Ethical Issues in Transfer Pricing

Robert W. McGee*

ABSTRACT: Most papers on transfer pricing deal either with technical aspects of the topic or strategy. Research on ethical aspects of transfer pricing is almost totally absent from the business literature and is scantily covered in the ethics literature. The purpose of this paper is to fill that gap. Transfer pricing presents managers with several ethical issues. There is a legal obligation to pay taxes but there is also a fiduciary duty to shareholders to maximize profits. Someone stands to be harmed regardless of what kind of transfer policy is adopted but whether this harm constitutes unethical conduct has not been adequately explored. The author applies ethical theory to resolve these issues.

1. INTRODUCTION

Most papers on transfer pricing deal with either technical aspects of the topic or both. Very few papers examine ethical issues overtly. A ProQuest search found only two articles that specifically address ethical issues in transfer pricing.¹ I became aware of a third paper by chance while attending a conference but that paper was not published in an ethics journal and did not pop up on my ProQuest search because it is not one of the journals that ProQuest tracks.²

Most articles on transfer pricing are quantitative in nature, which is understandable given the nature of the subject. One of the main goals of establishing transfer prices is to minimize taxes for the enterprise as a whole,³ although that may not be the only goal. Transfer pricing can require complicated calculations,⁴ so it is understandable that most articles that have been published on transfer pricing are highly quantitative in nature. Very few substantive papers deal exclusively with qualitative approaches and only the three papers cited above address ethical issues.

* Director, Center for Accounting, Auditing, and Tax Studies, School of Accounting, Florida International University, USA. Email address: bob414@hotmail.com.

The purpose of this paper is to focus on ethical aspects of transfer pricing. The three papers that have addressed ethical issues have taken different approaches and have, at times, reached conflicting conclusions. The present article is intended to address these conflicts and fill a gap in the literature.

2. OVERVIEW OF THE TRANSFER PRICING LITERATURE

Since transfer pricing is a multinational subject, and since each country has its own transfer pricing rules, it is not possible to do a thorough and complete review of prior literature in one short article. However, it was thought that an adequate review could be made by focusing on the transfer pricing articles that had been published in the twenty-four journals the University of Texas-Dallas considers to be the top 24 business discipline journals. A search found 50 transfer pricing studies to have been published in those journals. Reviewing the specifics of each of those studies is not called for, since the focus of the present paper is on ethical rather than quantitative approaches. However, a few words can be said about some of those studies, as well as a few studies published in other sources, to give the reader a flavour for what the issues are and what research has already been done.

An Ernst & Young survey of 850 multinational corporations in 24 countries found that 40 percent of all respondents considered transfer pricing to be the most important tax issue facing their organization, which ranked higher than any other tax issue. It is so important that some large accounting firms have published guidance to assist their clients adopt a transfer pricing strategy.

The intelligent use of transfer pricing can also yield nontax benefits. For example, some countries have laws that restrict the transfer of capital. Transfer pricing policy can be structured to facilitate the transfer of capital. Such nontax considerations complicate management planning. It is a well known fact of mathematics that it is not possible to maximize two variables simultaneously, which can lead to conflicts. If one tries to maximize after-tax income (minimize taxes), one cannot simultaneously adopt a policy of maximizing the ability to transfer capital from one country to another. Management must set priorities.

A few qualitative studies have been published on transfer pricing. Jarillo published a short comment on a paper by Blois, the focus of which was transaction costs and networks. A few paragraphs of the Jarillo article discussed the case where the application of a transfer pricing rule might maximize joint profits between an independent supplier and customer. Thus, it was not really an article about transfer pricing, but rather an article that discussed transfer pricing in passing. The main focus of the article was transaction costs and networks.

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Ross, Vitale and Beath\textsuperscript{11} published an article that classified IT chargeback as an example of transfer pricing. They pointed out that transfer prices acted as a coordinating function to manage interdependence among business units. A good chargeback system motivates managers to make economic decisions that maximize the utilization of resources on a firm-wide basis and also aids in evaluating management performance.

Shackelford\textsuperscript{12} discussed several papers that examined the issue of whether corporations shifted income to the United States after the Tax Reform Act of 1986 reduced corporate taxes. The studies he discussed were inconclusive. One might think that companies were able to reduce their taxes by shifting income but that did not always happen in the studies he discussed. One reason he proffered was because the nontax costs of shifting income might have been higher than the amount of tax savings. Another reason why companies did not always shift income after the decline in tax rates was the fact that tax considerations played a secondary role compared to markets, infrastructure, access to capital, labour costs and political stability.

He also pointed out that income shifting was an uncertain business because the transfer pricing rules could and did change. Because the transfer pricing rules could change, companies tended to prefer contracts that were flexible and reversible.

