WENT FOR COST, PRICED AT COST? AN ECONOMIC APPROACH TO THE TRANSFER PRICING OF OFFSHORED BUSINESS SERVICES

LORRAINE EDEN
Professor of Management
Texas A&M University
4221 TAMU College Station, Texas 77843-4221
Phone 979-862-4053. Fax 979-845-9641.
Email: leden@tamu.edu
WWW: http://cibs.tamu.edu/leden http://www.voxprof.com

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Abstract: What are the transfer pricing implications of the rapid growth in offshored business services? In this paper, I explore the recent trend to offshoring business services, using a case study of the teleservices industry. Teleservices firms own foreign subsidiaries that provide inbound and outbound call services to third party clients. I explore the “facts and circumstances” of the industry and use economic analysis to develop transfer pricing rules for their offshored call centers. Even though the mantra, “Went for cost, Stayed for quality”, applies in teleservices as in other offshored business services, I conclude “Went for cost, Priced at cost” remains the appropriate transfer pricing mantra for tax authorities and transnational corporations to follow.

Keywords: offshoring, transfer pricing, teleservices, international taxation, business services, outsourcing

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I. INTRODUCTION

International trade and foreign direct investment (FDI) patterns are increasingly shifting from manufacturing to services (UNCTAD, 2004). The reasons for the rapid growth in services FDI are several. First, transnational corporations (TNCs) in the manufacturing sector may set up foreign affiliates to provide support functions for the corporate group; financial, trading and marketing affiliates are common examples. Service multinationals in industries such as airlines, banking, accounting and consulting are rapidly becoming internationalized. In addition, the privatization of former state-owned enterprises in sectors such as telecommunications, electricity and postal services, has encouraged inward FDI, particularly in Latin America and Central and Eastern Europe. More recently, information technology enabled services (ITES), providing back office and support functions (payroll, order fulfillment) and front office functions (customer care) are being relocated to emerging market economies such as India. While the original move offshore was driven by the availability of low-cost labor, the current mantra is now, “Went for cost, Stayed for quality” (Dossani and Kenney, 2003).

The research question we address in this paper is: What are the transfer pricing implications of this rapid growth of FDI in business services? Transfer pricing is the pricing of products traded between affiliated units of a transnational corporation. Because the prices are set in-house, there are opportunities for TNCs to manipulate the prices and avoid or evade government regulations. In order to curtail these opportunities, most governments have adopted transfer pricing regulations based on the OECD guidelines (OECD, 1995). These guidelines require TNCs to follow the arm’s length principle; that is, firms must price each intracorporate transaction as if it had occurred between two unrelated parties negotiating for the same product under the same circumstances as the related party firms (Eden, 1998, 2001). Transfer pricing is regularly seen as the most contentious issue in international taxation according to surveys of
TNCs (Ernst & Young, 2003; UNCTAD 1999).

In this paper, I explore the implications of the new trend to offshoring business functions for transfer pricing. As TNCs move their business services offshore, they must devise new pricing policies for pricing their intracorporate transactions in business services. At the same time, both home and host governments must develop transfer pricing regulations for enforcing the arm’s length standard on these transactions. Some tax authorities are now moving in this direction; the US Internal Revenue Service recently issued proposed regulations on taxation of business services (Anwar et al., 2004) and the Central Board of Direct Taxes in India has issued two circulars on outsourced business services (Fazelbhoy, 2005). The issue is clearly highly controversial. Fazelbhoy, for example, states, “The tax treatment of outsourcing in India has been a source of heated debate and stand-offs between industry and tax authorities” (2005: 33).

Because individual facts and circumstances are highly important in determining the most appropriate (“best method”) transfer pricing methodology, I explore the transfer pricing of offshored business services through a case study of one of the most commonly offshored business services: teleservices. The typical teleservices firm (e.g., Convergys, EDS) provides a full range of inbound and outbound call services to third party clients (e.g., Dell, UPS) and owns foreign subsidiaries that deliver call center services to customers of these third party clients. In the case study, I explore the “facts and circumstances” of this rapidly growing industry and use economic analysis to develop transfer pricing rules for offshored intracorporate transactions in business services. I conclude that teleservices TNCs moved their call center activities offshore for cost reasons. Even though quality considerations have become more important for offshored services, “Went for cost, Priced at cost” remains the appropriate transfer pricing mantra for both TNCs and national tax authorities.

II. OFFSHORING OF BUSINESS SERVICES

The terms offshoring and outsourcing are often confused in the public press. I distinguish them in Table 1 below (Eden, 2004). *Outsourcing* is the relocation of one or more stages of production from within the firm to an external party; that is, the firm shifts from “make” to “buy”. (These are cells 2 and 4
in the table). When a production stage is moved from inside to outside the firm’s boundaries, its level of vertical integration falls. During the 1990s, most firms attempted to restructure their value chains by selling off low-value stages of production and concentrating on their core, high-value-adding activities. The externalized production can be sold off to an arm’s length party in the same country as the TNC (the home country) or to an arm’s length party in a foreign country. When the transaction involves a domestic firm, the activity is called “domestic outsourcing”; when the activity involves a foreign firm, the term is “foreign or international outsourcing”.

[Table 1 goes about here]

**Offshoring** is the relocation of one or more stages of production from the home country to a foreign country. (These are cells 3 and 4 in the table.) Production can be shifted to a wholly or partly owned foreign affiliate in a foreign country (the host country). This is “captive offshoring” or, more simply, FDI (cell 3). Production can also be shifted to an arm’s length party in the foreign country, where that firm could be either a domestic firm or another transnational corporation; this can be referred to as “external offshoring”. An outsourced offshored activity is one that has both moved outside the firm (externalized) and outside the home country (internationalized); this is cell 4 in Table 1.

Firms have been outsourcing and offshoring manufacturing operations for many years, typically to export processing zones and more recently to China. A critical change in the business strategies of North American multinationals over the past five years has been the rapid growth in outsourcing and offshoring of services. White collar, skilled jobs in the service industries are now following blue collar jobs in manufacturing, in areas such as basic data entry, telemarketing and claims processing (Mann, 2003; McKinsey, 2003). Large companies are now outsourcing both their both upstream back office functions and downstream customer relations functions to arm’s length providers (Alvarez, Couto and Disher, 2003; Kearney, 2004; McKinsey, 2003; UNCTAD, 2004).

In addition, business service operations (BSO) in sectors such as telecommunications, transportation and health care, and business process operations (BPO) such as human resource management, call centers and cheque processing, are moving offshore. Bardhan and Kroll (2003: 4) suggest, “Any job that involves
mostly ‘…sitting at a desk, talking on the phone and working on a computer…’ is a job under potential threat” of being offshored. They argue that the types of jobs that have been and are likely to be offshored have the following characteristics (ibid: 4): No face-to-face customer servicing requirement; high information content; work process is telecommutable and internet enabled; high wage differential with similar occupation in the destination country; low setup barriers; and low social networking requirement.

The movement offshore is primarily driven by the location savings that countries like Ireland, Canada and India can offer relative to costs in the United States (Read, 2002; UNCTAD, 2004). In e-services such as call centers, data entry, software engineering, physical proximity is not necessary for efficient and effective delivery. The recent movement to international offshoring such activities, initially to Canada (e.g., call centers to New Brunswick in the late 1990s) and more recently to India, is a new version of the old-style offshoring of low-skilled manufacturing jobs to export processing zones. Scholars now distinguish between “first phase offshoring” when low-skilled manufacturing jobs shifted offshore to developing countries, and “second phase offshoring” of information technology enabled services (ITES) jobs to countries like India.

How fast is this second phase of offshoring growing? While the actual statistics are unknown, Tanaka (2005: 23) says that rule-of-thumb estimates suggest that one-third of business services are outsourced and one-third offshored. Thus, captive offshoring (cell 3) represents about 2/9 or 22%, and international outsourcing (cell 4) about 1/9 or 11%, of all business services. Bardhan and Kroll (2003: 2) estimate that India’s ITES sector directly employs over 200,000 people; generates approximately $US 2.3 billion in exports, of which 70 percent goes to the United States; and is growing at 60 percent per year. By 2008, the ITES sector is expected to employ two million workers and exports to exceed $US 50 billion.

Critical factors encouraging offshoring are (1) cost savings, (2) availability of English-speaking graduates, (3) good information technology (IT) infrastructure, and (4) a favorable government attitude towards FDI and international trade. Bardhan and Kroll (2003: 6) conclude that the occupations at risk of international outsourcing from the United States include office support, business and financial support, computer and math professionals, paralegals and legal assistants, diagnostic support services and medical
transcriptionists, which represent 11 percent of the US work force in 2001.

