

VALUE, PRICES AND THE EVOLUTION TO MODERN TRANSFER PRICING¹

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Abstract. *This paper briefly presents the view of the main economic schools on the economic concepts of value and prices with a higher emphasis on three Romanian economic thinkers (N. N. Constantinescu, Constantin Ionete, N. G. Roegen).*

Subsequently the paper highlights that the modern concepts of transfer pricing and transfer prices have been studied through various economic models (Hirschleifer, Eccles, Kanodia) that perceive a multinational company as a micro-economy in itself, leading the concept of value and prices beyond the classical and neoclassical ideas.

However, the conclusion of the paper is that transfer pricing provides new challenges both for the economic theory, with severe implications in modern microeconomics (conduct of new business models), macroeconomics (inflation and its measurement) and taxation of companies. Hence, both the practitioners and the academicians should further enhance the specific models on transfer prices by incorporating the concepts developed by bio-economics (eco-economics, which specially pay attention to the qualitative aspects of value and prices).

Keywords: *value, price, transfer pricing, multinational company.*

1. Brief theoretical considerations on value and prices

According to the Macmillan Dictionary of Modern Economics, „the price of a good or of one resource is an item which reveals what has to be given up to in order to obtain that good or resource. Usually, the price is

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*provided in monetary terms, although the payment does not have to be necessarily made in a monetary form*².

According to the current International Valuation Standards “*the concept of **value** represents an economic concept related to the price most likely to be concluded by the buyers and sellers of a good or service available for purchase. Value establishes the hypothetical, or notional, price that typically motivated buyers and sellers are most likely to conclude for the good or service. Thus, value is not a fact, but an estimate of the most likely price that will be paid for a good or service available for purchase at a given time. Therefore, the economic concept of value reflects the view of the market on the benefits of the person that owns the goods or receives the services*”³. A similar definition is also provided by DEX, the Romanian explicative dictionary, stating that “**value** means the capability of things, facts, ideas, phenomena of both meeting the existing social needs and attaining the ideals generated by the latter; the sum of qualities making an object, a being, a phenomenon worthwhile”⁴.

Price and value have always been central to economics. If price is looked upon as an economic phenomenon, the dictum enunciated as early as the ancient days by Aristoteles and Xenophon postulating that „*price is the amount of currency that a buyer is willing and able to give a producer for a good sold on the market by such producer*”⁵ is unanimously acknowledged. As briefly described below, the major economic schools formulated various theories for price and value.

Therefore, in the **classical economic theory**, represented by Adam Smith, David Ricardo, J. B. Say, price’s substance lies in the economic value of the transacted goods, such value being determined both by the consumption of manufacturing factors and the remunerations charged by their owners. The prevailing conditions of the market cause price to settle at or around the level of economic value, and usually price does not move away from its economic basis, i.e. economic value. *Classical school*

² Approximate translation from the Mcmillan Dictionary for Modern Economy, CODECS Publishing, Bucharest, 1999, pag. 309.

³ Approximate translation from the International Valuation Standards, Edition VII, 2005, pag. 26.

⁴ DEX, Romanian Academy, „Iorgu Iordan” Institute, 3rd Edition, Bucharest, 1998, pag. 845.

⁵ Coralia Angelescu, Dumitru Ciucur, Niță Dobrotă, Ilie Gavrilă, Paul Tănase Ghiță, Constantin Popescu, Cornel Tarhoaca, *Economy, 5th Edition*, The Economic Publishing, The Academy of Economic Studies, Bucharest, 2000, pag. 130.

thought out and developed the objective theory of value as determined by work.

In the classical thought, as well as the Marxist thought, value is a historical category specific to the manufacturing of goods, and substance of value is the labour incorporated in the goods. Value is therefore objectively determined, being commensurate with the amount of social work spent to manufacture the goods and incorporated therein. On the market value is socially recognized, as it presents itself as exchange value. As a result, value is a social relation specific to goods-based economy⁶.

Similarly to the classical economists, albeit not part of their group, Karl Marx believes that labour is still the foundation of value: “*labour is the only source of value or, more precisely, its very substance*”. He goes on to distinguish between use value and exchange value as he believes it is not exchange that regulates the amount of value in a good, but on the contrary, the amount of value of a good regulates its exchange relationships. However, for Marx the value law is not directly the pricing law. As a matter of fact there are many a priced, but valueless, good. This is why Marx in his “*Das Kapital*” considers that the sole source of value is the labour incorporated in the goods manufacturing process and rules out of the class of exchangeable goods any goods that are not products of work but rather gifts of nature (such as ground, forest or water).

