

## Organization

- Important Features of the PCI and PCI-FDI Surveys
- FDI Performance
- Vietnam versus Competitors
- Special Investigation: The Scope and Drivers of Transfer *Mispricing*

## DESCRIPTION OF FDI IN VIETNAM

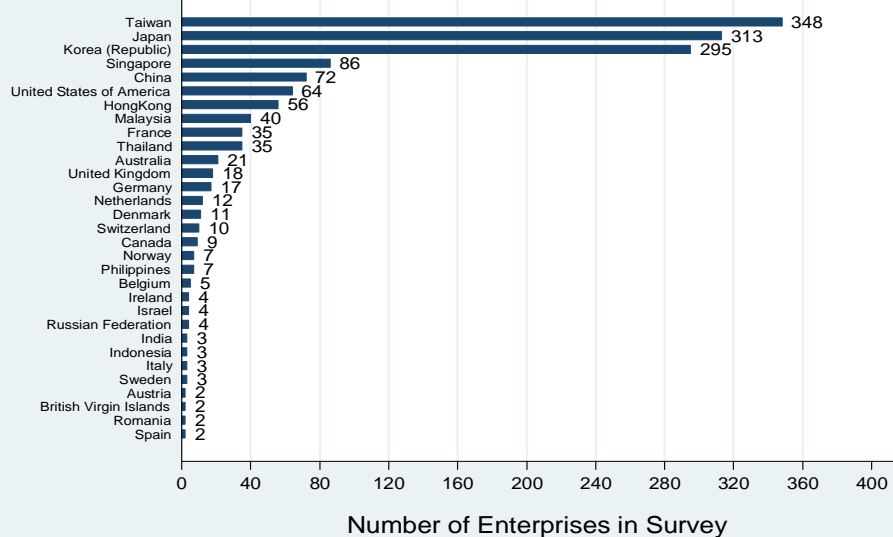


### Key Features of the PCI-FDI Survey

- Annual business survey used to gauge Vietnamese business environment.
- 2013 data contains 1,610 foreign firms (92% are 100 percent foreign owned).
- Sample is stratified by age, legal form, and broad industrial sector.
- Completed in 13 provinces with large investor populations (nationally representative survey).
- 75% of firms from Asia (Japan, Korea, Taiwan, Sing.)