A.T. Kearney has done an exhaustive study of the factors affecting offshoring across several industries (Kearney, 2004a). The firm repeated this study separately for the IT sector (Kearney, 2004c) and for business process functions (Kearney, 2004d); the latter is most relevant for the teleservices industry. Offshore locations are evaluated on three factors: cost (40% of the total), environment (30%) and people (30%). I have amalgamated the 11 country scores from the BPO report into Table 2 below. The order of the columns reflects the overall score for each country. In the last two columns of the table, I have calculated the scores for India and Canada, two key offshore locations for business process services, as a ratio of the average score. These two columns show the areas where each country is above the average (ratio greater than 1) and below the average (ratio below 1).

[Table 2 goes about here]

The highest country on the list is India with an overall score of 7.3. India ranks first on cost and people, but only seventh on environment. Canada and Mexico are tied with an overall score of 6.2, almost a full point below India. Canada ranks the lowest of the 11 countries on cost, but is first on environment and second on people. Mexico’s tied score with Canada is driven by a much better score on cost, but worse performances on environment and people. Immediately behind Canada and Mexico is Brazil, with an overall score of 6.1. This difference is probably not statistically significant, suggesting that Mexico and Brazil are in the same overall category as Canada and should be seen as its closest competitors. In the next tier are countries clustered in the 5.6 to 5.8 range (Hungary, Ireland, Australia, Czech Republic, Philippines and Russia). China is last with an overall score of 5.2, a significant drop from the previous tier. A.T. Kearney’s country comparisons for offshoring in the business-processing sector suggest that there are multiple competitors as offshoring locations for US multinationals.

III. A CASE STUDY: CAPTIVE OFFSHORING OF TELESERVICES

Since transfer pricing is all about “facts and circumstances”, in order to develop useful insights into the appropriate transfer pricing policy for cell 3 in Table 1 (captive offshoring), I provide a case study of
offshored services in one particular industry rather than examining the business services sector as a whole. *Teleservices* is a new industry that is rapidly setting up captive subsidiaries offshore. It may therefore be a bellwether for other business services.

There are two basic types of teleservices: inbound and outbound. Inbound teleservices typically include product service and support, response to customer inquiries and order processing. Outbound teleservices may include direct sales, product inquiry and lead generation and appointment setting. These services are designed to improve the overall customer experience and build closer relationships between companies and their customers. Outbound services are shrinking relative to inbound, as government “no call” regulations that prohibit firms from making unsolicited calls have spread from state to state.

The typical teleservices TNC provides a full range of inbound and outbound call services to third party clients and owns several foreign subsidiaries that deliver call center services to customers of these third party clients. The parent’s activities are of two types: support activities, and activities both upstream and downstream from the call center stage of production. The call center stage is “in the middle” of the value chain. Its activities are determined by the parent, and all risks (credit, market, foreign exchange) and responsibilities are primarily assumed by the parent.

The teleservices industry was created by Fortune 500 firms downsizing and outsourcing their customer relationship management functions, starting in the late 1980s. The industry provides a broad range of customer interface services (see the last row in Table 2): service agreement management, internet customer service, warranty management, call center service, problem/resolution management, customer enquiries, sales channel management, inventory management, and service fulfillment. These functions were previously provided in-house. Thus, teleservices is an *outsourced* activity. In addition, the teleservices industry, over the past five years, has been heavily engaged in *offshoring*, by moving call centers out of the United States and overseas where labor costs are lower.

Plakias (2003) estimates that total revenues in the teleservices industry were $18.5 billion in 2002, of which $16.9 billion were generated by live agents and $890 million through automated telephone and internet. The key firms in the industry are Convergys, EDS and Teletech (the top three) followed by
Teletech, West Corporation, Sitel and Sykes. Teleservices revenues from offshore operations totaled $3.4 billion in 2002, about 18% of total revenues, which is expected to grow to 25% by 2008.

An example of a typical teleservices TNC is illustrated in Figure 1. Suppose several Fortune 500 firms (Dell, UPS, MCI) decide to outsource their inbound and outbound teleservices activities to one of the big teleservices firms, such as Convergys (http://www.convergys.com/) or Sitel (http://www.sitel.com/). What would the activities look like? Figure 1 maps the likely transactions between a teleservices TNC (e.g., Convergys or Sitel) and its third party clients (e.g., Dell, UPS and MCI). The figure assumes that the teleservices firm is performing services that have been outsourced from Dell, UPS and MCI, and that the firm has located all of its call centers offshore, in Canada, India and Brazil. These offshore call centers are responsible for providing inbound and outbound teleservices to customers of MCI, Dell and UPS.

[Figure 1 goes about here]

Which activities of the TNC are performed where? I use Figure 2, illustrating the value chain in the teleservices industry, to answer this question. The value chain shows the primary and support activities involved in creating, producing and selling a product to a customer (Eden, 1998).

[Figure 2 goes about here]

The *support activities* are the horizontal activities at the top of the value chain in Figure 2. These functions are provided to the TNC as a whole, on a support and strategic basis. There are three support activities: *strategic management* (at the corporate and business strategy levels), *finance and administration* (e.g., all forms of overhead administration and finance including foreign exchange transactions) and *technology development*. In terms of technology development, while there may be little R&D done in the teleservices industry, it is clear that firms must either develop their own proprietary software (a production intangible) or purchase it from other firms. In addition, there are in-house process technologies that are also likely to be proprietary but not protected by patents. Teleservices firms, for example, would normally have their own information technology enabled systems (ITES) involving designing of programs and scripts, network management, call routing and data retrieval, and quality
control. These intangibles are sources of competitive advantage, along with reputation and brand name.

The primary activities, for a teleservices provider, are of three types: back office functions that are directly upstream from the call centers (e.g., information systems services provided to the call centers, facilities management), the call center stage, and front office functions (e.g., sales and marketing to third party clients). Since the front and back office functions are well understood, I focus on call centers.

At the call center stage, the typical site\(^1\) has telephone sales representatives and customer service associates handling inbound and outbound 1-800 telephone calls from workstations (Gans, Koole and Mandelbaum, 2003). Some call centers now include not only telephone services but also email, fax, webpages and online chat with customers. A telling description is provided by Gans, Koole and Mandelbaum (2003: 3), “The working environment of a large call center… can be envisioned as an endless room, with numerous open-space cubicles, in which people with earphones sit in front of computer terminals, providing tele-services to phantom customers.” Local management in these centers typically hire, train and supervise workers and negotiate contracts with local suppliers of, for example, long distance telephone services, but normally do not have any responsibility vis à vis the overall management of the teleservices TNC as a whole. Since each site would normally focus on providing services to one major client or several smaller clients, local management is also responsible for tailoring services (e.g., in terms of training and quality control) to the demands of third party client firms.

If third party client firms outsource their customer relationship management functions to teleservices firms, do the teleservices firms also outsource parts of their value chains? In particular, is the call center stage of the teleservices value chain typically insourced or outsourced? I argue that all stages in the teleservices value chain are typically performed in-house; that is, teleservices firms (at least at present) do not outsource their value chains. One might expect the call center stage to be outsourced given that it appears to be a low-tech, low-value added stage of the value chain. For example, UNCTAD (2004: 151) places call centers in the low-skill services category:\(^2\)

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\text{Low-skill services. These are services with the lowest entry barriers in terms of skills, scale and technology. They include data entry or call centres (although some call centres require higher}
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\(^1\) Gans, Koole and Mandelbaum, 2003

\(^2\) UNCTAD, 2004
skills, computer or technical support). They tend to need general – but not very high – levels of formal education, a working knowledge of the relevant language and/or basic computer skills. There are generally few economies of scale or agglomeration: a call centre may be viable with 30 operatives in a site where there are no similar centres or knowledge institutions. The level of development of other services or manufacturing is not necessarily important for competitiveness in such activities. For this reason, there are likely to be few positive spillovers in terms of supplier linkages or skills creation.

Figure 3 below, adapted from A.T. Kearney (2004), illustrates this point, by comparing the maturity and complexity of offshore information technology and business process services. Level 1 services are primarily (but not all) teleservices services, which have low functional complexity and high maturity of the supply market (that is, high competition). Call centers (the black square) are clearly graded as low functional complexity.

