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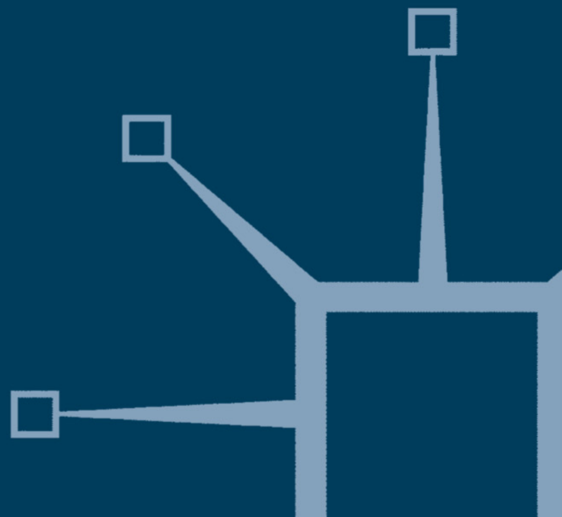
The Political Economy of International Tax Governance

Thomas Rixen



Transformations of the State

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This illustration is taken from the original etching in Thomas Hobbes' *Leviathan* of 1651. Palgrave Macmillan and the editors are grateful to Lucila Muñoz-Sanchez and Monika Sniegs for their help in redesigning the original to illustrate what 'transformations of the state' might mean. The inscription at the top of the original frontispiece reads '*non est potestas Super Terram quae Comparetur ei*' (Job 41.33): 'there is no power on earth which can be compared to him'. In the Bible, this refers to the seamonster, Leviathan. (Original Leviathan image reprinted courtesy of the British Library.)

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Thomas Rixen

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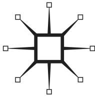

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Abbreviations

ALS	arm's length standard
APA	advance pricing agreement
Art.	Article
Attac	Association pour la Taxation des Transactions pour l'Aide aux Citoyens
BIAC	Business and Industry Advisory Committee
C	credit (strategy choice in double taxation game)
CARICOM	Caribbean Community and Common Market
CEN	capital export neutrality
CFA	Committee on Fiscal Affairs
CFC	controlled foreign corporation
CIN	capital import neutrality
COMECON	Council of Mutual Economic Assistance
COW	Correlates of War
CPM	comparable profits method
CUP	comparable uncontrolled price
D	deduction (strategy choice in double taxation game)
DISC	domestic international sales corporation
DTA	double tax agreement
E	exemption (strategy choice in double taxation game)
EC	European Commission
ECJ	European Court of Justice
ECOSOC	Economic and Social Council (of the United Nations)
ETI	extraterritorial income
EU	European Union
FATF	Financial Action Task Force (of the OECD)
FDI	foreign direct investment
FIF	foreign investment fund
FSC	foreign sales corporation
FSF	Financial Stability Forum (of the G-7)
G-7	Group of Seven (leading industrialized nations)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GWP	gross world product
ICC	International Chamber of Commerce
IFA	International Fiscal Association
IMF	International Monetary Fund
IR	International Relations

IRS	Internal Revenue Service
ITIO	International Trade and Investment Organization
ITO	International Tax Organization (does not exist but is suggested by some)
JITSIC	Joint International Tax Shelter Information Center
LAFTA	Latin American Free Trade Association
MAP	mutual agreement procedure
MC	model convention
MFN	most favoured nation
MNE	multinational enterprise
MOU	memorandum of understanding
NN	national neutrality
NR	no relief (strategy choice in double taxation game)
OECD	Organization for Economic Cooperation and Development
OEEC	Organization for European Economic Co-operation
para.	paragraph
PD	prisoner's dilemma
PE	permanent establishment
PFIC	passive foreign investment company
PTR	preferential tax regime
R	residence (used to indicate the residence principle or country in some tables or diagrams)
S	source (used to indicate the source principle or country in some tables or diagrams)
T	tax regularly (strategy choice in double non-taxation game)
TAG	Technical Advisory Group on Treaty Characterization Issues Arising from E-commerce
TIEA	Tax Information Exchange Agreement
TJN	Tax Justice Network
TTD	tax treaty database
U	under-tax (strategy choice in double non-taxation game)
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
WTO	World Trade Organization

