The regulation of international transfer pricing: a theological critique.

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Abstract

This paper presents an overtly theological critique of the governmental regulation of the international transfer pricing activities of multi-national enterprises.

In the transfer-pricing arena, it is known that MNEs transfer substantial values across national borders. The Organisation for Economic Cooperation and Development developed a set of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995) as the basis for regulating transfer pricing. The underlying appeal in the Guidelines is to (rationality in) economic decision making. However, we argue that this appeal to economic rationality is problematic and use Papal Encyclicals on social justice to provide a critique of the regulation of international transfer pricing. Hence, this paper seeks to apply theological insights to an apparently more secular and material problem.

The regulation of international transfer pricing:
a theological critique.

1. Introduction

This paper presents an overtly theological critique of the governmental regulation of the international transfer pricing activities of multi-national enterprises (MNEs).

In the transfer-pricing arena, it is known that MNEs transfer substantial values across national borders. The major trading nations through the medium of the Organisation for Economic Cooperation and Development (OECD) developed a set of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 1995-8) as the basis for regulating transfer pricing. The underlying appeal in the Guidelines is to (rationality in) economic decision making. However, we argue that it is at the point of this appeal to economic rationality as the basis of their legitimacy, where the tensions for the OECD and the Guidelines lie, and for three reasons: firstly, their effectiveness in achieving economic rationality, secondly, the status of economic rationality as a goal, and thirdly the apparent effect of favouring certain interests in the distribution of income.

In contrast, the Roman Catholic Church in the Papal Encyclicals, Rerum Novarum (Leo XIII, 1891), Quadragesima Anno (Pius XI, 1931), and the Centesimus Annus (John Paul II, 1991) appeals to concepts of social justice and the protection of the weak and the poor as taking precedence over the welfare of interest groups. We use these more challenging concepts of the public interest to provide a critique of the regulation of international transfer pricing. Hence, this paper seeks to apply theological insights to an apparently more secular and material problem.

The paper proceeds as follows. Section 2 introduces the OECD Transfer Pricing Guidelines. Section 3 outlines the conceptual basis of the OECD Guidelines, and uses the transfer pricing literature to show the difficulties inherent in this approach to regulating the international transfer pricing activities of multi-national corporations. Section 4 outlines and investigates an alternative approach based upon Roman Catholic concepts of social justice.

2. The OECD Guidelines

Transfer pricing in divisionalised enterprises has in recent years attracted the attention of governments and revenue authorities in all major trading jurisdictions (Casna, 1998, Tyrrall and Atkinson, 1999). Their ostensible aim is to prevent MNEs from utilising their transfer prices to shift income towards low tax jurisdictions, hence reducing or even evading their corporate tax burden. Although Pagan (1993) felt that ‘transfer pricing (was) dominated in government circles by the outdated and incorrect view that it is mainly about counteracting tax evasion by MNEs’, more recent academic (Borkowski, 1997; Mehafdi, 2000) and press (Warner, 2004) evidence indicates that governments have not changed their views. Surveys invariably find that management of their overall tax burden is either identified (Cravens and Shearon, 1996) or at the very least not rejected (Tyrrall and Atkinson, 1999) as a primary focus of their transfer pricing policies. Empirical studies tend to find that international transfer pricing is exploited as a means of tax evasion (Bartelsman and Beetsma, 2000; Gramlich and Wheeler, 2003) or at least that the possibility cannot be rejected (Cravens and Shearon, 1996). In other words, the taxation authorities feel that MNEs regard transfer pricing as a game of liars’ poker between MNEs and taxation authorities.

The most vigourous response to the perceived abuse of international transfer pricing by MNEs has come from the Internal Revenue Service of the USA. Practitioners and academics agree that the international burgeoning of transfer pricing legislation has in large measure, been triggered by the increase in both the extent and the enforcement of the US Internal Revenue Code, Section 482 (s482) regulations and the OECD Guidelines (Elliott, 1995, Tyrrall, 1997, Casna, 1998, Elliott, 1998, Tyrrall and Atkinson, 1999). Following the US enforcement action, there has been considerable evidence of international homogeneity in transfer pricing policies in respect of fiscal regulation, mainly through the widespread acceptance of the OECD Transfer Pricing

Guidelines (Tyrrall and Atkinson, 1999; Eden et al, 2001). This arises partly to ensure that a nation is not placed at a competitive disadvantage due to the international mobility of capital (Peters, 1991, p19), but also because the effects of institutional isomorphism (particularly mimetic and normative isomorphism) tend to counter-act national differences. Even developing countries (eg MERCOSUR in Il Jornada Tributaria do Mercosul, 1997) and those who seek to support them (United Nations Conference on Trade and Development, Transfer Pricing, 1999) acknowledge the primacy of the Guidelines despite their accepted similarities to and influence from the US s482regulations (Eden et al, 2001).

