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Title: **TRANSFER PRICE DETERMINATION IN A MULTINATIONAL CORPORATION: DECENTRALIZED DECISION-MAKING, AGENCY COSTS, AND STRATEGIC INTERACTION**

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Abstract: Under decentralized decision-making (DDM), how does the multinational corporation (MNC) adjust the transfer price when international (effective) corporate tax rates change, ceteris paribus?

First, Eric Bond's (1980) decentralized model of transfer pricing is extended by completing the comparative static analysis. The results are more general than Bond (1980), confirm that the uses the transfer price as a profit-shifting mechanism to minimize its global tax liability to maximize its global after-tax profit, and show that an interior solution for the transfer price is possible. An interior solution implies that tax authorities may be less concerned with transfer pricing "abuses" than the centralized Thomas Horst (1971) model predicts. Also, underlying explanations are developed to support the assumptions of DDM, top management maximizing the MNC's global after-tax profit, and DGMs (division general managements) maximizing division after-tax profit.

Second, although agency costs are implicit in the basic model, an agency cost channel is explicitly built into the model to further address the criticism that the neoclassical firm is a "black box." That channel is: A perceived unfair transfer price by the parent DGM, reduced managerial incentives, lower parent DGM effort, a lower quality intra-firm good, lower subsidiary productivity, higher subsidiary costs, lower subsidiary profit, and lower MNC after-tax profit. The comparative static results incorporate the effect of a perceived unfair transfer price, which is another important factor in addition to tax rates that determines the MNC's transfer price. The MNC's ability to use the transfer price to shift profit and avoid taxes is further limited when agency costs are considered.

Third, under negotiated transfer pricing, profit-maximizing DGMs cooperate and choose the upper or lower arm's length transfer price and the centralized output. Under zero negotiation costs, negotiated transfer pricing dominates centralized transfer pricing, due to the cumulative effect of greater than or equal MNC global after-tax profit and lower agency costs than centralized transfer pricing. After the negotiated transfer price is chosen, profit-maximizing DGMs use a bookkeeping entry, instead of the transfer price, to allocate the joint gain from cooperation, where the share of the gain depends on DGMs' relative bargaining strength.

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