Such reports should be used as supplementary factor during the auditing and investigation process not as the basic one.

2) consider the possibility of using the transfer pricing techniques to distort reported profits after the tax holiday period.

### 8.4.5 The Role of GAFI Over Royalties and Fees Paid to Foreign Companies

As mentioned previously, know-how contracts must be registered at the GAFI. But it should be noticed that the Authority does not have real power to adjust the amount of royalties and fees in cases where they are exaggerated.

### 8.4.6 Factors Affecting the Flow of FDI into Egypt

It was mentioned in Chapters 6 and 7 that this issue was raised for discussion with company executives. It was important to identify the major factors that positively affect the flow of FDI into Egypt from the government's viewpoint (represented in GAFI's officials).

Executives were asked to provide their perception as to the effect of each factor on a 3-point scale to show high, medium and low. To identify the major factors affecting the flow of FDI into Egypt, each of factors are ranked according to their relative effect on such a flow.

Table 8.5 presents executives' responses to the factors which positively affect the flow of FDI into Egypt. It shows the frequency and percentage of respondents and the numerical mean response.

Table 8.5 shows that the Egyptian government policy to attract FDI, large domestic market and political and social stability are the most important factors having positive effect on the flow of FDI into Egypt. Cost advantages and growth of Arab markets, seem to have a relatively small positive effect on the flow. The following is a description of the results obtained and interpretations for each factor.

#### 8.4.6.1 Government Policy towards FDI

The government policy towards MNCs may have a strong influence on inward investment. The openness policy in Egypt with the packages of incentives and guarantees against non-economic risks led to significant changes in the flows of inward investment.

Table 8.5 shows 77% of respondents considered this factor as having a high positive effect, and 23% of them perceived it as having a medium positive effect. At the same time, no respondent mentioned that this factor has a minor effect on the flow of inward investment.

**Table 8.5**

**Officers' Responses to the Factors which Positively Affecting the Flow of FDI into Egypt**

| Factors | Frequency and Percentage of Response | | | | | | Total No. of Respon-dents | Mean |
|---|---|---|---|---|---|---|---|---|
| | Low Effect (1)* | | Medium Effect (2)* | | High Effect (3)* | | | |
| | Number | % | Number | % | Number | % | | |
| 1) Government policy towards FDI | - | - | 6 | 23% | 20 | 77% | 26 | 2.769 |
| 2) Growth rate of the domestic market | - | - | 7 | 27% | 19 | 73% | 26 | 2.731 |
| 3) Political and social stability in Egypt | 2 | 8% | 9 | 38% | 13 | 54% | 24 | 2.458 |
| 4) Maximising return on investment | 3 | 12% | 11 | 42% | 12 | 46% | 26 | 2.346 |
| 5) Repatriation of profits and capital | 7 | 27% | 7 | 27% | 12 | 46% | 26 | 2.192 |
| 6) Tax holiday and other incentives | 5 | 19% | 7 | 27% | 12 | 54% | 26 | 2.115 |
| 7) Cost advantages | 11 | 48% | 8 | 35% | 4 | 17% | 23 | 1.696 |
| 8) Attractive growth of Arab markets | 14 | 67% | 4 | 19% | 3 | 14% | 21 | 1.476 |

* 1, 2, and 3 are numerical values used to calculate the overall effect of each factor, which is then divided by the total number of respondents to calculate the mean values.

### 8.4.6.2 Growth rate of the Domestic Market

This factor is primarily considered as one of the main motives for MNCs to invest abroad. The result coincides with Lecraw's study (1991), in that market potential is one of the most important determinants for investing abroad. A similar result was produced by Brooke (1986) as he found that 80% of 120 MNCs regarded dominating the market is the main reason for FDI.

As mentioned in Chapter 4, Egypt has a big and wide market as it has a large population compared to the region's other countries. As Table 8.5 shows, non of the respondents disregarded the positive effect of the large domestic market on the flow of FDI into Egypt. About 73% of respondents considered this factor as having a high positive effect, and 27% of them regarded it as a having a medium positive effect.

### 8.4.6.3 Political and Social Stability in Egypt

Political instability of a country affects negatively the economic and social welfare of its people, this in turn negatively affects FDI. Since drawing up the peace treaty with Israel in 1979 and ending the state of war, Egypt has become more socially and politically stable than before. Despite some events that threatened the political stability, such as the assassination of President Sadat in 1981, and the riots and mutiny of Central Security Forces in February 1986, Egypt is regarded as politically and socially stable.

These results agree with those of Lecraw's study, in that the extent of political risk in a host country is regarded one of the most important factors that influences the decision making of MNCs to invest abroad. Lecraw found that "the greater the decrease in country risk, the greater FDI inflows" (1991, p.171).

### 8.4.6.4 Maximising Return on Investment

As a general rule, generating profits is the major objective of doing business. This is particularly true when a company invest abroad where greater risks are involved.

Officers differed in their response to the effect of this factor on the flow of FDI into Egypt. As shown in Table 8.5, 46% of executives considered this factor as having a high positive effect and 42% regarded it as having medium effect. The remaining 12% viewed it as having a low effect.

The findings of this study are consistent with those of Brooke (1986), who found that ensuring achievement of profits is one of the main incentives to conduct business abroad.

### 8.4.6.5 Repatriation of Profits and Capital

The possibility of remitting profits and capital was also highlighted as an important factor influencing the MNCs' decision to invest in a particular country. As mentioned in Chapter 4, the Egyptian Code gives foreign companies the right to remit their invested capital and transfer their generated profits. But the ability of a company to transfer its profits and/or capital depends largely upon: the company's foreign exchange generating capacity; and its negotiating capability with the GAFI to get the approval for such transfers.

Table 8.5 depicts that 54% and 27% of respondents regarded the transfer of profits and capital as a factor having a large or medium effect on the flow of inward investment to Egypt. Only 27% of respondents considered this factor to have a low effect on the investment decisions.

### 8.4.6.6 Tax Holiday and other Incentives

Tax incentives are one of the most common sets of investment incentives used by host governments to encourage FDI. In Egypt FDI is exempted from several types of tax for a particular period of time which can be up to 15 years for some kinds of projects (see Chapter 4).

The effect of tax incentives on the flow of FDI into Egypt seems to be significant. As Table 8.5 shows, 54% of respondents regarded this factor as having a high degree of influence on the investment decision and 27% of them considered it to influence the investment decision to a medium degree. On the other hand, 19% of respondents viewed it have a low effect on the flow of inward investment.

### 8.4.6.7 Cost Advantages

MNCs are sometimes lured to move abroad to benefit from the cheap raw materials and labour force. Cost advantages seem to have only a little positive effect on the flow of FDI into Egypt. As Table 8.5 shows, only 17% of respondents considered this factor as having a high positive effect. It should be noticed that respondent officers mentioned that FDI is attractive in extractive sectors such as oil and mining. Of the 23 officers, 35% indicated that this factor influences the investment decision to a medium extent. The majority of responding officers (48%) revealed that the cost advantages factor has a low influence on the flow of investment into Egypt.

It is believed that MNCs are attracted to invest in Egypt because of the low costs of labour compared to other countries. At the same time, they intend to supply their subsidiaries with raw materials.

### 8.4.6.8 Attractive Growth of Arab Markets

Egypt is located in the centre of the Arab world. It is relatively more developed than the other Arab countries. It has the biggest human resources, and a relatively efficient industrial capital for the area. This gives Egypt a major role in the socioeconomic development process in the Arab world and makes its collaboration necessary in any regional initiatives. Therefore it was expected that the MNCs would be interested in Egypt, to make use of the available manufacturing facilities to produce goods and supply the Arab markets.

Unlike the prior expectations, Arab markets do not seem to have a substantial positive effect on the flow of FDI into Egypt. Table 8.5 depicts that the majority of respondents (67%) considered this factor as having a low effect. Otherwise, 33% of respondents regarded this factor as having either a medium positive effect (19%) or having a large effect (14%).

This could be explained by the fact that MNCs are interested basically in the Egyptian market and then (if feasible) in the Arab markets.

### 8.4.7 Common Requirements of Foreign Investors

The foreign investor always stipulates a number of guarantees from the government, such as an adequate infrastructure (port facilities, roads etc.); water, and electricity at reasonable prices; exemption of equipment from import duties; and external tariffs aimed at protecting products from competitive imports. Some investors dictate royalties in the form of a lump-sum technology purchase instead of a flat percentage of the value of sales. In some extreme cases, the investor conditions royalties to be a combination of a lump sum representing capitalisation of a proportion of expected royalties (which the supplier may then convert into an equity shareholding in the recipient entity without actually having to lay out capital) plus regular royalty payments based on the value of sales or the volume of output. The amount of royalties and management fees is often exaggerated. In some cases, MNCs refuse to export and commercialise the output in excess of local demand.

### 8.4.8 Comment

In conclusion, the GAFI disregards the possibility that transfer pricing techniques may be used by MNCs to avoid exchange control, inflation rate, and more importantly to distort the profitability of subsidiaries. The empirical studies on the MN transfer pricing policy (Chapter 3) indicate the likelihood of abuse of this policy by enterprises in host developing countries. Therefore, it is the duty of the government to keep this in mind and not to disregard the results given by this study.

### 8.5 General Comments of Government Authorities

Four general comments have been made by interested government agencies on the ways in which control measures should be improved.

First, nearly all authorities contacted consider that control over transfer pricing techniques should be exercised primarily for capital and intangible assets. They also generally believe that a combination of regulatory and competitive controls is necessary to improve this issue.

The **second** general observation was to emphasise the importance of government developing and sustaining negotiation skills in the area of transfer pricing.

The **third** comment was to stress the importance of augmenting monitoring and enforcement of controls on declared qualities and quantities of imported and exported products.

**Finally**, a majority of government officials advised that there is a need for some centralised and co-ordinated investigation in specialised areas where the particular government authority's resources and expertise are insufficient.

### 8.6 Auditors' Opinions

An interview took place in a big accountancy firm that audits most foreign investment business in Egypt. The purpose of the interview was to investigate the role of the auditor in auditing transfer pricing policies.

During the interview two questions were asked. First, Does the external auditor check the transfer prices? Second, what will happen if investors intend to use the transfer pricing technique either to overestimate or underestimate the value of imported inputs?

In general, financial reporting for MNCs is not governed by legislative requirements applied to public sector companies. Also, there is no statutory requirement that the financial statements should be published.

In answering the first question, it was stated that the auditor's role is to audit financial statements in accordance with International Auditing Guidelines. There is no responsibility for the external auditor to examine transfer pricing policies. Only, the auditor's report to the shareholders must include any significant information which he

thinks should have been disclosed, or which he believes should be brought to the attention of the shareholders.[1]

With respect to the second question, it was pointed out that the external auditor does not pay attention to this matter. Information should contain the amount of intra-group transactions that have taken place. Because of nonexistence of international transfer pricing disclosure requirements, the auditor would have no responsibility for verifying the reasonableness of assigned transfer pricing values.

### 8.6.1 Comment

As mentioned, none of the MNC subsidiaries working in Egypt are under obligation to disclose their financial performance publicly, thus enabling the foreign corporates to keep them commercial confidential.

When the matter of disclosure was discussed with company executives they were not in favour of extending disclosure requirements to subsidiaries of MNCS in Egypt.

It should be noted that the United Nations' report (1988) requires the company as a whole to disclose in its financial statements, the accounting treatment applied for transfer pricing policies. In particular, it should indicate whether such transactions have been made on the basis of market prices or, in the absence of such prices, other methods which should be described. In discussing this issue with auditors interviewed they mentioned that the subsidiary is required only to disclose the volume of such transactions.

On the other hand, the auditor would need to consider the effect of audited financial statements on any third party claims which require valuation adjustments or additional liability provisions. The auditor would have the responsibility to be satisfied that intra-firm transactions are accounted for in a manner which is consistent with their underlying economic substance. In consequence, the disclosure of transfer pricing should be harmonised to give the auditor both (1) a standard for judging fair presentation and (2) responsibility for obtaining adequate audit evidence as to the accuracy of the disclosure.

In summary, the auditor's responsibility for examining international transfers are derived from his duty to examine and report upon company financial statements. So, it appears that auditor's responsibilities for examining MN transfer prices are derived from his duty to examine and report upon company financial statements. He is

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[1] For details of information that should be disclosed, see UNCTS (1989, pp.32-34).

charged with making such tests as he considers "necessary in the circumstances" in order to express his opinion whether the financial statements examined are "presented fairly" in accordance with generally accepted accounting principles.

The independent auditor, exercises little influence on the valuation of intra-firm transfers and no professional responsibility is specifically recognised in this respect. There is also no guide for the performance of such a function which includes the disclosure of such transfers.

Of course disclosure of intra-company transactions may enable the user of the financial statements to identify amounts that are not based on the arm's-length transactions and to assess the extent of any dependence on intra-company activities. This disclosure could take many forms, ranging from revealing only that such transactions exist to detailed descriptions of transfer transactions, and pricing methods.

### 8.7 Summary

A part of the field study was to investigate the attitudes of the Egyptian authorities about abusing transfer pricing by MNCs. These departments comprise of tax authorities, customs authorities, and the GAFI. Some interviews took place with officials in each department.

Meanwhile, the external auditor's concern is to report to the shareholders the state of affairs of the business. The responsibility of the auditor involves the verification of the correctness of herald profits/losses which might be affected as a result of dubious transfer pricing policies. A part of the field study was to investigate the attitudes of external auditors in Egypt towards auditing the MN transfer prices.

