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Creating the International Tax Order:  
Transfer Pricing and the Search for  
Coordination in International Tax Policy

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**ROBERT SCHUMAN CENTRE**

**Creating the International Tax Order:  
Transfer Pricing and the Search for  
Coordination in International Tax Policy**

**CLAUDIO M. RADAELLI**

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## Abstract\*

Coordination in international tax policy is extremely problematic. Economists and political scientists have explained this lack of coordination by arguing that tax competition triggers a prisoner's dilemma. In this article I argue that not all international tax policy can be reduced to the prisoner's dilemma syndrome. Transfer pricing policy, the object of this study, can be modeled as a coordination game. By drawing upon game theory and new institutional analysis, I argue that institutional entrepreneurs who decide to play their favorite option first can facilitate the emergence of international policy coordination. This idea is examined in the context of the creation of the new OECD rules on transfer pricing. The conclusion is that coordination emerges in transfer pricing policy through a process of conflictual institutionalization.

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## INTRODUCTION

Deep economic integration has 'internationalized' tax policy problems (Tanzi 1995). Yet there is a fundamental difficulty in building cooperation in international tax policy. There are various reasons for this, including the fact that both policy-makers and experts disagree about what an 'international tax regime' should consist of and what international organizations should do. But the problem of coordination in international tax policy cannot be reduced to the fact that policy-makers and experts do not know what to do. Indeed, political action often takes place even when there is fundamental uncertainty and social sciences do not provide solid recommendations (Lindblom 1990). Thus one has to explain poor cooperation by considering the strategic structure of international tax policy.

Turning to game theory for this type of explanation, the conventional argument is that international tax policy suffers from the prisoner's dilemma syndrome (Hallerberg 1996). With capital movement liberalization and free trade - this is the starting point of the argument - states compete for attracting capital and non-location specific activities of multinationals by lowering tax rates and offering special tax regimes. The race-to-the-bottom cannot be avoided because there are substantial incentives to free-ride<sup>1</sup>. Even if collective action could be attained among a limited number of countries, the remaining 'non-co-operative' countries would enjoy increasing returns, especially if they are small tax havens (Frenkel, Razin & Sadka 1991; Kanbur & Keen 1993).

Put differently, the more cooperation proceeds, the more reluctant countries find themselves in a favorable position. Cooperation in tax policy is self-limiting, not self-stimulating (Genschel and Plümper 1997). This is consistent with the standard game-theoretical propositions that in a prisoner's dilemma (a) large numbers of players inhibit cooperation and (b) asymmetries favor small players. Although business tax rates have not fallen to zero, there are signs that unbridled tax competition<sup>2</sup> has already produced undesirable effects such as the degradation of the international tax system (OECD 1998), and the shift of the

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<sup>1</sup> This general argument on tax competition allows for exceptions, such as the existence of a Stakelberg leader who can stop the race-to-the-bottom by imposing a minimum threshold to tax rates. Economic models (Gordon 1992) and historical examples (Wilhelmine Germany, analyzed by Hallerberg 1996) show that the downward pressure on taxes induced by tax competition can be stopped, but the general idea remains that international tax policy is a very intractable example of prisoner's dilemma.

<sup>2</sup> The adjective 'unbridled' is used here to denote the most pernicious implications of tax competition. Indeed, tax competition has positive as well as negative effects (McLure 1986; Frey and Eichenberger 1996). Therefore one should not claim that the lack of coordination in tax policy is always inefficient.



tax burden on unskilled labor in the European Union (European Commission 1996).

The prisoner's dilemma, however, makes cooperation difficult to achieve but not impossible. The literature on international policy regimes shows that collective action can overcome the prisoner's dilemma (Martin 1993). Further, competition does not necessarily end up with the race-to-the-bottom (Vogel 1995). This raises doubts over the usefulness of the prisoner's dilemma for interpreting all international tax policy issues.

I share these doubts and accordingly present three points. First, international tax policy should be examined on an issue-by-issue basis. The characteristics of the policy process depend on the issues involved (Hocking 1993; Krasner 1991). The downside of this choice is that interdependencies between different issues cannot be taken into account. Definitively, there is a trade-off between accounting for issue interdependence and analyzing the dilemma of cooperation on an issue-by-issue basis. One could even raise the objection that by looking at transfer pricing in isolation the whole picture of international tax policy is missed. The point is well taken, but transfer pricing policy is characterized by specific policy instruments, distinctive patterns of institutionalization, and most importantly by a strategic structure of interaction that is different from the one that can be found in other tax issues, such as the taxation of portfolio investment. Thus, the choice of investigating tax policy on an issue-by-issue basis can be defended.

Elaborating upon the first point, the second point is that the most appropriate model should be chosen on the basis of the specific tax issue under consideration. Transfer pricing, accordingly, should be analyzed by taking into account the structure of strategic interaction in this issue area. For transfer pricing the best model is not a cooperation game, but a coordination game<sup>3</sup>.