## Countries Represented in Survey



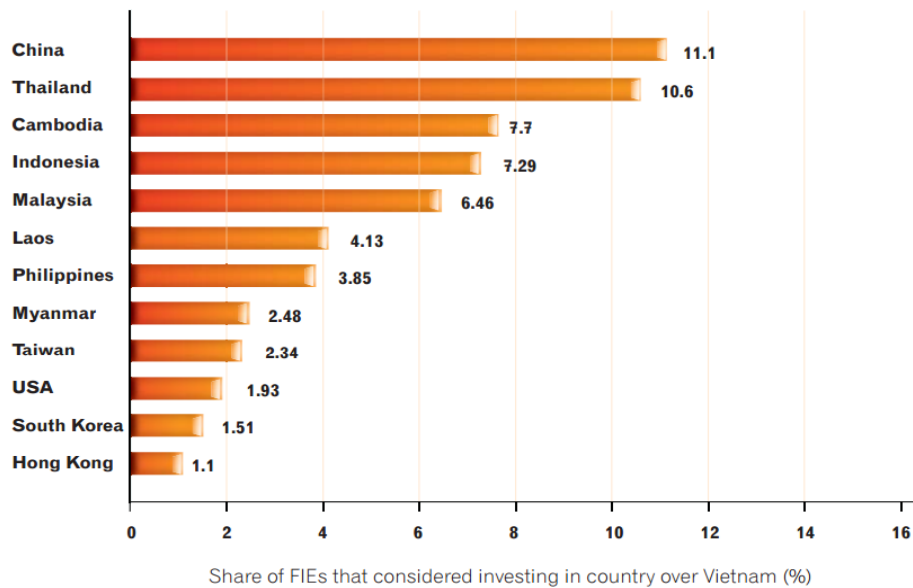
## Performance of FIEs over Time

Year	Firms Increasing Investment	Median K Size (\$ Million)	Firm Adding Employees	Median Size (Employees)
2010	37.3%	2.0	54.0%	90
2011	27.8%	1.5	47.1%	85
2012	5.1%	1.5	32.2%	87.5
<b>2013</b>	<b>5.1%</b>	<b>1.4</b>	<b>33.4%</b>	<b>125</b>
Year	Firms Reporting Profits	Firms Reporting Losses	Firms Intending to Expand	
2010	70.1%	24.6%	68.5%	
2011	73.9%	20.5%	45.5%	
2012	60.0%	28.0%	32.7%	
<b>2013</b>	<b>64.1%</b>	<b>23.8%</b>	<b>28.2%</b>	

# VIETNAM VERSUS COMPETITORS



## Vietnam's Biggest Competitors for FDI



## How do investors rank Vietnam relative to alternatives?

How would you compare the business environment in Vietnam to other countries in which you considered investing?

I face less corruption in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
I face fewer regulatory constraints in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
I face lower tax rates in Vietnam.	<input type="checkbox"/> YES	<input type="checkbox"/> NO
I face lower risks of expropriation in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
I face fewer policy uncertainties in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
Infrastructure is better in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
Public service delivery is better in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO
I play a more active role in policymaking in Vietnam	<input type="checkbox"/> YES	<input type="checkbox"/> NO

**Question was repeated, asking FIEs to compare Vietnam to:**

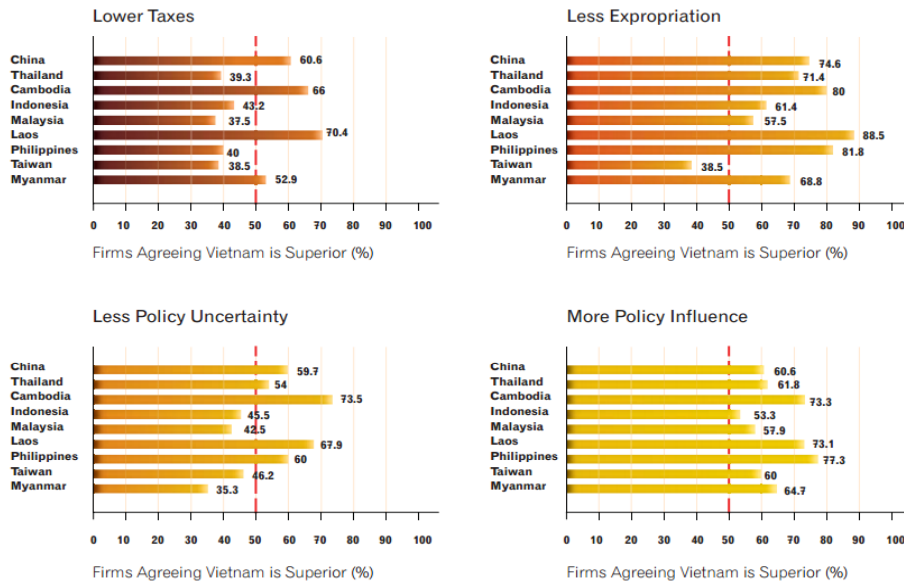
1.) The home country of the multinational