The basis of the Guidelines is the arm's length principle whereby the profits accruing to associated companies in different tax jurisdictions ought to reflect 'the commercial or financial relations ... which would be made between independent enterprises' (Article 9, OECD Model Tax Convention, 1963). The underlying appeal in the Guidelines is to (rationality in) economic decision making – to what a 'reasonable independent business manager' would agree in similar circumstances.

Elliott (1995) accepts that the main objective of tax authorities is to assess tax on a fair level of profit, rather than simply to maximise their own tax revenues. However, the intent of this weight of regulation, and its associated penalties, may not be simply to ensure that MNEs incur the appropriate taxation on all their international activities, but rather to appropriate as large a slice of the MNE tax cake for each particular tax jurisdiction as possible. Both the Editorial (Russell, p2) and the leading article (Henshall, p3) in Tax Planning International Transfer Pricing (Vol 2, No 2, Feb 2001) hold that '(t)he role of tax advisors is to offer structures to draw I(ntellectual) P(roperty) into low-tax jurisdictions and that of tax authorities, fearing erosion of the taxable base, to stop it." Thus, a tendency towards competitive severity of transfer pricing regulations may be detected as nations seek to maximise their own tax take, or minimise their tax leakage in a game of beggar-thy-neighbour against other nation states. An early Inland Revenue press release on the developing transfer pricing legislation appeared to relegate the tax avoidance aspects to the status of an after-thought (quoted in Elliott, 1998). The UK Consultative Document (Inland Revenue, 1997) in several places coyly proclaims the need to 'protect (...) a substantial proportion of our tax base', without clarifying from which danger (liars' poker or beggar-thy-neighbour) protection is most sought. There is evidence via ITP court cases (e.g. Bausch and Lomb, DHL, and Eli Lilly) and anecdotal evidence from transfer pricing consultants that taxation authorities regard transfer pricing investigations as a particularly fertile area for revenue capture.

3. A critique of the OECD Guidelines

The implicit assumption underlying the application of arm's length pricing to the assessment of corporation tax is that within an organisation an uncontrolled price or return represents a fair division of profit across divisions (Smith, 2002). Hence the only factor driving firms away from using transfer prices that achieve this result is the presence of taxation. If corporate profits were not taxed, then market prices would predominate. Furthermore, the use of arm's length prices in the assessment of corporation tax will ensure parity of treatment between firms where the logic of production leads them to locate divisional boundaries within national boundaries and those where the logic of production leads them to span national boundaries. Putting it differently, the arm's length principle will ensure that firms are not incentivised to span national boundaries purely for reasons of tax minimisation.

A further implication is that application of the arm's length standard will be an optimising procedure leading to economically rational (Pareto optimal; ref. needed?) outcomes at either or preferably both micro-economic (firm) and macro-economic (economy) levels. Such assumptions and outcomes seem essential to any appeal to economic rationality as a reason for the application of the arm's length standard. They are also entirely natural to an organisation such as the OECD which is unequivocally committed to the market as the organising force for economic endeavour (OECD, 2002). However, there are both theoretical and empirical reasons for supposing that the assumptions upon which application of the arm's length principle is apparently based are incorrect, and ipso facto it neither can nor will achieve economically rational decisions among related agents, if indeed that is its goal.

Arguably an MNE (or indeed any large organisation) comes about partly because of internalisation (Coase; also Buckley and Casson, 2002) but partly as a solution to transactions cost problems (Williamson, 1985) - in other words because the costs of operating and co-ordinating activities through the market exceed those of doing so within the organisation. For Williamson, any serious study of economic organisation must take account of the human failings of bounded rationality and opportunism that are exacerbated in the context of asset specificity (ibid.). Figure 1 outlines Williamson's approach to transactions cost economics.

