

The regulation of international transfer pricing: a theological critique.

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Outline

- provide a critique of the regulation of international transfer pricing using:
- academic literature on transfer pricing and taxation, and
- Roman Catholic concepts of social justice, leading to
- a suggested alternative approach.



OECD Guidelines

- arm's length principle; i.e. what a 'reasonable independent business manager' would agree in similar circumstances.
- the underlying appeal to rationality in economic decision making
- so - should give economically rational (Pareto optimal) outcomes at micro- and macro-economic levels?
- But this is problematic for 4 reasons
 - Purpose of transfer pricing
 - effectiveness in achieving economic rationality at both micro- and (by extension) macro-economic levels
 - effects of the regulation on income distribution

Economic purpose of transfer pricing

- MNEs formed to solve transaction cost problems.

	Bounded Rationality - Absent	Bounded Rationality - Admitted
Opportunism - Absent	Bliss	General clause contracting
Opportunism - Admitted	Comprehensive contracting	Serious contracting difficulties

- Organisational solutions raise need for transfer pricing mechanisms

Transfer pricing literature

■ Management literature

- economic and mathematical programming approach,
- strategic approach,
- behavioural approach,

■ taxation literature.

- evasion
- fairness and distribution of taxable income

Algebraic or mathematical programming approaches

■ Sub-optimality

- Use of neo-classical assumptions (marginal analysis)
- No generally agreed result except market prices inappropriate for income maximisation!
- Hence exogenous imposition of arm's length price sub-optimal!

■ Flexibility

- Assumes availability of arm's length price but prices not exogenous
 - only range of prices/returns identifiable.
- Allows firms discretion over transfer prices used.
- Imposing taxes on non-market prices will drive them in a tax-reducing direction with indeterminate result.

■ so flexibility may off-set sub-optimality! Or not....

Strategic transfer pricing literature

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. Low disagreement on prices.	4. HQ mandated, market based transfer pricing. High disagreement on prices.

Contracting conditions and strategy

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

Behavioural transfer pricing literature

- Vertical integration raises problems of
 - intermediate products, and
 - supernormal profits
- neither of which are inherently (im)moral but do raise questions of distribution of profit.
- Organisation enables managers to make ‘credible commitments’ - but creates issues of mutual fairness.
- Managers do not agree on market prices if they are not perceived as fair, especially in face-to-face or repeated transactions.

Taxation literature

- International spread and homogeneity of transfer pricing legislation based on OECD Guidelines.
- Theoretical evidence that MNEs can and empirical evidence that MNEs do use transfer pricing to reduce tax burden.
- Evidence of alignment of corporate tax rates.
- severe penalties cause income-shifting into severe penalty regimes.
- less-developed countries have less-enforced transfer pricing regimes.

Stiglitz (1988)	<i>Arm's length outcome:</i>
Economically efficient	<i>MNE cake may or may not be smaller</i>
Administratively simple	<i>Liar's poker - transfer pricing specialists increase and extract dead-weight costs of taxation</i>
Flexible	<i>????</i>
Politically accountable	<i>Liar's poker - tax authority slice of cake is not predictable</i>
Fair	<i>Competitive severity – a game of beggar-thy-neighbour among nation states?</i>

Transfer pricing literature: summary

- Economic, strategy, behavioural and tax literatures all reject market prices and hence a quasi-market price (arm's length price) solution.
- Arguably a standard rebuttal of neo-classical economics approach - but all these literatures are operating from within that theoretical framework.
- Rejection of arm's length price - because market solution has been rejected in favour of organisational solution - where
- “economics comes closer to being a ‘science of contract’ than a ‘science of choice’ ... the maximizer must be replaced by the arbitrator, the outsider who tries to work out the compromises among conflicting claims” (Buchanan).¹³

Conflicting claims

- wealth distribution not disconnected from wealth creation.
 - dependent on efficacy of juridical/institutional framework, and
 - ultimately must appeal to some moral order - at least within the organisation.
- It could remain within the organisation if vertical integration of production did not cross borders due to
 - logic of production
 - tax considerations
- But beyond the organisation
 - dependent on efficacy of juridical/institutional framework, and
 - ultimately must appeal to some moral order -
- derived from? Enter the OECD

OECD Guidelines and the "self-interested utility maximising atomised individual"

- OECD role in providing 'soft law' eg the arm's length principle.
- But appeal to "*self-interested utility maximising atomised individual*" universalises private interests above public interest.
- but this is the same individual in need of control through institutions
- a problem likely to be exacerbated by enactment of rules specifically framed on conceptual basis of self-interest
- vicious circle(s) that can only be broken by appeal to an over-riding categorical imperative... a moral order....
- which over-riding categorical imperative? Which moral order?