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Thomas Rixen
Berlin/Bremen

Series Preface

Over the past four centuries, the nation state has emerged as the world's most effective means of organizing society, but its current status and future are decidedly uncertain. Some scholars predict the total demise of the nation state as we know it, its powers eroded by a dynamic global economy on the one hand and, on the other, by the transfer of political decision-making to supranational bodies. Other analysts point out the remarkable resilience of the state's core institutions and assert that even in the age of global markets and politics, the state remains the ultimate guarantor of security, democracy, welfare and the rule of law. Do either of these interpretations describe the future of the OECD world's modern, liberal nation-state? Will the state soon be as obsolete and irrelevant as an outdated computer? Should it be scrapped for some new invention, or can it be overhauled and rejuvenated? Or, is the state actually thriving and still fit to serve, just in need of a few minor reforms?

In an attempt to address these questions, the analyses in the *Transformations of the State* series separate the complex tangle of tasks and functions that comprise the state into four manageable dimensions:

- the monopolization of the means of force,
- the rule of law, as prescribed and safeguarded by the constitution,
- the guarantee of democratic self-governance, and
- the provision of welfare and the assurance of social cohesion.

In the OECD world of the 1960s and 1970s, these four dimensions formed a synergetic constellation that emerged as the central, defining characteristic of the modern state. Books in the series report the results of both empirical and theoretical studies of the transformations experienced in each of these dimensions over the past few decades.

Transformations of the State? (Stephan Leibfried and Michael Zürn (eds), Cambridge 2005) and *Transforming the Golden-Age National State* (Achim Hurrelmann, Stephan Leibfried, Kerstin Martens and Peter Mayer (eds), Basingstoke 2007) define the basic concepts of state transformation employed in all of these studies and provide an overview of the issues addressed. Written by various interdisciplinary teams of political scientists, lawyers, economists and sociologists, the series tracks the development of the post-Second World War OECD state. Here, at last, is a state-of-the-art report on the state of the state and, we hope, a clearer view of its future.

Achim Hurrelmann, Stephan Leibfried,
Kerstin Martens, and Peter Mayer
Series Editors

1
Introduction

Economic activities cross national borders, whereas the power to tax is bound to the nation state. In order to deal with the two problems for income taxation resulting from this incongruity – potentially overlapping national claims to tax that cause *double taxation* and increased possibilities of tax evasion and avoidance (*double non-taxation*) – countries engage in international cooperation.

The governance of international taxation has mostly been the subject of rather technical discourses by tax lawyers and a few economists. It has gone largely unnoticed by most students of international political economy. The political and economic determinants of international cooperation in this area have received little or no attention. This lack of research is surprising because every political scientist would agree that taxation is inherently important (see, for example, Strange 1994, 87). Taxes are the most direct link between the private and public economy, between market and state. Thus, they are at the heart of the field of political economy. Given that changes in the relation of market and state caused by economic globalization are *the* major theme of contemporary research, it is a serious shortcoming of the literature not to have investigated international tax cooperation. The present study is a first effort at closing this gap.

International tax governance consists of several elements on the unilateral, bilateral and multilateral levels interacting with each other. States started to conclude *bilateral* double tax agreements (DTAs) at the beginning of the twentieth century to avoid double taxation. Today almost all tax treaties are based on a non-binding *multilateral* model convention developed and regularly updated by the Organization for Economic Cooperation and Development (OECD), the central organization of the international tax regime. This established institutional infrastructure has recently become the locus of efforts to establish international cooperation against harmful tax competition. In addition, states have their own *unilateral* rules for the taxation of international income. The main purpose of this book is to make sense of the governance structure of international taxation from the disciplinary perspective

of international political economy. The institutional choice, development and transformation over time of international income taxation are analysed and explained in this study.[1]