Third, game-theoretic models provide the initial conceptual framework, but they must be supplemented by forms of analysis more sensitive to the contextual aspects of the policy process. Accordingly, I draw upon the insights of new institutionalism in organization theory (Powell & DiMaggio 1991; Zucker 1988). The latter shows how institutional entrepreneurs lead the policy process towards *conflictual* institutionalization. The article is organized as follows. I review the policy problem of transfer pricing and provide the conceptual framework for analysis, before empirical evidence is introduced (by considering

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<sup>3</sup> Similarly, authors working on game-theoretical approaches to international relations have argued that the nature of interdependence between states differs across issue areas and have criticized the tendency to consider the prisoner's dilemma as *the* problem of international coordination (Krasner 1991; Snidal 1985).

the US arena and then the wider OECD arena). Finally, I present some concluding thoughts.

## **AN OVERVIEW OF THE TRANSFER PRICING PROBLEM**

### **What transfer pricing is all about**

The search for international tax cooperation started a long time ago, first with agreements between states for the taxation of diplomats at the turn of the century, followed by the work of the League of Nations. More recently, the Organization for Economic Cooperation and Development (OECD) has developed models for bilateral tax treaties and guidelines for transfer pricing policy. Broadly speaking, today the international tax system still follows the path-breaking suggestions of the League of Nations. The main components of this system are the tax treaty network, the classification of types of income (in international tax policy the right to tax is allocated either to the source or to the resident country depending on the type of income), the residence principle (which stipulates that a state shall tax residents comprehensively, that is by including the income produced by residents abroad, although in practice this principle encounters serious limitations), and tax rules for transfer pricing. As 60% of world trade is accounted for by multinationals, transfer pricing rules are one of the most important elements of the international tax system (OECD 1995).

The essence of transfer pricing tax rules is to establish how transactions within a multinational (the price that a subsidiary, for example, charges to the parent company for specific components of a product) should be accounted for tax purposes. The OECD, the major forum for international tax policy, has always recommended the so-called arm's length method as a standard for transfer pricing. The essence of this method can be articulated as follows: for tax purposes, related enterprises within a multinational are treated as if they were separate businesses. Consequently, multinational companies must account for transactions (of goods and services) between their subsidiaries at transfer prices identical to the ones charged to unrelated companies.

The pressure points on this method boil down to the fact that the arm's-length is extremely difficult to employ when sophisticated transactions occur. Sometimes it is impossible to refer a cross-border transaction within a multinational to a similar transaction between unrelated companies because the product exchanged is unique. If there is not a market for a particular product it is impossible to establish the market value of a transaction. Moreover, the



proliferation of transactions involving 'intangibles', research and development (R&D), and central services makes the arm's-length method less manageable. Finally, by postulating that enterprises within a transnational group are separate entities, the method goes against the rationale of a transnational company. Indeed, a transnational company is established for the very purpose of dealing with a unitary business.

These pressure points have spawned criticisms of the arm's length. One alternative to the arm's length is worldwide unitary taxation (this is the alternative supported by a few American states, but not by the US government), another is profit methods (more popular at the US Treasury). Let us start with unitary taxation first. The idea of the unitary tax method is to substitute complicated calculations and almost endless tax disputes with a formula for distributing taxable income in different jurisdictions. According to the unitary method, a company's taxable income in a given state is calculated by multiplying the total world-wide company's income by a factor based on some mix of property, payroll and sales located within that state. The unitary system (also known as formula apportionment) is hence based on the idea of apportioning the taxable income by means of a formula reflecting the activity of the transnational company in a given jurisdiction. As such, it presents clear benefits to revenue authorities<sup>4</sup>. Under the arm's-length method, multinational companies can disguise their profits in one way or another; by contrast, when unitary methods are applied, there is no way to conceal the fact that an extensive market presence in a state (as measured by property, payroll, and sales) has to be reflected in substantial taxable income within that jurisdiction.

The flip side of the coin, however, is that the unilateral resort to formula apportionment leads to double taxation (because it conflicts with other rules used elsewhere). In addition, multinationals object to formula apportionment because of its impracticalities and high compliance costs. The US federal government has chosen to reject formula apportionment because of its negative international repercussions. At the same time, aware of the problems created by

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<sup>4</sup> This statement should not be exaggerated, however. Formula apportionment based on factors such as payroll, sales, and property could negatively affect the United States because significant income generated by US transnational companies is not attributable to the three factors, but to intangible property. In other words, it is not clear at all whether the United States as a whole would benefit from the application of formula apportionment on a world scale or not. At the same time, specific US states hosting foreign companies could benefit from world-wide apportionment, at the cost, however, of making international coordination of transfer pricing issues impossible. Of course, single US states can be more interested in getting revenue than in building international cooperation, but this is precisely the reason why the US federal government has argued against a unilateral resort to world wide formula apportionment.

the arm's length, it has favored methodologies that rely less on comparable transactions (which can be extremely hard to find) and more on broad industry-based profit measures (profit-level indicators). The idea is to measure a range of transfer prices by reference to objective measures of profitability. Profit methods, however, require considerable expertise within tax administrations, accurate economic information on the different industries, and sophisticated econometrics. In terms of human resources, database and methodologies the US is by far in a better position than any other member of the OECD. Unsurprisingly then, European countries raise obstacles to profit methods.

