# Transfer Pricing Regulations and Incentives of Foreign Direct Investment*

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**Abstract**

A change of transfer pricing regulation regime can affect not only firms' ability of profit shifting but also their location choice. We use a duopoly model to consider the impacts caused by regime shifts of transfer price regulation, featuring incentives for foreign direct investment (FDI). Home and foreign governments jointly choose a transfer price regulation regime among three regimes and then, for a given regulation regime, a home firm chooses export or FDI as its foreign market entry mode. For each of three regulation regimes, we examine transfer prices, FDI incentives, and welfare and we investigate the impacts of regime shifts on FDI and welfare. We find that, given that corporate tax rates are constant, a regime shift can change the optimal entry mode. We also find that social welfare can jump up or down because of firm's relocation caused by a regime shift.

*Keywords*: foreign direct investment; transfer prices

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