Contracting conditions	**Bounded rationality - absent**	**Bounded rationality – admitted**
Opportunism – absent	1. Bliss	2. General clause contracting
Opportunism – admitted	3. Comprehensive contracting	4. Serious contracting difficulties

Figure 1. Contracting conditions for bounded rationality and opportunism (based on Williamson, 1985)

It is interesting to note that only in quadrant one do the conditions for economic organisation based entirely upon market transactions obtain, in a quadrant labelled 'bliss', a state more readily associated with the realms of heaven or the Garden of Eden than that of mundane economics. All other states of the world involve the more or less extensive activity of fallible contractual man rather than innocent Homo Economicus. Such contractors or arbitrators might operate as genuinely 'reasonable independent business managers' agreeing arms length contracts in a more or less open market basis. However, the key finding of transaction cost economics is that, despite the overall preferability of market relations, any move out of quadrant 1 of figure 1 is likely to entail organisational or hierarchical solutions to the contractual difficulties present in the other quadrants. Organisational solutions might prevail for reasons of competitive efficiency or of practical necessity. Thus, in quadrant 3 there may be an opportunity for strategic choice in production arrangements (the make or buy decision), while in quadrants 2 and 4 organisational control is likely to be the only solution to the transaction cost problems inherent in achieving the desired outcomes. Since wealth creation within organisations is the result of such hierarchical or social rather than market interactions, this raises the question of whether the optimal transfer prices used in the management of such relationships theoretically should or empirically would be agreed as market or arm's length prices.

This question has been extensively addressed in the four main strands of the transfer pricing literature: the economic and mathematical programming literatures, the strategic and transaction costs literatures, the behavioural literature and the case study literature. There is an extensive transfer pricing literature which attempts to provide methods of estimating optimal transfer prices for divisionalised corporations which 'would enable divisions to maintain their autonomy while making decisions that benefit the entire organisation' (Abdel-khalik and Lusk, 1974, p8). However, the project has proved fraught with difficulties. Hirschleifer (1956) admitted that the results from his marginal costing approach did 'not lend themselves to easy generalisation' (p 108). Mathematical (linear) programming approaches based on an opportunity cost perspective foundered on the 'need for perfect information, the possibility of ... cheating' (Abdel-khalik and Lusk, 1974, p20) and hence the operational difficulties associated with them (Tyrrall, 1997). Thus transfer pricing lacks agreed theoretical or practical modelling techniques.

This is perhaps unsurprising given the plasticity of financial and management accounting (Emmanuel et al 1990, p282) and the need for organisations to consider a wide range of inter-related variables in deciding their transfer prices and transfer pricing methods (Curet and Elliott 1997, Boyns et al, 1999). As a result of this plasticity in transfer pricing,

The economic strand in the transfer pricing literature focuses on the use of algebraic or mathematical programming methods to establish optimal transfer prices based on neo-classical economic principles. These studies (e.g. Hirshleifer, 1956, Abdel-khalik and Lusk, 1974; Grabski, 1985; Baldenius, 2000) have consistently failed to generate a general transfer pricing approach, but have been marked in their agreement that the use of market prices as transfer prices is inappropriate for the maximisation of corporate income, except in the trivial case where the division is operating at close to its own capacity in a purely competitive market. Similar theoretical studies on the effect of the s.482 regulations have tested the logical corollary that a strict exogenous imposition of the arm's length standard could be sub-optimal in terms of firms' output decisions, and have found this to be the case (e.g. Samuelson, 1982; Slof, 1999; Halperin and Srinidhi, 1996). Again, the sole exception is in the perfect market with no benefits to internal trade (Wagenhofer, 1994). Thus, it is possible that economic output is lowered by the imposition of the arm's length method.

These studies also highlight a further flaw in the s482 regulation, viz. its assumption that exogenous arms length prices or returns are available for use as comparables. This availability would necessitate the simultaneous presence of both vertically integrated and vertically segregated entities in the relevant market (Smith, 2002), implying not only that there was no competitive advantage in either form of productive arrangement (Wagenhofer, 1994), but also that price determination is fully exogenous to the vertically integrated producer. Both seem unlikely. Firms within a common sector tend to share organisational characteristics (ref needed). It is more likely that firms will tend to regard the transfer price as at least partly an endogenous outcome of their own ex ante investment decisions, so that such decisions will be influenced by the likely price/return outcomes in a sector where they have significant market power (Smith, 2002). These relationships create an ex post situation observed in both theoretical approaches (Halperin and Srinidhi, 1996) and practitioner experience (Smith, 2002; Tyrrall and Atkinson, 1999) that it is difficult to identify comparable uncontrolled transactions, with the result that tax authorities can only identify a range of relevant prices or returns. This, in turn will allow firms ex post discretion over the transfer prices they utilise, so that they are non-market prices. Any imposition of taxation upon such discretionary prices is likely to drive prices in a tax reducing direction, which may or may not be towards market prices. Ironically, Smith (2002) finds that this ex post discretion in establishing an arms length price could be used by firms to offset the sub-optimality in output levels inherent in its strict application.