But there were arguments in the other direction as well. Because U.S. tax rates had dropped relative to the rest of the world, there were incentives to shift income and the transaction cost of doing so might involve little more than accounting entries. It was not always necessary to make changes to the factors of production to achieve the goal. The lowering of tax rates that occurred as a result of the tax Reform Act of 1986 also caused companies to reexamine their transfer pricing policies, since it became possible to reduce taxes, in some cases by a considerable amount.

Of the three qualitative articles that were found on transfer pricing, the Shackelford article was the most substantive. It was the only study that examined transfer pricing head on and in depth. But it bordered on being quantitative toward the end when he criticized some technical points of the studies he critiqued.

The vast majority of the transfer pricing articles took quantitative approaches. Fowler\textsuperscript{13} found that multinational enterprises set transfer prices to their Canadian subsidiaries to maximize overall enterprise profits. When determining the profit maximizing price, companies considered not only marginal tax rates of both the parent and subsidiary but also the subsidiary’s dividend payout rates, tariffs and level of subsidiary ownership. Pugel and

\textsuperscript{12}Douglas A. Shackelford, \textit{Discussion of the impact of U.S. tax law revision on multinational corporations’ capital location and income-shifting decisions and geographic income shifting by multinational corporations in response to tax rate changes}, 31 J. ACCT. RES. (1993).
Ugelow\textsuperscript{14} commented on the Fowler\textsuperscript{15} article. They corrected some mathematical errors and recomputed the data on a Fowler table.

Burns\textsuperscript{16} asked financial executives what factors influence their transfer pricing decisions. She found that some variables and factors have a greater influence on transfer pricing decisions for some types of companies. Of the 14 variables examined, competition and market conditions in the foreign country and helping the foreign subsidiary attain a reasonable profit ranked higher than tax minimization. U.S. federal income taxes ranked fourth. Taxation in the foreign country ranked fifth. Some less important variables included economic conditions in the foreign country, import restrictions, price controls, exchange controls, customs duties, U.S. export incentives, management of cash flows, floating exchange rates and other U.S. federal taxes.

Al-Eryani, Alam and Akhter\textsuperscript{17} gathered questionnaire data from 164 multinationals and found that firm size and legal constraints are significant determinants in the selection of transfer pricing strategies. Eden and Rodriguez\textsuperscript{18} examined the relationship between transfer prices and international price indices. Eden, Valdez and Li\textsuperscript{19} examined the impact of the U.S. transfer pricing penalty on the stock market valuation of Japanese multinationals with U.S. subsidiaries. They found that the penalty caused their market value to drop by 12.6 percent.

Kassicieh\textsuperscript{20} discussed the behavioural consequences of setting transfer prices using a mathematical model. Bushnell & Oren\textsuperscript{21} examined a case where an assembly division selects an internal supplier of an intermediate product, then examined the relationship between production level and transfer price.

Kachelmeier and Towry\textsuperscript{22} discussed the issue of fairness in conjunction with negotiated transfer pricing. Edlin and Reichelstein\textsuperscript{23} examined the efficiency of specific investment under negotiated transfer pricing. Bailey and Boe\textsuperscript{24} address issues of goal congruence and

conflict. Merville and Petty\textsuperscript{25} attempt to optimize transfer pricing in an environment of competing and conflicting goals.

Watson and Baumler\textsuperscript{26} placed the issue of transfer pricing in a behavioral context but do so from the perspective of mathematics. Ronen and McKinney\textsuperscript{27} attempted to construct a transfer pricing system that allows division managers to make optimal business decisions even though the transfer pricing policy might subsidize or tax their division. Vaysman\textsuperscript{28} demonstrated that it is possible for a company to design a managerial compensation scheme that keeps managers fairly happy while also enabling the company to come close to maximizing profits.

Abdel-khalik and Lusk\textsuperscript{29} appraised the nature and scope of some major transfer pricing models. Ronen\textsuperscript{30} commented on their paper and they replied to Ronen’s comments.\textsuperscript{31} Arya and Mittendorf\textsuperscript{32} found that transfer pricing has a distortionary effect on the supply chain.

A few papers focused on the opportunity cost aspects of transfer pricing. Onsi\textsuperscript{33} published a paper that addressed the issue of opportunity cost. Talwar\textsuperscript{34} commented on his paper and Onsi\textsuperscript{35} replied to the Talwar comment. Smith\textsuperscript{36} found that transfer pricing had an effect on investment decisions. Dikolli and Vaysman\textsuperscript{37} found that the use of information technology in transfer pricing bargaining has advantages that outweigh the opportunity cost of managers’ bargaining time and that negotiated transfer prices result in higher profits than cost-based methods.

