

Abstract

Göteborg University
Gothenburg School of Economics
and Commercial Law
Department of Business Administration
Box 610, 405 30 Gothenburg
Sweden
<http://www.bjornlantz.com>

Doctoral thesis 2000
Author: Björn Lantz
bjorn@bjornlantz.com
Language: Swedish text with
summary in English
195 pages
ISBN 91-7246-181-0

Transfer Pricing with efficient incentives

The transfer pricing problem can be defined as the problem of formulating a pricing model that induces efficient production for internal monopolistic actors under divisional autonomy (including the right to possess private information). The theoretical base for this problem is the problem of (bilateral) monopoly. When an actor has market power, he maximizes his profit by supplying or demanding a quantity that is lower than the Pareto optimal quantity. If there is no external market at all for an intermediate product, the internal market is characterized by bilateral monopoly. Both actors will then want to transfer a Pareto suboptimal quantity in order to get a more favourable price. As they strive for different combinations of price and quantity, they will have to negotiate to find a solution. This negotiation is often assumed to result in a quantity that is Pareto suboptimal, as that is what both actors initially strive for. In this purest form, the transfer pricing problem thus coincides with the problem of bilateral monopoly.

The purpose of this study is to develop, analyze and test a theoretical transfer pricing model that solves this problem. The emphasis lies on efficient incentives, which means that we focus on how bilateral monopoly actors with private information can get incentives to abandon their wish to exploit each other and instead use their private information to strive for the Pareto optimal quantity. It is shown that a rather simple negotiation model characterized by bilaterally optional two-part tariffs (BOTs) using the previous period's tariff as a threat tariff accomplish this. Thus, from a dynamic perspective, this model solves the theoretical transfer pricing problem as well as the problem of bilateral monopoly under asymmetric information.

The BOT-model is also evaluated empirically in a laboratory setting. It is shown that under this form of regulation subjects earn significantly higher, though Pareto suboptimal, aggregate profits than under unregulated negotiations. This conclusion holds for both symmetric and asymmetric information.

Keywords: Transfer pricing; bilateral monopoly; incentives; decentralization

Printed in Sweden
Livréna Grafiska AB, 2000

© Björn Lantz and BAS