Arguably these algebraic and linear programming approaches are of purely theoretical interest, as there is no evidence of their application in practice (Eccles, 1985; McAulay and Tomkins, 1992). Internal to their logic is a level of managerial information-handling that is probably unachievable and which in any cases raises tensions between divisional autonomy and central control (Emmanuel and Mehafdi, 1994). Nevertheless, it may be argued that although managers do not explicitly employ such techniques to determine overall organisational outcomes, their actions may be interpreted as if they did (McAulay and Tomkins, 1992). In either case, the findings of this theoretical literature, based as they are upon the same neo-classical assumptions as the arms length method, challenge the applicability of the arms length method to international transfer pricing.

The arm’s length principle is also subject to challenge on the basis of transaction cost economics. Meer-Kooistra (1994) demonstrates how company transfer pricing arrangements are organisationally related to transaction cost issues of asset specificity, information asymmetry and uncertainty. Hence the transfer prices which evolve within the organisation ought to reflect the strategic goals of the organisation in terms of wealth creation. Transaction cost economics may thus explain not only why there are firms, but also why firms differ in their organisational characteristics (Aoki, 1990). Indeed, Eccles (1985) in characterising transfer pricing as an important aspect of the strategic management of MNEs develops a contingency model in which certain strategic approaches will or should encourage cost-based solutions to transfer pricing while other strategic approaches will or should encourage market-based solutions (figure 2).

Strategy	**Vertical Integration - low**	**Vertical Integration – high**
Diversification: low	1. Transfer pricing – irrelevant, hence non-existent	2. HQ mandated, cost based transfer pricing. Moderate disagreement on prices.
Diversification: high	3. Exchange autonomy, market based transfer pricing.	4. HQ mandated, market based transfer pricing.

	Low disagreement on prices.	High disagreement on prices.

Figure 2: Eccles (1985)

The theoretical foundations and the adumbration of this theory are inherently attractive, although the early empirical evidence is somewhat less persuasive. Colbert and Spicer (1995) draw similar conclusions on a firmer empirical basis with specific reference to firms displaying a high level of vertical integration. Unsurprisingly, given their common concerns, a mapping of the Williamson (1985) model onto the Eccles (1985) model shows clear complementarities (figure 3).

Contracting conditions and strategy	**Vertical Integration: low** **Bounded rationality: absent**	**Vertical Integration: high** **Bounded rationality: admitted**
Opportunism: absent **Diversification: low**	1. Bliss Transfer pricing – irrelevant, hence non-existent	2. General clause contracting. HQ mandated, cost based transfer pricing. Moderate disagreement on prices.
Diversification: high **Opportunism: admitted**	3. Comprehensive contracting. Exchange autonomy, market based transfer pricing. Low disagreement on prices.	4. Serious contracting difficulties. HQ mandated, market based transfer pricing. High disagreement on prices.

Figure 3: Combined transaction cost / transfer pricing model.

Firms that display high levels vertical integration (Quadrants 2 and 4) are likely to be present in sectors where market solutions are sub-optimal, and hence do not offer readily available market prices as a transfer pricing reference point. Even when transfer pricing models (whether strategic or algebraic) recommend market-based solutions to transfer pricing (Quadrant 3), these solutions infrequently lead to actual market or arm's length prices, even in the absence of taxation. Thus the overall thrust of these strands of the transfer pricing literature is that there are a substantial number of MNEs for whom a strict application of arm's length transfer pricing could prove sub-optimal in strategic and transaction cost terms.