Some papers were heavily technical in nature. Halperin and Srinidhi analyzed the effects of the resale price method and the cost plus method on resource allocation decisions of multinationals when U.S. tax rates are higher than non-U.S. rates\textsuperscript{38} and also the effect that transfer prices have on resource allocation.\textsuperscript{39} They did a study of the transfer pricing rules for

\begin{thebibliography}{99}
\bibitem{36} Michael J. Smith, \textit{Ex Ante and Ex Post Discretion over Arm’s Length Transfer Prices}, 77 \textit{Acct. Rev.} 161-184 (2002).
\end{thebibliography}
intangibles using the arm’s length pricing approach. Burton and Obel used a random number generator to generate a statistical sample, and then used the data to arrive at conclusions.

Lambert discussed capital allocation within firms from a transfer pricing context. He also examined cost allocation problems. Harris, Kriebel and Raviv examined the issue of how a firm should allocate a resource among divisions when the resource’s productivity in each division is known only to the division manager. Westland examined congestion and network externalities in the short run pricing of information systems services. Kogut and Kulatilaka extended the stochastic dynamic programming model used in other studies to analyze hysteresis effects and in-country growth options. They showed that management coordination leads to changes in the heuristic rules used for performance evaluation and transfer pricing.

Ronen and Balachandran examined transfer pricing from the perspective of uncertainty under a decentralized regime. Kanodia examined uncertainty from a risk sharing perspective. Obel and Vander Weide examined capital budgeting problems under uncertainty where decision objectives verge from those of headquarters. Hass used a decomposition algorithm for quadratic programming to determine optimal pricing in a decentralized firm. Moore used human subjects in a simulation to examine a resource allocation problem.

Chalos and Haka examined transfer pricing under bilateral bargaining. Luft and Libby examined managers’ judgments about the effects of market prices and accounting profit information on negotiated transfer prices. Anctil and Dutta looked at negotiated transfer pricing from the perspective of divisional vs. firm-wide performance evaluation. Alles and Datar developed a model where two oligopolistic firms select their cost-based

transfer prices strategically, then derive implications for cost system choice and transfer pricing.

Lee and Whang\(^{55}\) examined the incentive problems that may result when decisions are delegated to site managers where each attempts to maximize his or her own performance metric. Arya, Mittendorf and Yoon\(^{56}\) demonstrated that manufacturers can benefit from decentralized control and the use of transfer prices above marginal cost using dual distribution.

Kanodia\(^{57}\) examined participative budgets as coordination and motivation devices and included transfer pricing policies in his analysis. Harris\(^{58}\) compared U.S. multinational companies’ income and investment activities before and after the Tax Reform Act of 1986 to see whether shifting had occurred after U.S. tax rates declined. Klassen, Lang & Wolfson\(^{59}\) also looked at shifts resulting from changes in tax rates but included the United States, the UK, France and Canada in their analysis. Jacob\(^{60}\) extended Harris\(^{61}\) by linking the level of taxes paid and profits reported to the volume of intergeographic area transactions within firms.

Baldenius and Reichelstein\(^{62}\) examined market-based transfer pricing when an upstream division has monopoly power in selling a proprietary component both to a downstream division within the same firm and to unrelated customers. They found that when the internal transfers were billed at prevailing market prices the transactions were distorted by double marginalization. They suggest imposing discounts to improve overall profits.

While many studies either assume or conclude that differential tax rates have an important influence on transfer pricing decisions, a study of Chinese tax audits by Chan and Chow\(^{63}\) found that not always to be the case. In fact, none of the companies in their study considered differential tax rates to be the main reason driving their transfer pricing policy. They actually shifted income out of China despite the fact that Chinese tax rates were lower than the rates in the other countries. Their reason for shifting was because of foreign exchange risks and control.\(^{64}\)


\(^{56}\) Anil Arya, Brian Mittendorf & Dae-Hee Yoon, *Friction in Related-Party Trade When a Rival Is Also a Customer*, 54 MGMT. SCI. 1850-1860 (2008).


\(^{64}\) Id., at 96.
3. **ETHICAL ISSUES**

One of the main goals of establishing transfer prices is to minimize taxes for the entity as a whole.\(^{65}\) The overall strategy is to recognize revenue in low-tax jurisdictions and to deduct expenses in high-tax jurisdictions.\(^{66}\) Transfer pricing methods make it possible for multinational corporations to reduce their tax liability by a substantial amount.

However, using the transfer pricing rules to reduce total tax liability raises several ethical questions for some ethicists.\(^{67}\) Do corporations that use the transfer pricing rules to minimize taxes pay less than their fair share of taxes in some jurisdictions? Are they being bad corporate citizens? Are managers in some tax jurisdictions rewarded unfairly for their efforts because the transfer prices corporations choose either reduce or increase their bonuses for reasons that have nothing to do with performance? What duty do corporations have to pay taxes to various governments? Is society harmed when corporations structure their transfer pricing methods in order to minimize taxes?