### **The nature of strategic interaction in transfer pricing policy**

Whatever method is chosen, the aim of transfer pricing policy is to allocate taxable income among different jurisdictions with two purposes. First, there is the goal of avoiding international double taxation: world trade can proceed without tax impediments only if international transactions within multinationals are not taxed twice. Second, transfer pricing rules limit tax-induced income shifting within companies. Indeed, multinationals can avoid taxes by manipulating the value of international transactions taking place within the firm.

The question arises whether transfer pricing is inherently different from other tax issues in terms of the nature of strategic interaction. True, there is an element of cooperation games (i.e., tax competition) in transfer pricing policy: for example, a few years ago Florida decided to accommodate the preference of foreign multinationals for certain transfer pricing rules with the aim of attracting more foreign business. Similarly, in 1984 Oregon abandoned unitary tax with the hope of attracting firms dissatisfied by California's unitary tax provisions (Hocking 1993:148-149). Additionally, low tax rates attract the profits of multinationals. Accordingly, countries can compete by lowering tax rates.

However, income shifting via transfer pricing complicates the picture. Tax planning, indeed, makes a high-tax jurisdiction an interesting place for the allocation of costs. Thus 'a country's high statutory corporate tax rate might constitute less of a disincentive to locate investment there than would be the case in the absence of income shifting' (Daly 1997: 796). Additionally, relocation of a multinational's activity is less simple than moving an account from one country to another. Most importantly, in transfer pricing *actors want to use a common standard, although they cannot agree on the standard to be employed* (arm's length, unitary taxation or profit methods). The main problem



is standard setting, not free-riding (typical of cooperation games). This is what makes strategic interaction in this issue area similar to a coordination game such as battle of the sexes. In this game, players want to coordinate their strategies, but there is no agreement about which outcome is better. In fact, this game has two Nash equilibria in pure strategies:  $(S_1; s_1)$  and  $(S_2; s_2)$ .

**Figure One - Battle of the Sexes**

		Player 2	
		$s_1$	$s_2$
Player 1	$S_1$	(2,1)	(0,0)
	$S_2$	(0,0)	(1,2)

In a prisoner’s dilemma, a player can impose costs on the other players independent of the other players’ choice. For example, unbridled tax competition for portfolio investment is a beggar-thy-neighbor policy wherein a country allocates costs on the other countries, whatever they do. But in battle of the sexes each player allocates costs and benefits on another player contingent upon the other’s choice: ‘neither state can choose its best policy without knowing what the other intends to do, but there is no obvious point at which to coordinate’ (Snidal 1985:932). This is what is at stake when the issue is building (or breaking) international conventions in transfer pricing.

**The conceptual framework: game theory and institutional entrepreneurs**

The consequences of changing conceptual lenses are not trivial. First, in a coordination game, players want to coordinate their strategies, but they prefer different outcomes. Second, the lack of centralized enforcement (or enforcement by issue-linkage) is indicative of coordination without a cooperation problem. Under ‘battle of the sexes’ conditions, the absence of a central organization setting standards does not impede coordination (Krasner 1991; Stein 1982). Regimes based on diffuse reciprocity, generalized principles, and convergence of expectations are conceptually distinct from international organizations. Coordination can still be reached, and perhaps more efficiently, given that fragmentation allows actors to side-step vetoes which are a common cause of deadlock in centralized structures (Genschel 1997).

As observed by Snidal (1985:932), in a coordination game 'no centralized enforcement is necessary, because neither state has incentive to depart from an established convention'. Additionally, 'any role for centralized authority in coordination problems is likely to be less concerned with enforcement than with codification and elaboration of an existing or latent convention and with providing information and communication' (Snidal 1985:932). Regimes involved in coordination problems 'will generally have low levels of institutionalization, concerned primarily with facilitating the choice, interpretation, and observance of a particular convention. This will involve information gathering and informal consultation about the preferences and policies of states as well as providing a forum for the resolution of bargaining problems pertaining to the choice of a particular convention' (Snidal 1985:938). This is an exact description of the role played by the OECD in transfer pricing. Historically, the OECD has assisted and facilitated the evolution of conventions such as the arm's length method, and, as shown below, it has provided a forum for the negotiation of new guidelines in the 1990s.

A third property of coordination games pertains to policy change. Once reached, a solution in battle of the sexes tends to be very stable because of the self-enforcing properties of equilibria in this type of game (Snidal 1985). This implies that regime stability can become dysfunctional when new conditions affect the issue area. In transfer pricing, the main problem so far has not been how to reach a point of equilibrium (in fact, the arm's length method represented the standard). Rather, the problem has been how to adapt the OECD regime to new economic conditions (for example, the growth of intangibles and unique products) which had made the arm's length obsolete in many circumstances. International transfer pricing policy in the 1990s, therefore, has revolved around the issue of producing change and adaptation in an inherently stable policy regime.