[Figure 3 goes about here]

Why are call centers typically not outsourced? I argue that, despite their low-level of complexity and skill, quality control of call centers is a critical factor in the overall success of a teleservices firm. Casson (1982) argued that the high transaction costs associated with ensuring quality control of arm’s length suppliers were the major reason for vertical integration in perishable fruit industries such as bananas. A reputation for high quality enabled firms like Dole and Chaquita to charge significantly more for perishable fruit, thus making insourcing profitable. Quality control has also been a critical factor in determining which functions manufacturing firms have kept in-house rather than outsourced. Similarly, I argue that that in business services such as teleservices, brand reputation is based on the firm’s ability to deliver consistently high-quality services. The need to monitor for quality requires insourcing of the teleservices firm’s activities including the low-skilled call center stage. That is, third party clients are willing to outsource their inbound and outbound call activities if the teleservices firm can guarantee a high-quality product tailored to the needs of the specific client. This means the call center stage must be internalized within the teleservices firm.
A related issue is the level of general services provided at the call center stage of production. AMR Research (http://www.amrresearch.com) argues that there are three levels of sophistication in call center operations: low, medium and high. Table 3 below gives examples of each type of call center. I argue that the higher the level of services, the greater the need for quality controls and the more likely that call center services are internalized within the teleservices TNC.

[Table 3 goes about here]

Now I turn to analyzing which stage or stages of the teleservices value chain have been offshored and why, and where they have gone. Typically, it is only the call center stage of the value chain that has been offshored and assigned to subsidiaries (Gans, Koole and Mandelbaum, 2003; A.T. Kearney, 2004c; Plakias, 2003). The other stages of the value chain are typically performed by the TNC parent in the home country (shaded in gray in Figure 2). Since most of the MNEs in this industry are US firms, this suggests that the teleservices industry today consists of US parents performing the gray-shaded functions and their wholly owned subsidiaries performing the call center stage of the value chain.

UNCTAD (2004: 158) notes that, “In the call centre industry, the largest contract services providers include Convergys, ITC Group, Sitel and Sykes – all from the United States”. These firms have call centers in Argentina, Brazil, Canada, Colombia, India, Indonesia, Jamaica, Mexico, Morocco, the Panama, Philippines, South Korea, Singapore, Sri Lanka, Taiwan and Thailand – a veritable “alphabet soup” of countries. The Report (2004: 161) also notes that “more than half the 500 FDI projects in call centres recorded in 2002 and 2003 went to developed countries, notably Canada, Ireland and the United Kingdom”; but the “preferred locations for call centres in the near future include India, the Philippines, China, South Africa, Mauritius and the United Arab Emirates”. Table 4 below shows the country distribution of call center FDI projects in 2002-2003.

[Table 4 goes about here]

What are the main factors attracting call centers to particular locations? UNCTAD (2004: 161) argues that, “geographical and psychic distance to markets matters, as do linguistic, cultural and other affinities – and that costs are not the only determining factor”. The report states that labor costs are 50-70
percent of total costs for call centers located in developed countries (e.g., Canada, Ireland), and that cost
savings in the range of 30-40 percent can be achieved by moving to India (2004: 165). However, cost
savings are not the only factor determining FDI location for call centers. Quality of services, quality of
telecommunications infrastructure, availability of labor skills, language skills, staff attrition and turnover,
cultural affinity, and the time zone also matter. Moreover, government policies, in particular, location
subsidies, can be important when choosing between otherwise similar locations.

Therefore, the teleservices industry tends to be insourced and offshored (cell 3 in Table 1). Through
*insourcing*, the teleservices TNC can enforce similar quality and standards of performance across all its
call centers. The TNC can monitor performance and ensure that the needs of third party clients are met at
a consistently high level. Economies of scale and scope can be exploited at the firm level. Through
*offshoring*, the teleservices TNC can take advantage of abundant semi-skilled labor and good ITES
infrastructure in other countries.

I now turn to an economic analysis of transfer pricing in this industry, based on the facts and
circumstances presented above.

**IV. TRANSFER PRICING OF TELESERVICES IN THEORY**

Firms in the teleservices industry are vertically integrated transnational corporations where the
upstream stage provides the full range of teleservices (the parent) and the downstream stage (the
subsidiaries) provide call center services. Moreover, these MNEs are also horizontally integrated MNEs
since there are several call centers all offering basically the same or similar services (inbound and
outbound call activities) to the same or similar customers (customers of third party clients).

As such, I can apply traditional microeconomic theory of the TNC (Eden, 1998) to analyze the firm’s
activities. Figure 2 simplifies the analysis by assuming the parent firm (PAR) wholly owns two call center
subsidiaries, one call center in the United States (USCO) and one in Canada (CANCO), both providing
identical services to customers of third party clients. The TNC parent is assumed to have some price
setting ability in terms of its negotiations with third party firms, and therefore its demand curve, DPAR, is
downward sloping. $D_{\text{PAR}}$ shows the actual price paid by third party clients for the services provided by the TNC’s subsidiaries. For simplicity, I assume all third party clients are charged the same price per unit of service, $P_X$, regardless of which call center provides the service and the nature of the services provided.\footnote{The volume of these services, $X$, equals the sum of the services provided by each of its call centers; that is, $X = X_{\text{US}} + X_{\text{CA}}$. Thus, total revenues received by the TNC equal the revenues generated by the call centers, that is, total revenues equal $P_X (X_{\text{US}} + X_{\text{CA}})$.}

From previous work on this topic (Eden, 1998), for profit maximization, ignoring tariffs, corporate taxes and other market barriers, a vertically and horizontally integrated TNC will set:

$$\text{MR}_{\text{PAR}} - \text{MC}_{\text{PAR}} = \text{NMR}_{\text{PAR}} = \text{MC}_{\text{US}} = \text{MC}_{\text{CA}} = \text{p}$$

(1)

where $\text{MR}_{\text{PAR}} - \text{MC}_{\text{PAR}}$ equals the net marginal revenue, $\text{NMR}_{\text{PAR}}$, the parent firm receives on its own activities; that is, $\text{NMR}_{\text{PAR}}$ equals the marginal revenues the TNC parent receives from third party clients, $\text{MR}_{\text{PAR}}$, minus the costs of its own activities, $\text{MC}_{\text{PAR}}$ (management, marketing, business services, process technology development, and so on). This is the vertical integration component; the TNC equates its net marginal revenues from its own activities to the marginal cost of its subunit’s activities, assuming the TNC consists of two plants, one upstream and one downstream. The parent’s activities can be either upstream or downstream from its subsidiary’s activities.

The horizontal integration comes from there being more than one plant at the same stage of the value chain, in this case, the call center stage. The TNC, for profit maximization, allocates output production between the plants such that the marginal cost is the same across all the call centers. With two call centers, profit maximization requires $\text{MC}_{\text{US}} = \text{MC}_{\text{CA}}$.

The *efficient* transfer price $\text{p}$ is the Lagrangian on the constraint that all output is sold (Eden, 1998). This is the opportunity cost of producing $Q_X$. In the absence of an external market price, the efficient transfer price is the transfer price that equates $\text{NMR}_{\text{PAR}}$ to the marginal cost of each of the subunits. Thus, each subunit gets a transfer price that just covers its marginal production costs. This price is clearly lower than the price charged by the TNC to third party clients, $P_X$, because that price must cover not only the call centers’ activities but also the parent’s activities. The efficient transfer price is also the profit-
maximizing transfer price in the absence of an external market price in a world without tariffs and nontariff barriers (Eden, 1998).

However, if an external market does exist for this product (that is, if there are other producers of call center services willing and able to supply this market) then the Hirshleifer Rule (Eden, 1998) says that, barring interdependencies, the efficient (and profit-maximizing) transfer price is the external, or arm’s length, market price. This is shown in Figure 4 below, which consists of three graphs. All three graphs have the same vertical axis (price) and horizontal axis (quantity). Starting in the middle graph, with the TNC parent firm, net marginal revenue, NMR\textsubscript{PAR} is the vertical distance between the MR\textsubscript{PAR} and MC\textsubscript{PAR} curves. Thus, NMR\textsubscript{PAR} intersects the horizontal axis at point b, which is directly below point a where MR\textsubscript{PAR} = MC\textsubscript{PAR}. The net marginal revenue curve is then plotted in the top graph. The bottom graph shows the marginal cost curves for the two call centers, with MC\textsubscript{US} being higher than MC\textsubscript{CA} reflecting the assumed lower costs of production in Canada than in the United States. The two marginal cost curves are horizontally summed as the $\sum$ MC curve; this curve is reproduced in the top graph. Where $\sum$ MC intersects NMR\textsubscript{PAR} satisfies equation (1) and maximizes profits for the TNC as a whole. This is point e with output $X_0$ in total, $X_{US}$ from the US plant and $X_{CA}$ from the Canadian plant.