3.1. **Duty to Clients and Employer**

Tax practitioners have a duty to their clients to minimize taxes. Hansen, Crosser & Laufer\(^ {68}\) state that it is their ultimate goal. Accountants who work in a corporation’s tax department have a similar duty to minimize their employer’s taxes. Milton Friedman\(^ {69}\) espoused the view that the social responsibility of business is to increase its profits, which includes the view that it should minimize expenses, including taxes. Primeaux and Stieber,\(^ {70}\) one a theologian and the other a business professor, expanded on Friedman’s position.

Related to this duty argument is the efficiency argument. Primeaux and Stieber state their position as follows:

> From our perspective, any misuse or abuse of scarce resources (commonly referred to as factors of production and organized into four major categories – land, labor-time, capital, entrepreneurship/creativity) constitutes unethical behavior. Why? Because it is morally irresponsible on religious, philosophical, or legal grounds …\(^ {71}\)

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\(^{68}\) Id., at 679.


Messaoud Mehafdi\textsuperscript{72} states that transfer pricing ‘squanders scarce resources, destroys value and incurs unnecessary costs which eat into profits and cash flows.’ However, his argument is not convincing. While calculating optimum prices is not a costless venture, the resources expended on good cost accountants are more than offset by tax savings. Thus, if one looks at the big picture, investing in good cost accountants yields a highly positive return. Resources are preserved rather than squandered and after-tax income for the enterprise as a whole actually increases, perhaps by millions of dollars. Thus, the squandering of resources argument does not hold up under analysis.

Richard Posner, the eminent jurist and co-founder of the law and economics movement, would say that a policy is ethical if it increases efficiency and unethical if it does not.\textsuperscript{73} In another place he states that wealth maximization should be the goal.\textsuperscript{74} The underlying premise of Pareto efficiency is utilitarian. It is the de facto welfare criterion in managerial accounting texts.\textsuperscript{75} The literature of welfare economics is imbued with utilitarian ethics.\textsuperscript{76}

Tax practitioners and corporate accountants who do not minimize their client’s or employer’s taxes are thus acting unethically because they are breaching their contractual or fiduciary duty and because they are acting inefficiently. Using pricing strategy to achieve this goal by applying the transfer pricing rules of Section 482 of the U.S. Internal Revenue Code and similar provisions in the tax codes of other countries to maximum advantage is thus a duty. If overall taxes are not minimized it should be because nontax considerations outweigh tax considerations.\textsuperscript{77}

3.2. Fairness to Managers

Transfer pricing has an effect on performance evaluation.\textsuperscript{78} Fairness requires that managers be compensated based on performance. If their unit is profitable, their bonus should reflect that fact. Likewise, if their unit is not profitable, their bonus should reflect that lack of profitability.

But problems result when unit profitability is artificially increased or decreased because of the transfer pricing decisions headquarters makes in order to maximize overall corporate after-tax income.\textsuperscript{79} If transfer prices are set so that revenues are recognized in low-tax jurisdictions and expenses and cost of goods sold are maximized in high-tax jurisdictions, the result is different than if the market or internal negotiations are used to determine the transfer price.

\textsuperscript{72}Messaoud Mehafdi, \textit{The Ethics of International Transfer Pricing}, 28 J. BUS. ETHICS 365-381 (2000), at 369.


\textsuperscript{78}Id., at 403-404.

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It is easy to rectify this inequity. One set of prices can be selected to minimize taxes while another set of prices can be chosen to determine manager bonuses. This technique is called dual pricing. It is a quite common solution and is mentioned in accounting texts.80

3.3. Duty to Government and/or Society

Both the tax and the philosophical literature address issues relating to the duty to pay taxes. Several reasons have been given for this duty. Being part of a civilized society requires the payment of taxes according to one eminent American jurist.81 Paying one’s fair share is a moral obligation. People who pay less than their fair share force everyone else to pay more than their fair share.82 The big unanswered question is what is one’s fair share? Does fair share have any relationship to the ability to pay83 or to what the government does with the money?84 To benefits received?85 Is one obligated to pay at all if the government is evil or corrupt? 86 Various studies have concluded that the duty to pay taxes is less than absolute. There are limits.87

One question that has been raised in the literature is whether it is ethical to avoid taxes. In other words, is there a duty to pay more than what the law legally requires? Mehafdi88 seems to think there is a moral duty to pay more than is legally owed in the case of transfer pricing. Hansen, Crosser and Laufer89 also raise this question. But some jurists disagree.