Here game theory provides two useful insights. For one reason, time matters. A long duration of the game makes players more concerned with the precise distributional characteristics of coordination outcomes (Krasner 1991; Snidal 1985). In the prisoner's dilemma, time (in the form of repeated games) provides incentives to cooperation (Axelrod 1984), but in battle of the sexes time may induce players 'to upset prevailing coordinated outcomes in an attempt to institute a movement to other conventions which are more favorable to them' (Snidal 1985:936). For another, leadership also matters. Leadership can provide adaptability when circumstances change (Snidal 1985:939-940). An entrepreneurial actor can promote change in otherwise static regimes.



Of course, players can move first both in cooperation and in coordination games. For example, trade can be modeled as a cooperation problem, and it is clear that certain players often seek to move first in this issue area. But the consequences of moving first in a coordination game are peculiar. In battle of the sexes, if a player moves first, independently from the other player's consensus, the other player's opportunity space is reduced to two options: either co-ordinating by accepting the first player's conditions, or no coordination at all. If the first player has already moved to  $S_1$ , coordination at the second player's conditions is no longer an available option (fig. one). Coordination via sequential agreement ( $S_1, s_1$ ) will be preferred to no coordination at all ( $S_1, s_2$ ).

But who is likely to destabilize the status quo? In a prisoner's dilemma the status quo will be threatened by *small* players who cheat surreptitiously for 'immediate self-aggrandizement' (Stein 1982:130). In battle of the sexes, dissatisfaction with the status quo will take the form of a public attempt - by a *large* player - 'to force the other actor into a different equilibrium outcome' (Stein 1982:130). Asymmetries (for example, the presence of small and large states) 'favor larger and more influential states' (Snidal 1985:935). This is extremely important for international tax policy. In tax issues where strategic interaction follows the patterns of a prisoner's dilemma (an example is tax competition for portfolio income), small states are systematically advantaged (Kanbur & Keen 1993). In the case of transfer pricing, by contrast, large states are not blackmailed by small tax havens and therefore can play a more dynamic role.

The notion of solutions that can be reached by committed players moving first is rather abstract, however. The study of the emergence of institutions is of fundamental help in going beyond abstract notions and explaining how order is created out of entropy. In an influential paper, organizational theorist Lynne Zucker (1988) has challenged the conventional approach to social systems, based upon the ideas of stability and homeostasis. By contrast - Zucker argues - social scientists should 'open Pandora's box, allowing disorganization to emerge as a central principle' (Zucker 1988:25). This is useful for the analysis of policies such as international taxation where there is not as yet a strong element of cooperation and players struggle with a situation of entropy and disagreement about the principles to follow.

The fundamental question becomes how is order created? In her paper, Zucker complains that 'institutional theory is alone among social science theories in having no explicit or formal theory of the role that individual interests and accompanying power differentials play in institutionalization' (Zucker 1988:27). Another organizational theorist, DiMaggio, provides a solution by

arguing that institutional order arises out of institutional entrepreneurs who impose their institutionalization projects upon entropy. Following the classic Eisenstadt (1968:413), an institutional entrepreneur is 'able to articulate new goals, set up new organizations, and mobilize the resources'. There is a similarity with the concept of policy entrepreneur as developed by Kingdon (1984), but DiMaggio (1988) stresses the more conflictual elements involved in the structural politics of institutionalization: institutions emerge through a *political* process in which the institutional entrepreneur mobilizes power for creating new norms, values, rules and 'ways of doing things'.

As hinted above, new institutional theory has the merit of shedding light on the problematic aspects of institutional entrepreneurship. When institutional entrepreneurs appear, conflict, consensus and power are jointly present in the policy process. Institutionalization, indeed, requires the mobilization of power resources and, at the same time, is itself a source of power. The structural politics of creating rules, principles and 'ways of doing things' (i.e., institutionalization) is inherently conflictual. Innovation and entrepreneurial projects in international taxation, given the low institutionalization of this policy, originate conflict precisely because imposing governance upon a turbulent international tax world is all about using and creating power. Whilst some actors actively promote their project for the future tax world, others will resist.

To sum up, the problems of the international tax system cannot be always reduced to the prisoner's dilemma. There are also issues, such as transfer pricing, where strategic interaction can be modeled as a coordination game. Accordingly, solutions can be achieved even in the absence of formal standard-setting organizations. Committed players facilitate the emergence of solutions, but - new institutionalism theory hastens to add - the process leading to these solutions is conflictual.