[Figure 4 goes about here]

The efficient transfer price is $p$ (directly across from point e) and the arm’s length price to the third party clients is $P_x$ (point f on the demand curve, which is directly above point e). The transfer price $p$ divides the total profit of the TNC between the two call centers and the parent firm. Total profit (in the absence of fixed costs, which would have to be deducted here) is measured by triangle 0ge in the top graph (the area under the net marginal revenue curve for the parent firm and over the summed marginal cost curve for the subsidiaries). Total profit is therefore the sum of area 2 (which goes to the TNC parent) and area 1 (which is split between the two subsidiaries depending on their cost curves, the subunit with the lower cost getting a higher share of the profits). Area 2 (the parent’s profit) is shown in the top two graphs, and area 1 (the subsidiaries’ profits) in the top and bottom graphs.

It should be clear from the graph that the transfer price, and therefore the split in profits, is
determined by the elasticity of the NMR\textsubscript{PAR} and $\sum$ MC curves. Making either curve flatter or steeper shifts the allocation of profits. For example, the more elastic (flatter) is NMR\textsubscript{PAR}, the smaller is area 2. Elasticity is primarily driven by availability of substitutes and degree of competition in the marketplace (and by time, since elasticity rises over time as the availability of substitutes increases and contracts can be rewritten). Thus, the better the substitutes and more competition the TNC faces in the output market for teleservices the more elastic NMR\textsubscript{PAR} will be and the smaller will be area 2.

Similarly, the more elastic is the $\sum$ MC curve, the smaller is area 1. The elasticity of the call centers’ supply (marginal cost) curves depends primarily on the costs incurred in purchasing factor inputs, primarily labor costs. The better the substitutes and the more competition in factor and input markets in each of the call center locations, the flatter will be the marginal cost curves for the subsidiaries, and the lower will be area 1. Since call centers are a labor-intensive activity and typically located in areas where labor costs are low and low skilled labor is in plentiful supply, marginal cost curves for the call centers should be relatively elastic. Moreover, because the level of labor skills is not high (Grade 12 education plus training), closing down a plant to shift production to a lower cost location is a relatively easy activity in this industry compared to, for example, a manufacturing industry like autos. This also increases the elasticity of the marginal cost curve, particularly over the longer term when capital mobility is possible.$^5$

I have assumed so far that there are no other arm’s length suppliers of call center services in the places where the TNC’s subsidiaries are located. If an external market in call center services exists, the TNC could simply have contracted out for these services to an arm’s length provider. The Hirshleifer Rule (Eden, 1998) says that if an arm’s length price exists, the profit maximizing TNC will accept this price as the efficient (and profit maximizing) transfer price. This is the case except where (1) the external product is not comparable with the TNC’s product (note, however, that if differences can be quantified the transfer price can be adjusted for these differences) and/or (2) there are interdependencies on the supply or demand side that are not taken account of in the external price (e.g., intrafirm economies of scale or scope or synergies).
V. TRANSFER PRICING OF TELESERVICES IN PRACTICE

What is the appropriate transfer pricing methodology for the TNC to use in intrafirm transactions with its foreign subsidiaries? Two sets of government regulations come into play here: the home country’s regulations, which apply to the TNC’s overall corporate profits, and the host government’s regulations, which apply to the foreign subsidiaries. Both governments probably adhere to the arm’s length standard under the OECD transfer pricing guidelines (OECD, 1995), but there are often differences between the two sets of regulations (Eden, 2001). Moreover, where more than one transfer pricing method can be used in a particular situation, each government is likely to choose the method that shifts income into its jurisdiction and therefore makes it taxable. This causes tax disputes between governments, where the TNC is caught in the middle.

In the case of our example with a US parent and a Canadian subsidiary, both countries do follow the arm’s length standard and the Canadian regulations are based on the US regulations (Eden, 2000; Eden, Dacin and Wan, 2001). One problem is that these rules were developed for a world where most intrafirm transactions involved manufactured goods and natural resources. As a result, the rules for intrafirm transactions in services and intangibles are much less developed. In fact, the US regulations for intercompany services have recently changed (Anwar et al., 2004). The new regulations follow the traditional transfer pricing regulations for manufacturing firms, but adapt them to services. The core methods are the comparable uncontrolled services price (CUSP) replacing CUP, the gross services margin method (CSM) replacing the resale price method, the cost of services plus method (CSP) replacing cost plus, and versions of CPM and profit splits replacing their manufacturing counterparts. I examine each of the main transfer pricing methods below.

A. CUSP or CUP

The OECD regulations prefer the use of the CUP method, if an exact CUP exists, or adjustments can be made to an inexact CUP. There are only a few possible CUPs at the call center stage. First, the call center subsidiaries may be selling call center services (inbound and outbound transactions) on an external market, and if those transactions existed and were sufficiently similar in type, size and market, that
external market price might be suitable for a CUP. Second, there may be available contractual providers of call center services, willing to contract with the TNC parent to provide only call center activities. A third possibility would be to look at contractual providers of call center activities (if such firms exist) in another country where there is public information available, and attempt to quantify the geographic market differences.

As I have argued above, however, quality control issues and the need to tailor activities closely to the demands of third party clients, have led teleservices MNEs to internalize the call center stage of the value chain; thus, there are not large numbers of external firms available offering to contract for these services. As a result, an external market in call center services does not exist and none of these approaches to determining a CUP appears to be likely. To the extent that teleservices MNEs all insource their call center activities, there are no exact or inexact arm’s length prices.

Interestingly, there are CUPs, but not at the call center stage. Each contract between a teleservices TNC and a third party client is a CUP so each teleservices TNC will have several CUPs. Moreover, the teleservices industry is competitive, with large numbers of suppliers and buyers (Plakias, 2003), so that there are multiple good arm’s length prices available for teleservices industry as a whole, also. However, this CUP represents all the costs of the services provided by the TNC to its clients, not just the services at the call center stage, and therefore rewards all the functions performed, intangibles held and risks borne by the TNC as a whole. It is therefore an inappropriate transfer price.

The problem is illustrated in Figure 5 below, which shows a teleservices parent firm undertaking the activities outlined in the value chain (see Figure 3), and its call center subsidiary. The parent firm undertakes the functions and risks associated with box A (Parent Costs) on which it earns a gross margin (area B) commensurate with other teleservices firms in the industry. In addition, the parent owns production intangibles (area C) based on process and/or product technologies that it has developed in-house capabilities. These may or may not be protected by patents. The firm also owns marketing intangibles, such as its brand name and reputation (box D). Another possibility is management intangibles if the firm has superior management routines developed over time that are tacit in nature (box E). From
the call center perspective, the call center incurs its own costs and possibly some risks (box H) with a
gross markup commensurate with what other call centers are receiving (area G). The call center may also
have some production intangibles associated with superior higher quality production, process
technologies developed in-house at the subsidiary level, and so on. These may or may not be patented.7

[Figure 5 goes about here]

The transfer pricing issue is to split the total profit (boxes A through H) between the parent TNC and
its call center subsidiaries. The problem is that there are no CUPs for valuing the call center’s activities.
There are CUPs that can be used to value the sum of boxes A through H, but not to split the profit
between the teleservices parent and its subsidiaries.

B. Gross Services Margin Method or Resale Price Method

The fact that the only CUPs are likely to the prices negotiated by teleservices MNEs and their third
party clients suggests that one method for determining the arm’s length price might be to use the resale
price method and back out the returns to the TNC, leaving the residual for the call centers. However, there
are serious problems with this proposal.

First, because of the continuum price problem, the cost plus and resale price methods lead to quite
different splits of the profits between the related parties: the resale price method shifts the unallocated
profits to the upstream manufacturer; the cost plus method shifts the unallocated profits to the
downstream distributor (Eden, 1998). Allocating a market-based return to a manufacturing unit (in this
case, the call center subsidiary) and a market-based return to the distributor (in this case, the parent),
typically leaves an unallocated amount of profit (area I) between the related parties. This can occur even
after accounting for all known and measurable intangibles. The “leftover profit” occurs because of the
way that the resale price method and cost plus method treat the activities of the related parties. In effect,
each method is one-sided, looking only from the perspective of one party to the transaction and treating it
as a contractual provider of services. For example, the resale price method treats the parent as a
contractual provider of teleservices to the call center, and allocates all residual profits to the call center
stage of production. The cost plus method, on the other hand, treats the call center as a contractual
provider of call center services, and allocates all residual profits to the parent firm. The resale price method therefore is inappropriate because it allocates too much profit to the call center subsidiaries.

A second problem is that the resale price method works best when the tested party has little or no intangible assets. The equivalent would be to assume that the parent firm’s activities involve only area A so that all that must be valued is the gross margin (area B). However, as I argued above, the value chain of the typical teleservices TNC places all the core activities with the parent firm (the shaded areas in Figure 2). Thus, the parent firm is the only unit with significant intangibles and therefore the resale price method is inappropriate here.

