

CORE DISCUSSION PAPER
2004/69

**TRANSFER PRICING AND ENFORCEMENT POLICY
IN OLIGOPOLISTIC MARKETS**

Oscar AMERIGHI¹

October 2004

Abstract

In this paper we set up a symmetric two-country model with trade costs and international ownership to study the transfer pricing decisions by two multinationals operating in markets with Cournot competition. We let governments choose both the corporate profit tax rate and the level of enforcement of the “arm’s length” principle and we examine how enforcement policies affect the tax competition game. Furthermore, we analyze in what direction economic integration, in terms of a reduction in trade costs and/or a larger international ownership of multinationals, influences the symmetric equilibrium level of the two policy instruments. We show that increased economic integration may lead to *higher* equilibrium tax rates, and that, as governments increase the level of enforcement, equilibrium tax rates *increase* as well. Moreover, we find that, when the two MNEs are not fully owned by domestic residents, trade liberalization *decreases* the equilibrium enforcement policy, while increased international ownership *increases* the level of enforcement.

Keywords: multinational enterprises, transfer pricing, tax competition, enforcement policy, economic integration.

JEL Classification: H87, F02, F15, F23.

¹CORE, Université catholique de Louvain, Belgium and Department of Economics, University of Bologna, Italy. E-mail: amerighi@core.ucl.ac.be

I wish to thank Giacomo Calzolari, Jean Hindriks and Susana Peralta for helpful comments and suggestions. I also thank Antonio Minniti and Cecilia Vergari for useful discussions. Financial support from Department of Economics, University of Bologna, Italy, is gratefully acknowledged.

This paper presents research results of the Belgian Program on Interuniversity Poles of Attraction initiated by the Belgian State, Prime Minister’s Office, Science Policy Programming. The scientific responsibility is assumed by the author.