## **REFORMING TRANSFER PRICING RULES: INSTITUTIONAL ENTREPRENEURS AND CONFLICTUAL INSTITUTIONALIZATION**

### **The US arena**

One of the major aims in building cooperation in tax policy is to forge consensus over transfer pricing rules. The OECD has been instrumental in diffusing the arm's length method through its guidelines and model conventions. The method also had an important political implication: the reference to market transactions, which is the core of the arm's-length, provides



a 'natural' criterion for the allocation of taxable income between one jurisdiction and another. This 'natural' criterion, as noted by Picciotto (1993:404), has the effect of de-politicizing and technicizing the process of inter-jurisdictional allocation. The harsh criticisms that in the US surround the arm's-length have had the opposite effect of revealing the political nature and the consequent potential for conflict, of international allocation of taxable income.

The arm's length is under stress both for technical and policy reasons. The technical reasons have been explained above: it is almost impossible to draw upon comparable market transactions for certain functions (R&D, personnel, and headquarter services) and certain products (intangibles). The policy problem refers to the abuse of transfer pricing rules by multinationals: although it is very difficult to provide precise data, there is indirect evidence on income shifting via transfer pricing<sup>5</sup>.

Analyzed in terms of strategic interaction, this situation resembles a coordination game where a player (the US) is worried about distributional consequences. Income shifting by foreign-owned multinationals, in fact, deprives the US of revenue. Coordination games with distributional consequences arouse conflict (Krasner 1991). However, the battle of the sexes properties of this strategic situation are such that a committed player can 'force' a new co-operative equilibrium. In order to examine this process, we turn to empirical evidence. The analysis proceeds in two steps. First, I will argue that the risk of breaking up consensus is real. The major threat comes from American states willing to play outside the boundaries of international consensus. Accordingly, they pursue a very aggressive policy in transfer pricing, without considering the implications for the international tax system. Second, I will show how the US federal government has been instrumental in leading the OECD countries towards a new equilibrium, represented by the 1995 OECD transfer pricing guidelines (OECD 1995). The cost of reaching a new equilibrium has been high in terms of conflict, however. Not only was the US government at pains to fend off the domestic threat represented by the least co-operative states, but American action at the international level was initially perceived by the other OECD countries as a destabilization of the then current standard. Indeed, in order to reach a new equilibrium one has to 'destabilize' the old one first! The process leading to cooperation via institutional entrepreneurship is inherently conflictual.

<sup>5</sup> Evidence is indirect, however. For example, Grubert *et al.* (1993) compared the tax liabilities of US-owned firms with the tax bills of foreign-owned companies in the United States and concluded that approximately half of the variation was not explained by size, firm age and other variables. But this unexplained variation could be either the result of income shifting or the impact of omitted variables (Hines 1996).



Let us begin with the threats to the arm's length. As already mentioned, in the US criticisms of the arm's length method are rife. Even President Clinton charged foreign multinationals operating in the US with abuses of the arm's-length method during his 1992 presidential campaign. Given the federal structure of the American political system, it is also interesting to investigate political pressure against the arm's-length method at the state level. A number of states, such as Alaska, North Dakota, Montana and, until 1986, California, have opted for a particular extension of unitary taxation based on worldwide reporting. Foreign companies are assessed on their worldwide income, which is then apportioned in order to compute the amount of taxes to be paid to the state's revenue authorities. Multinationals have always resisted the 'worldwide' extension of unitary taxation. As documented by Hocking (1993), the controversy over California's unitary taxation in the 1980s spawned a political confrontation involving California, the federal level, transnational lobbying, British policy-makers and even the European Community. Hocking concludes that 'whilst it would be a simplification of a complex set of circumstances to view the alignment of forces as consisting of foreign business interests, governments and international bodies, together with key US federal government agencies versus the states, it is not a gross distortion of reality' (Hocking 1993:200).

California repealed worldwide unitary taxation in 1986, following a period of tense confrontation in which the UK government introduced retaliatory legislation and a bill was introduced into the US Congress for limiting worldwide unitary taxation<sup>6</sup>. The 1986 provisions gave companies the possibility to be assessed for tax purposes with a 'water's edge' limitation, i.e. the corporate income to be considered for tax purposes in California would be limited to the one originated within the US borders. The new California law included an 'election fee' to be paid by companies willing to opt for the 'water's edge' and new powers of the California Franchise Board regarding the determination of whether businesses were unitary or separate entities<sup>7</sup>.

In conclusion, a cross-border fiscal problem at the state level became fully politicized so much so that the relationship between the UK and European institutions (such as the European Community), on the one hand, and the US, on

<sup>6</sup> Retaliatory measures were passed in Section 54 of the 1985 Finance Act. In the US, the bill introduced by Senator Wilson in 1985 prohibited states from taxing corporations under the worldwide unitary tax method.

<sup>7</sup> The situation was not completely settled as foreign companies maintained that they were not prepared to pay an 'election fee' for opting out of the worldwide assessment. A legal battle between the UK Barclays Bank and California went on up until 1994 and terminated with a decision of the Supreme Court in favour of California.

the other, was under pressure. This sheds light on the amount of entropy present in the international tax system: the decision of a sub-national government can trigger an international row. The reason for this is that the international tax system has a very limited degree of institutionalization and therefore is particularly vulnerable to entropy.