Similar findings emerge from the behavioural and case study literatures on transfer pricing. The presence of organisation enables managers to ‘make credible commitments … to support exchange’ (Williamson, 1990). Thus, for example, organisations are able to overcome Williamson’s (1985) hold-up problem (a quadrant 4 problem) by allowing managers to negotiate transfer prices prior to divisional investment but then renegotiate ex post when outcomes are revealed, while retaining the ultimate sanction that HQ can insist on specific performance if either party attempts to renege (Edlin and Reichelstein, 1995). However, these potentialities are accompanied by a mutual managerial concern for fair treatment of participants. Experimental studies involving both students and experienced managers indicate that subjects do not settle on market prices even when these are available, if they do not result in a distribution of profit between divisions that is perceived as fair (Chalos and Haka, 1990; Ghosh, 2000; Luft and Libby, 1997), a result also implied by Avila and Ronen (1999). The more directly managers have to engage in negotiations (i.e. face-to-face rather than through electronic media) the more salient issues of fairness become (Kachelmeier and Towry, 2002). Organisational case studies of transfer pricing arrangements also find that managers place a strong emphasis upon fairness (e.g. Kovac and Troy, 1989).

Both the economic and the strategic strands in the transfer pricing literature carry the implication that widespread revenue authority enforcement of the arm's length standard may be sub-optimal in output terms (Pareto inefficient) at the micro-economic and by extension at the macro-economic levels. If firms rigourously apply arm’s length prices and allow these to determine sub-optimal output levels, there will be a consequent reduction in corporate taxable income. If, on the other hand, firms exercise their opportunities for discretion over transfer prices to approximate more closely to optimal output levels, corporate taxable income may be increased or reduced. In either case, whether the total subsequent tax imposed is increased or reduced will depend not only upon the level of corporate taxable income, but also upon the jurisdiction(s) in which that income is deemed to have been earned and the relevant tax rates in force. In short, the results for output, taxable income and corporate taxation are indeterminate.

The behavioural and case study literatures imply an alternative approach to transfer pricing and its taxation, which may open a path to mitigating the sub-optimality inherent in arm’s length pricing. By allowing for the existence, or even dominance, of contractual man rather than simple economic man, an ethical or moral basis for the assignment and distribution of wealth is admitted, based on concepts of fairness. Buchanan neatly summarises the logic of this approach as follows:

> economics comes closer to being a ‘science of contract’ than a ‘science of choice’ (on which account) the maximizer must be replaced by the arbitrator, the outsider who tries to work out the compromises among conflicting claims (Buchanan; 1975; 229).

Underlying this approach to governance is the combination of an arbitrator and an institutional design specialist. In international transfer pricing, discrete contracting between counter-parties or rather a simulacrum of that activity is central to the OECD Guidelines. It follows that in these regulations, we begin to move way from questions of economic rationality towards questions of fairness. The legitimacy of this type of governance rests on the efficacy of its juridical framework, but one that ultimately must appeal to some ethical or moral order.

The OECD certainly recognises the need for an institutional and regulatory framework for the organisation of economic affairs, and indeed casts itself as playing an important role in that regard. It characterises itself as providing a 'unique forum' for its members to produce 'internationally agreed instruments, decisions and recommendations to promote rules of the game … in a globalised economy' (OECD, 2002). Through this mechanism the OECD provides what it terms as ' "soft law" - non-binding instruments on difficult issues and 'legally binding agreements to crack down on bribery or codes for the free flow of capital and services' (OECD, 2002). The OECD does not specify what status - soft law or legally binding instrument - it views its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD, 1995-8) as having. However, the fact that the Guidelines have been almost universally adopted as national law in those jurisdictions which seek to regulate transfer pricing activity lends them de facto, if not de jure, status as a legally binding instrument.

The arm's length principle promulgated by the Guidelines is explicitly based upon the judgement of what a 'reasonable independent business manager' would do in a similar set of circumstances. This appeal to what a reasonable independent business manager may deem economically rational universalises private interests as being above public interest. Putting it differently, this is the very individual who is deemed to be in need of control through recourse to institutional arrangements. Further, this same individual seeks to achieve fair play again through recourse to institutional (organisational) arrangements, precisely because he or she recognises that issues of wealth creation are not separable from issues of wealth distribution. The OECD appear to have traversed a circular route, and that circle may be vicious one. The dependence on economic rationality does not seem to provide the desired foundation, and it seems we must look elsewhere to find it.