This chapter presented the role of governmental authorities in scrutinising transfer pricing strategies. It has been concluded that only the customs authorities have a role in examining intra-company prices for the purpose of excising tariffs. There is neither co-ordination nor co-operation of exchange transfer prices information between tax and customs authorities. In general the Egyptian government is largely unaware of the transfer pricing aspect.

On delving further into the problem, the chapter exhibited the appraisal of the role of the external auditor in verifying transfer pricing policies. It has been found that his role is currently very limited.

# Chapter 9

# Summary and Concluding Remarks

## 9.1 Introduction

Transfer pricing is one of the most considerable sources of conflict between MNCs and their host countries. A major purpose of this study was to survey transfer pricing and profit shifting practices by MNCs, with the case study of Egypt as a host country. This chapter summarises the key issues of the study including research objectives, research methodology, principal survey findings and conclusions and limitations of the study. Suggestions as to the contributions of this study will be presented toward the end of the chapter.

This research's concern with MNC transfer pricing practices in Egypt is based on theoretical and practical studies. It should be noted that the findings and recommendations of the study cannot solve the problem. However, it is hoped the study will encourage the government authorities to give more concern to the transfer pricing problem and raise more vital questions which may suggest further studies in this field in the future. Also, the study pinpoints some important consequences of MNCs and foreign investment policy on the Egyptian economy.

Transfer pricing techniques are used to control the allocation and distribution of goods and resources within a company, either domestic or MN. Establishing MN transfer prices are more complicated as it is affected by external factors. So, MN transfer pricing strategies are generally the result of regulations enforced by the various taxing authorities in both host and home countries, foreign exchange rates, and other variables. MNCs, by the very nature of their international operations, are engaged in risk-pooling. Thus, they are keen to determine the prices of their transactions, whether exports or imports, dependent on those prevailing on the international markets.

## 9.2 Findings and Conclusions from the Literature Review of the Transfer Pricing Topic

In fact, the transfer pricing topic has been subject to attention by many academics from economics, accounting, operations research, and behavioural backgrounds. Chapters 2 and 3 have dealt with the theoretical background of the transfer pricing issue.

Different approaches to solving transfer pricing problem have been examined in Chapter 2. These included economic models which include both market and marginal (incremental) pricing. The second technique was mathematical programming models which equate the transfer price with the opportunity cost of the intermediate product, deal with multiple divisions and multiple products, and allow for the inclusion of realistic production constraints. The third approach was the accounting one which focuses on allocating intra-firm resources in order to optimise the overall profit and, at the same time, motivate the subunits' managers and provide a fair performance evaluation. This approach suggested cost-based methods for determining the transfer price. The final approach was a behavioural orientation which dealt with transfer pricing in a social system context, i.e. considering such factors as the degree of decentralisation, interdependence, degree of integration and specialisation, and extent of cooperation in the company in order to arrive at the best of the previously given methods for a given company. Some features have been extracted from studying transfer pricing approaches:

1- Despite the extensive work on the transfer pricing subject, none of these approaches resolved the essential problem in a satisfactory way.

2- It is suggested that the market price is probably the most acceptable price if a reasonably competitive market exists. If no such market exists, however, the firm should set the transfer price on an appropriate basis for both divisions taking into account the overall profit.

### 9.3 Determinants of Transfer Pricing Strategies

When MNCs make their transfer pricing decisions they take into consideration external and internal variables. These determinants have been presented in Chapter 3. The chapter discussed also the most important rules that countries use to tackle transfer prices for taxation purposes. The best taxation rules for such purposes are argued to be those of the U.S. 482 Internal Revenue Code and OECD. The main result of Chapter 3 can be summarised in five points:

1- Generally, MNCs are accused that they do not hesitate to make their benefits at the expense of host countries, for the sole purpose of increasing profits through different ways such as restrictive business practices and transfer pricing. The latter device, i.e., transfer pricing, is the most important, being used to conceal profits in high income tax countries to be accumulated in more lenient countries.

2- There are a large number of transfer pricing variables that encourage MNCs to manipulate prices of intra-company transactions.

3- Despite some nations, in particular developed ones, that have developed regulations for dealing with the transfer pricing issue, many host countries have been handicapped in dealing with the problem.

4- When a subsidiary makes remittances to its parent company based upon artificially high transfer prices, it causes a reduction in the subsidiary's earnings and hence a reduction in its taxes due. So, such transactions must be based upon truthful and accurate pricing. The international code, such as the one by OECD, could be highly useful to companies as well as governments in this matter.

5- International organisations, e.g., the UN and OECD, should help developing countries in regulating MN transfer pricing practices. Also, for the interest of developed countries in the long-run to help developing nations by supplying them with information about arm's-length prices.

## 9.4 Principal Conclusions Reached on the Business Environment and the Role of FDI in Economic Growth in Egypt

As described in Chapter 4, a significant improvement in the Egyptian investment climate has taken place. Since the early 1970s, the government has had a convergence of attitude towards FDI and MNCs as they play an increasingly important role in economic development. Egypt, with its resources and strategic location, offers a stable business and social environment. The chapter produced some results as follows:

1- The Egyptian government tried to stimulate FDI by offering a wide range of incentives including tax concessions, official financial support and other measures pertaining to exchange controls, and well trained labour forces.

2- The government should continue in future to attract and accelerate foreign investment into Egypt. The most important issue for the government is to remove any doubt among foreign businessmen over whether the bureaucratic obstacles have really been removed. This means the government should devote greater efforts to streamlining and simplifying its administrative structure.

3- But the production of MNCs should be a substitute for imports and directed to the export market which may save foreign exchange. This because MNCs produce internationally known brand names and can take advantage of the

distribution networks of their parents overseas. Additionally, the government should follow the policy of "import substitution" to "export promotion" via substantial tax benefits to be granted to investing companies, as a motive to increase exports.

4- Foreign investments eligible for tax breaks should be restricted to those concerning the transfer of high technology.

5- Tax breaks should be given to corporations contributing to the balance of payments, providing a given number of job opportunities, and those engaging in large-scale capital investment projects.

6- The activities of MNCs include negative as well as positive effects upon the Egyptian economy. With the exception of their employment impacts, there is clear evidence that these companies tend generally to carry out policies which are primarily in their interests but which adversely affect the economic welfare of the host country. This result suggests that adequate and effective host government control is necessary for making foreign investment beneficial to the national economy.

7- MNCs might exaggerate the technology transferred, particularly when it is presented as a part of the capital of a joint venture project. For example an Egyptian refrigerator company that is considered as one of the most successful public sector companies had an agreement with a French company for a joint project. The agreement stipulated that four main marketing buildings and the headquarters building would be valued at half a million Egyptian pounds, while the goodwill of the foreign partner would be valued at E£1.8 million (Kasem, 1984, p.213). This agreement was unfair because of undervaluing the tangible assets and overvaluing the intangible one. This agreement does not involve the transfer of technology in the full sense of the word, but it means also using patents which are used to protect the technology indirectly. Therefore, the government should consider not accepting contributing technology as a share of joint venture capital.

8- MNCs should consider preparing detailed country-by-country reports showing both tangible and intangible contributions to the host nation. Information in the reports should include their contribution to job opportunities and spreading new technology, and so on. This procedure will improve the picture of MNCs.

### 9.5 Rationale for Future FDI

Egypt has to strike a reasonable balance between inflows of FDI and technology and the outflows of foreign exchange in terms of remittances of royalty, technical know-how fees, dividends and also repatriation of capital. The liabilities resulting from FDI should be carefully considered *vis-à-vis* the benefits to the economy in terms of technology upgrading, higher production, improved productivity, quality-cum-cost competitiveness and export additionality. The rule of thumb for encouraging FDI appears to be that it should not result in a net outflow of foreign exchange. The country's need for FDI and the technology is of a continuing nature because these are essential inputs for accelerating the development process and keeping pace with the rapidly changing world in the field of science and technology.

### 9.6 Research Methodology

The methodology of the study has been presented in Chapter 5. Case Study methodology was followed to collect required data for the research from 11 MNCs operating in Egypt. Extensive interviews with officers in companies were held and a questionnaire was used during the interviews. As the sample of the study was small, there was no need to use statistical techniques to analyse the collected data.

### 9.7 Major Findings and Conclusions From Case Studies

This study has mainly sought to assess the extent of the use of transfer pricing strategies by MNCs to shift profits outside the host country. As Egypt was concerned, case studies of MNCs practicing their activities there have been investigated. Hence, Chapters 6 and 7 provide an overview of transfer pricing practices in companies involved in the field study. The role of government authorities was described in Chapter 7.

The findings of Chapter 6 indicate that the pretence of the use of certain variables, particularly market price, does not imply the use of the market price method. Companies involved in the case study are using cost-based or cost-based plus the lost contribution margin methods even when market prices for intra-company transfers are available. Companies ignored methods such as mathematical programming and marginal costing in favour of cost-based methods due to the complexity of the former methods. The findings of the case studies are:

1- It has been found that employing transfer pricing techniques to shift profits outside the country is due to various dimensions or determinants.

2- Economic conditions in Egypt have first position in order of importance when MNCs design their transfer pricing systems.

3- The results revealed that "market conditions" received the highest rating of importance by MNCs in Egypt. Four other variables to which high rating were given by U.S. companies are: competitive position, performance evaluation, income taxes and the level of inflation.

4- The most important factors that induce MNCs to shift profits via transfer pricing techniques are the increasing of the overall profits, inflation rate, exchange fluctuations and tax rates.

5- Variables given very high rating by pharmaceutical companies are competitive position of the subsidiary, price controls over medicines, multiple exchange rates, and the level of inflation.

6- Factors that have received very low ranking include political aspects because the investment law guarantees foreign investments against the risk of nationalisation, expropriation and so on. Other very low rating factors were anti-trust legislation, and rules and requirements of financial reporting.

7- Payments for interest, royalties, and technical assistance and management fees have grown more rapidly than profits. It is believed that MNCs use such intangibles to shift funds outside the country. There is no restriction imposed by the Egyptian government on such repatriations.

8- The accounting profession appears to have ignored the transfer pricing problem. It has tended to examine the issue of transfer pricing from a management accounting perspective, with relatively little attention being given to external financial reporting (Masson, 1979, p.56).

9- MNCs, when dealing with their foreign investments, are now pursuing a long term objective, i.e., to achieve a strong position in the host country, which depends on its economic stability. To encourage MNCs to help in the development of the host country, it is the responsibility of the host country to adopt measures to improve the business environment such as implementing educational, agricultural, and industrial development programmes. Also, the business environment in the host country is influenced by the exchange rate of its currency relative to the MNCs home currency, inflation rate, rate of customs duties, restrictions imposed on repatriation of profits and any other restrictions and regulations related to investing and conducting business in that country.

10- In order to encourage MNCs to adopt reasonable economic policies toward their subsidiaries, a host government should provide a favourable business environment. Measures toward this objective might comprise:

(a) providing tax relief for new and heavy industries in the country,

(b) reducing restrictions,

(c) lower tariffs,

(d) providing foreign subsidiaries with access to local markets, and

(e) adopting policies to reduce the rate of inflation.

11- On the other hand, MNCs should help in the economic development of the host country by understanding and supporting its development objectives and requirements and accommodating them when processing their policies in order to guarantee a strong competitive position for their subsidiaries in that country. In addition, MNCs might adopt policies to enhance their position in the country such as keeping adequate cash in the subsidiary and maintaining good relations with the host government by complying with the host country's regulations such as financial reporting requirements and business regulations.

Government authorities in Egypt have no control over MN transfer prices, as mentioned in Chapter 8. In such a case, some recommendations would be useful:

1- The magnitude of overpricing becomes obvious to the authorities when arm's-length prices become available on the international market and these prices are compared with the prices charged by parent companies to their subsidiaries. The government therefore should be aware that it is necessary to examine and monitor prices of imported goods to ensure that they represent arm's-length prices or are similar to international competitive prices. A special committee should be constituted to overhaul transfer prices used by MNCs in Egypt. Members of the committee should be specialised and qualified in the area of MN transfer pricing, either intra-company transactions or transfers of intangibles. Officials must have a clear idea of the causes of transfer pricing so that they will be able to detect the malpractice. The number of members available should also be enough to develop and litigate transfer pricing issues. This procedure should encourage MNCs to review carefully current transfer pricing policies and the documentation and support for such policies, as they face an increased likelihood of government scrutiny.

2- The government should press for more resources and enforcement powers to seek documents from MNCs. Also, tax administration auditors should be allowed time to work.

3- In fact, when any government attempts to regulate transfer pricing it will be confronted by the MNC. This is because the MNC has private information about the parent unit's costs which is not available to the host government. If the host government suboptimally regulates the MNC, it may encourage the parent company to misreport its costs in order to maximise net global profit. In this regard, the host government must entice the MNC to reveal transfer pricing policies. The host government can control the final good's price through providing a subsidy (tax) to guarantee non-negative profit and impose a profit remission restriction.

4- It is almost universally recognised by tax authorities that combating artificial pricing depends on being able to establish arm's-length prices. So, in carrying out an international audit, tax authorities should stress the importance of applying the arm's-length principle to intra-company transactions. However, if arm's-length pricing is impossible, the consistent application of approximations, such as the cost plus method, might suffice. At the same time, the financial statements required for tax purposes must report the volume and value of imported inputs from related parties. The tax authorities then compare this information to that on normal prices to see if arm's-length pricing is being observed. In this matter, tax authorities could adopt the arm's-length principle consistent with the Section 482 regulations of the U.S IRS.