However, the threat to international tax stability does not come only from California. The American 'revolt' against the arm's length method is echoed in Congress by 'champions' of the unitary method such as Senator Byron Dorgan of North Dakota. His opinion is that the calculations required by the arm's length method produce an extra-burden on tax administration and permit multinationals substantial income shifting.

Given this state of the play in the domestic arena, the US government decided to take the lead in the international reform of transfer pricing rules, but without supporting the advocates of worldwide unitary taxation. From the perspective of the federal government, the California tax saga demonstrated how tax rows could create dangers to free trade and even risks of ruffling diplomatic feathers between the US and European countries. Therefore, the US Treasury chose a third way between unitary taxation and the arm's length, the key idea being to dilute the pivotal position of the arm's length and to accept new methodologies, based for example on economic analysis of profitability. The next section shows how the transfer pricing policy process evolved in the international arena.

### **The international arena**

Given the domestic political pressure on the US Treasury to challenge the arm's-length principle, the Treasury decided to pioneer international transfer pricing reform and, at the same time, it condemned the worldwide formulary approach (Samuels 1995). The Treasury decided to play in the international arena without waiting for prior consensus, and issued proposed regulations on international transfer pricing in 1992. The move, although anticipated by a Congressional decision on intangibles (1986) and a White Paper produced by the Internal Revenue Service in 1988, was not prepared by bi-lateral or multi-lateral talks between the US and the other OECD partners. The US position was that Americans were legitimately changing their *national* legislation because of a precise congressional mandate and dissatisfaction with the distributional consequences of the arm's length (i.e., income shifting by foreign owned multinationals). These proposals were followed by the 1993 temporary regulations and eventually the 1994 final regulations were issued. An important point to observe is that these three episodes reflect a process of learning and adaptation of the players. The US played first, but then had to cope with the



reaction of other countries in order to reach agreement at the OECD level. This element of learning cannot be captured by the stylized structure of game theory, but it represents an important aspect of building coordination in international tax policy.

Turning now to the 1992 proposed regulations, they were extremely critical of the arm's-length principle. The most controversial element of the proposed regulations was the appearance of a profit-based method, the 'comparable profits interval'. The latter, contrary to the arm's-length, is not based on transactions: this means that revenue authorities can make adjustments of transfer prices without looking at specific transactions. Instead, they consider overall profit indicators of the controlled company and compare them with the profit indicators of comparable companies. To some commentators, for example the Baker & McKenzie North American Tax Practice Group (1994:546, emphasis in original) it appeared that the comparable profits interval method had become *'the most important method, as it had a role both as a primary pricing method and as a required check on most of the other methods'*.

The reactions to the 1992 proposed regulations were - as noted in the Baker & McKenzie briefing report (1994:547) - 'vociferous and often critical'. Lodin, for example, stated that the choice of profit methods 'represents a major deviation from the internationally accepted concept of the arm's-length principle, which moreover will be impossible to apply in a wider international context' (Lodin 1995:240). It is at this point that the other players reacted to the American move. A special task force, composed of nine member countries, was set up by the OECD, with the purpose of analyzing the US proposed regulations. This task force recommended several amendments to the US proposals.

From this point on, the policy process evolved toward a closer dialogue between the US and the countries represented within the OECD task force. As hinted above, a general characteristic of this process was learning and mutual adaptation. In reaction to the report of the OECD task force, the 1993 US temporary regulations eliminated part of the emphasis on profit methods<sup>8</sup>. The dialogue between the US and the OECD continued with a second OECD report in 1993 in which further amendments were suggested (OECD 1993). Finally, the 1994 final regulations were issued by the Treasury. These regulations reaffirm the American position that more than one method has to be considered acceptable. The best method is the one that, given certain facts and

<sup>8</sup> In the 1993 temporary regulations profit methods were no longer considered a mandatory check on other methods and therefore lost their primacy. In addition, the comparable profit interval was rejected in favor of the comparable profit method.

circumstances, comes closer to arm's-length results. The arm's length is reduced to a yardstick (there is a range of arm's length prices, not a single one), and 'arm's length results' can be reached by employing different transfer pricing methodologies. In this conceptual framework, profit methods are not given priority; yet they are considered valid in cases of last resort. To sum up, behind the scenes of a technical debate about the difference between the arm's length as a method or yardstick, the US final regulations maintain the criticism over the pivotal position of the arm's length, but, reflecting a process of learning from the OECD reports, are still cautious on the use of profit methods. Yet they can be used, and tax inspectors in the US often go beyond the arm's length by relying on American regulations that are now considered fully legitimate by the OECD.