The OECD is not unaware of this difficulty. D.J. Johnston, Secretary-General to the OECD, in his Preface to the 2002 OECD Annual Report quotes Franklin D. Roosevelt "We must lay hold of the fact that economic laws are not made by nature. They are made by human beings" (OECD, 2002). In order to counter the difficulty, the OECD appeals both implicitly and explicitly to notions of the public good in justification of its activities:

> Since 1961 … the OECD's vocation has been to build strong economies in its member countries, improve efficiency, hone market systems, expand free trade and contribute to development in industrialised as well as developing countries.
> (It) is also expanding its relationship with civil society … (and) … increasingly invites public comment on … its work (OECD, 2002).

Here we see an appeal to OECD regulation as being 'in the public interest', in other words, by appeal to a Kantian categorical imperative. However, the apparently neutral reference to economic values as the basis for this public interest leaves unanswered the circularity already highlighted as inherent in such an appeal. Hence at the very least the door remains open for an appeal to another frame of reference for determining the public good, and it may even be argued that another frame of reference must be found.

4. Roman Catholic teaching on social justice.

In this analysis we appeal to Roman Catholic teaching on social justice as that frame of reference for a number of reasons. At the very least, it might be supported as an interesting project in its own right. Putting it differently, we might simply arbitrarily select this well-known and widely respected alternative framework in order to see what light it may shed upon the problem, if only on the grounds that the Papal Encyclicals which outline Roman Catholic teaching on social justice are objective – in the sense of being there, independently of us as investigators and of the OECD as (quasi)legislators.

However, such an approach need not be seen as entirely arbitrary. Moral theology provides a starting point, in that normative statements are accepted as being prior to positive statements. Thus moral theology accepts its normative basis and utilises it in its approach to reasoning (refs. needed?). Furthermore, the theological content of these Papal Encyclicals is not dissimilar to theologies of social justice promulgated by other Christian churches (e.g. Church of England, 1985 and 1995; Methodist Church, 2004), or indeed by Islamic thinkers (e.g. Al-Ghazzali – see Mehmet, 1997). However, due to the nature of the institutional framework of the Roman Catholic Church, Papal Encyclicals have more authoritative theological and institutional standing than pronouncements within other churches.

It is interesting to note that the use of some non-theological alternative frameworks (e.g. that offered by Rawls, 1971) might give similar results to the use of Papal Encyclicals, while other non-theological approaches (e.g. a Marxist approach to transfer pricing such as that adopted by Armstrong, 1998) reach different conclusions, a point to which we shall return.

We focus mainly on the three great encyclicals of Catholic social thought: the *Rerum Novarum* (promulgated by Pope Leo XIII in 1891), the *Quadragesimo*, (Pius XI, 1931) and the *Centesimus Annus* (John Paul II, 1991).

The relationship between economics and theology is examined in the *Quadragesimo* (op cit; 42):

> Even though economics and moral science employs each its own principles in its own sphere, it is, nevertheless, an error to say that the economic and moral orders are so distinct from and alien to each other that the former depends on the latter. Certainly the laws of economics as they are termed...determine the limits of what productive human effort...can attain in the economic field and by what means. Yet it is reason itself that clearly shows, on the basis of the individual and social nature of things and men, the purpose which God ordained for all economic life.

Thus although the laws of economics may determine what can or cannot be achieved, they do not provide guidance on what should or should not be attempted. In a Kantian framework, the appeal to economic rationality as an imperative would be classified as a hypothetical imperative, rather than a categorical imperative. The *Rerum Novarum* (1891) explicitly recognises the need for an over-riding categorical imperative. It stresses the natural right to property but argues that individual control and benefits be complemented and to an extent buttressed by sharing (McKee, 1991). This question of the assignment and distribution of property rights is not peripheral to but central to the regulation of international transfer pricing, together with the allocation of the income associated with those property rights. The *Rerum Novarum* recognises that private property is deemed a basis of freedom but highlights the contradiction of the economic liberal position by arguing that freedom can only be gained if the distribution of property rights can be organised socially.

The *Centesimus Annus* (1991) developed this line of thinking further. Economics is related to theology through Catholic social thought in being deemed "an interdisciplinary nexus" (op.cit; 59). The *Centesimus Annus* sums up this institutional affinity:

> Models that are real and truly effective can only arise through the efforts of all those responsibly confront concrete problems in all their social, economic, political, and cultural aspects as these interact with one another (op.cit.; 43).