C. Cost of Services Plus (CSP) or Cost Plus Method

A third possibility is the cost plus method. From the perspective of the TNC parent, the question is what gross markup the TNC would have to pay an arm’s length contractor to provide the call center stage of the value chain rather than use its own in-house subsidiaries. If there is an external market with several possible outside suppliers of call center services, the opportunity cost to the TNC of an in-house supplier is the markup over costs that would be charged by an arm’s length call center. While the cost plus method, like the resale price method, suffers from the continuum price problem, I see this as much less problematic in teleservices. Moreover, the call center is the appropriate tested party since it has the simplest activities with the least intangibles. The key issue is determining the appropriate gross markup.

The call center stage is a service provider and should be rewarded with a gross margin based on its functions performed, risks assumed and own intangibles. The gross margin should not be large since this activity is not sophisticated and the typical call center assumes little risks and owns little intangibles. Under the cost plus method, all remaining returns would be allocated to the parent firm. In terms of Figure 5, the parent firm receives its normal return for the functions, assets and risks on behalf of its subsidiary (areas A + B + C + D + E) plus any residual profits (area I); the call center subsidiary receives its normal return for its functions, assets and risks (areas F + G + H).

D. Other Methods

Another possibility is to use CPM or its “OECD cousin”, TNMM. The tested party should be the call
center unit because it has the least and simplest functions. However, since call centers are typically in-house operations, it is impossible to use transfer-pricing resources such as COMPSTAT or WORLDSCOPE, for example, to determine a net margin for comparable service providers.\(^8\) The only metric available would be net returns of other teleservices MNEs, defeating the purpose of allocating profits between the parent and its subsidiary.

Profit splits are the last method considered here. Under the residual profit split (similar to the old BALRM, basic arm’s length rate of return method), both parties would be given a normal return (using either a gross margin method or TNMM) for their own activities, and then a valuation placed on each of their intangibles. However, that still leaves a remainder (area I in Figure 5) to be allocated between the parent and its subsidiary, which I argue belongs to the parent firm. Few all center subsidiaries own and/or have developed intangible assets of their own (area F), and therefore a residual profit split seems an extraordinary amount of work here. A residual profit split would involve having to put an arm’s length valuation on each of the intangibles held by the parent, a tricky business at best, in addition to valuing the primary activities performed by each party and the support activities performed by the parent firm. This is far more work than would be involved in the cost plus method.

So far, I have not focused on the primary motivation for offshoring business services: the potential location savings. A key transfer pricing issue is likely to be the question of location savings, and their allocation (if the savings exist) between the parent and its foreign subsidiaries (and thus, between the taxing authorities in the home and host countries). I turn to this below.

VI. WHO GETS THE LOCATION SAVINGS?

Location savings are the “cost savings that an MNC realizes as a result of locating from a high-cost to a low-cost jurisdiction” (Allen et al., 2004: 158), or more succinctly, “the cost savings from operating in a cheaper location” (Eden, 1998: 245). Location savings become a transfer pricing issue when the producer in the foreign location is owned or controlled by the TNC. In this situation, the price established between the buyer and seller is not an arm’s length price, but a transfer price. All OECD countries require
transfer prices to follow the *arm’s length standard*, whereby the transfer price is based on the price that two unrelated firms would negotiate if the same or similar product were traded under the same or similar circumstances as the related party transaction.

Therefore, thinking about location savings wholly from a transfer pricing perspective suggests several extensions. First, location savings apply to a subunit owned or controlled by the multinational where the subunit produces outside of the home country. Second, location savings are *relative measures* as they are defined for one particular location relative to another. This means that the location must be defined as *specifically* as possible since the measure applies to a particular producer in a particular location at a particular point in time. A different producer in the same location at the same point in time could well produce at a higher or lower cost. A different location within the same host country could also easily involve different amounts of cost savings. In addition, lastly, the cost savings could easily vary over time as, for example, wage rates or productivity levels change. Moreover, the two locations do not have to be the home and host locations, but could involve two host countries (e.g., Canada and India), where the issue is the amount of cost savings from relocating from one host location to another.

Third, location savings are measured as *net savings* since most locations involve some costs that are lower and others that are higher, when two jurisdictions are compared. Labor costs may be lower in location X, but energy costs lower in location Y. Therefore, net savings must be computed between the two locations. Fourth, exchange rates matter in determining the location savings since location savings must be measured in a common currency. Most multinationals probably use the local currency in their subunit and consolidate financial statements on an annual basis in the home currency. Who bears the foreign exchange risk therefore becomes an issue in determining the arm’s length transfer price.

Fifth, location savings ignore the revenue side of the balance sheet and concentrate only on the difference in production costs in two locations. However, revenues can also vary between locations. Microeconomic theory (Eden, 1998) tells us that the TNC allocates production between two locations based on their relative marginal costs, and allocates sales between two locations based on their relative marginal revenues. Therefore, the volume of intrafirm transactions is affected by *both* marginal costs and
marginal revenues. This implies that, because all firms (including MNEs) respond to price signals, the volumes of production and sales are likely to be different in the two locations. It is therefore important to distinguish between location savings measured on an ex ante or ex post basis.

The ex ante calculation of location savings involves asking how much the TNC would save simply from the drop in costs, holding all other things constant (production levels, factor intensity, product price). In effect, the ex ante calculation measures the location savings from the original location’s perspective. For example, assume production currently takes place in the United States by the US parent and the parent shifts production to Canada, creating a new subsidiary. The ex ante calculation of location savings is based on the parent’s point of view (assuming the alternative location was production in the Home country), comparing costs in Canada to costs in the United States, using the original US information (price, quantity, costs). The ex post calculation, on the other hand, measures location savings after the TNC has closed its domestic location and opened operations in the host country; thus, the location savings are measured from the new location’s perspective.

Which of the two approaches – ex ante or ex post – is better? There is no unambiguous answer to this question, but three observations can be made. First, from the TNC’s point of view, the strategic issue is the determination of where to produce, so the ex ante figures are the critical perspective. The firm must compare its current location with other possible locations so the initial location is the appropriate base case. Second, from the tax authority’s perspective, when it goes to determine the arm’s length transfer price, the available information is the current, that is, the ex post, situation. The output, price, costs, and so on of the current producer are known. The hypothetical situation, for comparison, is with the original location, which may or may not still be in production. Third, from an economist’s perspective, the issue is similar to the construction of price indexes. The Paasche index is based on the original price \(((P_1 - Po)/Po)\); the Laspeyres index on the new price \(((P_1 - Po)/P_1)\). The preferable measure is a blend of the two: \(((P_1 - Po)/(P_1 + Po)/2)\). Price index professionals, like transfer pricing professionals, understand the problem, but go ahead and use the most readily available.

Lastly, a key issue in the location savings is not simply measuring the total size of the savings. From
a transfer pricing perspective, the key issue is *allocating the savings between the buyer and the seller*; that is, how much of the location savings belong to the buyer (s/he gets a price break) and how much to the seller (s/he gets to keep some of the location savings)?

Economic theory tells us that the allocation of gains between two parties depends on their *relative bargaining power*, which depends on the goals, resources and constraints on each of the parties (Allen et al., 2004: Eden, Lenway and Schuler, forthcoming). The stronger the resources or core competencies (e.g., tangible and intangible assets) held by one party, the greater its bargaining power. The strength of one’s resource base, in bargaining theory, is always measured from the other party’s perspective. For example, suppose a distributor and a manufacturer are engaged in bargaining. The manufacturer owns product intangibles that produce a unique product that the manufacturer wants to sell in a local market; the distributor owns access to all the distribution channels in that market. Relative bargaining power depends on the valuation each party places on the other party’s resources. The stronger the valuation the manufacturer places on the distribution channels owned by the distributor, the greater the distributor’s bargaining power. The stronger the valuation the distributor places on the product (and thus on the product intangibles) owned by the manufacturer, the greater the manufacturer’s bargaining power. Therefore, the intangibles held by each party are an important factor in allocating location savings between buyer and seller.