2.) Between province and alternatives in Vietnam

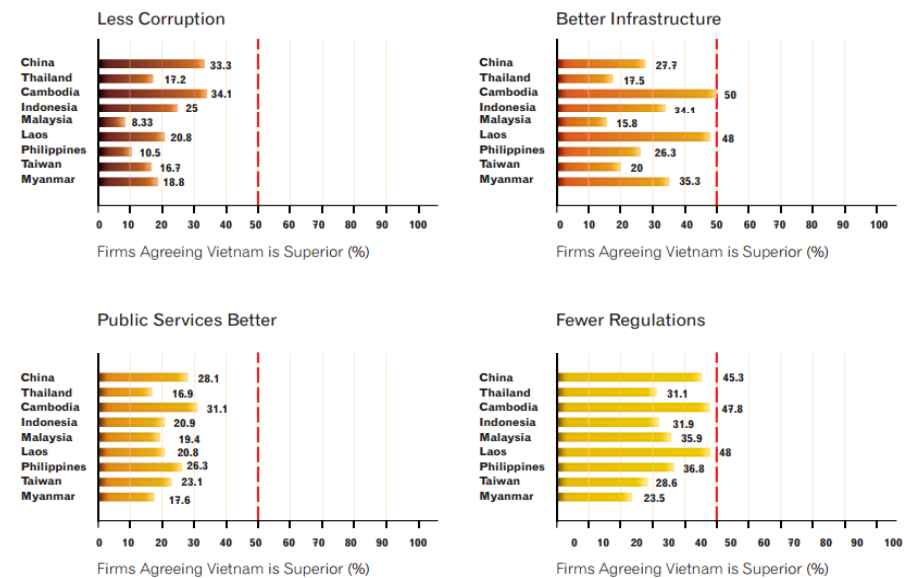
## Overall Assessment

Comparison between:	Competitor	Home Country
<u>Criteria</u>	<u>% Agree</u>	<u>% Agree</u>
I face less corruption	34.2%	22.5%
I face fewer regulatory constraints	43.5%	34.1%
I face lower tax rates	52.4%	49.2%
I face lower risks of expropriation	63.8%	50.7%
I face fewer policy uncertainties	59.7%	44.8%
Infrastructure is better	36.9%	9.0%
Public service delivery is better	31.9%	21.0%
I play a more active role in policymaking	59.2%	46.1%

## Vietnam's Strengths



## Vietnam's Weaknesses



## Views of Key Sectors

ISIC (4)	Sector	Vietnamese Strengths			
		I face fewer policy uncertainties	I face lower tax rates	I face lower risks of expropriation	I play a more active role in policymaking
A	Agriculture, Aquaculture	85.7%	85.7%	71.4%	100.0%
C16	Man. Wood Products	50.0%	57.1%	46.7%	82.4%
C22	Man. Rubber & Plastic	62.7%	46.9%	65.3%	50.0%
C28	Man. Machinery	50.0%	45.0%	52.4%	57.9%
C27	Man. Electronics	54.5%	55.0%	66.7%	52.4%
<i>J</i>	<i>Information &amp; Communication</i>	<i>53.6%</i>	<i>58.9%</i>	<i>57.9%</i>	<i>50.0%</i>
<i>K</i>	<i>Finance and Insurance</i>	<i>62.5%</i>	<i>37.5%</i>	<i>75.0%</i>	<i>88.9%</i>
<i>M</i>	<i>Professional, Scientific</i>	<i>50.0%</i>	<i>35.6%</i>	<i>50.0%</i>	<i>48.9%</i>
ISIC (4)	Sector	Vietnamese Weaknesses			
		I face less corruption	Infrastructure is better	Public service delivery is better	I face fewer regulatory constraints
A	Agriculture, Aquaculture	100.0%	71.4%	100.0%	85.7%
C16	Man. Wood Products	68.8%	40.0%	53.3%	80.0%
C22	Man. Rubber & Plastic	31.3%	36.7%	34.7%	45.1%
C28	Man. Machinery	19.0%	40.0%	15.0%	15.8%
C27	Man. Electronics	33.3%	40.9%	33.3%	40.9%
<i>J</i>	<i>Information &amp; Communication</i>	<i>30.4%</i>	<i>34.5%</i>	<i>24.1%</i>	<i>31.6%</i>
<i>K</i>	<i>Finance and Insurance</i>	<i>62.5%</i>	<i>25.0%</i>	<i>14.3%</i>	<i>50.0%</i>
<i>M</i>	<i>Professional, Scientific</i>	<i>28.6%</i>	<i>23.4%</i>	<i>19.1%</i>	<i>35.4%</i>