In the moral theology of *Centesimus Annus*, the economy has two principal goals:

- to provide for the material well-being of human beings; ie a responsibility for the creation of wealth, and
- to create the opportunity for people to provide for their material needs, ie a responsibility for the distribution of wealth.

The suspicion of the Roman Catholic Church of continental liberalism of the 19th century (as consequence of its implications for the development of socialism) is replicated today in the Church's reaction to individualistic and materialistic theories of human organisation. Catholic suspicion of the free market has receded somewhat in the late 20th century. The *Centesimus Annus* accepts the efficacy of the market economy. However, the concerns first expressed in the *Quadragesimo* about the impersonal ownership structure of the modern corporation remain. At the time of publication of the *Quadragesimo* (1931), the Church was concerned with the obligation of the corporation's owners to their workers. In a modern setting this obligation is now seen to extend to a range of stakeholders. Despite the apparent softening of Catholic social thought towards the market in the later part of 20th century, there is papal unanimity across the centuries:

> the right ordering of economic life cannot be left to a free competition of forces *(Quadragesimo*; 88)
>
> and
>
> property should benefit all, and a strong juridical framework should be in place" (*Centesimus Annus*; number).

Distribution of wealth is not merely an afterthought to the creation of wealth. Underpinning the two principal goals of the economy is the concept that the economy is an aspect of society in its own right, but one that that expresses a common good. The logic of this extension leads Catholic social thought inexorably towards an institutional perspective on economics which must take account of the human failings of bounded rationality and opportunism in order to regulate economic actors.

The *Centesimus Annus* explicitly recognises the need for an over-riding categorical imperative. At first glance, it would seem that the apparent gap between the two ends of the spectrum, the economic and the moral aspects of regulation, or the hypothetical and categorical imperatives, might be bridged by appeal to the concept of moral sentiment present in both Adam Smith and Catholic social thought. However, Catholic social thought recognises that appeal to mere sentiment is likely to be insufficient to restrain the forces of self-interest, a problem likely to be exacerbated by the enactment of rules specifically framed on the conceptual basis of that self-interest. Rather the market must be:

> circumscribed within a strong juridical framework which places it at the service of human freedom in its totality and which sees it as a particular aspect of that freedom, the core of which is ethical and religious (*Centesimus Annus*; 42).

However, such an articulation of the public interest takes place in an arena of bounded rationality where opportunism must be confronted and constrained by moral theology.

In the context of international transfer pricing rules, the OECD Guidelines can be conceptualised as a juridical framework for the assignment and distribution of property rights, taking us back to the natural right to property as a social contract within Catholic social thought. Viewed in this way, the OECD guidelines do not reify (or for that matter deify) rational economic man (*Homo economicus)* but rather appeal to the instincts of the representative actor of the MNC - the reasonable independent business manager - to resolve the international transfer pricing problem. By imposing the unobservable, incalculable or non-existent arm's length price, the Guidelines permit this reasonable independent business manager to resolve the international transfer pricing problem by mutual negotiation with his counterpart in the tax authority.

Perhaps the OECD nations were, consciously or unconsciously, aware of both the inapplicability of arm's length prices to MNCs and the circularity implicit in the arm's length standard (ref needed?). The impact of an appeal to the reasonable independent business manager rather than to Homo economicus would explain the imposition of a market/negotiation-based framework for the regulation of international transfer pricing. For the reasonable independent business manager could be permitted to apply the arm’s length principle in a manner that offset the potential for Pareto sub-optimality, a shortcoming which Homo economicus would rather condemn as second best.

However, this outcome has also given rise to a potentially more radical critique of the arm’s length solution based on Marxist principles. Armstrong (1998) characterises international transfer pricing in general and the arm’s length method in particular as being instruments of the class exploitation of labour by capital. Since arm’s length method is inherently sub-optimal in output terms, and the actual incidence of corporation tax is accepted as both indeterminate and probably indeterminable (reference needed), someone is indeed likely to be worse off due to the application of the arm’s length standard, and it is by no means certain that it will be the someone best placed to sustain the loss. The wealthier (OECD) nations are able to appropriate larger slices of the MNC tax cake because of the superior negotiating power at the disposal of their tax authorities vis-à-vis the MNEs. This effect is disguised not only by the indeterminacy of tax incidence, but also by the way in which the arm’s length standard specifically placed the locus of negotiation between MNC and tax authority, rather than between tax authorities.