In a later stage of the development of economics, **Neoclassical economic theory**, represented by William Jevons, John Clark, Alfred Marshal, Federico Pareto, and Carl Menger, laid down the subjective theory of price, stating that price is determined by the marginal utility and the shortness of the supply of the goods, and the amount in which such goods are available compared to the existing needs and solvent demand. Thus, the greater the marginal utility of a good and the more infrequently available is, the greater its economic value and price are. Based on such factors a relationship is always formed between supply and demand that influences both level and dynamics of prices.

From such perspective, neoclassicism approach deems that all economic goods are valuable, regardless of whether or not they are commodities. Therefore, value is not a historical category, as it occurs both in natural economy and goods-based economy, and the substance of value is the utility of the goods. Value depends upon the mix of utility and

⁶ Gheorghe Popescu, *The evolution of economic thinking*, 3rd Edition, Cartimpex Publishing, 2004.

quantity and ceases to be „a social relation”, as in the classical approach, but instead „a subjective measure” determined by each individual by relating the amount of goods they consume to their own system of needs. „Marginal utility” underlies the formation of value, i.e. the lowest utility of the last consumed item that meets the lowest need.

The brief presentation above helps us observe that **the key distinction between the classical theory and the neoclassical theory as to value and price arises from the primary cause that determines price.** According to the classics, price mostly expresses the goods’ manufacturing conditions, how goods are achieved by combining manufacturing factors, with manufacturer acting as “conductor” of price. Instead, in the neoclassical approach price is determined by the prevailing conditions of the market, and how goods’ sparseness and marginal utility occur, with the decisive role in the formation and evolution of price being played by buyers. The table below describes a comparative analysis of the classical theory and the neoclassical theory of prices.

Brief comparative analysis on classical theory and neoclassical theory of prices	
Classical theory	Neoclassical theory
Value is based on labour incorporated in goods and is a social relation specific to the production of goods.	Value is based on the utility derived by consumers; therefore all economic goods are valuable, irrespective of their commodity or non-commodity status.
Value is consequently determined by its manufacturing cost, i.e. the consumption of manufacturing factors and the remunerations claimed by their owners.	Substance of value is the utility of goods. However, in order to be able to respond to the „paradox of value”, the relationship between needs and the available and consumed quantity of goods must be considered, as value therefore depends on the mix of utility and quantity.
On the market value becomes socially acknowledged and acts as exchange value. As a result, value is a social relation specific to the goods-based economy.	Value and price cease to be a „social relation”, but „a subjective measure” determined by each individual.
Manufacturer is the „conductor” of price.	Price is determined by the prevailing market conditions, how rarity and marginal utility of the goods occur, and buyers act decisively upon the formation and evolution of prices.

The 20th century economists (such as Keynes, Schumpeter, Knight, Samuelson, Friedman) also approached, directly or indirectly, the issue of value and prices, but they emphasised *market mechanisms and its imperfections, its method of control* (liberalism vs. political dirigisme) and *the shift from microeconomic approach, as championed by both classics and neoclassics* (except for Marx) *to macro economy*.

For instance, **J. M. Keynes** never provided a distinct analysis of the theory of value, but postulated a theory of prices laying great store on a specific price, i.e. interest rate, in other words the price of money. Keynes asserted that price of money, like any other price, is determined on the market by the balance between the demand for loans and the supply of temporarily available financial resources. In Keynes' opinion, money supply depends on the current policy of the central bank, whereas the money demand hinges on people's choices to own some of their wealth either in cash or in the form of interest-bearing assets. Keynes classified such choices according to *transaction motive, precautionary motive* and *speculative motive*. One can be therefore surmise that Keynes too is a follower of the neoclassical theory and believes that price is a subjective notion as determined by the prevailing market conditions (demand vs. supply), but, critically important, Keynes believes that market alone is incapable of ensuring a proper economic balance, as state is compelled to step in and implement various economic policies. Consequently, the stability of economic system is not tacitly achieved by the „market invisible hand” (Adam Smith), as value and price are two concepts susceptible of substantially deviating from their balancing value.

