

COMPARABILITY: PUBLIC INVITATION TO COMMENT ON A SERIES OF DRAFT ISSUES NOTES – RESPONSE TO THE OECD

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This is a response to the invitation for comments from Working Group #6 of the OECD Committee on Fiscal Affairs on draft issues related to the choice of comparables for transfer price regulation. Item B-8 in the section on uncontrolled transactions indicates that the working group has ruled out the use of controlled comparables even in vertically integrated industries. This position is consistent with the conventional wisdom which asserts that standard arm's-length methods cannot perform well when controlled comparable data is used because it encourages tacit collusion on transfer prices in a way that amplifies profit-shifting incentives. While this conventional wisdom certainly applies in competitive industries, it need not apply to industries with high degrees of vertical integration.

In an academic paper, [“Transfer Pricing In Vertically Integrated Industries”](#) co-authored with Petter Osmundsen of Stavanger University College, Stavanger, Norway, we show that strategic linkages between vertically integrated firms operating in the same final good market moderate, and can possibly reverse, profit-shifting incentives if the correct comparison method is used. The Cost-Plus method turns out to be the most effective in limiting the equilibrium amount of profit-shifting out of the high-tax country and it yields the highest tax revenues for the high-tax country. Our results are based on two observations. First, using transfer prices to shift profits from high-tax jurisdictions to low-tax jurisdictions requires a favorable transfer price and a significant volume of trade in intermediates. Second, a high volume of trade in intermediates will generally be correlated with a high volume of final good production. In imperfectly competitive markets, if all competitors respond to tax incentives by increasing both intermediate good and final good production, final good prices will fall enough to result in lower operating profits. As a result, competition incentives create a cost to profit-shifting. Our analysis shows that the choice of a comparability method will influence the magnitudes of the profit-shifting and the competition incentives. The economic structure of the Cost-Plus method increases the competition costs while the other common methods have the opposite effect. Our work suggests that the use of controlled comparables may be superior to the proposed alternative in the draft of weaker comparability standards.