My central argument is the following: double tax avoidance – historically states' only concern – is a *coordination game with a distributive conflict*. A bilateral approach, supported by an international organization disseminating information and shared practices that all have an interest to follow, can best accommodate countries' concern for the distribution of tax revenues and other economic benefits connected to the tax base. The institutions needed to deal with this problem do not have to be equipped with enforcement capabilities. The nature of the problem is such that it can be handled in a 'sovereignty-preserving' fashion. As the economy becomes more global, this setup enables the related phenomena of tax evasion, avoidance and competition.[2] These issues exhibit the institutionally more demanding strategic structure of an *asymmetric prisoner's dilemma*. The cooperative solution of the fundamentally transformed tax game ultimately requires the establishment of multilateral institutions, which are able to effectively enforce rules upon countries. But, precisely because of the dilemma structure, the establishment of cooperation is very difficult. In addition, the institutions of double tax avoidance, due to their nature as solutions to a coordination problem, exhibit characteristics of path-dependence. While the change in the functional requirements of tax cooperation leads to various institutional reforms, the pre-existing setup of double tax avoidance constrains and shapes the responses to the problem of double non-taxation. This is evidenced by the fact that reform only proceeds in an indirect and incremental fashion.

By developing this argument the book makes four contributions. First, I aim for an explanation of the institutional design of the global regime of direct taxation. As shown below, the particular design of the regime is in need of an explanation for several reasons. Using established tools of rational choice institutionalism (see, for example, Lake and Powell 1999; Koremenos *et al.* 2001), I provide such an explanation by reconstructing actors' preferences, prevailing concerns at different times and the resultant interest constellations. I argue that the strategic structure of the 'international tax game' can explain institutional design.

While the purpose of this exercise is primarily empirical – the desire to understand institutional choices in international tax policy – it also contributes to theories of international institutions. Given the extensive body of scholarship on international institutions, it is quite surprising that very few contributions deal explicitly with bilateralism. Almost all studies focus on regimes that are organized multilaterally. This lack of research is a serious shortcoming, because empirically, there is a lot of bilateralism in international relations. The United Nations treaty database, for example, has collected 5130 bilateral treaties adopted from 1990 to 1999; in the same period, 351 multilateral treaties were signed (United Nations 2003b).

These numbers indicate that bilateralism is an important feature of international cooperation.[3] By narrowing down its focus to multilateral cooperation, an important part of international life is simply disregarded. But research is not only narrowed down to multilateral cooperation: it is also blind to the choice between bilateralism and multilateralism. What are the advantages or disadvantages of bilateral compared to multilateral cooperation? Existing theories of international institutions do not investigate this question. One reason for this may be that the focus on multilateralism is only implicit in most studies. Because of this, the alternative to multilateral cooperation, that is, bilateralism, cannot be put in perspective and does not receive any attention.[4]

This leads to an incomplete understanding of cooperation, including multilateralism. As is also the case in international taxation, institutions often exhibit a mix of both bilateral and multilateral elements, which interact in systematic ways. A straightforward classification of a regime as bilateral or multilateral is not always possible. However, an analyst who implicitly assumes a multilateral form will necessarily be blind to these aspects of institutional design. I contend, therefore, that if we are to gain an appropriate understanding of international institutions, it is necessary to develop theory-driven accounts of the choice of bilateralism and multilateralism and the ways in which these forms can interact. It is necessary to investigate the relative benefits and costs of both multilateral and bilateral cooperation to get leverage to explain the (co-)existence and variations of these institutional forms. Not only 'multilateralism matters' (Ruggie 1993b); bilateralism *and* multilateralism also matter. My explanation of institutional choice in international taxation addresses these issues directly. Since it is cast in sufficiently general terms, it should prove useful for future theory development on the choice between, and the coexistence of, bilateralism and multilateralism.