Let me relate this to the teleservices industry case. In teleservices, the parent firm normally has developed and owns valuable intangibles (production, marketing and managerial assets) that are essential to its competitive advantage as a teleservices firm. These intangibles are what distinguish one teleservices firm from other teleservices providers, and what lead third party firms such as MCI and UPS to outsource their customer relationship management activities to one particular teleservices firm rather than another. On the other hand, call center subsidiaries typically have little or no intangible assets of their own nor hold any unique assets that are not available through other channels. For example, call center subsidiaries normally do not own a unique distribution channel, control the only labor supply available for a particular activity, own the only raw material (e.g., bauxite) that can be used in a particular refinery (e.g., alumina).
This suggests the larger share of profit should go to the parent firm, reflecting its greater share of the activities, intangibles and risks. Moreover, economists tell us that the elasticity of demand and supply is also critical here. Elasticity of supply is determined by the number of alternative sellers (suppliers) and the degree of competition among the suppliers. If there is high competition (large numbers of sellers) the price elasticity of supply is high and the supply (marginal cost) curve is quite flat. If there are few suppliers and/or competition is very low, then the supply curve is inelastic and quite steep.

I explore these arguments using Figure 3, where the value chain graph shows the activities (primary and support) performed by each of the parties. Relative bargaining power depends on how critical each party views the other’s activities. If one party were to replace its in-house partner with an arm’s length partner, how easy would that be to do? Elasticity of demand and supply tells us which party is easier to replace. In the absence of the call center subsidiary, the parent could either provide the call center stage itself (and may well do so) or shift its operations to another country (e.g., India, the Philippines) or (if it were willing to do) contract out the call center stage to an arm’s length supplier in the host country. The number of alternatives is high for the parent firm in terms of its choices for the call center stage of the value chain. Moreover, the elasticity of factor supply to the call center stage is also high since the work involves typically a high school education as a minimum. On the other hand, in the absence of the parent firm, the call center would have to either scale up and perform all the activities that its parent currently provides (the shaded areas in Figure 3) or contract with another teleservices TNC to provide these activities. Elasticity therefore implies that relative bargaining power remains with the parent firm.

Note that, as time passes, the supply and demand elasticities will both rise. In the short run, the number of available alternatives is small and so the price elasticity is lower. However, unless there are strong barriers to entry into this industry, high profits (rents) attract new firms and the elasticity rises. The teleservices industry is clearly labor intensive and mobile; thus, firms can move plants from one location to another relatively easily. This mobility increases in the long run when all costs are variable costs.

In the figures below, I explore the allocation of the location savings from an ex ante perspective, looking at location savings from the TNC’s viewpoint. Assume that the teleservices firm consists initially
of the parent firm and a US domestic subsidiary. The parent is contemplating closing its US subsidiary and opening a new subsidiary in Canada to take advantage of the location savings. The per-unit location savings is shown by the vertical downward shift in the marginal cost curve; that is, $MC_{US} - MC_{CA}$ measures the per-unit location savings, between Canada and the United States, at the call center stage of the value chain. The issue, therefore, is the total amount of the location savings and their allocation between the buyer (the US parent) and the seller (the Canadian subsidiary CANCO). The figures do not tell us the reason behind the location savings, just that they exist and can be measured. Note that all prices and costs in Figure 6 are in a common currency, assumed the US dollar. There are several possible cases, depending on the elasticities of demand and supply. I show two cases. In Figure 6, I assume that the marginal cost curve for the call centers are very flat, reflecting the high substitutability and low intangibles at this stage of the value chain.

With some simplifying assumptions, it is possible to do a quick analysis of how the location savings are distributed in Figure 6. Point a represents the base case (the call center is located in the United States). Total profit of the TNC is represented by the area under the NMR$_{PAR}$ curve and over the $MC_{US}$ curve, that is, by area 1 plus area 2. The transfer price $p$ splits the profits between the buyer and seller, with the parent (the buyer) getting area 1 and the seller, the subsidiary, getting area 2.

Assume $MC_{CA}$ is parallel to, and lies below, $MC_{US}$ by the distance ab. This distance represents the per-unit location savings that the firm could earn if it closed the US subsidiary and shifted production to Canada. Suppose this occurs. The new lower costs encourage expansion of output and the new equilibrium is at point c. Total profit of the TNC has now expanded to the area under NMR$_{PAR}$ and over $MC_{CA}$, that is, to areas $1 + 2 + 3 + 4 + 5 + 6 + 7$. The net gain in TNC profit is areas $3 + 4 + 5 + 6 + 7$. Because I assumed the two MC curves were parallel to one another, by construction areas $3 + 5 + 7$ must equal areas $2 + 3 + 5$, which means area 2 equals area 7. Thus, the overall gain in TNC profit due to the location savings is areas $2 + 3 + 4 + 5 + 6$, which equals rectangle $p$abd plus triangle abc. The efficient, and profit-maximizing, transfer price $p^*$ is determined by the intersection of NMR$_{PAR}$ with $MC_{CA}$ at point
c. Thus, the parent firm receives areas 3 + 4, while the subsidiary receives areas 5 + 6. The flatter the marginal cost curves at the call center stage, the greater the share of profit going to the parent firm.

In the long run (five years?), looking ahead to the competition from India and the other countries in Table 5, one might expect the subsidiary’s cost curve to be almost horizontal, implying all or almost all location savings should accrue to the US parent. This situation is illustrated in Figure 7. Assume, again, that the teleservices TNC consists of a US parent and its domestic subsidiary. The original equilibrium is at point a. Because $MC_{US}$ is flat, all the profit (area 1) goes to the parent. If the parent closes the US affiliate and shifts production to Canada, substantial location savings are made (area 2). The TNC expands production based on these savings, so the new equilibrium is at point c. Total profit is now areas 1 + 2 + 3, but because $MC_{CA}$ is flat, all the location savings accrue to the US parent. The subsidiary receives a normal rate of return for its services, but no more.

[Figure 7 goes about here]

One last issue related to location savings is the question of whether they remain with the TNC (parent plus subsidiaries) or are moved downstream to the third party clients. This issue also depends on the goals, resources and constraints on the two parties, where the parties are now the teleservices firm and its third party clients. Since the client firms are typically Fortune 500 firms and there are large numbers of teleservices firms, this suggests that the bargaining power is more likely to be on the side of the Fortune 500 client firms. In that case, the net marginal revenue curve of the parent, $NMR_{PAR}$, will be quite flat, reflecting the high degree of competition in the market for teleservices and the teleservices firm’s relatively low bargaining power vis à vis its third party clients. In this situation, the location savings are likely to be passed to the third party client firms.

VII. POLICY RECOMMENDATIONS AND CONCLUSIONS

All indicators suggest the world economy is at the beginning of a major shift in business services, from in-house onshore activities to outsourced offshore activities. Some argue this is a “second wave” following the “first wave” of manufacturing activities offshore in the 1960s and 1970s. The teleservices
industry is clearly one of the industries at the forefront of this movement. As such, it can provide useful lessons for thinking about other service industries. Understanding the implications of this new trend is a fundamental problem in international business in the 21st century.

The typical teleservices TNC owns several foreign subsidiaries that deliver call center services to customers of third party clients. The parent’s activities are of two types: support activities, and activities both upstream and downstream from the call center stage of production. The call center stage is “in the middle” of the value chain. Its activities are determined by the parent, and all risks (credit, market, foreign exchange) and responsibilities are primarily assumed by the parent.

Teleservices TNCs are therefore both vertically and horizontally integrated. The transfer pricing literature tells us that the optimal transfer price for such a firm equates the net marginal revenue of the parent to the marginal costs of each of the call centers. The optimal transfer price determines how the profits between parent and sub are split. The parent’s profit is determined by the elasticity of the net marginal revenue curve while the subsidiary’s profit is determined by the elasticity of its marginal cost curve. The elasticity of the subsidiary’s marginal cost curve in turn is affected by factors such as costs, skill level and availability of labor. Since call centers are typically located in areas where labor costs are low and skilled labor in plentiful supply, the subsidiary’s marginal cost curve is highly elastic, translating into a smaller share of profits for the call center relative to its parent firm.

If an external market price existed at the call center stage (which appears not to do), the Hirshleifer Rule tells us that this would be the profit-maximizing transfer price. Moreover, transfer pricing regulations, under the OECD’s arm’s length standard, suggest that the best method to be used in this situation is a CUP. However, since an external market price does not exist at the call center stage of the value chain, CUP is not appropriate method in this situation. Moreover, the resale price method is inappropriate because of the intangibles held by the parent firm and because it allocates all residual profits to the call center stage. CPM, or TNMM, is difficult to apply because of the lack of data on profit margins at the call center stage.

In my opinion, the cost plus method (or, as the new US services regulations call it, the cost of
services plus method) is the best method for pricing call center activities. Since the call center stage is basically a contract services provider, the cost plus method – which treats the manufacturer (in this case, the service provider) as a contractor producer and allocates the residual profits to the downstream firm – is the appropriate method. Another possible method would be the residual profit split method. It would give basically the same result but would involve substantially more work (and guesswork) because the individual intangibles would need to be valued. Thus, the cost plus method also dominates the residual profit split.