Over and over again courts have said there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.90

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.91

80 CHARLES T. HORNGREN, S.M. DATAR, G. FOSTER, M. RAJAN & C. ITTNER, COST ACCOUNTING: A MANAGERIAL
EMPHASIS, 13th international ed. (PEARSON EDUCATION, 2009), at 807-808.
81 Oliver Wendell Holmes, Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S.
87, 100 (Holmes, J., dissenting opinion, 1927).
82 A. LEHMKUHL, THEOLOGIA MORALIS I (1902), n. 981, as cited in Martin T. Crowe, The Moral Obligation of
Paying Just Taxes. Catholic University of America Studies in Sacred Theology No. 84 (1944).
83 ROBERT W. MCGEE, THE PHILOSOPHY OF TAXATION AND PUBLIC FINANCE (KLUWER ACADEMIC PUBLISHERS,
2004).
Theology No. 84 (1944); ROBERT W. MCGEE, THE ETHICS OF TAX EVASION (DUMONT INSTITUTE FOR PUBLIC
POLICY RESEARCH, 1998); ROBERT W. MCGEE, THE PHILOSOPHY OF TAXATION AND PUBLIC FINANCE (KLUWER
ACADEMIC PUBLISHERS, 2004).
86 ROBERT W. MCGEE, THE PHILOSOPHY OF TAXATION AND PUBLIC FINANCE (KLUWER ACADEMIC PUBLISHERS,
2004).
89 Don R. Hansen, Rick L. Crosser & Doug Laufer, Moral Ethics v. Tax Ethics: The Case of Transfer Pricing
91 Learned Hand, Helvering v. Gregory, 69 F.2d 809 (CA-2, 1934), at 810.
No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.92

Hansen, Cresser and Laufer93 point out that compliance with the law is not necessarily ethical. They suggest perhaps there is a higher ethical calling. They are correct that not all laws need to be obeyed. The various civil disobedience movements hold this belief as a fundamental tenet. Unjust laws may be disobeyed. One might argue that there is even an ethical duty to disobey unjust laws. But it is difficult to justify paying more than the legal minimum in the case of taxes.

Tax avoidance does not provide an exemption from ethical behavior. Accounting professionals should be more concerned with what is right than with technical compliance with the law. In seeking to earn profits and minimize costs professionals must be held accountable to some level of collective well being ... if there is any hope for society in the aggregate to prosper, then some effort must be directed to encourage actions which serve the ‘greater good’.94

The entitlement theory holds that those who have earned the income have a superior claim to it than those who have not earned it.95 Applying this theory to taxes and government, one might easily conclude that the corporation, which has earned the income, has a claim that is superior to any government, since the government has done nothing to earn the income.

Walter Williams has made the following comment in this regard:

But you might say, if government didn’t do all that it’s doing we wouldn’t have a just society. What’s just has been debated for centuries but let me offer my definition of social justice: I keep what I earn and you keep what you earn. Do you disagree? Well then tell me how much of what I earn belongs to you – and why?96

If one were to follow this line of reasoning to its logical conclusion, government has no legitimate moral claim to any portion of anyone’s income, whether individual or corporate. But even if we concede that government has some legitimate claim to some portion of one’s total income, it does not follow that corporations have some mystical moral duty to pay more than the legal minimum. The claim of those who have earned the income is superior to the claim of some invisible society that has done absolutely nothing to earn the income. Thus,

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92 L. Clyde, Ayrshire Pullman Motor Services and D.M. Ritchie v. The Commissioners of Inland Revenue, Court of Session (Scotland), First Division, 14 TC 754 (1929), at 763-764.
94 Id., at 685.
95 ROBERT NOZICK, ANARCHY, STATE & UTOPIA. (BASIC BOOKS, 1974).
96 WALTER WILLIAMS, ALL IT TAKES IS GUTS (REGENRY PUB, 1987), at 62.
even if one can justify paying a portion of earned income to government, one cannot justify the transfer of corporate wealth to some segment of society without the consent of shareholders. Corporations are private clubs. If individual shareholders want to transfer their wealth to government or to some segment of society, that is their business, but it is a breach of fiduciary duty for corporate managers to give the government more than the legal minimum, since the assets they are transferring do not belong to them. Those assets belong to the shareholders.

3.4. Another Efficiency Argument

As was discussed above, the argument that there is some claim that society can exercise that is superior to the claim of those who have actually earned the income cannot hold up under analysis. Those who have earned the income have a superior claim to those who have not earned it.

But let’s take the argument a step further. What are the unintended consequences to society of minimizing taxes? If we want to speak in collective terms, is society helped or harmed if a corporation decides to minimize its taxes? I would venture to say that society is actually helped if corporations have a policy of minimizing taxes.