## SPECIAL ANALYSIS OF TRANSFER MISPRICING



## Debate in Vietnam

- **Serious discussion broke out this summer between foreign investors and Vietnamese tax authorities.**
  - General Department of Taxation declared that 57% of the 5,500 FIES it investigated reported net losses between 2010 and 2011.
  - Announced extensive audit in several provinces
    - 122 FIEs found in violation of transfer mispricing rules
    - Additional tax payments of over \$10 million requested.
  - List included several iconic MNCs
- **Not unique to Vietnam**
  - Special report by OECD.
  - Mirrlees commission in United Kingdom
  - Similar debates going in USA, UK, and emerging markets around the world

## What is Transfer Pricing?

- Definition: the act of assigning internal prices for goods and services that are sold within a company and between subsidiaries of the same company.
  - Normal practice that has been a part of business since the invention of the firm (Coase 1937)
- More common understanding: a profit allocation method used to calculate and attribute MNCs' net profit (or loss) before tax in countries where it does business.
- In principle, a transfer prices should match either what the seller would charge an independent, external customer, or what the buyer would pay an independent, external supplier.
  - These benchmark transactions are known as *"arm's length"* prices.
  - In practice, can be hard to determine.

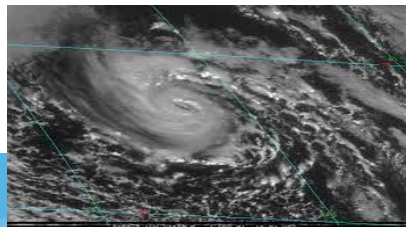


## What is Transfer Mispricing?

- Incorrect application of internal prices to lower profits in a division of an enterprise that is located in a country that levies high taxes, and raise profits in a country that levies no or low taxes, such as a tax haven.
  - Over-charging for equipment and inputs
  - Over-valuing internal consulting services
  - Payments for brands and licenses that are not charged to similar subsidiaries in other countries
  - And borrowing from subsidiaries in low tax environments (often tax havens)
- Transfer mispricing is the most common form of *"Profit Shifting."*
  - The manipulation of costs and revenues within an MNC across taxing jurisdictions (countries) so as to record profits where they will be taxed at the lowest rate.

## Drivers of Increased Activity

1. Expanding international trade has increased the magnitude and diversity of products.
2. Surge of FDI into developing countries in the past two decades has expanded the number of foreign subsidiaries working in any given host country, forcing host countries to deal with different accounting practices, corporate cultures, and the unique home-country tax jurisdictions of their new guests.
3. Rise of MNCs and the mainstreaming of international production chains that leads to components of products being developed in multiple countries around the world.
4. The necessity of these MNCs to return the highest value to their shareholders means that reducing their tax obligations is a critical component of their business models.
5. Finally, the information age has increased the value of intellectual property and technology.



## Analyzing Requires Accurate Measurement

- Extremely difficult to accomplish with a large number of observations.
- Requires both knowledge of internal transactions (often proprietary) and comparison to external parties.
- Methods available for studying (auditing) small number of firms.
- Data availability means most systematic analysis has been done on US firms, Never in an emerging market.

## List Experiment to Measure Transfer *Mispricing*

- Known officially as the *Unmatched Count Technique*, the strategy is derived from the social psychology and public health literature.
- Goal is to learn information about sensitive questions that respondents are reluctant to share, as it may be illegal or embarrassing.
- How do you do it?
  - Sample is randomly divided into two groups.
  - One half receives a question with a list of innocuous but relatively infrequent action items.
  - A second half receives a list of the same items, plus an additional sensitive question.
  - Both samples are invited to count the number of activities they participated in.
  - The proportion engaging in sensitive behavior can be estimated by comparing the results of the two groups.
- Critically, non-sensitive items must be uncorrelated and the control group should have limited responses near the floor or ceiling of activity numbers.
- Shown in repeated tests to out perform other survey based methods for gather sensitive information (Counts and Jann 2011)