5- In case of special problems arising as a result of the difficulty of obtaining the documents necessary to ensure that the transfer price is reasonable, tax authorities should be authorised to request the subsidiary to produce foreign-based information that is relevant to the tax authorities. This procedure could take a formal form, i.e., all subsidiaries might be requested to provide such information in a form annually. It is believed that this situation will ensure better tax-payer reporting and compliance where cross-border transactions are involved.

6- Anti-avoidance rules should be introduced as a part of the tax reform process. Such rules should apply to all tax-payers and not be specifically directed against MN or foreign companies in Egypt.

7- The government should focus to a considerable extent on determining the royalties paid to the foreign transferor or licensor. This entails information from or audit of companies outside of the Egyptian jurisdiction and, under the current status of international co-operation, requires voluntary disclosure of such information by the foreign parent or related company, which in many cases is not forthcoming.

8- The tax authorities should pay attention to charging R&D expenses, i.e., the reasonableness of the basis for allocating them, and be sure that there is no double-charge involved (as for example when these expenses are also a component in establishing transfer prices). In cases where royalties and similar payments were exaggerated, tax authorities should impose withholding taxes at a higher rate than applied as a way to limit them. Egypt has entered into a number of bilateral international tax agreements with other countries for the purpose of avoiding double taxation.

Many international tax agreements may involve provisions concerning income allocation in accordance with arm's-length principles. Also these provisions attempt to provide a framework in which an adjustment to profits in one country may be offset by a corresponding adjustment in the other country. Therefore, the Egyptian government could get advantages from more detailed information acquired through bilateral agreements.

9- Foreign companies should be obligated to export a designated portion of their output, in order to help the Egyptian government develop new markets for its products, earn foreign exchange, and overcome balance of payments problems.

10- The government representation in the GAFI, or any control authority should follow some accounting analyses such as cost/benefit analysis to assess the effect of MNCs' activities on local companies' growth, indigenous technical and management learning and domestic market structure.

11- Foreign companies should be encouraged to adopt reasonable economic policies toward their subsidiaries in the country. This requires the Egyptian government to provide a favourable business environment to FDI and MNCs. For example reducing restrictions, providing tax exemptions for new and heavy industries in the country, and giving permission to MNCs to sell in foreign currency in the local market.

12- On the other hand, MNCs themselves should help in the economic development of the host country by understanding and supporting its development objectives and needs and accommodating them when formulating their policies in order to guarantee a strong competitive position for their subsidiaries operating in the country. In addition, MNCs might adopt policies to enhance their position in the country such as keeping adequate cash in their subsidiaries and maintaining good relations with the host government by complying with the host country's regulations such as financial reporting requirements and business regulations.

## 9.8 The Absence of Efficient Control over Transfer Prices by the Egyptian Government

Since at least the mid-1960s, governments that are host to MNCs have been highly suspicious of transfer prices used by these companies to evaluate intra-company transactions. The problem emerged because the host governments failed to realise that the MNCs optimisation problem was not static.

Shifting profits through transfer pricing techniques is very difficult to control. Tax authorities have no power to scrutinise transfer prices. Even, if they have authority, it is difficult to obtain the information to test these prices. Also, it is difficult to assign a fair price if arm's-length prices cannot be found. Sometimes alternative methods, such as apportioning global value-added on a cost-plus basis, cannot be applied.

The Egyptian government does not pay attention to this issue. This matter requires a kind of coordination among the various Egyptian authorities that have an interest in transfer pricing. The regulation of transfer pricing is vital, particularly as many MNCs are starting their activities in Egypt.

It should be noted that the tax authorities in Egypt do not have the power to compel MNCs to disclose unpublished data about costs and prices. More important, perhaps, is the lack of qualified staff. There is no information about the number of inspectors assigned to MNCs. At the same time, tax officials do not check the prices of intra-company transactions as they rely on customs officials in this matter. It is hard to avoid the impression that the Inland Revenue regards transfer pricing as a problem of minor importance.

Therefore, Internal Guidelines must be developed with respect to the audit of transfer pricing issues and training sessions for tax personnel should be held across the country.

What one can deduce from this study is that the possibility of manipulating transfer pricing in Egypt does exist and its use by MNCs may increase, especially after the expiry of tax exemption incentives. It has been argued that the tax differential between countries is one of the greatest stimuli for abusing transfer pricing by MNCs (Lall, 1983). In addition, there are no monitoring measures or any policy to control imports by MNCs in Egypt. Hence, companies are free to negotiate their transaction terms.

**9.9 Royalties and Technology Transfer**

MNCs might regard fees and royalties to be "either a substitute for, or supplement to, dividends as a means of remitting earnings" (Brooke and Remmers, 1970, p.102). MNCs might use this device especially in under-developed countries, where there is a scarcity of officials capable of discussing such matters with MN management on an adequately informed basis. Some governments appear to prefer that foreign companies repatriate income by these hidden routes, rather than as dividends which may be politically sensitive. US MNCs in joint ventures attribute a considerable importance to royalties as a means for shifting profits because partners do not share in them. As a general manager of the Far Eastern area of a US MNC mentioned, the Japanese subsidiary is a joint venture, "And we're putting a damn sight more into it than our partner is. So, as compensation for this additional effort-our trademarks, and our product developments that we're giving-we are getting a royalty payment which is rightly due to us." (Robbins and Stobaugh, 1974, p.88)

With regard to the position in Egypt, the tax regulations do not involve any administrative principles for the allocation of income between related taxpayers with domestic and foreign income.

Royalties paid to the MNCs constitute a substantial element of technology transfer costs. In most cases, royalties are computed as a percentage of sales revenues, and sometimes an arbitrary amount is paid when signing the license contract, i.e., before starting production.

In most cases, overcharging royalties is the predominating feature in returns on technology transfer, especially in the case of joint ventures. For example, in the Wilkinson project for producing razor blades, the foreign partner stipulated that the Egyptian partner should pay the following amounts:

1- E£100,000 within 90 days of establishing the project.

2- 4% royalties on net revenues paid in hard currency.

3- Another 2% royalty payments every 3 months,

4- In case of delaying paying the above amounts 7% interest will be applied (Kassem, 1984, p.215).

Royalty rates ranged between 1.5% and 7% for 10 to 25 years. However, an extreme case is an aluminium company which held an agreement to pay royalties of 1.5% of net sales for 50 years to the foreign investor (Abdel-Rahman, 1986, p.313). In the engineering sector, a German company (Siemens) stipulated that the local partner should pay royalties of 3% of net revenues, and the percentage will go up to 7.5% if the production exceeds a certain limit (Abdel-Rahman, 1986, p.314). Some recommendations could be suggested in this matter:

1- As a result of the momentous size of outflows of royalties and fees for technical assistance paid out to MNCs as an alternative way of profit shifting, the government should study even more closely the technology transfer contracts which link foreign companies to their Egyptian subsidiaries.

2- Following on from the previous point, the government should enact legislation relating to the acquisition of technology and know-how by MNCs. Also, it should study of appropriateness of imported technologies concerning the priorities and economic objectives of the country.

3- The government should pay attention to the amounts paid to the scientific offices in pharmaceutical companies as those amounts represent a way to shift funds abroad.

4- It is not reasonable to hold technology transfer contracts that requires the payment of royalties for long periods, especially at the present time where the technology changes continuously because of ongoing R&D. Thus technology contracts should be limited to a period of not more than 10 years.

### 9.10 MNCs and Disclosure of Transfer Pricing Policies

Of course, transfer pricing disclosure is essential to the government in its efforts to obtain from MNCs more beneficial arrangements. The Egyptian government should determine its own information requirements on transfer pricing and prescribe appropriate disclosure rules based thereon.

In the light of the unfairness of the transfer prices used by MNCs, it would be necessary to regulate the disclosure of additional information regarding transfer pricing policies. Such disclosure will be in addition to the annual financial statements

required by the government and should be applied to all subsidiaries of MNCs regardless of their size. If disclosed prices are different from the market price, full details must be given by the company, including reasons for the use of such prices and why they are thought to be close approximations to the market price.

### 9.11 Policy Implications of the Study

The Egyptian government does not pay attention currently to the policies that MNCs practice in order to shift more profits outside the country. The most important technique used for shifting profits is transfer pricing.

It is hoped that the results of this study should help the Egyptian government in giving more attention to the issue to encourage MNCs to set economically meaningful transfer prices. At the same time, rules and regulations govern FDI should be simplified.

### 9.12 Power to Require Information

Tax authorities should have power in certain circumstances to require the production of information for tax purposes. They may require a company to produce information which is relevant to the adjustment of transfer prices.

Also, in certain circumstances tax authorities may require books and accounts and other documents or records which are relevant to transfer pricing adjustment to be produced for examination by an Inspector of Taxes.

It should be noted that officers are governed by very strict rules about the confidentiality of information received by them in the course of their duties. They are prohibited from disclosing such information except for tax purposes.

### 9.13 Exchange of Information with Other Countries

As the Egyptian government holds agreements for the relief of double taxation with some oher countries, disclosure should be permited with tax authorities in these countries. Transfer pricing information should also be exchanged for the purpose of ensuring that tax is adequately charged.

### 9.14 Necessity for Establishing a Section for Transfer Pricing Problems

In the absence of transfer pricing rules imposed by the taxing authorities, MNCs have opportunities to maximise their profits.

Nearly all tax officials interviewed suggested areas on which they would welcome assistance. These ranged from the investigation of certain freight, capital equipment

and bulk supply contracts to the validity of particular management services, consultancy fees, loan arrangements and licensing of technology. The opportunity for such a section for transfer pricing problems to provide an overall co-ordinating role was also stressed. It could provide government authorities with early warning of changes in the methods and areas of transfer pricing manipulation. Additionally, it could be the natural focus for liaison with international authorities and other governments concerned with transfer pricing manipulation by MNCs.

### 9.15 How Would the Section for Transfer Pricing Problems Operate?

The main features of the proposed section have been discussed in some detail with interested authorities and would be as follows:

#### 9.15.1 It Would be Located in Tax Authorities

Transfer pricing information is usually extracted from tax returns or obtained in connection with a tax audit by making use of normal procedures under which the tax payer in many countries may be required to submit all information deemed to be relevant by the tax inspector to the determination of transfer prices. For instance, transfer pricing information in the U.K. may be obtained from taxpayers using general powers for obtaining information either by a local tax office in the course of its normal procedures, or by the special Head Office Unit dealing with major transfer pricing investigations. However, special information powers which exist as part of the U.K. transfer pricing provisions can be used.

It is recommended that the proposed section should be located in tax authorities. Its location in tax authorities is preferable to all other authorities for the following reasons: First, a key element in the successful operation of the section will be free and ready access to information. Comprehensive powers are already available to tax authorities to obtain information for income tax assessment and collection purposes. Secondly, as any government's major concern with the effects of transfer pricing manipulation is the loss of revenue, the location of the section in tax authorities will ease liaison with those sections responsible for enforcement and recovery of tax. Finally, this location would facilitate the benefits the section could derive from the Authority's links with international taxation developments.

#### 9.15.2 It Would Have a Small Permanent Core of Staff and be Assisted by Relevant Departmental Officers.

There is general agreement that the best combination for the permanent core staff of the transfer pricing section would be an accountant with tax investigation experience and an economist with a business background in a developing country.

### 9.15.3 Enforcement and Audit Policy

The objective of auditing transfer pricing policies and related MN transactions, is to ensure that Egyptian subsidiaries have reported their appropriate share of total income by paying no more than or receiving less than, reasonable arm's-length prices in their transactions.

Where the committee should decide to review a subsidiary's intra-company transactions, experienced auditors could examine each component in the package, i.e., transfer prices, royalties, intra-company financing, service fees, etc. This might prevent, for instance, the double deduction for parent's R&D costs, once by way of an intra-company royalty or cost-sharing arrangement, and again as an element of the transfer pricing.

## 9.16 How "Profit-shifting via Transfer Pricing" might be Estimated:

For various reasons, MNCs are reluctant to disclose information relating to the use of transfer pricing for profit outflows. Such information could trigger tax investigation and further tax payments. There are examples of cases involving the use of transfer pricing not being defended in the court.[1] In Egypt, no study has been reported to estimate the amount of profits shifted outside the country via transfer pricing techniques.

Examining transfer prices requires data on product prices, whether import and export prices or domestic prices found in other countries, which are rarely available. Hence most researchers rely on comparisons of value added expressed as a proportion of sales, or net output per employee, either between similar sectors in different countries or between different sectors in the same country.[2] However, using this technique to investigate transfer prices is not conclusive proof of shifting profits. Differences in value added comparing one sector with another may be due to more efficient production techniques, or economies of scale.

## 9.17 Suggestions for Further Research

This study examined transfer pricing strategies and profit shifting in 11 MNCs that have activities in Egypt. The sample of the study restricts its generalisability. To help establish generalisations of the findings, further research could be done in this area. The following suggestions could be bases for further study:

---

1 See for example, the case of Litton Industries, which was accused of intra-company transfer pricing illegally to defraud the US Government of import duties, cited in Craypo (1975).

2 This procedure is used in Stewart (1977) where value added is expressed as a percentage of sales.

1- A more comprehensive study of most MNCs operating in Egypt would give general conclusions about transfer pricing strategies and profit shifting.

2- The conditions suggested in the literature for a particular method to be used were discussed in Chapter 3. It would be of interest to collect data relating to these conditions and to include these in the analysis.

3- A study might be carried out on companies that have started to pay taxes, i.e., after the expiration the tax holiday periods. This might shed additional light on the importance of tax factors on formulating transfer pricing strategies.

4- As shown in Chapters 6 and 7, the parent company frequently formulate transfer pricing policies, therefore, another study should be carried on parent companies as well their subsidiaries in Egypt.