My position is based on efficiency. It is clear to anyone who has ever observed the workings of government that the private sector is more efficient than government. Numerous studies support this position. Table 1 presents some evidence that compares government provision of services to the private provision of services. The table clearly shows that the private sector is substantially more efficient than government.

<table>
<thead>
<tr>
<th>Function</th>
<th>% Savings by Privatization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aircraft maintenance</td>
<td>42-66</td>
</tr>
<tr>
<td>Asphalt overlay construction</td>
<td>49</td>
</tr>
<tr>
<td>Base operations support</td>
<td>42-46</td>
</tr>
<tr>
<td>Bus services</td>
<td>31</td>
</tr>
<tr>
<td>Educating students</td>
<td>51</td>
</tr>
<tr>
<td>Federal (U.S.) government</td>
<td>28-83</td>
</tr>
</tbody>
</table>


99 *JOHN C. GOODMAN, PRIVATIZATION* (NATIONAL CENTER FOR POLICY ANALYSIS, 1985), at 119.

100 *REASON PUBLIC POLICY INSTITUTE, PRIVATIZATION 2002: 16TH ANNUAL REPORT ON PRIVATIZATION* (2002), at 5.


102 *REASON PUBLIC POLICY INSTITUTE, ANNUAL PRIVATIZATION REPORT* (2009), at 89.
Grass maintenance 104 29
Grounds maintenance 105 11-23
Housing maintenance 106 19-42
Human resources 107 20-30
Janitorial services 108 42
Prisons 109 28
Refuse collection 110 30
Street cleaning 111 30
Street maintenance 112 27
Supply/logistics 113 1-38
Traffic signal maintenance 114 36
Vehicle operations & maintenance 115 48
Visual information services 116 61

That being the case, it makes sense to keep as many assets as possible in the private sector, since transferring them to the government sector results in misallocation of resources, which some of the authorities cited above conclude is unethical. Even if government is engaged in good work, it does not follow that corporations have any moral duty to support this good work if doing so squanders resources. Furthermore, corporate managers have a fiduciary duty to their shareholders not to transfer corporate assets to any individual, group or entity, including government, unless the transfer benefits the corporation.

3.5. The Harm Principle
Several philosophers over the centuries have argued that individuals should be permitted to engage in any activity so long as it does not result in harm to others. 117 This principle has

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104 JOHN C. GOODMAN, PRIVATIZATION (NATIONAL CENTER FOR POLICY ANALYSIS, 1985), at 119.
105 Id.
106 Id.
107 Id.
108 Id.
109 JOHN C. GOODMAN, PRIVATIZATION (NATIONAL CENTER FOR POLICY ANALYSIS, 1985), at 119.
110 Id.
111 Id.
112 M. C. Duff, Corrections Privatization Generates Savings and Better Services, 12 WISCONSIN INTEREST 21-28 (2003), at 24.
114 Id.
115 Id.
116 Id.
117 JOHN LOCKE, SECOND TREATISE ON GOVERNMENT (PROMETHEUS, 2002); JOHN STUART MILL, ON LIBERTY (LONGMAN, 2006).
come to be known as the harm principle. A variation of this principle is that individuals should be able to engage in any activity that does not violate the rights of others. These principles are actually quite different when viewed through the lens of a philosopher and I will discuss them as separate ethical principles in a few minutes. But first I need to address the arguments of one of the few scholars who have written on ethical aspects of transfer pricing.

Mehafdi asserts that transfer pricing ‘can be detrimental to the interests of host countries.’ He goes on to state that the harm can be physical, economic or psychological. Those harmed could be the transferor, the transferee, the company as a whole or some external third party. He suggests that where the harm can be quantified, there can be compensation to the party who is harmed, which can take the form of adjustments to the transfer price. He refers to those who are harmed as victims.

The physical damage he refers to is wear and tear of a division’s assets or depletion of inventories in the case of division managers who are transferors or transferees as well as the company’s top management and shareholders. He lists physical damage to the host country to include depletion of finite natural resources, environmental damage, health hazards to the local workforce and the wider society. Unfortunately, he does not elaborate on how transfer pricing causes physical damage to these groups, except to say that damage is caused by a corporation’s pursuit of economic growth and profit maximization, an allegation he does not back up with evidence.

His argument that transferors or transferees might suffer economic harm is easier to support. Transfer prices that are set to increase the revenue of the transferring corporate unit necessarily decrease the profits of the unit to which the goods are being transferred, and vice versa. One corporate unit suffers loss of return on assets, loss of sales revenue, loss of cash flow and perhaps loss of market opportunities. But the losses of one unit are exactly offset by gains to the corporate unit at the other end of the transaction, so one unit’s loss is exactly offset by the other unit’s gain. One might argue that transfer pricing increases transaction costs, but if the taxes saved are more than the transaction costs incurred, the corporation as a whole benefits.