One the other hand, the followers of the new economics, affiliated to famous **Chicago School**, such as **Frank Knight** and **Milton Friedman**, firmly believed that the neoclassical pricing theory faithfully describes economic reality and free market is the one that can most effectively handle resources and distribute income, without any intervention of the state. Another major economist of the 20th century, **Paul Anthony Samuelson**, attempted through his „neoclassical synthesis” to bring together the supporters of Keynesism, Neoliberalism, Malthusianism, monetarism and other economists, and fostered the idea of mixed economy containing both free market elements and control elements. As to value and prices, Samuelson accentuates both the rarity of resources (objectivity) and the law of decreasing returns (subjectivity), while achieving a balance between classics and neoclassics, between both objective and subjective principles of value.

20th century Romanian economists, including **N. N. Constantinescu** (1920-2000) **Constantin Ionete** (1922-2011) and **N. G. Roegen** (1906-1994) also approached the theory of value and pricing system, while positioning closer to the classical theory and contributing significant inputs as regards the critique of the theory of labour value starting from the developments of the Romanian economy or bioeconomy (Roegen).

Thus, N.N. Constantinescu concludes in his work „*The Theory of Labour Value and Today's World*” (in Romanian, “*Teoria valorii muncă și lumea contemporană*” (1984)) that the theory of labour value need not be thoroughly removed from the scholarly sphere as do neoclassics and some of the modern economists who only favour the balance between supply and demand and therefore marginal utility. This would be necessary precisely in order not to let solely the mechanisms of the capitalist system, i.e. seeking business owners' profit, domineer the creation and distribution of value around economy. Constantinescu believes that the law of labour value has not said its last word in history yet. Even assuming new forms, the economic role of labour would not wane, but labour force would consider the fact that its creating power has mounted so greatly that it has generated an affluence of products and services that render both sale and purchase all but useless. However, should this happen, the notion of labour-based economic value in its sense until now would cease to exist. Constantinescu therefore foretold what we are now witnessing in the second decade of the 21st century, namely a surfeit of products and services. In other words, such is overwork today that labour is wasted, it is worthless, and the value of products must be derived employing different methods.

Economist Constantin Ionete approaches prices in particular, showing that price is a unit of consistent consumption of social labour with a system's characteristics. Thus, a systemic approaching of prices proceeds from their dynamic structure, characterized by the internal state of its component elements (costs, net income etc.) subject to a permanent influence by both inputs and outputs and an interconnection with the entire economic system together with its sub-systems. In this respect, Ionete points out that „*the decision-making process in pricing and its institutionalization involves the employment of econometrics and quantifying methods in general, in order to analyse prices as a complex dynamic system, develop models, and combine the ontological and phenomenological approach of prices with labour consumption computational methods*”⁷.

⁷ Constantin Ionete, *Prices and the dynamic equilibrium of economy*, Scientific and Enciclopedic Publishing, Bucharest, 1983, p. 25.

In his work „Decline, Entropy, Ecology, Economy” (in Romanian, *Descrerea – Entropie – Ecologie – Economie* (1979)), within the broader context of entropy law (that can be deemed as the most economic law of all natural laws), Nicholas Georgescu Roegen states that “*economists are fond of saying that there is no such thing as a free meal, that everything must be paid based on its value so that price and value get to always even out. Entropy law teaches us that humankind lives under an even more severe commandment: in entropy terms a meal costs more than its price*”⁸. Unlike neoclassics, who refer to production in terms of value, Roegen considers production in strictly physical terms and, unlike his predecessors who maintained that “labour is the father and the active principle of wealths as the nature (lands) are the mother”⁹, he believes that „*the whole history of humankind unequivocally proves that nature too plays an important role in the economic process, and also informs the genesis of economic values*” and, from such perspective, goes on to say „*a non-traditional economist such as I am would add that any input in the economic process is valuable natural resources and any output is worthless garbage*”¹⁰.

2. Transfer pricing: a modern concept of value and prices

In the first part of the article we briefly described the evolution of economic thought on value and price and noted that it has evolved continuously and accompanied nations’ economic and social development in time. The dramatic economic development over the last century, primarily driven by the impulse of the revolution of information technology (the IT boom) and the increasing globalisation have led to the unprecedented development of a new approach of managing companies, i.e. the advent of transnational corporations. Such corporations have generated such a complex organization that we can safely say that they are an economic micro-system in its own right, as a single corporation maintains dozens of branches in multiple countries serving multiple functions, such as manufacturer, supplier, trader etc.