For indeed a framework that located the negotiation between tax authorities - global formulary apportionment - was proffered as a solution to the problem. Paradoxically, the adoption of the arm's length standard was the outcome of a series of negotiations that specifically rejected global formulary apportionment as the basis for the OECD guidelines. In other words, an apparently market-based rule was more acceptable than an overtly negotiated rule. Under global formulary apportionment, national taxation authorities would jointly agree a formula (based upon revenue, costs, assets, finance or some weighted mixture of these and other items) for the allocation of MNC incomes to tax jurisdictions (refs. needed) prior to their taxation at the ruling rates. Given the demonstrably social and contractual nature of the taxation of international transfer pricing, such a negotiated approach to its juridical resolution might seem more satisfactory on theoretical grounds in allowing possibilities for both greater Pareto optimality and fairer distribution of wealth. However, a formula for the apportionment of MNC global income could not be agreed among taxation authorities. One easy explanation of this outcome is that any formulaic approach would permit MNCs to minimise their tax burden simply by accounting or even real manipulation of the appropriate elements of the formula (ref. needed?). However, it is not clear that such difficulties could not be resolved with adequate policing by national tax authorities, nor that arm's length prices are any less susceptible to manipulation, or require any less policing.

The Roman Catholic theology of social justice hints at a basis for such a formula – employee numbers. Interestingly, this has a number of attractions from the perspectives of each of four main strands of the transfer pricing literature: the economic and mathematical programming literatures, the strategic and transaction costs literatures, the behavioural literature and the case study literature. Assuming MNE profit before tax (PBT) were allocated among revenue authorities on the basis of the number of employees in each jurisdiction, then MNEs would be free to maximise global profits utilising optimal transfer prices to monitor and control their activities, since these prices would no longer be of any concern to the revenue authorities. Putting it differently by shifting the tax allocation focus from a position above the PBT line to the PBT line itself, MNEs are incentivised to maximise PBT.

In addition, employee numbers are not subject to accounting manipulation, and are comparatively simple to audit. Hence, the dead-weight losses to MNEs in compliance costs of justifying and documenting the arm’s length method, and to revenue authorities in audit costs are eliminated.

Given the tendency for MNEs to shift employment to developing nations where employment costs are lower, this would have the theological attraction of shifting MNC tax base towards such nations. Given the disparity between developed and developing world wage levels, it is unlikely that any conceivably realistic levels of corporation tax in developing nations would counteract the effects of the lower labour cost base on MNC profits. There is already evidence to suggest that competition among developing nations for employment opportunities from MNEs acts to drive down their corporation tax rates. Perhaps ironically, this fact of neo-classical economics may mean that developing nations would not be able to benefit as greatly from this as might be hoped. Thus, it is possible that the output and tax base of MNEs would increase, the tax take of developing nations would increase but the actual total tax imposed upon MNEs might fall, because the tax authorities in developing nations have a weaker position than the tax authorities of developed nations vis-à-vis MNEs. The likely outcomes would merit investigation via further theoretical research.

It seems unlikely that global formulary apportionment ever will be agreed among taxation authorities. Despite the challenges to presented by steadily more intractable issues, such as cost contribution arrangements (OECD Guidelines, Ch 8), e-commerce (ref. needed), or permanent establishments (ref. needed), the OECD is resolute in seeking and finding solutions in accordance with the arm's length standard. Hence, a shift to allocation of corporate income is likely to be difficult, if not impossible to achieve, unless the tensions inherent in the arm's length principle become unsustainable. This may be regarded as unfortunate, since an appeal to a higher authority than that of economic theory not only avoids the circularity inherent in the basis of the OECD guidelines, but also offers the possibility of a more optimal solution (employee numbers) in terms of economic theory. It is unfortunate but perhaps not surprising that in this imperfect world that there may be a greater benefit from the use of employee numbers as an allocation mechanism to the MNEs than to the developing nations. However, Roman Catholic theology would accept a perfect outcome as unobtainable in this world, and hence a less imperfect outcome as being desirable. Of course, to the unbeliever the circularity in the OECD approach is simply removed to another realm, that of theology rather than economics. Nevertheless in that realm of theology, questions of belief are more readily recognised at such, while questions of social justice cannot simply be left to the 'invisible hand' of market forces but must be played out in a avowedly sinful world.

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