So far only US regulations have been considered. What about the OECD guidelines? The old 1979 OECD guidelines on transfer pricing were in need of revision and the US initiative operated as a catalyst of the revision process. A major effort of the OECD was to build consensus and avoid the risk of the US defecting from international cooperation. The 1994 US regulations were issued a few days after the OECD new guidelines were presented to the public in draft. In the OECD draft the use of profit methods was considered appropriate when data would not exist or would be so poor as to flaw transaction methods. Influential OECD officers hastened to affirm that the US regulations 'are consistent with the spirit - and in some cases use languages which are strikingly similar to the OECD draft guidelines' (Hay, Horner, & Owens 1994:425). In turn, Leslie B. Samuels, assistant secretary for tax policy at the US Treasury, praised the OECD 'for making an extremely important contribution to tax administration'. He went on to say: 'This is why the revised OECD guidelines are so important. They represent broad acceptance by all our major trading partners of the reality that the traditional methods are appropriate when the data to apply them is adequate. But the traditional methods must be supplemented by new methods when the data is not adequate' (Samuels 1995:66).

This position was however criticized by commentators who argued that:

The USA was in a hurry because it wanted to obtain the blessing of the OECD for its highly problematical regulations on transfer pricing, which were being revised at the same time as the OECD was conducting its deliberations. Thus we already hear from official American sources that the new American regulations have been endorsed by the OECD, and that the latter's guidelines were in line with the regulations of the US (Ritter 1994:312).



Of course, the US Treasury and the OECD worked together. US officers were aware of the potentially destabilizing impact of their ideas and hence they attempted to minimize the divergence between the US and the OECD. The latter had independently decided to revise its guidelines on transfer pricing, but could not disregard the fact that the US is a tremendously important part of the tax system. Therefore the OECD revision had to convey at least part of the US concerns with the arm's length. Moreover, by 'blessing' the US regulations, the OECD strengthened the US federal government *vis à vis* the unitary tax constituency, represented in Congress and hegemonic in a handful of states.

It would be a gross simplification, however, to state that the OECD countries co-ordinated passively at the US position. The OECD draft was discussed by European governments (France and Germany being the most active countries), professional associations (such as the *Fédération des Experts Comptables Européens*, FEE 1995), and pressure groups (for example, the International Chamber of Commerce, ICC 1995). All of them insisted on the same point: profit methods should not be considered compatible with the arm's-length methods. However, a compromise was reached at the OECD level in 1995 when the first part of the final OECD guidelines was published. The final guidelines issued by the OECD contain an extremely qualified acceptance of profit methods: indeed they are not banned, but they have to be based on transactions and only as a last resort (table one). The idea is that profits arising from controlled transactions are compared to profits arising from comparable transactions between independent entities. The final guidelines reject the possibility to compare overall profit indicators: instead of profits with profits, transactions are compared with their respective profits (OECD 1995). In conclusion, the OECD guidelines are not a photocopy of the US guidelines. Both the US and the remaining OECD countries took part in a learning exercise and they had to re-adjust their initial positions in order to reach consensus, although the final point of coordination is closer to the US position than to the European initial position of defending the arm's length under any circumstance.

Two points must be stressed. First, at the end of this process the US and OECD positions, although different, have now become compatible. The OECD has not provided standardization, but has nevertheless secured compatibility between previously incompatible positions. In the terminology of information technology and telecommunications, the OECD guidelines perform like a 'converter' which makes the American transfer pricing 'technology' compatible with European 'technologies' (Farrell & Saloner 1992). Mr. Jim Marshall, head of the KPMG European transfer pricing network, expressed this concept when describing the final OECD guidelines with the following words: 'this gives the

US an umbrella under which it can work'<sup>9</sup>. Second, the risk of failure and major entropy, had the European countries rejected the option of seeking to harmonize the OECD guidelines with the American regulations, was a driving force on the road to coordination<sup>10</sup>. The risk was made very vivid and plausible by the presence of pro-unitary tax voices within the US<sup>11</sup>. European countries and the US had to adjust their initial positions and learn from each other; yet it was the US position which represented a clear center of gravity in this policy process. This is consistent with the structural characteristics of coordination games. Historical sequencing and leadership matter: the decision to move first and the capability to provide leadership assisted the transition from the old equilibrium to the new one.

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<sup>9</sup> *Financial Times*, Global deals averts threat of transfer pricing war, 28 July 1995. A sympathetic comment of the OECD guidelines came from the US: see US Council for International Business, US Council welcomes approval of OECD transfer pricing guidelines, press release, 29 June 1995.

<sup>10</sup> This is clearly acknowledged by Mr Bernd Runge of the German Finance Ministry. He explains the reason why a very reluctant German government decided to agree: 'Had the OECD negotiations failed, it would have meant the dissolving of international consensus, put into question the work of the OECD on transfer pricing, weakened the OECD tax committee and shattered the model for non-OECD member states' (Runge 1995: 505, my translation).

<sup>11</sup> Runge (1995) argues that the US used the threat of more radical demands from the US Congress (in case of failure to reach consensus at the OECD level) as a negotiating tactic.