# APPENDICES

# Appendix (A)

## Interview Guide and Questionnaire for Company Executives

WARWICK
BUSINESS SCHOOL

Dear Manager

I am conducting a study of transfer pricing policies through case studies of MNCs working in Egypt

At the present time I am engaged in gathering data for a doctoral thesis. The purpose of the research is to determine factors that the company take them into consideration when setting transfer prices

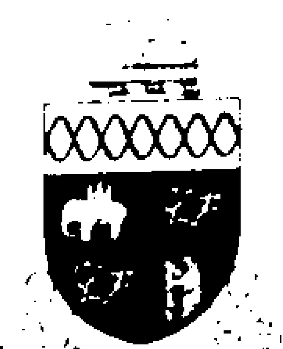
Your Company can be great assistance to me by spending a short time with you to discuss this issue. Any proprietary information would be disguised, of course, including the name of the company, if you are desired. All data is to be strictly confidential and anonymous.

Please feel free to make any additional comments or remarks that you may wish to make.

Yours sincerely

Sabri El-Segini
Ph.D Scholar





THE UNIVERSITY OF WARWICK COVENTRY CV4 7AL UNITED KINGDOM
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## Interview Guide and Questionnaire for Company Executives

This questionnaire falls into five sections, as follows:

| | |
|---|---|
| **Section I.** | Company Information. |
| **Section II.** | Formulating Transfer Prices. |
| **Section III.** | Variables Affecting Transfer Pricing Policies and the Importance of these Variables. |
| **Section IV.** | The Importance of Transfer Pricing from the Perspective of the Egyptian Authorities. |
| Section V. | Intangible Assets and Allocating Headquarters Expenditures. |

# Section I

## Company Information

1- Name and address of the establishment:

______________________________________________

______________________________________________

2- Nationality of the parent company:

______________________________________________

3- Year in which the subsidiary commenced operations in Egypt:

______________________________________________

4- Type of activity in Egypt:

______________________________________________

5- Method of Investment in Egypt: (please tick one of the following)

a) Wholly foreign-owned

b) Joint venture

c) Other (please specify)

______________________________________________

______________________________________________

6- If your company is a joint venture, who are your partners? (please tick)

a) Local private sector company (s) and/or individuals ☐

b) Local public sector company (s) ☐

c) Different nationalities ☐

d) Other (please specify)

______________________________________________

______________________________________________

7- What is the currency used by the company in its management accounts? (please tick the appropriate)

a. Parent country currency
b. Host country currency
c. Other (please specify)

______________________________________________

8- Name and job title of the person who completes the questionnaire:

______________________________________________

______________________________________________

## Section II

## Formulating Transfer Prices

1- Approximately what percentage of your total purchases are intra-group purchases?

______________________________________________

2- Approximately what percentage of your total sales are intra-group sales?

______________________________________________

3- When your subsidiary imports products, raw materials or services from the parent company or another subsidiary, one or more transfer pricing methods could be used to price these transactions. Please indicate (on a five-point scale) how frequently each of following methods is used. (please tick)

| [Never [used [ 1 | Rarely used 2 | Sometimes used 3 | Frequently used 4 | Usually used 5 ] ] ] |
|---|---|---|---|---|

| | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| **Cost-Based Prices** | | | | | |
| Actual variable cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual variable cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual full cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual full cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard variable cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard variable cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard full cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard full cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Marginal cost (long-run) | [ ] | [ ] | [ ] | [ ] | [ ] |
| Negotiated price | [ ] | [ ] | [ ] | [ ] | [ ] |
| Dual price (one price for the transferor, another for the transferee) | [ ] | [ ] | [ ] | [ ] | [ ] |
| **Market-Based Prices** | | | | | |
| Arm's-length price (prevailing price) | [ ] | [ ] | [ ] | [ ] | [ ] |
| Adjusted market price | [ ] | [ ] | [ ] | [ ] | [ ] |
| Some other price. (please specify) | | | | | |
| ______________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |
| ______________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |

4- If your subsidiary exports products, raw materials or services to any part of the group, one or more transfer pricing methods could be used to price these transactions. Please indicate (on a five-point scale) how frequently each of the following methods is used. (please tick)

| [Never [used [ 1 | Rarely used 2 | Sometimes used 3 | Frequently used 4 | Usually used 5 ] ] ] |
|---|---|---|---|---|

| | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| **Cost-Based Prices** | | | | | |
| Actual variable cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual variable cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual full cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Actual full cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard variable cost | [ ] | [ ] | [ ] | [ ] | [ ] |
| Standard variable cost plus markup | [ ] | [ ] | [ ] | [ ] | [ ] |

Standard full cost [ ] [ ] [ ] [ ] [ ]

Standard full cost plus markup [ ] [ ] [ ] [ ] [ ]

Marginal cost (long-run) [ ] [ ] [ ] [ ] [ ]

Negotiated price [ ] [ ] [ ] [ ] [ ]

Dual price (one price for the transferor, another for the transferee) [ ] [ ] [ ] [ ] [ ]

**Market-Based Prices**

Arm's-length price (prevailing price) [ ] [ ] [ ] [ ] [ ]

Adjusted market price [ ] [ ] [ ] [ ] [ ]

Some other price. (please specify)

______________________________ [ ] [ ] [ ] [ ] [ ]

______________________________ [ ] [ ] [ ] [ ] [ ]

5- If the subsidiary uses more than one method for transfer pricing, what are the reasons for this?

______________________________________________________________

______________________________________________________________

______________________________________________________________

______________________________________________________________

______________________________________________________________

6- Does an external market price exist for your intra-company transactions?

Yes [ ] No [ ]

7- If Yes, how would you describe the market for these transfers? (please tick)

Very uncompetitive Very competitive

1 2 3 4 5

8- Approximately what percentage of your sales goes to the following markets?

a. Domestic market ——%

b. Overseas market ——%

Total 100%

9- Are there restrictions imposed by the Egyptian government on your imports?

Yes ☐ No ☐

10- If your answer is yes, what are the kinds of restrictions?

________________________________________

________________________________________

________________________________________

________________________________________

11- Are there restrictions imposed by the Egyptian government on your exports?

Yes ☐ No ☐

12- If your answer is yes, what are the kinds of these restrictions?

________________________________________

________________________________________

________________________________________

________________________________________

13- Who is responsible for formulating and reviewing transfer pricing policies in your subsidiary? (please tick)

| | Formulating | Reviewing |
|---|---|---|
| a) Parent headquarters | ....... | ....... |
| b) Subsidiary managers | ....... | ....... |
| c) Both a and b | ....... | ....... |
| d) Other (please specify) ______ ______ | | |

14- If the transfer pricing policies are formulated by the parent headquarters, is there a conflict if these prices affect the performance evaluation of your subsidiary?

Yes ☐ No ☐

15- If your answer is yes, how great to this conflict?

Little conflict much conflict

1 2 3 4 5

16- How frequently are transfer pricing policies reviewed?

a) Monthly ☐

b) Quarterly ☐

c) Bi-annually ☐

d) Annually ☐

e) Other (please specify)

______

______

17- Does your parent company allow your organisation to purchase from outside sources the following kinds of goods which could also be supplied by the parent company or another subsidiary?

| | Yes, *with complete freedom* | Yes, *subject to the approval of parent company* | No |
|---|---|---|---|
| a) Raw materials | ☐ | ☐ | ☐ |
| b) Intermediate products | ☐ | ☐ | ☐ |
| c) Capital goods | ☐ | ☐ | ☐ |

18- If your organisation purchases capital goods from the parent company, are their prices differ from prices in a free market? (please tick)

Lower ☐ The same ☐ Higher ☐

19- Are intra-group transfers assigned the same values for financial statement purposes as for income tax purposes? (please tick)

Never the same Always the same
1 2 3 4 5

20- Do you, as a manager, believe that the reported profit for your subsidiary reflects your performance? (please tick appropriate answer)

a) Yes, it is a fair measurement of management performance

b) A few imperfections, but still a useful measurement

c) Serious flaws, I do not think it is a fair measurement

21- If you checked (b) or (c) above, please comment upon the most significant imperfections or flaws.

________________________________________

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________________________________________

# Section III

## Environmental Variables Considered in Determining Transfer Pricing Policies and the Importance of these Variables

1- This part indicates a list of variables that may influence the setting of transfer pricing policies in MNCs. Please indicate (on a five-point scale) the degree of importance that your parent company attaches to each of the following variables.

| Not at all important | Fairly important | Important | Very important | Most important |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |

**Variables considered for transfer pricing policies:**

| | | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1- | Maximisation of the group's overall profit | [ ] | [ ] | [ ] | [ ] | [ ] |
| 2- | Differentials in income tax rates and income tax legislation among countries | [ ] | [ ] | [ ] | [ ] | [ ] |
| 3- | Rates of customs duties and customs legislation in Egypt | [ ] | [ ] | [ ] | [ ] | [ ] |
| 4- | Anti-dumping and Anti-trust legislation in Egypt | [ ] | [ ] | [ ] | [ ] | [ ] |
| 5- | Compliance with tax and customs regulations of home country | [ ] | [ ] | [ ] | [ ] | [ ] |
| 6- | Restrictions imposed by the Egyptian law on the repatriation of profits and capital | [ ] | [ ] | [ ] | [ ] | [ ] |
| 7- | Restrictions imposed on the amount of R&D, royalties and other overhead costs charged against the subsidiary | [ ] | [ ] | [ ] | [ ] | [ ] |
| 8- | Maintenance of adequate cash flow in the subsidiary | [ ] | [ ] | [ ] | [ ] | [ ] |
| 9- | The need of the subsidiary to seek local funds | [ ] | [ ] | [ ] | [ ] | [ ] |
| 10- | Shifting profits to another subsidiary to cover part of its losses | [ ] | [ ] | [ ] | [ ] | [ ] |
| 11- | Level of inflation in Egypt | [ ] | [ ] | [ ] | [ ] | [ ] |
| 12- | Multiple exchange rates | [ ] | [ ] | [ ] | [ ] | [ ] |
| 13- | Existence of price controls in Egypt | [ ] | [ ] | [ ] | [ ] | [ ] |
| 14- | Existence of export subsidies | | | | | |

| | | |
|---|---|---|
| | and tax holidays in Egypt | [ ][ ][ ][ ][ ] |
| 15- | Market conditions (competition) in Egypt | [ ][ ][ ][ ][ ] |
| 16- | Risk of expropriation and nationalisation in Egypt | [ ][ ][ ][ ][ ] |
| 17- | Existence of local shareholders | [ ][ ][ ][ ][ ] |
| 18- | Performance evaluation of each subsidiary | [ ][ ][ ][ ][ ] |
| 19- | Divisional autonomy | [ ][ ][ ][ ][ ] |
| 20- | Maintenance of good relations with the host government | [ ][ ][ ][ ][ ] |
| 21- | The bureaucratic system to deal with Egyptian authorities | [ ][ ][ ][ ][ ] |
| 22- | Ambivalence of regulations in Egypt | [ ][ ][ ][ ][ ] |
| 23- | Rules and requirements of financial reporting for your subsidiary | [ ][ ][ ][ ][ ] |
| 24- | Simplicity and ease of application of transfer prices | [ ][ ][ ][ ][ ] |
| 25- | Others (please specify) | |
| | ________________________________ | [ ][ ][ ][ ][ ] |
| | ________________________________ | [ ][ ][ ][ ][ ] |

2- Referring to the above list, which five are the most important influences on transfer pricing policies for your subsidiary?

________________________________________________________________

________________________________________________________________

________________________________________________________________

________________________________________________________________

________________________________________________________________

3- What is the dominant corporate objective of your transfer pricing system?

a) to maximise consolidated after-tax profit of your parent ☐

b) to minimise payments on income taxes, customs duties, and other taxes paid

to home and host countries [ ]

c) to maximise sales volume [ ]

d) to evaluate the performance of subsidiaries [ ]

e) other (please specify) [ ]

______________________________________________

______________________________________________

4- What is the importance of MNCs to the Egyptian economy? (please tick)

| [Not at all important 1 | Fairly important 2 | Important 3 | Very important 4 | Most important 5 ] |
|---|---|---|---|---|

| | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| a) Serving to increase the stock of investment and capital | [ ] | [ ] | [ ] | [ ] | [ ] |
| b) Providing employment opportunities | [ ] | [ ] | [ ] | [ ] | [ ] |
| c) Providing government revenues (taxes and customs duties) | [ ] | [ ] | [ ] | [ ] | [ ] |
| d) Increasing national output and raising social welfare | [ ] | [ ] | [ ] | [ ] | [ ] |
| e) Transfer of new technology | [ ] | [ ] | [ ] | [ ] | [ ] |
| f) Other (please specify) | | | | | |
| ______________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |
| ______________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |

5- The following are some factors that attract MNCs to invest abroad. In your opinion, to what extent each of following factors influenced your company to invest in Egypt? (please tick)

| | Low 1 | Medium 2 | High 3 |
|---|---|---|---|
| 1) Government policy towards FDI | [ ] | [ ] | [ ] |
| 2) Access to new markets | [ ] | [ ] | [ ] |

| | | | | |
|---|---|---|---|---|
| 3) | Political and social stability | [ ] | [ ] | [ ] |
| 4) | Maximising return on investment | [ ] | [ ] | [ ] |
| 5) | Repatriation of profits and capital | [ ] | [ ] | [ ] |
| 6) | Tax holidays and other incentives | [ ] | [ ] | [ ] |
| 7) | Cost advantages (raw materials and labour force) | [ ] | [ ] | [ ] |
| 8) | Attractive growth of Arab markets | [ ] | [ ] | [ ] |
| 9) | Other (please identify) | | | |
| | ______________________________ | [ ] | [ ] | [ ] |
| | ______________________________ | [ ] | [ ] | [ ] |

6- To your knowledge, what are the major obstacles that MNCs face in improving the investment environment in Egypt?