## List Experiment in 2013 PCI

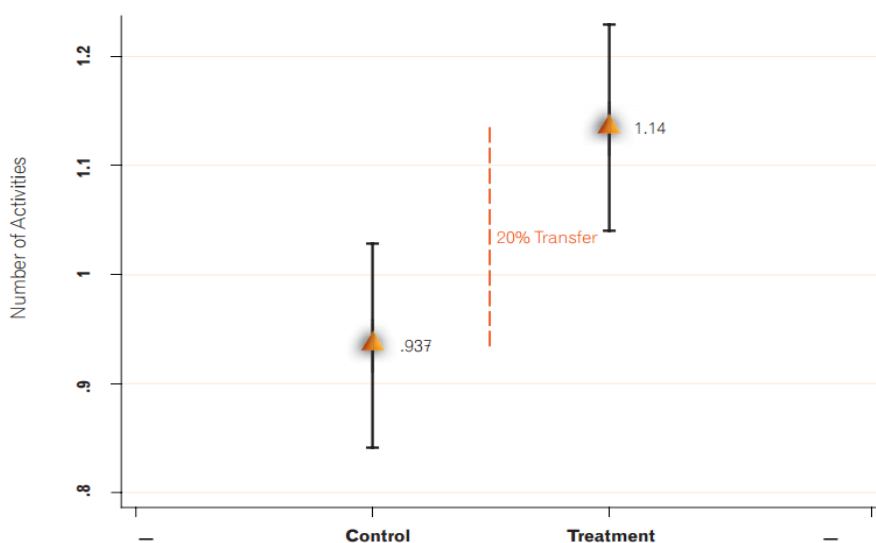
E10. Please look at the following list of activities that foreign firms currently use to lower their tax burden in Vietnam.

- ☐ Hired an international law firm to advise on tax policy
- ☐ Hired a domestic law firm or consultancy to advise on tax policy
- ☐ Increased purchases from Vietnamese vendors
- ☒ *Raised the price of internal purchases of goods and services to lower reported profits [FORM B]*

Please do not answer about any one of these activities specifically, we are only interested in the TOTAL NUMBER you may have employed. How many of the above activities did you engage before filing your most recent tax payment?

NUMBER OF ACTIVITIES: ☐ 0 ☐ 1 ☐ 2 ☐ 3 ☐ 4

## Estimated Share of Transfer Mispricing



## Estimated Transfer Mispricing by Performance Category

Performance Category		n	Estimated Transfer Pricing (%)						
			Share of Firms		SE	T-Stat	P-Value	Low Estimate	High Estimate
8	More than 20% profit margin	39	65.1%	***	10.1%	6.4	0.00	48.9%	81.3%
7	10-20% profit margin	105	44.5%	***	6.9%	6.4	0.00	33.5%	55.5%
6	5-10% profit margin	262	12.3%		9.7%	1.3	0.23	-3.2%	27.8%
5	0-5% profit margin	455	9.1%	*	4.8%	1.9	0.08	1.4%	16.8%
4	Broke even	163	19.7%		15.2%	1.3	0.22	-4.6%	44.0%
3	5-0% loss	176	30.9%	*	17.4%	1.8	0.10	3.1%	58.7%
2	10%-5% revenue loss	76	-2.1%		24.6%	-0.1	0.93	-41.5%	37.3%
1	Loss of 10% revenue or greater	68	-0.3%		20.4%	0.0	0.99	-32.9%	32.3%

Non-shaded areas represent sector where the estimated activity is not statistically significant.