Because teleservices MNEs “went for cost”, there are usually location savings involved. Economic theory tells us that location savings are allocated between the parent firm and its subsidiary based on relative bargaining power. Relative bargaining power in this situation lies with the party that has the greatest resources and the least constraints on its activities. This is clearly the parent firm because it owns the production, marketing and management intangibles associated with this industry, assumes most or all of the risks, and performs most of the functions. Relative bargaining power therefore favours allocating any residual profits to the parent. In addition, given the low tech nature of call center activities and the ready availability of low skilled labor willing to perform these activities, the economics of the call center stage again support the shift of location savings (to the extent they exist) to the parent firm. The high elasticity of supply for the call center subsidiary implies that location savings to go primarily to the US parent in the short run.

The transfer pricing mantra for teleservices MNEs should therefore be “Went for cost, priced at cost”. However, this may create a real sense of déjà vu; the cost plus method -- what is new here? Three facts may add some additional relevancy and urgency to this discussion.

First, I have been conceptualizing the transfer pricing problem from the viewpoint of the TNC and an anonymous tax authority. However, there are two tax authorities involved here, the home country government (typically, the US Internal Revenue Service in this industry) and the host country government. The argument that the best method rule is the cost plus method allocates the lion’s share of profit back to the TNC parent, increasing the taxable income base in the United States. This should be
welcome news to the IRS. On the other hand, host governments where the call centers are located are also hungry for tax revenue and a cost plus methodology clearly leaves them even hungrier.

The recent moves to develop transfer pricing rules for offshored business services by both the US and Indian tax authorities are emblematic of the importance and controversy associated with this topic. Unfortunately, simply stating that transfer pricing rules must follow the OECD’s arm’s length standard is not sufficient to avoid controversy and double taxation. From the TNC’s perspective, the worst of both worlds is for both governments to use gross margin methods: cost plus by the home government (shifting the bulk of profits to the parent) and the resale price method by the host government (shifting the bulk of profits to the subsidiary). The residual profit caused by the continuum price problem is therefore taxed twice, even though both governments are following the arm’s length principle. As more activities are shifted offshore, the reality of double taxation becomes more and more likely. To the extent that tax authorities better understand the economic principles behind the taxation of business services, such conflicts should be less likely.

Moreover, there are now multiple countries competing to attract call centers. Given the labor-intensive nature of production and the higher mobility of capital in this services industry, any attempt by one host government to tax a call center too highly or double taxation through conflicting transfer pricing methods not resolved at competent authority could easily cause capital flight to another location. While tax havens are not currently major host locations for call center activities, they do offer potential roosting havens for the mobile geese of the 21st century. Again, better understanding of the economics of transfer pricing should help reduce the incentives for capital flight.

One last caveat is in order. I have been assuming that call centers engage in low-skilled teleservices activities with few intangibles. This accurately characterizes most of today’s offshored business services. However, the mantra “Went for cost, Stayed for quality” (Dossani and Kenney, 2003) suggests that the level of skills in these centers is increasing. Moreover, there are a variety of business services now being offshored. For business services that are clearly sophisticated (level three services in Figure 3), the residual profit split method may be a better method for allocating profits between the TNC parent and its
offshore subsidiary than the cost plus method. Therefore, over time, as the quality and complexity of offshored business services increases, I expect the applicability of the cost plus method to decline. Unfortunately, shifting to other methods such as profit splits and TNMM is likely to exacerbate transfer pricing disputes in this sector.

In conclusion, international tax authorities and transnational corporations need to pay close attention to transfer pricing of offshored business services because there are more complications and uncertainties involved in this new area of international commerce than in traditional taxation of manufactured goods. In this paper, I have attempted to outline the problem areas, evaluate the alternatives and propose a solution. “Went for cost, Priced at cost”, at least for the foreseeable future, is the best transfer pricing method, based on an economic analysis of the facts and circumstances, for offshored business services.
ENDNOTES

1 In manufacturing, an individual location is called a plant; in services, a center or site.

2 UNCTAD (2004: 151) says, “medium-skill services…are complex services that require more advanced
skills, and may offer considerable scale economies and agglomeration effects. Examples include financial
and accounting services, standardized programming work, routine data analysis and processing or back-
office services such as ticketing and billing. Specialized training would generally be required (and so also
the necessary training institutions). The building of competitive capabilities may also call for a large local
market where the skills accumulate over time. Some services may require a minimum critical mass of
different skills in one location to provide the whole package.” Call centers clearly cannot be considered
medium-skilled services.

3 Gans, Koole and Mandelbaum (2003: 12) argue that service quality in call centers can be measured in
several ways. The first method focuses on the accessibility of agents (How long did the wait time on the
telephone before speaking to an agent? How many callers abandoned the queue before reaching an
agent?). The second deals with service effectiveness (Was the customer’s problem resolved or was
additional work required?) The third deals with the content of the agent-customer interaction (Did the
agent manage the conversation flow in the prescribed manner?). The fourth deals with output of the
interaction (Was the customer satisfied?).

4 Obviously, a more sophisticated analysis would incorporate differential pricing for different types of
services provided to different clients from different locations. I ignore these complications here.

5 Changes in the business environment can affect the TNC’s decision-making and profitability. If costs
should change between the plants (for example, the Canadian dollar falls causing MC\textsubscript{CA} to shift
downwards relative to MC\textsubscript{US}), the TNC will shift production from the higher to the lower cost plant. This
would cause a downward shift in MC\textsubscript{CA}, for example, which would then cause the summed marginal cost
curve to shift to the right, intersecting the NMR\textsubscript{PAR} curve somewhere between points e and b. The TNC
would expand production and the transfer price would fall.
6 For a recent analysis of intangibles from a transfer pricing perspective, see Przysuski, Lalapet and Swaneveld (2004).

7 The OECD transfer pricing guidelines refer to these as manufacturing intangibles, which seems an inappropriate term for a service provider. I have therefore called them production intangibles (a more general term).

8 See Eden and Smith (2001) for an analysis of the availability and quality of transfer pricing resources.

9 Quinn and Hilmer (1994) define core competencies as (1) sets of skills or knowledge that cut across traditional functions and allow the organization to consistently perform an activity better than its competitors; (2) flexible, long-term platforms capable of adaptation or evolution to meet customers’ needs over time; (3) unique sources of value that are difficult to duplicate and in which investments in intellectual resources will have the highest payoff; (4) activities where the firm is a market leader and can maintain leadership; (5) elements that relate directly to understanding and serving customers, which the organization can provide at lower cost or more effectively; and (6) activities embedded in the organization’s values, structures, and management systems, which are not dependent on a few talented individuals.

10 The Indian tax authority’s September 2004 circular states in paragraph 6, “In determining the profits attributable to an IT enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of the ‘arm’s length principle’”. While this is a necessary condition, it is not sufficient to avoid international tax disputes. See Fazelbhoy (2005: 36).

11 Ernst & Young (2003) found that 40 percent of all transfer pricing adjustments resulted in double taxation. This percentage will likely increase as business services grow as a percent of international intrafirm transactions.
Figure 1: Modeling a Teleservices TNC

- Call Center Subsidiary
- Call Center Subsidiary
- United States
- Customers of 3rd Party Clients

Countries:
- Canada
- India
- Brazil

Client Firms:
- MCI
- UPS
- Dell

3rd Party Client Firms
Figure 2: The Value Chain of a Teleservices TNC

- **Strategic & Operations Management**
- **Finance & Administration**
- **Technology Development (Product, Process)**

**Back Office Functions**
- Information Systems Services
- Facilities Management

**Call Center Functions**
- Servicing Inbound & Outbound Customer Calls
- Site Training
- Site Recruitment
- Site Quality Control

**Front Office Functions**
- Sales & Marketing to Third-Party Client Firms

Parent Activities

Subsidiaries’ Activities
Figure 3: Maturity and Complexity of Offshore IT and Business Process Services

Source: based on Kearney (2004b).
Figure 4: Profit Maximization by a Teleservices TNC
Figure 5: The Transfer Pricing Problem for a Teleservices TNC

- Teleservices Parent Costs
  - Support Activities
  - Primary Activities
    - Upstream from Call Center Stage
    - Downstream from Call Center Stage

- Gross Margin
- Production Intangibles
- Marketing Intangibles
- Management Intangibles
- Unallocated Profits
- Production Intangibles
- Gross Markup
- Call Center Costs
Figure 6: Location Savings for a Teleservices TNC in the Short Run
Figure 7: Location Savings for a Teleservices TNC in the Long Run
Table 1: Comparing In/Off-shoring and In/Out-sourcing