______________________________________________________________

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7- Please list in order of importance the five most crucial factors which have influenced your continued production in Egypt.

______________________________________________________________

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______________________________________________________________

______________________________________________________________

8- Do you consider, by reference to other subsidiaries "in the group", that :

a) Your organisation's profit is:

High ☐ Reasonable ☐ Low ☐

b) Egyptian tax rates are:

High ☐ Reasonable ☐ Low ☐

9- If your subsidiary wanted to expand its investments in Egypt, what kind of finance would it rely on?

a) Self-finance, whether internally or through the parent company or another subsidiary. ☐

b) Domestic borrowing from financial institutions. ☐

c) Other (please specify)

______________________________________________

______________________________________________

## Section IV

### The Importance of Transfer Pricing from the Perspective of the Egyptian Authorities

This section attempts to throw light on the importance of transfer pricing from the point of view of the Egyptian authorities

1- Do government authorities legislate to ensure that transfer prices are set on arm's-length bases?

Yes ☐ No ☐

2- If there are regulations to determine transfer prices according to an arm's-length method, how do they define it? (please circle)

i) Competitive prices

(market prices for the same or similar products sold to an independent third party under the same or similar circumstances)

ii) Resale prices method

iii) Cost-plus method

iv) Any other method found to be acceptable (please explain)

________________________________________

________________________________________

3- Do customs departments often re-compute your intra-group transfers arbitrarily for the sake of raising customs duties?

Yes ☐ Sometimes ☐ No ☐

4- Do negotiations take place with customs officials with regard to the price of intra-group transactions?

Never ☐ Sometimes ☐ Always ☐

5- If your answer is sometimes or always, would you please explain the nature of these negotiations according to the increasing of prices.

________________________________________

________________________________________

________________________________________

________________________________________

6- Does the tax authority attempt to change your declared profit in order to decide the income to be taxed?

Yes ☐ Sometimes ☐ No ☐

Please comment on your answer.

________________________________________

______________________________________________

______________________________________________

7- Could you please indicate the extent to which your company finds itself in dispute with the tax authority with respect to taxable income.

Never ☐ Sometimes ☐ Always ☐

8- If your answer is sometimes or always, could you please briefly describe the most recent dispute and how it has been settled.

______________________________________________

______________________________________________

______________________________________________

______________________________________________

9- Would the external audit program usually involve any tests to ensure transfer pricing policies have been applied ...

| | **Yes** | **No** |
|---|---|---|
| a) accurately? | ☐ | ☐ |
| b) consistently with prior periods? | ☐ | ☐ |

10- If financial reporting in Egypt requires the disclosure of transfer pricing policies do you think that this might affect the information confidentiality in your subsidiary?

Yes ☐ No ☐

Please comment on your answer.

______________________________________________

______________________________________________

# Section V

## Intangible Assets and Allocating Headquarters' Expenditures

This section is concerned with all types of intangible assets that you receive from your parent company, including headquarters charges that have to be allocated to the MNC. These intangible assets include royalties, and research and development fees (R&D). Headquarters expenditures comprise joint expenses like management and marketing costs, and transportation costs and loan interest.

1- Are the cost of loans, equity or other corporate funds allocated by the parent company to your subsidiary?

Yes ☐ No ☐

2- Is the rate allocated for the use of loans or equity by foreign operations determined on any of the following factors:

a) the current weighted average cost of corporate capital
b) the home country prime rate
c) a historic average rate
d) an average regional rate
e) other (please indicate)

________________________________________

________________________________________

3- What is the basis of charging or allocating the following expenses:

a) Management and other overhead expenses

________________________________________

b) Research and Development expenses (R&D)

________________________________________

c) Transportation costs

________________________________________

d) Interest on excess cash invested by the parent company

______________________________________________

e) Technical assistance

______________________________________________

4- What are the criteria for allocating R&D cost, 'know-how' and patents, for services supplied by the parent company or by other affiliates?

______________________________________________

______________________________________________

______________________________________________

______________________________________________

WARWICK
BUSINESS SCHOOL

سيدى الفاضل /

– بعد التحيـة ،

ان الغرض من هذه الدراسة هو تحديد العوامل المؤثرة فى تحديد أسعار تحويل البضائع والخدمات بين الشركة متعددة الجنسية وفروعها الموجودة فى الدول المضيفة . ونظرا لقلة الدراسات التطبيقية فى هذا المجال خاصة فى مصر فان هذه الدراسة تكتسب أهمية خاصة وتعتمد بياناتها الى حد كبير على المعلومات التى سيدلى بها المديرون الماليون فى المنشآت الأجنبية العاملة فى مصر .

ومما لاشك فيه أن تعاونكم المتمثل فى مقابلتكم لى والاجابة على الاسئلة المتضمنة فى قائمة الاستقصاء المرفقة سوف يدعم طرق البحث العلمى ويبرز المشاكل التى تواجه الشركات الأجنبية فى مصر .

وأود أن أحيط سيادتكم بأن ماتدلون به من بيانات سيكون له طابع السرية وسوف تستخدم فقط لغرض أكاديمى بحت .

لذلك سوف أكون شاكرا ومعترفا بالفضل لقيامكم بمل، الاستقصاء المرفق والسماح بمقابلة سيادتكم .

وتفضلوا خالص احترامى وتقديرى ،

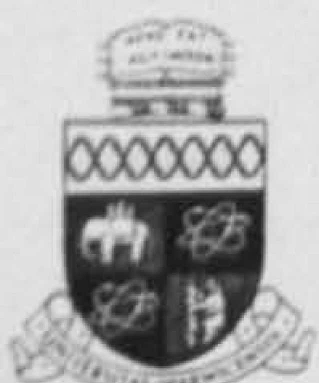
صبرى عبد الحميد السجينى

مبعوث لدراسة الدكتوراه فى المحاسبة

جامعة ووريك – كوفنترى

انجلترا





THE UNIVERSITY OF WARWICK COVENTRY CV4 7AL UNITED KINGDOM
TELEPHONE (0203) 524306 TELEX 317472 UNIREG FAX (0203) 523719 OR 524411

**توجيهات عامة بخصوص الاستقصاء :**

١ ـ تركز هذه الدراسة على موضوع أسعار التحويل TRANSFER PRICES ويقصد بذلك السعر الذى يحدد للصفقات المتبادلة ـ سواء كانت فى شكل مواد خام ، نصف مصنوعة ، منتجات تامة الصنع ، خدمات مختلفة ـ وذلك بين الفرع والشركة الأم أو أى فرع آخر .

٢ ـ هذه القائمة تحتوى على خمسة أقسام رئيسية كالتالى :ـ

أ ـ بيانات عامة        ب ـ تحديد أسعار التحويل .

جـ ـ العوامل البيئية المؤثرة فى تحديد سياسات أسعار التحويل وأهمية هذه العوامل .

د ـ مدى اهتمام السلطات الحكومية فى مصر بموضوع أسعار التحويل ـ

هـ ـ الاصول غير الملموسة وتخصيص المصاريف العامة .

٣ ـ ان اجابة غالبية الأسئلة يحتاج منكم أن تضعون علامة ✓ داخل (  ) الذى يعبر عن اجابتكم .

٤ ـ هناك أسئلة قليلة تحتاج منكم كتابة الاجابة فى المساحة المخصصة لذلك .

٥ ـ مرة ثانية ، أؤكد لسيادتكم أن أراؤكم مهمة جدا لهذه الدراسة ، لذلك فان توجيه قدر من العناية والدقة عند اجابة الأسئلة سوف يساعدنى فى انجاز دراستى على أكمل وجه .

٦ ـ ان نتائج هذه الدراسة سوف تكون متاحة لسيادتكم فى وقت لاحق .

مع خالص الشكر على مساهمتكم الفعالة .

## القسم الاول : بيانات عامة عن المنشأة :

١ ـ اسم وعنوان المنشأة فى مصـــــر :

....................................

....................................

٢ ـ جنسية الشركة الأم : ..............................

٣ ـ تاريخ بدء النشاط فى مصر : ..............................

٤ ـ طبيعة النشاط فى مصـــر : ..............................

٥ ـ طريقة الاستثمار فى مصر ( اختر اجابة واحدة من فضلك ) :

أ ـ استثمار أجنبى بالكامل ( )

ب ـ استثمار مشترك ( )

جـ ـ أخرى ، مثل ( )

.........................

.........................

٦ ـ اذا كانت المنشأة قائمة على أساس الاستثمار المشترك ، من فضلك حدد نوع المستثمرين :

أ ـ شركات قطاع خاص أو أفراد ( )

ب ـ شركات قطاع عام ( )

جـ ـ جنسيات مختلفة ( )

د ـ أخرى ، ( من فضلك أذكر من هم ) ( )

.........................

٧ ـ من فضلكم أذكر نوع العملة التى تستخدمها المنشأة فى اعداد الحسابات المالية بغـــرض تقييم الأداء ؟ ( يتم اختيار واحدة من الاجابات التالية ) :

أ ـ عملة الدولة الأم ( )

ب ـ عملة الدولة المضيفة ( مصر ) ( )

جـ ـ عملات أخرى مثل : ( )

........................

**القسم الثاني : تحديد أسعار التحويل :**

١ - كم تمثل النسبة المئوية لحجم المشتريات الداخلية للمنشأة ( عن طريق الشركة الأم أو فرع آخر ) تقريبا ؟

..............................

٢ - بالمثل ، كم تمثل النسبة المئوية لحجم المبيعات الداخلية للمنشأة وذلك للشركة الأم أو الى فرع آخر ؟

..............................

٣ - عندما تقوم المنشأة باستيراد منتجات ، مواد خام ، مواد نصف مصنوعة ، أو تستفيد بخدمات من الشركة الام أو فرع آخر ، فى هذه الحالة يتم استخدام طريقة أو أكثر لتحديد أسعار هذه الصفقات ، من فضلك حدد ( من خلال خمس نقاط ) درجة استخدام الطرق التالية :

| | غير مستخدمة نهائيا ١ | نادرا يتم استخدامها ٢ | أحيانا يتم استخدامها ٣ | غالبا يتم استخدامها ٤ | دائما يتم استخدامها ٥ |
|---|---|---|---|---|---|
| **طرق محددة على أساس ا لتكلفة :** | | | | | |
| - التكلفة الفعلية المتغيرة | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة الفعلية المتغيرة + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة الفعلية الاجمالية | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة الفعلية الاجمالية + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة المعيارية المتغيرة | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة المعيارية المتغيرة + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة المعيارية الاجمالية | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة المعيارية الاجمالية + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| - التكلفة الحديــــة | ( ) | ( ) | ( ) | ( ) | ( ) |
| - السعر على أساس التفاوض | ( ) | ( ) | ( ) | ( ) | ( ) |
| - السعر الثنائى ( سعر للمحول وسعر آخر للمحول اليه ) | ( ) | ( ) | ( ) | ( ) | ( ) |

**طرق محددة على أساس سعر السوق :**

| | | | | | |
|---|---|---|---|---|---|
| – طريقة السعر السائد فى السوق | ( ) | ( ) | ( ) | ( ) | ( ) |
| – طريقة سعر السوق المعدل (باستبعاد ربح البائع) | ( ) | ( ) | ( ) | ( ) | ( ) |
| – طرق أخرى ( من فضلك يتم ذكرها ) : | | | | | |
| ................... | ( ) | ( ) | ( ) | ( ) | ( ) |
| ................... | ( ) | ( ) | ( ) | ( ) | ( ) |

٤ – هذا السؤال مشابه للسؤال السابق ، وهو يركز على حالة قيام منشأتكم بتصدير منتجات ، مواد خـــام ، نصف مصنوعة ، أو أداء خدمات لأى فرع آخر أو الى الشركة الأم ، لذلك فان المطلوب تحديد درجـــــــة أهمية الطرق المستخدمة فى أسعار التحويل :

| | ١ | ٢ | ٣ | ٤ | ٥ |
|---|---|---|---|---|---|
| **طريقة التكلفـــــــة :** | | | | | |
| – التكلفة الفعلية المتغيرة | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة الفعلية المتغيرة + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة الفعلية الاجمالية | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة الفعلية الاجمالية + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة المعيارية المتغيرة | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة المعيارية المتغيرة + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة المعيارية الاجمالية | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة المعيارية الاجمالية + هامش للربح | ( ) | ( ) | ( ) | ( ) | ( ) |
| – التكلفة الحديـــــــة | ( ) | ( ) | ( ) | ( ) | ( ) |
| – السعر على أساس التفاوض | ( ) | ( ) | ( ) | ( ) | ( ) |
| – السعر الثنائى | ( ) | ( ) | ( ) | ( ) | ( ) |
| **طرق محددة على أساس سعر السوق :** | | | | | |
| – طريقة السعر السائد فى السوق | ( ) | ( ) | ( ) | ( ) | ( ) |
| – طريقة سعر السوق المعدل (باستبعاد ربح البائع) | ( ) | ( ) | ( ) | ( ) | ( ) |
| – طرق أخرى ( من فضلك يتم ذكرها ) : | | | | | |
| ................... | ( ) | ( ) | ( ) | ( ) | ( ) |
| ................... | ( ) | ( ) | ( ) | ( ) | ( ) |