## Estimated Transfer Mispricing by Industry

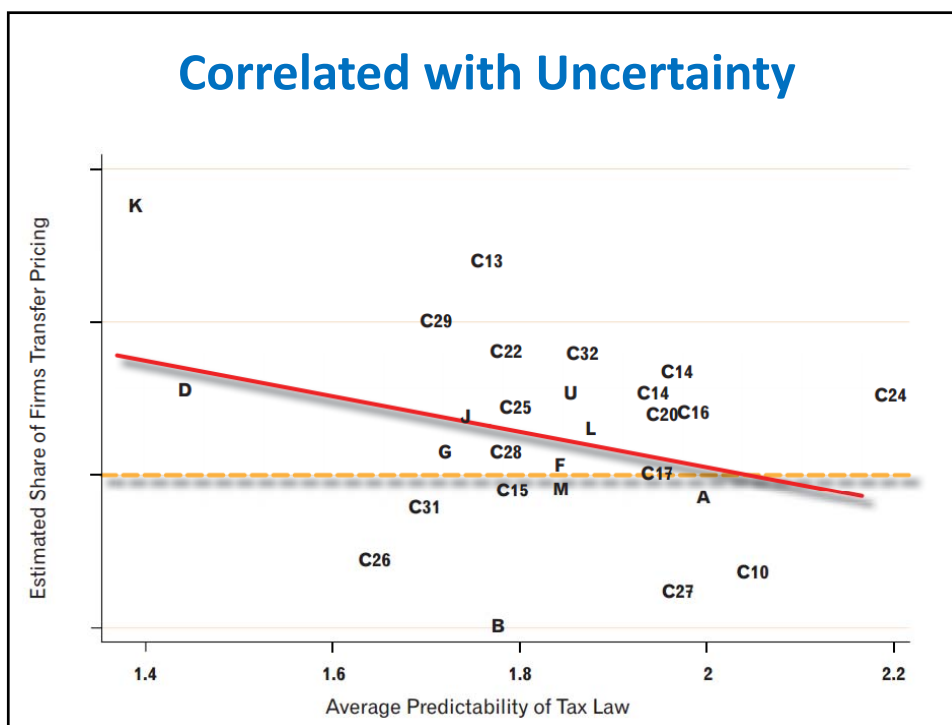
ISIC (4)	Sector	n	Estimated Transfer Pricing (%)
K	Finance and Insurance	17	90.0%
C13	Man. Textiles	47	70.0%
C29	Man. Motor Vehicles	91	51.0%
C32	Man. Other	186	41.0%
C22	Man. Rubber & Plastic	88	41.0%
C14	Man. Apparel	96	36.0%
U	Other Services (Educ., Health)	149	28.3%
C16	Man. Wood Products	40	23.1%
J	Information & Communication	89	20.0%
C24	Man. Basic Metals	37	26.9%
C25	Man. Fabricated Metal	93	23.3%
L	Real Estate	40	15.8%
C20	Man. Chemical Products	48	21.8%
G	Wholesale, Retail Trade	133	8.5%
D	Utilities (Electric & Water)	9	27.7%
C28	Man. Machinery	31	8.8%
C17	Man. Paper Products	42	1.9%

Shaded areas represent industries where the estimated activity is not statistically significant.

## Auto Industry at Vietnam Business Forum

- Tax burden was cited, but the auto representatives were concerned about complexity and frequent oscillations in tax policy. A few key examples include:
  - Continuous changes in import duties for components (as well as changes in rules about royalties for proprietary technology).
  - Changes in the vehicle registration tax, and different application to types of vehicles, have reduced market sales.
  - Complex and changing rules on origin and hybrid vehicles change the domestic tax rate and affect the predictability of local sales;.
  - Call for publication of a clear road map on automobile tax policy until 2018. Specifically, the investors specify their hypothesis succinctly.
  - “Further tax and policy stability will fortify investor confidence and growth in the industry. All of this will lead to increased customer choice and development of the country.”

**These Claims are Testable!**



## Regression Analysis

Dependent variable: difference between the activities reported by treatment group and predicted number of nonsensitive activities of control group.