Mehafdi’s claim that the company overall is harmed because of less value being created and reduced profits is not supportable. Transfer pricing merely shifts the amount of value created between units in the value chain. The total value created remains unchanged, or actually increases if one includes the valuable service performed by the cost accountants. Furthermore, transfer pricing enhances after-tax profits of the entity as a whole; it does not reduce them, as Mehafdi alleges.

Mehafdi points out that a transfer pricing policy might cause economic damage to the host country. The economic damages he cites are loss of tax income, loss of subsidies and other investments in foreign direct investment (FDI), increased national debt and increased

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118 MURRAY ROTHBARD, FOR A NEW LIBERTY (LUDWIG VON MISES INSTITUTE, 2006).
poverty. However, no country is entitled to tax revenue if a company or individual chooses not to do business with that country.

If an American or British company chooses not to invest in Country X, Country X does not receive the FDI it would receive if the American or British company had decided to invest in Country X. Unemployment will be higher than would otherwise be the case, but that is not the fault of the American or British company. It is the fault of Country X for not making itself more attractive as a place to invest. If Country X does not receive tax revenue, perhaps its policy makers should consider reducing its tax rates to make the country a more attractive place to invest. If Country X is harmed it is the fault of its own policy makers, not some foreign company that decides to invest elsewhere. The resulting poverty and national debt are not the fault of a foreign company that chooses not to invest in Country X.

One might even question whether the failure of a foreign company to invest in Country X harms Country X at all. If a foreign company decides to invest in Ghana instead of Haiti one cannot say that Haiti has suffered harm. It is in exactly the same place before and after the decision to invest in Ghana. Arguing that failure to invest in Haiti causes harm to Haiti is absurd. One might equally assert that deciding to invest in Ghana harms not only Haiti but also Cambodia, Vietnam, Nigeria and about 200 other countries. The only way to prevent harming those 200 countries is not to invest in Ghana. If a developing country has a large national debt or high poverty rates, it is not the fault of foreign companies that choose to invest elsewhere. It is the fault of the policy makers in that country who make their country a relatively unattractive place to invest.

Mehafdi’s argument that transfer pricing causes psychological damage has a grain of truth. Multinational companies need to be decentralized to a certain extent. That means local managers get to make decisions. When a transfer pricing regime is imposed from headquarters it takes away their decision making ability and autonomy. It is quite reasonable to expect a manager who gets the short end of the stick in a transfer pricing decision to be miffed, at the very least, as well as to feel a loss of control and perhaps a loss of self esteem, since the profit margin for that unit will decrease. Unit managers work long and hard to increase their unit’s profit margin. To have a portion of it sucked away by headquarters cannot help but make the unit manager upset. Several studies have mentioned this point.120

There also might be a loss of trust toward top management.121 A good management policy aims at keeping the troops happy. A top-down transfer pricing policy tends to make 50 percent of the troops unhappy. However, it also increases profitability by perhaps millions or hundreds of millions of dollars.

The psychological damage suffered by some unit managers can be partially compensated for by having a dual pricing policy, as was mentioned above. But it cannot undue the fact that their unit income statements look weaker than would otherwise be the case.

Let’s get back to a discussion of the harm principle now that Mehafdi’s views have been examined and discussed. The harm principle states that individuals should be able to engage in any activity that does not result in harm to others. Mill would go so far as to state that this is an ethical principle. This principle sounds liberal and noble. However, it is flawed because there is a difference between being harmed and having one’s rights violated.

Let’s take the example of a mom and pop grocery store. If a supermarket opens across the street from mom and pop’s store, it is highly likely that they will be harmed. Some shoppers will decide to give their business to the supermarket rather than mom and pop. If enough consumers make that decision, mom and pop might actually go out of business. They have been harmed, but it does not follow that their rights have been violated. Their right to sell their wares remains intact.

If one applies this enlightened view of the harm principle to transfer pricing, one quickly sees that even though some host country might be harmed, in the sense that it receives less tax revenues, its rights have not been violated because it is not entitled to a portion of income that the corporation earns in another country.

If one goes through the list of victims that Mehafdi identifies the same reasoning applies. If a German company decides to invest in Latvia rather than the United States because Latvia’s tax rates are substantially lower than those in the United States, one cannot say that American workers are harmed because they are in exactly the same position as before the decision to invest in Latvia. Latvian workers benefit because of their government’s foresight to keep tax rates competitively low.