٥ _ اذا كانت منشأتكم تستخدم أكثر من طريقة لتحديد أسعار التحويل ، ماهى أسباب ذلك ؟

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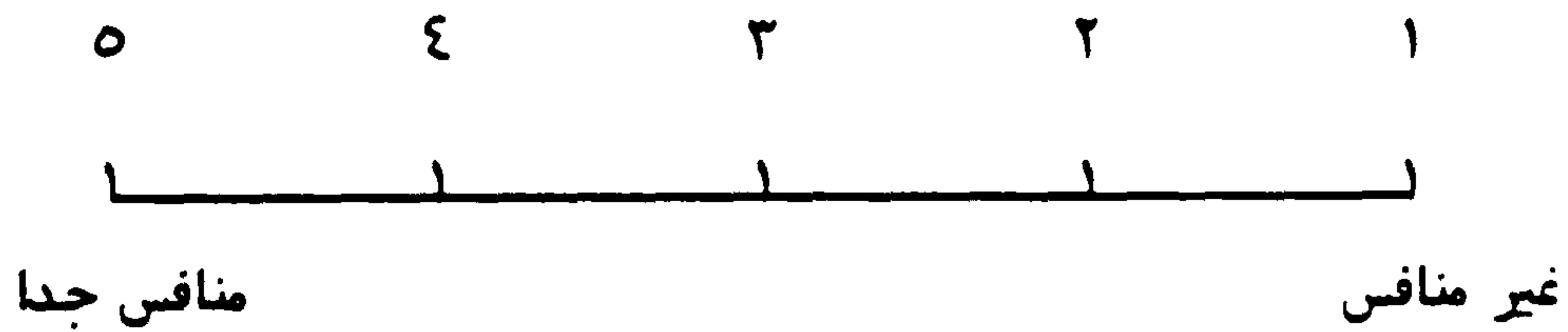
٦ _ هل يتوافر سعر السوق بالنسبة للصفقات الداخلية المتبادلة بين منشأتكم والشركة الأم أو فرع آخر ؟

نعم ( ) لا ( )

٧ _ اذا كانت اجابتكم ( بنعم ) كيف ترون سعر السوق بالنسبة للتحويلات الداخلية ؟




٨ _ تقريبا ماهى النسبة المئوية لمبيعاتكم موزعة على الاسواق التالية ؟

| | | |
|---|---|---|
| أ _ السوق المحلى | | ... ٪ |
| ب _ السوق الخارجى | | ... ٪ |
| | الاجمالــى | ١٠٠ ٪ |

٩ _ هل توجد قيود مفروضة على وارداتكم ؟

نعم ( ) لا ( )

١٠ _ اذا كانت الاجابة ( بنعم ) ، ماهى هذه القيود ؟

...............................

...............................

...............................

١١ _ هل توجد قيود مفروضة على صادراتكم ؟

نعم ( ) لا ( )

١٢ ـ اذا كانت الاجابة ( بنعم ) ، ماهى هذه القيود ؟

.................................

.................................

.................................

١٣ ـ من المسئول عن تحديد ومراجعة سياسات سعر التحويل بالنسبة لمنشأتكم ؟

| الجهة المسئولة | تحديد سعر التحويل | مراجعة سعر التحويل |
|---|---|---|
| أ ـ ادارة الشركة الأم . | .......... | .......... |
| ب ـ ادارة المنشأة فى مصر . | .......... | .......... |
| جـ ـ كل من (أ) و (ب) . | .......... | .......... |
| د ـ أخرى ( يتم تحديدها : | | |
| ............. | .......... | .......... |
| ............. | .......... | .......... |

١٤ ـ اذا كانت ادارة الشركة الأم تقوم بتحديد سياسات سعر التحويل ، هل يوجدتعارض بينكم وبين الشركة الأم فى حالة ما اذا كانت هذه الأسعار تؤثر على عملية تقييم الأداء لمنشأتكم ؟

نعم ( ) لا ( )

١٥ ـ اذا كانت الاجابة ( بنعم ) الى أى مدى يكون ذلك التعارض ؟

١ ٢ ٣ ٤ ٥

تعارض بسيط ـ تعارض كبير جدا

١٦ ـ يتم مراجعة سياسات سعر التحويل :

أ ـ شهريا ( ) ب ـ ربع سنوى ( )

جـ ـ نصف سنوى ( ) د ـ سنوى ( )

هـ ـ أخرى ، مثل ................. ( )

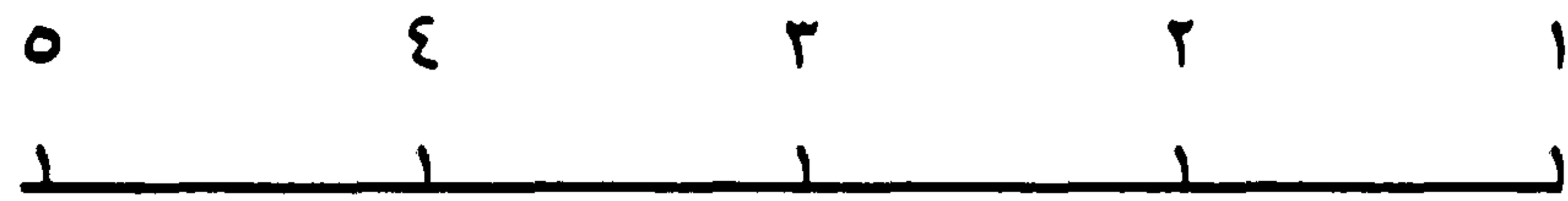
١٧ - هل تسمح الشركة الأم لمنشأتكم بشراء الأنواع التالية من المنتجات من مصادر خارجية ، علما بأن هذه المنتجات يمكن توريدها بواسطة الشركة أو فرع آخر ؟

| | نعم دون أية قيود | نعم بشرط موافقة الشركة الأم | لا |
|---|---|---|---|
| أ - مواد خام | ( ) | ( ) | ( ) |
| ب - مواد نصف مصنوعة | ( ) | ( ) | ( ) |
| جـ - سلع رأسمالية | ( ) | ( ) | ( ) |

١٨ - اذا كانت منشأتكم تحصل على سلع رأسمالية من الشركة الأم ، الى أى مدى تختلف أسعارها عن سعر السوق ؟

أقل من سعر السوق ( ) نفس السعر ( ) أعلى من سعر السوق ( )

١٩ هل تختلف أسعار التحويل المعدة لأغراض اعداد القوائم المالية عن الأسعار المحددة للأغراض الضريبية ؟




لاتمثل نهائيا نفس السعر دائما تمثل نفس السعر

٢٠ - بصفتكم مديرا للشركة هل تعتقدون أن الربح المعلن فى القوائم المالية يمثل معيارا عادلا لتقييم أداء المنشأة ؟ ( من فضلك اختر الاجابة المناسبة ) :

أ - نعم ، يمثل مقياسا عادلا لأداء المنشأة ( )

ب - يوجد بعض الخلاف ، ولكن يظل مقياسا مفيدا ( )

جـ - لايمثل مقياسا عادلا لتقييم أداء المنشأة ( )

٢١ - اذا كنتم اخترتم الاجابة (ب) أو (جـ) فى السؤال السابق ، ماهو تعليق سيادتكم على أسباب الخلاف؟

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القسم الثالث : العوامل البيئية المؤثرة فى تحديد سياسات أسعار التحويل وأهمية هذه العوامل :

١ـ يبين هذا الجزء قائمة بالعوامل التى تؤثر فى وضع سياسات أسعار التحويل فى الشركات متعددة الجنسيات من فضلك حدد ( من خلال خمس نقاط) درجة الاهمية التى تأخذها الشركة الأم بالنسبة لهذه العوامل :

| العوامل المؤثرة فى سعر التحويل | غير مهم نهائيا ١ | مهم بدرجة معقولة ٢ | مهم ٣ | مهم جدا ٤ | فى غاية الأهمية ٥ |
|---|---|---|---|---|---|
| ١ ـ تعظيم أرباح الشركة وفروعها | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٢ ـ وجود فروق فى معدلات ضريبة الدخل واللوائح الضريبية بين الدول ٠ | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٣ ـ معدلات الرسوم واللوائح الجمركية فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٤ ـ لوائح لمنع سياسة الاغراق فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٥ ـ الاتساق مع لوائح الضرائب والجمارك فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٦ ـ قيود مفروضة على تحويل الأرباح ورأس المال خارج مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٧ ـ قيود مفروضة على نصيب المنشأة من مصاريف البحوث والتقدم وأية مصاريف اضافية | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٨ ـ ضمان تدفق نقدى كاف فى المنشأة | ( ) | ( ) | ( ) | ( ) | ( ) |
| ٩ ـ حاجة الفرع لمصادر تمويل محلية | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١٠ ـ تحويل أرباح لفرع آخر لتغطية جزء من خسائره | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١١ ـ مستوى التضخم فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١٢ ـ وجود أسعار صرف متعددة للعملة الاجنبية | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١٣ ـ وجود رقابة على أسعار المنتجات فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١٤ ـ وجود مساعدات للتصدير واعفاءات ضريبية لمدة معينة فى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| ١٥ ـ عامل المنافسة فى السوق | ( ) | ( ) | ( ) | ( ) | ( ) |

١٦ ـ حظر المصادرة والتأميم ( ) ( ) ( ) ( ) ( )

١٧ ـ وجود شركاء محـــــليين ( ) ( ) ( ) ( ) ( )

١٨ ـ تقييم أداء كل فرع ( ) ( ) ( ) ( ) ( )

١٩ ـ استقلال المنشأة فى اتخاذ القرارات ( ) ( ) ( ) ( ) ( )

٢٠ ـ المحافظة على علاقات طيبة مع حكومة الدولة المضيفة ( مصــــــر ) ( ) ( ) ( ) ( ) ( )

٢١ ـ النظام البيروقراطى فى التعامل مع الجهات الحكوميـــــة ٠ ( ) ( ) ( ) ( ) ( )

٢٢ ـ عدم وضوح اللوائح الحكومية ( ) ( ) ( ) ( ) ( )

٢٣ ـ احتياجات التقرير المالى لكل فرع ( ) ( ) ( ) ( ) ( )

٢٤ ـ البساطة والسهولة فى تطبيق أسعار التحويل ( ) ( ) ( ) ( ) ( )

٢٥ ـ أخرى ( يتم ذكرها من فضلكم ) :

.................. ( ) ( ) ( ) ( ) ( )

.................. ( ) ( ) ( ) ( ) ( )

٢ ـ بالاشارة الى قائمة المتغيرات السابقة ماهى أهم خمس متغيرات ترون أنها تؤثر فى سياسات أسعار التحويـــــل لفــــرعكم ؟

أ ـ .........................................

ب ـ .........................................

جـ ـ .........................................

د ـ .........................................

هـ ـ .........................................

٣ ـ ماهو الهدف الرئيسى الذى يتحكم فى نظام أسعار التحويل ؟

أ ـ تعظيم ربح المنشأة ككل ( )

ب ـ تقليل العبء الضريبى والرسوم الجمركية ( )

جـ ـ تعظيم حجم مبيعات الشركة ( )

د ـ تقييم أداء الفرع ( )

هـ ـ هدف آخر ( يذكر من فضلكم : ........................ ( )

.................................... ( )

٤ - من فضلكم وضح أهمية الشركات الأجنبية فى دعم الاقتصاد المصرى :

| | غير مهم نهائيا ١ | مهم بدرجة معقولة ٢ | مهم ٣ | مهم جدا ٤ | فى غاية الأهمية ٥ |
|---|---|---|---|---|---|
| أ - زيادة حجم الاستثمارات ورأس المال | ( ) | ( ) | ( ) | ( ) | ( ) |
| ب - توفير فرص عمالة | ( ) | ( ) | ( ) | ( ) | ( ) |
| جـ - زيادة الموارد الحكومية ممثلة فى ضرائب الدخل والرسوم الجمركية | ( ) | ( ) | ( ) | ( ) | ( ) |
| د - زيادة حجم الانتاج القومى وزيادة الرفاهية الاجتماعية | ( ) | ( ) | ( ) | ( ) | ( ) |
| هـ - نقل التكنولوجيا الحديثة الى مصر | ( ) | ( ) | ( ) | ( ) | ( ) |
| و - أخرى ( تذكر من فضلكم ) | | | | | |
| ................ | ( ) | ( ) | ( ) | ( ) | ( ) |
| ................ | ( ) | ( ) | ( ) | ( ) | ( ) |

٥ - ماهى دوافع استثمار شركتكم فى مصـــــــر ؟

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٦ - من وجهة نظر سيادتكم ماهى العقبات التى تواجه الشركات الأجنبية لتحسين بيئة الاستثمار فى مصر ؟

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٧ ـ من فضلكم حدد أهم خمسة عوامل تتحكم فى استمرار منشأتكم الاستثمار فى مصر :

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................................

................................

٨ ـ هل تعتقدون ، بالاشارة الى فروع أخرى لشركتكم أن :

أ ـ أرباح منشأتكم :

عالية ( ) معقولة ( ) منخفضة ( )

ب ـ معدلات الضرائب فى مصر :

عالية ( ) معقولة ( ) منخفضة ( )

٩ ـ اذا أرادت منشأتكم أن توسع من حجم استثماراتها فى مصر ، فماهى مصادر التمويل التى قد تعتمدون عليها ؟

أ ـ تمويل ذاتى ، سواء داخليا أو من خلال الشركة الأم أو فرع آخر ( )

ب ـ الاقتراض من جهات مختلفة فى مصر ( )

جـ ـ أخرى ( تذكر من فضلك ) : ( )

....................