⁸ Gheorghe Popescu, Ruben Filimon, *Nicholas Georgescu-Roegen, Evolutionary Epistemology and the Arrow of Time*, Risoprint, Cluj-Napoca, 2009, p. 144.

⁹ The Economic Writings of Sir William Petty, CH Hull Publishing, vol. 2, Cambridge, Eng., 1899, p. 377.

¹⁰ Nicholas Georgescu-Roegen, *Energy, natural resources and economy*, Expert Publishing, 1996, p. 9.

In such context, the science of prices and value has been significantly enriched by analysing the matters that characterize the globalisation processes, the decision-making process on penetration of a new foreign market, management of overseas branches, relations between the managers of subsidiaries and the management of repatriation of income. Moreover, extensive exchange of information is now possible on the pricing practices agreed between corporation's branches. It is therefore increasingly clearer that, in a more and more complex world with brand new types of economic management (corporations), the development of a matching pricing system is required, particularly the *transfer pricing*.

Economic practice and theory defined the *transfer pricing* concept as early as mid-20th century as a distinct pricing system, i.e. *the prices charged in the transactions between the branches of a multinational company or between a branch and its parent company* (also referred to as „*affiliated/related parties*” as they have common shareholders and interests).

The matter of transfer pricing in economy was first formalized by Hirshleifer¹¹ (1956), who claimed that transfer price is the „fair” price only when a transacted good is produced in a perfectly competitive market. If a market has a less than perfect competition, then the „fair” price is the applicable marginal cost, considering several specific requirements.

The Hirshleifer model involves two entities of one multinational company that generate profit: a manufacturer and a distributor. The manufacturer has no foreign market to sell its goods on, whereas the distributor does have such foreign market. Hirshleifer proved that the optimal transfer price is the marginal cost incurred for the manufacturing of the intermediate good or service. Manufacturer must be able to charge marginal costs associated to various manufacturing levels so that the entity that manufactures the end product or provides the final service may choose its optimal manufacturing level. Thus, the optimal transfer price chargeable **by manufacturer to distributor** is the marginal cost incurred for the manufacturing of the intermediate product or provision of the intermediate service. Where a perfectly competitive market exists, a product is transferred at arm's length.

The managers of the two entities (manufacturer and distributor) acting as profit generators („*rational profit maximizers*”) will choose those manufacturing levels deemed to be conducive to profit maximization, given that the entities are independent from one another. If the group's

¹¹ Hirshleifer, J., *On the economics of transfer pricing*, Journal of Business, 1956, pp. 172-184.

management (the „*central management*”) decides on a transfer price ensuring that the group’s profits are optimized, then the independence of the entities will cease to exist. A possible challenge is that the entities’ managers’ assessment is based on the seeking of profit by each entity individually; as such managers are not stimulated to provide reliable information so that they can preserve their advantage. Therefore, based on such considerations, information may be distorted across the entire group and consequently adverse selection may occur.

The choices and development strategies followed by an organization are informed by the fact that the independence of the organization’s entities may outweigh the whole performance of the group. Also, an organization may use a number of organizational forms and processes to choose the optimal transfer price that enables the organization to derive profit. The diversified organizations have therefore employed the „*market-based transfer pricing*”, while interconnected organizations resorted to the “*cost-based transfer pricing*”. Organization’s strategy determines control processes that motivate individuals towards the achievement of the organization’s targets, in exchange for the entities’ profit being maximized to the detriment of larger profitability.

Based on Hirschleifer’s model, economist R. Eccles¹² perceived the group of multinational companies as a „mini-economy” where limited resources must be effectively assigned. Such approach is intended to help identify a transfer price that causes the divisions of a group of related companies conducting sale and purchase transactions with one another to choose the best manufacturing level ensuring that the profit of the entire group is maximized¹³.

Eccles’ model claims that transfer pricing, as part of an organization’s operating and intra-cooperative system, must be consistent with the strategy employed by such organization. Managers of the group’s entities perceive performance evaluation and individual reward system as fair when organization’s strategy is properly considered in determining the applicable transfer prices. Eccles therefore starts from the assumption of certainty concerning the organizational strategy. Should a suitable organizational strategy, an organizational structure and a transfer pricing scheme be into place, managers will perceive the existing performance evaluation and reward system as fair. In such case, they will be driven to

¹² Eccles R., *The transfer pricing problem: A theory for practice*, Lexington, Mass., Lexington Books, 1985.