<table>
<thead>
<tr>
<th>Location of Production</th>
<th>Ownership of Production</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Insourced (internalized)</td>
</tr>
<tr>
<td></td>
<td>Outsourced (externalized)</td>
</tr>
<tr>
<td>Onshore Production</td>
<td>1 Production kept in-house at home</td>
</tr>
<tr>
<td>(home country)</td>
<td>2 Production outsourced to third-parties at home</td>
</tr>
<tr>
<td>Offshore Production</td>
<td>3 Production by foreign affiliates in a host country</td>
</tr>
<tr>
<td>(foreign country)</td>
<td>4 Production outsourced to third-parties abroad</td>
</tr>
</tbody>
</table>

Table 2: Country Scores for Offshoring Business Processing Functions, 2004

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>Canada</th>
<th>Mexico</th>
<th>Brazil</th>
<th>Hungary</th>
<th>Ireland</th>
<th>Australia</th>
<th>Czech Rep</th>
<th>Philippines</th>
<th>Russia</th>
<th>China</th>
<th>AVG</th>
<th>India /AVG</th>
<th>Canada /AVG</th>
</tr>
</thead>
<tbody>
<tr>
<td>COST (40%)</td>
<td>3.4</td>
<td>1.5</td>
<td>3.0</td>
<td>3.1</td>
<td>3.1</td>
<td>1.8</td>
<td>2.0</td>
<td>3.1</td>
<td>2.9</td>
<td>3.1</td>
<td>3.1</td>
<td>2.74</td>
<td>1.24</td>
<td>0.55</td>
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<td>COST RANK</td>
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<td>7</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>6</td>
<td>5</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Labor cost</td>
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<td>2.2</td>
<td>2.5</td>
<td>2.4</td>
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<td>1.3</td>
<td>2.4</td>
<td>2.5</td>
<td>2.7</td>
<td>2.6</td>
<td>2.12</td>
<td>1.37</td>
<td>0.38</td>
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<tr>
<td>MGMT &amp; infrastructure costs</td>
<td>0.2</td>
<td>0.4</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.28</td>
<td>0.71</td>
<td>1.42</td>
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<td>Tax/treasury impact</td>
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<td>0.3</td>
<td>0.4</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
<td>0.4</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
<td>0.34</td>
<td>0.88</td>
<td>0.89</td>
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<td>ENVIRONMENT</td>
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<td>2.6</td>
<td>1.9</td>
<td>1.8</td>
<td>1.6</td>
<td>2.5</td>
<td>2.3</td>
<td>1.6</td>
<td>1.7</td>
<td>1.4</td>
<td>1.1</td>
<td>1.83</td>
<td>0.87</td>
<td>1.42</td>
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<td>ENV RANK</td>
<td>7</td>
<td>4</td>
<td>5</td>
<td>7</td>
<td>2</td>
<td>3</td>
<td>7</td>
<td>6</td>
<td>8</td>
<td>9</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Intellectual property</td>
<td>0.3</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.4</td>
<td>0.4</td>
<td>0.2</td>
<td>0.4</td>
<td>0.3</td>
<td>0.1</td>
<td>0.30</td>
<td>1.00</td>
<td>1.33</td>
</tr>
<tr>
<td>Geographic proximity</td>
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<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>0.2</td>
<td>0.31</td>
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<td>1.62</td>
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<tr>
<td>Cultural compatibility</td>
<td>0.3</td>
<td>0.5</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.32</td>
<td>0.94</td>
<td>1.57</td>
</tr>
<tr>
<td>Country infrastructure</td>
<td>0.3</td>
<td>0.4</td>
<td>0.2</td>
<td>0.3</td>
<td>0.2</td>
<td>0.5</td>
<td>0.5</td>
<td>0.2</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.30</td>
<td>1.00</td>
<td>1.33</td>
</tr>
<tr>
<td>Risk (economic, political, government support)</td>
<td>0.5</td>
<td>0.8</td>
<td>0.6</td>
<td>0.5</td>
<td>0.6</td>
<td>0.9</td>
<td>0.8</td>
<td>0.6</td>
<td>0.5</td>
<td>0.4</td>
<td>0.4</td>
<td>0.60</td>
<td>0.83</td>
<td>1.33</td>
</tr>
<tr>
<td>PEOPLE (30%)</td>
<td>2.3</td>
<td>2.1</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.5</td>
<td>1.4</td>
<td>1.0</td>
<td>1.1</td>
<td>1.1</td>
<td>1.0</td>
<td>1.37</td>
<td>1.68</td>
<td>1.53</td>
</tr>
<tr>
<td>PEOPLE RANK</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>3</td>
<td>4</td>
<td>8</td>
<td>7</td>
<td>7</td>
<td>8</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Employee retention</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.24</td>
<td>1.25</td>
<td>1.69</td>
</tr>
<tr>
<td>Language barriers &amp; literacy rates</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>0.39</td>
<td>1.03</td>
<td>1.28</td>
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<tr>
<td>Education level</td>
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<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.2</td>
<td>0.4</td>
<td>0.2</td>
<td>0.1</td>
<td>0.24</td>
<td>1.67</td>
<td>2.12</td>
</tr>
<tr>
<td>Size of labor market</td>
<td>0.4</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.3</td>
<td>0.17</td>
<td>2.35</td>
<td>0.58</td>
</tr>
<tr>
<td>Outsourcing experience</td>
<td>0.8</td>
<td>0.6</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.34</td>
<td>2.35</td>
<td>1.78</td>
</tr>
<tr>
<td>TOTAL (100%)</td>
<td>7.3</td>
<td>6.2</td>
<td>6.2</td>
<td>6.1</td>
<td>5.8</td>
<td>5.8</td>
<td>5.7</td>
<td>5.7</td>
<td>5.7</td>
<td>5.6</td>
<td>5.2</td>
<td>5.94</td>
<td>1.23</td>
<td>1.04</td>
</tr>
<tr>
<td>TOTAL RANK</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: author’s calculations using data in Kearney (2004d: 2, 3, 4, 6 and 8).
Table 3: Defining General Service Levels for Call Centers

<table>
<thead>
<tr>
<th>Support Level</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Straightforward calls that can be answered through simple queries, scripts, or frequently asked question lists and only require basic product knowledge. Typical call times are in the seconds to minute ranges.</td>
</tr>
<tr>
<td></td>
<td>• Office location and directions</td>
</tr>
<tr>
<td></td>
<td>• Simple product sales</td>
</tr>
<tr>
<td></td>
<td>• “How do I…”</td>
</tr>
<tr>
<td>2</td>
<td>Detailed questions that require significant depth of knowledge to answer. Typical resolution times are in minutes to hours.</td>
</tr>
<tr>
<td></td>
<td>• Detailed product comparisons</td>
</tr>
<tr>
<td></td>
<td>• System workarounds</td>
</tr>
<tr>
<td></td>
<td>• Warranty processing</td>
</tr>
<tr>
<td>3</td>
<td>Serious problems that require multiple people, multiple systems, and an expert level of product knowledge. Typical resolution times are hours to days.</td>
</tr>
<tr>
<td></td>
<td>• Major software bugs</td>
</tr>
<tr>
<td></td>
<td>• Difficult warranty issues</td>
</tr>
<tr>
<td></td>
<td>• Consultative selling</td>
</tr>
</tbody>
</table>

Source: 24-7 Intouch (2004).
Table 4: Export-oriented FDI Projects in Call Centers, 2002-2003

<table>
<thead>
<tr>
<th>Country</th>
<th>No of FDI Projects</th>
<th>% Share of FDI Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>56</td>
<td>11%</td>
</tr>
<tr>
<td>European Union</td>
<td>169</td>
<td>33%</td>
</tr>
<tr>
<td>United States</td>
<td>15</td>
<td>3%</td>
</tr>
<tr>
<td>All Developed Countries</td>
<td>279</td>
<td>54%</td>
</tr>
<tr>
<td>China</td>
<td>30</td>
<td>6%</td>
</tr>
<tr>
<td>India</td>
<td>60</td>
<td>12%</td>
</tr>
<tr>
<td>Philippines</td>
<td>12</td>
<td>2%</td>
</tr>
<tr>
<td>Singapore</td>
<td>16</td>
<td>3%</td>
</tr>
<tr>
<td>All Developing Countries</td>
<td>203</td>
<td>40%</td>
</tr>
<tr>
<td>Central &amp; Eastern Europe</td>
<td>31</td>
<td>6%</td>
</tr>
<tr>
<td>World</td>
<td>513</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: UNCTAD (2004: 162)
REFERENCES


