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The Economics of Advance Pricing Agreements*

by
Johannes Becker[†], Ronald B. Davies[‡] and Gitte Jakobs[§]

Abstract

Advance pricing agreements (APAs) determine transfer prices for intra-firm transactions in advance of tax filing. This paper presents a model in which these contracts serve to overcome a hold-up problem that occurs because governments cannot commit to non-excessive future tax rates. We find that implemented APAs lead to a Pareto improvement even when all agents are risk neutral. Multilateral APAs are, in general, more efficient than unilateral ones. However, not all efficient APAs are concluded in equilibrium, due to asymmetric information problems. For the same reason, equilibrium APAs are highly complex, just as in practice. Surprisingly, APAs may lead to an increase in profit shifting to the low-tax location and, in most cases, do not allow for a reduction in audit capacity.

JEL classification: H25, M41, G32

Keywords: Advance Pricing Agreements, Corporate Taxation, Multinational Firms, Transfer Pricing

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