TRANSFER PRICING UNDER ASYMMETRIC INFORMATION - AN EVALUATION OF ALTERNATIVE METHODS

Alfred Wagenhofer, University of Graz, Austria

This paper analyzes optimal transfer prices in a simple setting with two divisions. One division receives a special order. In order to fulfill it an upstream division has to supply an intermediate good. The production costs of the divisions are their respective private information. The objective of headquarters is to induce the divisions to take decisions which maximize firm value. It uses transfer prices to coordinate these decisions.

Cost-based, market-based, and negotiated transfer prices are compared whether they achieve optimal coordination, and whether they are undominated by the other methods. Market-based transfer prices fail to achieve optimal coordination among the divisions if there are sufficiently large production economies. If this is the case, the other methods may do better. Cost-based prices are shown to belong to the class of marginal cost plus a profit margin. The profit margin essentially gives the low cost divisions an incentive not to pretend to have high costs. Negotiation is discussed for two stylized settings, one in which one division is assigned all the bargaining power, and the other with equal divisional bargaining power.

Two main results are shown. (i) Cost-based prices always perform better than negotiated transfer prices, essentially because conflicting interests may lead divisions to depart from achieving the trade which is best from the view of the firm. (ii) Otherwise, the transfer pricing methods cannot be ranked with respect to achieving the maximization of firm value. Which method does better depends on the cost information held by the divisions, and the market prices for the intermediate good. The validity of these results under more general settings is discussed.