....................

**القسم الرابع : مدى اهتمام السلطات الحكومية فى مصر بموضوع أسعار التحويل :**

هذا القسم يلقى الضوء على أهمية سعر التحويل من وجهة نظر السلطات المصرية .

١ ـ هل تقوم السلطات الحكومية باصدار تشريعات للتأكد من أن أسعار التحويل تمثل السعر العادل ؟

نعم ( )

لا ( )

٢ – اذا كانت هناك تشريعات لتحديد أسعار التحويل طبقا لطريقة السعر العادل • كيف يتم تحديد هـذا السعر ؟ ( من فضلك اختر طريقة من الطرق التالية ) :–

أ – الأسعار التنافسية ( سعر السوق ) ( )

ب – طريقة أسعار اعادة البيع ( )

جـ – طريقة التكلفة + هامش للربح ( )

د – أى طريقة أخرى مقبولة ( تذكر من فضلك :

...................... ( )

...................... ( )

٣ – هل تقوم مصلحة الجمارك ، غالبا ، باعادة تثمين الواردات بغرض زيادة الرسوم الجمركية ؟

نعم ( ) أحيانا ( ) لا ( )

٤ – هل تقومون باجراء مفاوضات مع مصلحة الجمارك فى حالة اختلاف سعر الفاتورة عن السعر الذى تصر مصلحة الجمارك على تحديده ؟

لا ( ) أحيانا ( ) دائما ( )

٥ – اذا كانت اجابتكم أحيانا أو دائما ، من فضلكم حدد طريقة هذه المفاوضات وهل تؤدى الى تخفيض الرسوم الجمركية ؟

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تؤدى المفاوضات الى :

تخفيض الرسوم الجمركية ( ) عدم تخفيض الرسوم الجمركية ( )

٦ – هل تصر مصلحة الضرائب على تعديل الربح المحاسبى من أجل زيادة العبء الضريبى ؟

نعم ( ) أحيانا ( ) لا ( )

ماهو تعليق سيادتكم على الاجابة :–

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٧ ـ من فضلكم حدد ما اذا كانت منشأتكم تواجه بعض المنازعات مع مصلحة الضرائب وذلك لتحديد الربح الضريبى ؟

لا ( ) أحيانا ( ) دائما ( )

٨ ـ اذا كانت اجابتكم أحيانا أو دائما من فضلكم أذكر كيف تم تسوية هذه المنازعات :

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٩ ـ هل يشتمل برنامج المراجعة الخارجية على اختبارات للتأكد من أن سياسات أسعار التحويل قد طبقت :

| | نعم | لا |
| --- | --- | --- |
| أ ـ بدقة | ( ) | ( ) |
| ب ـ متسقة مع الفترات السابقة | ( ) | ( ) |

١٠ ـ اذا كانت متطلبات التقرير المحاسبى فى مصر تتضمن الافصاح عن سياسات أسعار التحويل ، هل تعتقدون أن ذلك قد يؤثر على سرية المعلومات فى منشأتكم ؟

نعم ( ) لا ( )

ماهو تعليق سيادتكم على الاجابة :ـ

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**القسم الخامس : الأصول غير الملموسة وتخصيص المصاريف العامة :**

هذا القسم يختص بكل أنواع الأصول غير الملموسة التى تستلمها منشأتكم من الشركة الأم ، تشتمل هذه الأصول على مصاريف البحوث والتطوير، كما تتضمن المصاريف العامة ، والمصاريف الأدارية والتسويقية ، مصاريف النقل وفائدة القرض من الشركة الأم أو فرع آخر .

١ ـ اذا حصلت منشأتكم على قرض من الشركة الأم فهل تتحطون فائدة القرض فى هذه الحالة ؟

نعم ( ) لا ( )

٢ ـ ماهو المعدل المستخدم فى تحديد فائدة القرض ؟ ( اختر واحدة من الاجابات التالية ) :

أ ـ طريقة التكلفة المرجحة ( )

ب ـ المعدل السائد فى الدولة الأم ( )

جـ ـ معدل متوسط تاريخى ( )

د ـ معدل متوسط محلى ( )

هـ ـ أخرى ( تذكر من فضلك ) :

................ ( )

................ ( )

٣ ـ ماهو أساس تخصيص المصاريف التالية :

أ ـ المصاريف الادارية والاضافية :

................

ب ـ مصاريف البحوث والتطوير:

................

جـ ـ مصاريف النقل :

................

د ـ الفائدة على النقدية الزائدة المقدمة من الشركة الأم :

................

هـ ـ المساعدات الفنيــــة :

.................

مع خالص الشكر على تعاونكم معى فى انجاز البحث الذى أقوم به ، اذا كنتم تريدون ذكر اسم سيادتكم ووظيفتكم يمكنكم كتابتها : الاسم :

الوظيفة التى تشغلونها :

# Appendix (B)

## Questions Directed to the Egyptian Authority for Investment

**Questions Directed to the Egyptian Authority for Investment about the Economic Effect of MNCs and the Importance of the Transfer Pricing Aspect from their point of view.**

1- There some factors that attract MNCs to set up their investments in a particular country.

In your opinion, to what extent each of following factors positively affecting the flow of FDI into Egypt? (please tick)

| | Low 1 | Medium 2 | High 3 |
|---|---|---|---|
| a) Growth rate of the domestic market | [ ] | [ ] | [ ] |
| b) Political and social stability | [ ] | [ ] | [ ] |
| c) Maximising return on investment | [ ] | [ ] | [ ] |
| d) Government policy towards FDI | [ ] | [ ] | [ ] |
| e) Maximising return on investment | [ ] | [ ] | [ ] |
| f) Tax holiday and other incentives | [ ] | [ ] | [ ] |
| g) Repatriation of profits and capital | [ ] | [ ] | [ ] |
| h) Cost advantages | [ ] | [ ] | [ ] |
| i) Attractive growth of Arab markets | [ ] | [ ] | [ ] |
| j) Other (please specify) | | | |
| ______________________ | [ ] | [ ] | [ ] |
| ______________________ | [ ] | [ ] | [ ] |

2- To what extent is the Egyptian government involved in determining transfer prices for MNCs working in Egypt?

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______________________________________________

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3- In your opinion, do MNCs adopt policies through their intra-group transactions to avoid restrictions imposed by the host government?

Yes ☐ No ☐

4- If your answer is yes, how do the Egyptian authorities control company operations?

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5- In relation to the economic contributions of MNCs to Egypt, do you believe that the dividends, royalties, and other payments which MNCs receive from their activities in Egypt are fair to the Egyptian government:

Not at all fair Very fair

1 2 3 4 5

6- Do the requirements of financial reporting in Egypt involve the disclosure of the bases of transfer prices by the MNC?

Yes ☐ No ☐

7- If your answer is yes, what are these bases? (give examples)

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8- Do the Egyptian authorities impose any restrictions on transferring profits by MNCs across national frontiers?

Yes ☐ No ☐

9- If your answer is yes, would you please indicate briefly these restrictions

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10- Does the economic environment in Egypt, induce MNCs to move capital funds out of the country?

Yes ☐ No ☐

11- If your answer is yes, how does the Egyptian government prevent the outflow of capital? (please tick)

a) Restriction of the remission of earnings at a certain percentage of total earnings

b) Taxing earnings transferred above a certain percentage of capital at a higher rate

c) Other (please specify)

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12- For subsidiaries in which the government has an interest in the equity, do you think that the share of income is appropriate, i.e., the subsidiary has not unfairly shifted funds to the parent or another subsidiary?

Yes ☐ No ☐

13- Please, explain from the Egyptian point of view, what degree of importance do MNCs play in Egypt with regard to the following points? (please tick)

| [Not at all [important [ 1 | Fairly important 2 | Important 3 | Very important 4 | Most important 5 ] |
|---|---|---|---|---|

| | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| a) Gross national product "value added" | [ ] | [ ] | [ ] | [ ] | [ ] |
| b) Opportunity costs incurred by the host country (Egypt) | [ ] | [ ] | [ ] | [ ] | [ ] |
| c) Benefits imputed to foreign investment's effects on exports and imports or the balance of payments | [ ] | [ ] | [ ] | [ ] | [ ] |
| d) Increase of the national income | [ ] | [ ] | [ ] | [ ] | [ ] |
| e) Increasing domestic investment by creating backward or forward linkages | [ ] | [ ] | [ ] | [ ] | [ ] |
| f) Improving technical knowledge and management skills through employment and training by the foreign subsidiary | [ ] | [ ] | [ ] | [ ] | [ ] |
| g) Social welfare | [ ] | [ ] | [ ] | [ ] | [ ] |
| h) Other (Please specify) | | | | | |
| ________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |
| ________________________ | [ ] | [ ] | [ ] | [ ] | [ ] |

14- Does the Investment Authority face difficulties in collecting required information from MNCs?

Yes ☐ No ☐

15- If your answer is yes, what are these difficulties?

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16- Does the auditor face difficulties in obtaining sufficient evidence relating to transfer pricing bases?

Yes ☐ No ☐

17- If your answer is yes, how much and what kind of difficulty does the auditor face? (please give examples)

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بسم الله الرحمن الرحيم

سيدى الفاضل /

ان الغرض من هذه الدراسة هو تحديد العوامل المؤثرة فى تحديد أسعار تحويل البضائع والخدمات بين الشركة متعددة الجنسية وفروعها الموجودة فى الدول المضيفة ، ونظرا لقلة الدراسات التطبيقية فى هذا المجال خاصة فى مصر فان هذه الدراسة تكتسب أهمية خاصة . وقد قمت بتصميم قائمتى استقصاء ، احداهما موجهة الى ادارة المنشأت الاجنبية فى مصر ، والأخرى موجهة الى الجهات الحكومية ممثلة فى الهيئة العامة للاستثمار بصفتها الجهة المختصة فى التعامل مع هذه الشركات ،كما توجد بعض الأسئلة الموجهة الى مصلحة الضرائب .

ومما لاشك فيه ان تعاونكم المتمثل فى مقابلتكم لى والاجابة على الأسئلة المتضمنة فى قائمة الاستقصاء المرفقة سوف يدعم طرق البحث العلمى .

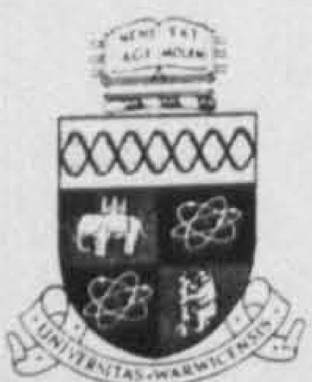
وأود أن أحيط سيادتكم بأن ماتدلون به من بيانات سيكون له طابع السرية ، وسوف تستخدم فقط لغرض أكاديمى بحت .

لذلك سوف أكون شاكرا ومعترفا بالفضل لقيامكم بملء الاستقصاء المرفق والسماح بمقابلة سيادتكم ،

وتفضلوا خالص احترامى وتقديرى ،

صبرى عبد الحميد السجينى
مبعوث لدراسة الدكتوراه فى المحاسبة
جامعة وورك — كوفنترى — انجلترا





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١ – الى أى درجة تقوم الشركات الاجنبية العاملة فى مصر بمساعدة الحكومة فى تحقيق الأهداف التالية :

| | منخفض | متوسط | عالى |
|---|---|---|---|
| أ – خلق فرص عمالة جديدة | ( ) | ( ) | ( ) |
| ب – نقل التكنولوجيا الجديدة | ( ) | ( ) | ( ) |
| جـ – تحسين ميزان المدفوعات | ( ) | ( ) | ( ) |
| د – زيادة استخدام الموارد القومية المتاحة | ( ) | ( ) | ( ) |
| هـ – أخرى ( يتم ذكرها ) : | | | |
| ................ | ( ) | ( ) | ( ) |
| ................ | ( ) | ( ) | ( ) |

٢ – الى أى مدى يظهر دور الحكومة المصرية فى تحديد أسعار التحويل بالنسبة للشركات الأجنبية العاملة فى مصر ؟

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٣ – من وجهة نظركم ، هل ترون أن الشركات متعددة الجنسية العاملة فى مصر تتبنى سياسات لتجنب القيود المفروضة عليها من قبل الحكومة المضيفة ؟

نعم ( ) لا ( )

٤ – اذا كانت الاجابة ( بنعم ) كيف تراقب السلطات المصرية عمليات هذه الشركات ؟

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٥ – بالنسبة للدور الاقتصادى الذى تقوم به الشركات الأجنبية فى مصر ، هل تعتقدون ان المبالغ التى تستلمها الشركات الأم من فروعها فى مصر فى صورة توزيعات ، اتاوات وخلافه يتم حسابها على أساس عادل بحيث يحفظ للحكومة المصرية حقها :

١ ٢ ٣ ٤ ٥

غير عادلة نهائيا ——————————— فى غاية العدالة

٦ - هل تنص احتياجات التقرير المحاسبى فى مصر على ضرورة الافصاح عن الأساس المتبع فى تسعير الصفقات المتبادلة بين الشركات متعددة الجنسية ؟

نعم ( ) لا ( )

٧ - اذا كانت الاجابة ( بنعم ) ، فماهى هذه الأسس ؟ ( يمكن التوضيح بأمثلة ) :

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٨ - هل تضع السلطات المصرية قيود على تحويل أرباح الشركات الأجنبية خارج الدولة ؟

نعم ( ) لا ( )

٩ - اذا كانت الاجابة ( بنعم ) ، لو سمحتم أذكر هذه القيود :