Sollicitudo Rei Socialis (1988)

- Role of the church is not to provide technical solutions but
- a “set of principles for reflection”
- “criteria for judgment,”
- “ and directives for action”

Moral Theology

- Selection of Roman Catholic moral theology on social justice for a number of reasons:
- Why not?
- Encyclicals are objective.
- But not entirely arbitrary
 - use a well-known (?) and respected alternative framework to see the result
 - theological content not dissimilar to that of other Christian churches
 - other non-Christian faiths?
 - more developed and authoritative standing than other theologies of social justice
 - An issue of voice

A starting point

- Use of other perspectives (e.g. Rawls?) might not give a very different result
- but moral theology has a starting point -
- 'Ought' precedes 'is'
- i.e. accepts its normative basis and utilises it in its approach to reasoning.

IOANNES PAULUS PP. II
CENTESIMUS ANNUS
1991

To His Venerable Brothers
in the Episcopate
the Priests and Deacons
Families of Men and Women religious
all the Christian Faithful
and to all men and women
of good will
on the hundredth anniversary of
Rerum Novarum

a “set of principles for reflection”

- *Centesimus Annus* - recognises need for over-riding categorical imperative
- *Quadragesimo Anno*: ‘reason ... shows, on the basis of the individual and social nature of things and men, the purpose which God ordained for all economic life.’
- *Centesimus Annus* - 2 principal goals for economy:
 - responsibility for the creation of wealth, and
 - responsibility for the distribution of wealth.

a “set of principles for reflection”

- *Quadragesimo Anno*: ‘right ordering of economic life cannot be left to a free competition of forces’
- *Centesimus Annus*: 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’

The public interest and the OECD

- OECD aware of this difficulty - appeal to categorical imperative of the public good in justification of their activities.
- OECD Guidelines as a juridical framework
- Viewed in this way, OECD Guidelines do not reify (or deify) *Homo Economicus* but rather appeal to the instincts of the representative actor of the agency of the corporation - the reasonable independent business manager - to resolve the international transfer pricing problem.

What alternative is there?

- Why market price based ruling (arms length pricing)?
- Rather than a negotiation-based ruling (global formulary apportionment)?
- An outcome of international negotiations!
- Transfers the negotiation over tax outcomes from one between tax authorities to one between tax authorities and MNEs

“criteria for judgment”

- Common theme of Encyclicals
- Option or preference for the poor
- Priority of labour over capital, of people over things.
- *Pacem in Terris*: Stronger nations to help the weaker to participate – assistance without dominance.

“criteria for judgment”

- *Pacem in Terris*: Interdependence of nations
- *Pacem in Terris*: Need for world wide public authority to promote the common good
- Justice in the World: taxation on a world wide basis

“directives for action”

- global formulary apportionment based
- Not on capital
- Not on revenues
- But on employee numbers?

Stiglitz (1988) - a good tax system should be:	<i>global formulary apportionment based on employee numbers :</i>
Economically efficient	<i>MNE cake should be unaffected</i>
Administratively simple	<i>Stand employees in a line and count them.</i>
Flexible	<i>????</i>
Politically accountable	<i>Tax authority slice of cake is highly predictable</i>
Fair	<i>tax authorities in low wage countries likely to get bigger slices than those in high wage countries</i>

Pros

- A better and more market based solution than the arms length method?
 - Businesses focus on profit and shareholder value
 - Governments set the tax rules
- Why? – a more complete/realistic view of human nature?

Cons

- Political acceptability? wealthy losers vs poor gainers
- Morality of transferring taxable income to dubious governments?
- Are gains from post-tax simplicity rather than employee allocation base?

Action: What next?

- How to make an impact?
- criticisms,
- comments,
- journals,
- advice.....

Relevance

- Internal Audit
 - Procedures
 - Risk – financial and reputational
- Corporate social responsibility
 - As corporate citizens of nation states

Ethics! Business!

- Keep them separate
- Ethics and better performance
- Good in the long term
- Share-holder value
- Need to focus on concrete issues