**Table One: A Comparison of US and OECD Transfer Pricing Rules**

	USA 1994 Final regulations	OECD 1995 Guidelines
Transfer pricing methodologies	<b>Comparable Uncontrolled Price (CUP)</b>  <b>Resale and cost-plus</b>  <b>Comparable Profits Method (CPM)</b>  <b>Profit Split</b>	<b>Comparable Uncontrolled Price (CUP)</b>  <b>Resale</b>  <b>Cost plus</b> <hr/> <b>Transactional Profit Methods:</b> a. Profit-Split b. Transactional Net Margin Method (TNMM)
Major differences	<ol style="list-style-type: none"> <li>1. No strict priority of methods. The CPM is considered a standard method.</li> <li>2. Flexibility: there is a range of arm's-length prices, not a single price.</li> <li>3. Recognition of profit-based methods as an approved alternative when transaction based methods cannot be applied. Profit methods operate by allocating income according to appropriate profit-level indicators for each of the parties to a controlled transaction.</li> </ol>	<ol style="list-style-type: none"> <li>1. Priority is given to the three traditional methods: CUP, resale and cost-plus.</li> <li>2. Only transactional profit methods are accepted, that is, methods based on transactions.</li> <li>3. Transactional profit methods can be used in cases of last resort. Their purpose is to determine whether transfer pricing policy of a company complies with the arm's length principle.</li> </ol>

Notes:

**Comparable uncontrolled price (CUP)**

CUP determines arm's length prices in the controlled transaction by reference to the amount charged in a comparable uncontrolled transaction.

**Resale-Price and Cost-Plus**

The two methods focus on opposite sides of the transaction. Resale price approaches the transaction by establishing a gross profit percentage for the distributor: any residual profit resides with the manufacturer.

The cost plus, instead, approaches the transaction by establishing the manufacturer's costs plus an appropriate mark-up: any residual profit resides with the distributor.

**Comparable Profits Method (CPM)**

The CPM relies less on comparable transactions and more on broad industry-based profit measures called profit-level indicators. It attempts to measure an arm's-length range of transfer prices by reference to objective measures of profitability.

**Profit Split**

There are two types of profit-split, the comparable (rarely used) and the residual, which allocates income from a transaction according to the relative contributions made by controlled parties to the transaction. Income attributable to routine contributions is allocated first. The remainder (or residual profit) is then allocated, primarily to the party owing valuable intangibles.

**Transactional Net Margin Method (TNMM)**

The net margin of the taxpayer from the controlled transaction should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions.



## CONCLUDING REMARKS

This study has shed light on one element of the international tax system in which the prisoner's dilemma is less important than the willingness to use common standards. Accordingly, strategic interaction in transfer pricing can be modeled as a coordination game. If this is correct, cooperation can be achieved even though the role of international 'standard-setting' organizations is limited. The OECD was able to offer a 'converter' between solutions which initially appeared mutually incompatible but the agenda for change was set by a single player. The US initiatives for transfer pricing reform were the main catalyst of the process. Cooperation, however, did not emerge smoothly. The events described in the previous section also show how difficult it is to generate consensus in international taxation. In the past, the arm's-length principle performed the function of 'framing' inter-jurisdictional problems of transfer pricing as technical problems (Picciotto 1993). The reference to 'natural' market mechanisms was essential in this respect. The current difficulties of the arm's-length method have shown the political dimension of inter-jurisdictional allocation of taxable income, which can no longer be considered a technical and de-politicized affair.

The emergence of policy innovation on the part of the US can be understood as a project of institutionalization. The 1979 OECD guidelines were no longer up to the job: the proliferation of intangible resources and the advent of the information society made a substantial revision necessary. The application of the arm's-length became increasingly problematic and revenue inspectors were in search of new ways of coping with new products, new industries and new forms of abuse. The US was the country suffering most from this development. Japanese and European companies operating in the US were minimizing their tax liability, presumably due to abuse of transfer pricing rules. In this scenario, the US took the leadership in innovation and, by moving first, forced the other OECD players to co-ordinate transfer pricing policy. The fact that a compromise was eventually struck with the 1995 OECD guidelines is the proof that international consensus - however fragile it may be - was achieved.

In this 'real world' process of cooperation building, institutional entrepreneurs cannot just play first and then wait for the other players to catch up. They have to persuade, accommodate and even reflect critically upon their initial position, as shown by the different waves of regulations issued by the US Treasury. The games that real actors can play (to paraphrase Scharpf 1997) are inevitably complex. Yet it is useful to draw upon the insights provided by game-theoretic models for understanding the structure of strategic interaction and then move on to consider the more dynamic aspects of the policy process with the aid of new

institutional theory. The following points, derived from game theory, have been corroborated by empirical evidence: (i) coordination without centralized authority is possible in international tax policy under battle of the sexes conditions, (ii) asymmetries favor large players rather than small states, (iii) time and leadership are the essential resources for change in otherwise dysfunctionally stable policy regimes, (iv) given its battle of the sexes characteristics, the analysis of policy change in international transfer pricing should emphasize conflict and the use of power, not market failures and the use of information (Krasner 1991). Finally, thinking of further research, the thorny question of choosing between rational choice and methodologies more sensitive to context and history is perhaps less dichotomic than is usually thought: successful cross-fertilization, instead, could be a more promising avenue.

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