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١٠ - هل تحفز البيئة الاقتصادية فى مصر الشركات الاجنبية على تحويل أرصدة رأس المال خارج الدولة ؟

نعم ( ) لا ( )

١١ - اذا كانت الاجابة ( بنعم ) ماهو دور الحكومة المصرية لتجنب تحويل رأس المال خارج الدولة ؟

( اختر الاجابة المناسبة من فضلكم ) :

أ - تحديد نسبة معينة للأرباح المسموح بتحويلها ( )

ب - فرض ضرائب عالية على الأرباح المحولة للخارج والتى تزيد عن الحد المسموح به . ( )

حـ - وسائل أخرى ( يتم ذكرها ) :

.................. ( )

.................. ( )

.................. ( )

١٢ - بالنسبة للمنشآت الأجنبية والتى تدخل الحكومة بحصة فى رأسمالها ، هل ترون أن الأرباح المعلنة عادلة بمعنى أن الفرع لم يقم بتحويل أرباح الى الشركة الأم بصورة غير مباشرة ؟

نعم ( ) لا ( )

١٣ - من فضلكم وضح - من وجهة نظر الحكومة المصرية - أهمية دور الشركات الأجنبية فى مصر بالنسبة للنواحى التالية

| | غير مهم نهائيا ١ | مهم بصورة معقولة ٢ | مهم ٣ | مهم جدا ٤ | فى غاية الأهمية ٥ |
|---|---|---|---|---|---|
| أ - زيادة الانتاج القومى ( القيمة المضافة ) | ( ) | ( ) | ( ) | ( ) | ( ) |
| ب - الانتفاع من الفرص البديلة للموارد | ( ) | ( ) | ( ) | ( ) | ( ) |
| جـ - تقليل الواردات /زيادة الصادرات ، تحسين ميزان المدفوعات . | ( ) | ( ) | ( ) | ( ) | ( ) |
| د - زيادة الدخل القومى | ( ) | ( ) | ( ) | ( ) | ( ) |
| هـ - زيادة الاستثمارات المحلية ذات العلاقة بالاستثمارات الاجنبية . | ( ) | ( ) | ( ) | ( ) | ( ) |
| و - تحسين المعرفة الفنية والمهارات الادارية من خلال التدريب والعمل فى هذه الشركات | ( ) | ( ) | ( ) | ( ) | ( ) |
| ز - زيادة الرفاهية الاجتماعية | ( ) | ( ) | ( ) | ( ) | ( ) |
| حـ - أخرى ( يتم ذكرها ) : | | | | | |
| .................. | ( ) | ( ) | ( ) | ( ) | ( ) |
| .................. | ( ) | ( ) | ( ) | ( ) | ( ) |

١٤ - هل تواجه الهيئة العامة للاستثمار صعوبات فى الحصول على المعلومات المطلوبة من الشركات الاجنبية العاملة فى مصر ؟

نعم ( ) لا ( )

١٥ - اذا كانت الاجابة ( بنعم ) أذكر هذه الصعوبات ،

.................................

.................................

.................................

.................................

١٦ - هل يجد المراجع الخارجى لهذه الشركات صعوبات فى الحصول على أدلة كافية بالنسبة لأسس تحديد سعر التحويل ؟

نعم ( ) لا ( )

١٧ - اذا كانت الاجابة ( بنعم ) ، ماحجم ونوع هذه الصعوبات ؟

( يمكن التوضيح بأمثلة ) :

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.................................

.................................

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# Appendix (C)

# Questions Directed to Tax Authorities

**Questions Directed to Tax Authorities**

1- What kinds of problems do you face when assessing the taxable income of MNCs?

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________________________________________

________________________________________

2- Do you think that companies change their reported profit to decrease the tax burden?

Yes ☐ No ☐

3- When you assess MNC's taxable income, do tax authorities take into consideration transfer prices?

Yes ☐ No ☐

4- If your answer is yes, do you find a substantial difference in transfer prices between the tax holiday period, and the period after when the company starts to pay income tax?

Yes ☐ No ☐

5- If your answer is yes, how do tax authorities deal with transfer prices to determine taxable income?

________________________________________

________________________________________

________________________________________

6- What are the criteria that tax authorities follow for deducting the following expenses from taxable income:

a) Payments for royalties

______________________________

b) Trademarks

______________________________

c) Commissions and fees

______________________________

e) Head office and management expenses

______________________________

WARWICK
BUSINESS SCHOOL

بسم الله الرحمن الرحيم

سيدى الفاضل /

ان الغرض من هذه الدراسة هو تحديد العوامل المؤثرة فى تحديد أسعار تحويل البضائع والخدمات بين الشركة متعددة الجنسية وفروعها الموجودة فى الدول المضيفة ، ونظرا لقلة الدراسات التطبيقية فى هذا المجال خاصة فى مصر فان هذه الدراسة تكتسب أهمية خاصة . وقد قمت بتصميم قائمتى استقصاء ، احداهما موجهة الى ادارة المنشأت الاجنبية فى مصر ، والأخرى موجهة الى الجهات الحكومية ممثلة فى الهيئة العامة للاستثمار بصفتها الجهة المختصة فى التعامل مع هذه الشركات ،كما توجد بعض الأسئلة الموجهة الى مصلحة الضرائب .

ومما لاشك فيه ان تعاونكم المتمثل فى مقابلتكم لى والاجابة على الأسئلة المتضمنة فى قائمة الاستقصاء المرفقة سوف يدعم طرق البحث العلمى .

وأود أن أحيط سيادتكم بأن ماتدلون به من بيانات سيكون له طابع السرية ، وسوف تستخدم فقط لغرض أكاديمى بحت .

لذلك سوف أكون شاكرا ومعترفا بالفضل لقيامكم بملء الاستقصاء المرفق والسماح بمقابلة سيادتكم ،

وتفضلوا خالص احترامى وتقديرى ،

صبرى عبد الحميد السجينى
مبعوث لدراسة الدكتوراه فى المحاسبة
جامعة ووريك ــ كوفنترى ــ انجلترا



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١ ـ من فضلكم أذكر المشاكل التى تواجه مصلحة الضرائب فى تحديد الدخل الضريبى فى الشركات الأجنبيـــة العاملة فى مصر ؟

.....................................

.....................................

.....................................

.....................................

٢ ـ هل ترون أن هذه الشركات تقوم بتعديل الربح المحاسبى من أجل تخفيف العبء الضريبى ؟

نعم ( ) لا ( )

٣ ـ عندما تقوم مصلحة الضرائب بتحديد الربح الضريبى ، هل تؤخذ أسعار تحويل الصفقات بين المنشـــأة الأجنبية فى مصر والشركة الأم أو فرع آخر ؟

نعم ( ) لا ( )

٤ ـ اذا كانت الاجابة ( بنعم ) ، هل وجدتم اختلاف جوهرى فى أسعار التحويل خاصة بالمقارنة بين فترة الاعفاء الضريبى للشركة والفترة التى تقوم الشركة بدفع ضرائب ؟

نعم ( ) لا ( )

٥ ـ اذا كانت الاجابة ( بنعم ) كيف تتعامل مصلحة الضرائب مع أسعار التحويل حتى تتمكن من تحديـــد الدخل الضريبى ؟

.....................................

.....................................

.....................................

٦ ـ ماهى المعايير التى تستخدمها مصلحة الضرائب لاستبعاد المصاريف التالية من الدخل الضريبى :

أ ـ المبالغ المدفوعة للشركة الأم كأتاوات :

.....................................

ب ـ المبالغ المدفوعة للشركة الأم نظير استخدام العلامات التجارية

.....................................

جـ ـ العمولات المدفوعة للشركة الأم :

.....................................

د ـ المصروفات الادارية والمصاريف العامة الخاصة بالمركز الرئيسى :

.....................................

# Appendix (D)

## Questions Directed to Customs Officials

**Questions Directed to Customs Officials**

1- Would you please mention the problems that face your department when determining customs duties on imports by MNCs in Egypt.

______________________________________________

______________________________________________

______________________________________________

______________________________________________

2- Do you think that these companies adjust invoice prices in order to lessen customs duties burdens?

Yes ☐ No ☐

3- If your answer is yes, what does your department do in order to pinpoint the customs duties?

______________________________________________

______________________________________________

______________________________________________

______________________________________________

4- Are there guidelines to describe the arm's-length price?

Yes ☐ No ☐

5- If your answer is yes, how is the price determined? (Please tick one of the following methods

a) prevailing market price

b) Selling price

c) Cost plus profit margin

d) Other (please specify)

______________________________________________

______________________________________________

6- Do negotiations take place with MN subsidiaries with regard to the price of intra-group transactions?

Never ☐ Sometimes ☐ Always ☐

7- If your answer is sometimes or always, would you please explain the nature of these negotiations.

______________________________________________

______________________________________________

______________________________________________

______________________________________________

8- Do Negotiations lead to decreasing customs duties?

Yes ☐ No ☐

9- What is the average of customs duties rate of last year on the following products:

a) Raw materials ____________________

b) Intermediate products ____________________

c) Finished goods ____________________

d) Capital goods ____________________

WARWICK
BUSINESS SCHOOL

بسم الله الرحمن الرحيم

سيدى الفاضل /

ان الغرض من هذه الدراسة هو تحديد العوامل المؤثرة فى تحديد أسعار تحويل البضائع والخدمات بين الشركة متعددة الجنسية وفروعها الموجودة فى الدول المضيفة ، ونظرا لقلة الدراسات التطبيقية فى هذا المجال خاصة فى مصر فان هذه الدراسة تكتسب أهمية خاصة • وقد قمت بتصميم قائمتى استقصاء ، احداهما موجهة الى ادارة المنشآت الاجنبية فى مصر ، والأخرى موجهة الى الجهات الحكومية ممثلة فى الهيئة العامة للاستثمار بصفتها الجهة المختصة فى التعامل مع هذه الشركات ،كما توجد بعض الأسئلة الموجهة الى مصلحة الضرائب •

ومما لاشك فيه ان تعاونكم المتمثل فى مقابلتكم لى والاجابة على الأسئلة المتضمنة فى قائمة الاستقصاء المرفقة سوف يدعم طرق البحث العلمى •

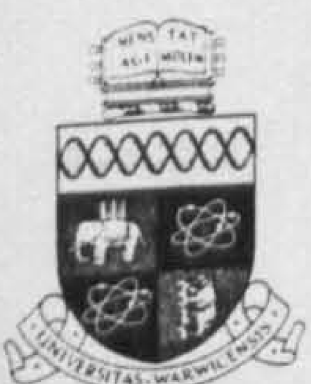
وأود أن أحيط سيادتكم بأن ماتدلون به من بيانات سيكون له طابع السرية ، وسوف تستخدم فقط لغرض أكاديمى بحت •

لذلك سوف أكون شاكرا ومعترفا بالفضل لقيامكم بملء الاستقصاء المرفق والسماح بمقابلة سيادتكم ،

وتفضلوا خالص احترامى وتقديرى ،

صبرى عبد الحميد السجينى
مبعوث لدراسة الدكتوراه فى المحاسبة
جامعة ووريك ــ كوفنترى ــ انجلترا





THE UNIVERSITY OF WARWICK COVENTRY CV4 7AL UNITED KINGDOM
TELEPHONE (0203) 524306 TELEX 317472 UNIREG FAX (0203) 523719 OR 524411

- من فضلكم اذكر المشاكل التي تواجه مصلحة الجمارك بشأن تحديد الرسوم الجمركية على واردات فروع الشركات الأجنبية العاملة في مصر ؟

______________________________

______________________________

______________________________

______________________________

٢- هل ترون أن هذه الشركات تقوم بتعديل أسعار الواردات من أجل تخفيف عبء الرسوم الجمركية ؟

نعم ( )  لا ( )

٣- إذا كانت الإجابة بنعم ، ماهو دور مصلحة الجمارك حتى تتمكن من تحديد الرسوم الجمركية بدقة ؟

______________________________

______________________________

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______________________________

٤- هل توجد تشريعات للتأكد من أن أسعار تحويل المنتجات تمثل السعر العادل؟

نعم ( )  لا ( )

٥- إذا كانت هناك تشريعات لتحديد أسعار تحويل المنتجات طبقا لطريقة السعر العادل ، كيف يتم تحديد هذا السعر ؟

من فضلك أختر طريقة من الطرق التالية :

أ- الأسعار التنافسية (أسعار السوق السائدة) ( )

ب- طريقة أسعار إعادة البيع ( )

ج- طريقة التكلفة + هامش للربح ( )

د- أى طريقة أخرى مقبولة (تذكر) :-

______________________________

______________________________

٦- هل تجرى مفاوضات بينكم وبين فروع الشركات الاجنبية فى حالة إختلاف السعر العادل عن السعر الوارد فى الفاتورة ؟

لا ( )　　　　أحياناً ( )　　　　دائماً ( )

٧- إذا كانت إجابتكم أحياناً أو دائماً من فضلكم حدد طريقة طبيعة هذه المفاوضات وهل تؤدى إلى تخفيض الرسوم الجمركية ؟

______________________________

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______________________________

تؤدى المفاوضات إلى :-

- تخفيض الرسوم الجمركية ( )
- عدم تخفيض الرسوم الجمركية ( )

٨- ماهومتوسط معدل الرسوم الجمركية خلال العام الماضي على المنتجات التالية:

أ- المواد الخام ______________________________

ب- المواد نصف المصنوعة ______________________________

ج- المنتجات تامة الصنع ______________________________

د- السلع الرأسمالية ( آلات مثلا ) ______________________________

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