4. OTHER ETHICAL ISSUES

Mehafdi asserts that there is ample evidence that companies use transfer pricing to circumvent capital controls or restrictions on funds movements and cites a few studies to support his claim. It is true that transfer pricing makes it possible to circumvent capital controls to take funds out of a country legally rather than illegally, but that is a good thing, for at least two reasons. For one, transfer pricing makes it unnecessary to resort to illegal means to take money out of a country, thus strengthening the rule of law. Secondly, it strengthens property rights because it allows those who own the property to transfer it as they see fit. Capital controls violate property rights. Using the transfer pricing rules to move capital thus reduces the amount of property rights violations, which makes the country a better place in which to live, work and invest.

Investment capital and profits are forms of property. In a just regime, property rights are protected. To the extent that some country prevents a company or an individual from transferring property from point A to point B it violates property rights. Transfer pricing is thus a means to protect property rights that might not otherwise be as strongly protected. Transfer pricing actually helps a just regime to do its job of protecting property.

Mehafdi asserts that ‘illicit’ profit repatriation contributes to poverty and loss of sovereignty for the host country. While it is reasonable to expect that taking capital out of a country might lead to increased unemployment and poverty in that country, it is equally true that the country where the funds are invested is likely to experience reduced unemployment and poverty. Mehafdi makes the mistake of looking only at the effects the transfer pricing policy will have on the country that loses the investment capital. In order to have a complete analysis one must also look at the effect the funds transfer has on the recipient country. What is one country’s loss is another country’s gain.

Mehafdi does not discuss the difference between licit and illicit profit repatriation, but if one applies property rights theory to the issue it is easy to conclude that all profit repatriations are licit, since the owner of the property should be able to transfer the property to another jurisdiction without interference. If there is an ethical issue at all it involves the ethics of some government preventing the transfer of property, since any restrictions must necessarily violate property rights.

It is difficult to see how the exercise of property rights – expatriating profits – can harm a country’s sovereignty. Mehafdi does not elaborate on this point. Perhaps he believes that governments should have control over private assets. If that is the case, perhaps having the ability to repatriate profits does have a negative effect on national sovereignty, but if that is so, it is a good thing, since governments should not be able to prevent property owners from exercising their property rights.

Jeffers, Burgess & Hughes allege that transfer pricing is subject to abuse and that transfer pricing manipulation is practiced. However, if one begins with the premise that there is no moral duty to pay government more than the law requires, it is difficult to see how abuse can exist, since the underlying premise for abuse is that someone is somehow doing something to improperly deprive someone else of something they are entitled to, which clearly is not the case when a company plays within the rules to minimize tax liability.

However, Jeffers, Burgess & Hughes go further by suggesting that many companies violate the law and engage in tax evasion, which is illegal, rather than tax avoidance, which is perfectly legal. They also suggest that governments should prosecute those who engage in what they consider to be abusive transfer pricing policies as criminals. The problem with this argument is that most companies are playing by the rules. An Ernst & Young study found

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that only 27 percent of tax audits result in an upward tax adjustment because of transfer pricing, which is a low percentage when one considers that tax audits of multinational corporations nearly always result in some kind of tax adjustment for some tax issue. Multinational corporations operate complex businesses and the proper tax treatment of certain items is not always clear. Legitimate differences of opinion might exist. It is not rational to state that all tax deficiencies should be considered criminal.

5. CONCLUDING COMMENTS

If one begins with the premise that corporations have no moral duty to pay more taxes than the law requires, most of the ethical objections to transfer pricing melt away. Corporate agents such as top management and the cost accountants who work for them have a fiduciary duty to their employer to minimize costs, which includes minimizing taxes. There is no duty to government to pay more than is legally owed.

Keeping resources in the private sector results in benefits to society because the private sector utilizes resources more efficiently than does the government sector. One might also point out that the private sector relies on voluntary exchange whereas the government sector relies on force or the threat of force, which one might argue makes the private sector ethically superior. Thus, keeping resources in the private sector causes that sector to become larger and stronger than would otherwise be the case.

Economic growth and job creation come from the private sector. One cannot say the same for the government sector. Government has no resources of its own. Whatever resources it has it must first take from someone. Government merely shifts resources. It does not create resources.

There is a negative correlation between the rate of taxation and the rate of economic growth.\(^{127}\) A one percentage point increase in a country’s tax/GDP ratio results in a half point drop in the growth rate.\(^{128}\) Redistributive tax policies reduce growth rates.\(^{129}\)

One possible problem, which may be classified as managerial or psychological rather than ethical, is the effect that transfer pricing policy has on unit managers. Although pricing policy needs to take into account the effect on the organization as a whole, some subunits may be adversely affected. Unit managers who have their unit’s profitability artificially reduced because of the company’s transfer pricing policy need to be made whole. That can be done by using a dual pricing policy, which computes bonuses using a formula that is different from the one used for transfer pricing.