	Mean	Firm	Performance	Predict	Tax Rate 1	Tax Rate 2	Tax Burden
	(1)	(2)	(3)	(4)	(6)	(5)	(7)
Multinational Corporation=1		-0.008 (0.078)	-0.020 (0.077)	-0.045 (0.064)	-0.012 (0.062)	0.115*** (0.022)	-0.044 (0.070)
Primary Inputs Purchased in House=1		0.130*** (0.034)	0.166* (0.082)	0.135 (0.089)	0.125* (0.062)	0.212*** (0.045)	0.147 (0.092)
Employment Size 2013 (1 to 8)		0.056*** (0.013)	0.053* (0.025)	0.062** (0.027)	0.035 (0.031)	0.025 (0.043)	0.058** (0.023)
Located in Industrial Zone=1		-0.003 (0.141)	0.047 (0.172)	0.024 (0.181)	0.091 (0.151)	0.127 (0.081)	0.050 (0.164)
Firm Performance (1=Losses; 8 Profitable)			0.033 (0.030)	0.052 (0.033)	0.060 (0.040)	0.095*** (0.028)	0.055 (0.038)
Predictability of Tax Law (1 to 3)				-0.279** (0.110)			
Lower tax rates in Vietnam than Home=1						-0.365*** (0.062)	
Lower tax rates in Vietnam than Competitor=1						-0.151* (0.084)	
Tax Burden (Low =1   High=3)							-0.037 (0.047)
Constant	0.199** (0.073)	-0.073 (0.114)	-0.241*** (0.044)	0.159 (0.222)	-0.104 (0.100)	-0.368*** (0.108)	-0.298 (0.176)
Country FE	No	No	No	No	No	No	No
Province FE	No	No	No	No	No	No	No
Sector FE	No	No	No	No	No	No	No
Observations	799	681	562	478	378	360	495
R-squared	0.000	0.018	0.029	0.068	0.061	0.089	0.041

## Summary of Findings

- 20% of firms engaging in Transfer Mispricing.
- No obvious differences by country of origin or level of development of home country.
- Strongly correlated with self-reported profit.
- Highest among industries with non-tangible assets (i.e. proprietary technology).

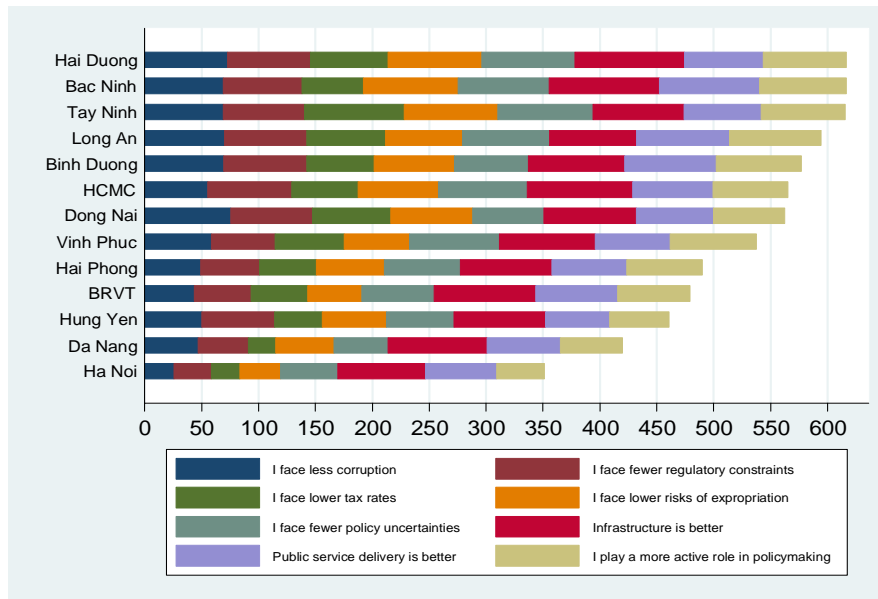
## Summary of Findings

- Firms using Vietnam as part of global supply chain between 13% to 20% more likely to engage.
- If home country has lower CIT than Vietnam, 37% more likely to misprice.
- Key: Tax volatility is a problem. Firms perceiving Vietnam tax policy as predictable are 46% less than their peers suffering from a higher level of volatile policy.

## Policy Implications

- Harmonize tax policy with international norms
  - Reconsider threshold for treatment of related parties.
  - Corporate Income Tax relative to major competitors
- Reduce unpredictability of tax policy
  - Advanced Pricing Arrangements provide one mechanism
  - But general instability is also a problem and deserves serious effort.

## Combined FDI Environment of Provinces



## Inverse Relationship between National and Provincial Needs