¹³ *Idem.*

meet the group's targets, as they will be rewarded for their efforts, all of which will encourage the attainment of objectives at group's and organization's levels respectively.

On the other hand, economist Kanodia (1979) adjusted Hirschleifer's (certainty-reliant) model to consider the uncertainty conditions. **Kanodia's model**¹⁴ assumes that central management uses a linear program based on reliable ("*honest*") reports for both manufacturer and distributor. Group's entities secure an optimal transfer price; however, like in the case of Hirschleifer's model, information may be unreliable (*asymmetry of information*) as no reward system is in place for the management. When such model is adjusted to fit the conditions of uncertainty, distributor is faced with a range of transfer prices for the end product. Together with the element of uncertainty, the management of the corporation's individual entities also receives an incentive, i.e. a percentage of the organization's profits. This state of affairs reflects distributor's risks, as the existing reward system will fail to comply with the Pareto optimum and a maximization of group's profits will be insecure.

Later on, Kanodia advances the notion of risks being split among entities, while setting a range of values for transfer prices and making it conditional upon the final price. In such case, the interaction between related parties is bound to result in a distribution of the group's total profits, with the Pareto optimum being achieved both for manufacturer and distributor. Also, risk splitting is supposed to motivate management to maximize profits.

Therefore, given the models above, we can see that any approach of the transfer pricing matter is primarily based on economic theory. Then and now, manufacturer's economic theory assumes that transacting parties attempt to secure a maximum profit and, even if this fail to happen on a short or medium term basis, a company still plans to derive profit on a long term basis to be able to make investments and expand its business. Economic profit means the return required for an entity to conduct its main business, but it also must include both its future capital investments and the return of the shareholders' investments in the firm (in microeconomic theory's term, this is the basic assumption for the viability of any company).

¹⁴ Myers, Joan K., Collins, Mary K., *An historical review of transfer pricing theories addressing goal congruence within the organization*, p. 3.

3. Conclusions

Theory of value and prices has evolved along with society to become the complex science that it is today, still resourceful and providing more and more, increasingly ample approaches. There is now an extensive literature dealing with price and value that has in time led to the development of an ever greater number of schools of thought, each of which with its own contribution in refining upon the existing or new issues related to price and value. The process is still going on thanks to state-of-the-art scientific tools and new approaches that help develop the science of price and value.

The challenges faced by today's increasingly globalized economy, where companies have re-positioned themselves in an integrated market, pave the way to a new type of organization, i.e. *corporation*. In the current business environment, characterized by a marked international economic integration, a transaction price is the outcome of the worldwide ever-moving economic processes experienced by multinational companies in various shapes and forms.

Corporations have generated such a complex organization that they may well be treated as an economic micro-system in its own right, with one corporation maintaining dozens of branches in dozens of countries serving multiple functions, such as manufacturer, supplier, trader etc. In such context, a suitable pricing system for such corporations, namely *transfer pricing*, was bound to be developed. This concept has been adopted relatively recently by the Romanian legislation, however it has a significant impact on businesses' taxable base and automatically on the state budget revenues.

The study of transfer pricing mechanisms is now only barely supported by the existing specialist literature, where the Hirschleifer, Eccles and Kanodia models attempted to extract fair value and determine optimal prices charged in the related party transactions between the divisions of one group of multinational companies.

The specialist literature in the field is still in its infancy in Romania. An avenue for future research would cover the transfer pricing matters from an eco-economic and legal angle, given that transfer pricing related tax inspections have multiplied significantly and the number of transfer pricing disputes is still growing. This is achievable by giving proper consideration to the concepts developed by the *bio-economy* (or *eco-economy*) championed by Nicholas Georgescu-Roegen, i.e. the law of entropy and processes of green economy or economy of limited supply.

Using such concepts would meet a *sine qua non* requirement of today's society, as it would be a specific and immediate thing to do and would also awake people to the genuine value of life and the cost of using limited resources. In other words, to the facts behind today's statistical numbers on the value and price of goods and services, as such numbers are publicly presented without the due critical consideration.

It must be noted that this contribution is attemptedly in line with the contributions of other Romanian economists (e.g. Constantin Ionete) who proved that pricing research obviously cannot limit itself to colligating ontological and phenomenological concepts in economic sciences.

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