However – and this leads me to the second objective – I do not stop at considering institutional choice but also consider institutional development over time. The account based on interests and structure is supplemented by a perspective on history and timing (see, for example, Pierson 2004). Can an institution be reformed? Or are there rigidities that make reform difficult? Which bypasses to reform might actors take? These kinds of questions are the topics explored under the rubric of so-called 'historical' or 'new' institutionalism (March and Olsen 1989; Thelen 1999), which has mostly been used in domestic and comparative political science. However, such issues of institutional development have not received sufficient attention in research on international institutions (Simmons and Martin 2002, 203; Zürn *et al.* 2007; but see March and Olsen 1998). Thus, by considering the development of international tax governance and referring to some of the mechanisms employed in the literature of domestic and comparative politics, I hope to demonstrate that such an extension is worthwhile.

By considering institutional development over time, I not only make a theoretical contribution to research on international governance but also propose an alternative perspective on the issue of tax competition. In the rapidly expanding literature on this topic, tax competition is seen as a natural corollary of economic globalization that is not itself in need of an explanation. It is assumed to be an exogenously given force. The focus is solely on the effects of tax competition for domestic tax policies; for example, in how far it leads to a 'race to the bottom' or not (Edwards and Keen 1996; Frey and Eichenberger 1996; Schwarz 2007). Political scientists have extended this analysis by focusing on domestic institutional factors that affect governments' responses (Hallerberg and Basinger 1998; Garrett and Mitchell 2001; König 2005; Ganghof 2006a).

These contributions generally do not consider the extent to which tax competition is caused by the institutions to avoid double taxation. As I demonstrate, international double tax avoidance is set up in a particular way that helps to create tax evasion, avoidance and ultimately tax competition. However, due to certain institutional rigidities worked out in Chapter 8, the existing institutions of double tax avoidance shape and constrain the responses to the emerging problem of tax competition. To a considerable extent, tax competition is endogenous to the institutional setup of double tax avoidance. Thus, I present the story of a regime that has the seeds of its own undermining planted within itself.

The third contribution is empirical. I present an accessible overview of a field that is usually occupied by specialists writing in rather technical language. The book is an improvement on the few existing contributions in that it presents a political history of the international tax regime focusing on actors' preferences, the prevailing concerns at different times and the resultant interest constellations. This qualitative historic narrative is supplemented by quantitative material on the network of bilateral tax treaties that I have compiled. The resultant tax treaty database (TTD, see Appendix) forms the basis for various descriptive statistics used throughout the book. Using the tools of network analysis, I explore the influence of some relevant political and economic variables – for example, the influence of a nation's wealth and investment position – on the network's structure and development. The book thus presents empirical material that has not been available in this form before.

By doing so, it opens up a new field of empirical research for political scientists and political economists who have in the past hardly paid any attention to issues of international taxation. The few existing contributions focus exclusively on the European Union (Puchala 1984; Genschel 2002). Of these books with a focus on Europe, Radaelli (1997) has one chapter on global taxation that touches quite generally on a few aspects of the regime. The one book that has presented an account of global tax cooperation (Picciotto 1992) does not take an explicit international relations (IR)

perspective, as the present study does. In turn, the IR perspective could prove interesting for international tax scholars, who are mostly lawyers or economists.

The fourth purpose is to investigate the role of tax sovereignty in an era of globalization. One reason why international cooperation in tax policy has hardly received any attention in international political economy may be a strongly held but rarely investigated presumption. The 'folk wisdom' in the discipline holds that cooperation is largely absent in taxation, because the power to tax is one – if not *the* – central attribute of sovereignty. It is often taken for granted that international cooperation in tax matters must be difficult to establish and is virtually absent because states cling to their sovereignty in this field. The little cooperation that exists is regarded as so rudimentary that it does not warrant interest. This is also, according to the cursory perception of the discipline, the reason why cooperation in tax matters takes the form of bilateral tax treaties instead of a 'solid' multilateral agreement (Abbott and Snidal 2000, 441). However, analysts very often merely assume governments' concern for sovereignty and do not subject the issue to a closer investigation.

By distinguishing between different dimensions of sovereignty, I show that even in taxation governments react to the pressures of economic globalization. In the face of growing tax evasion, avoidance and tax competition, they are increasingly willing to share – albeit only grudgingly – their *administrative sovereignty*, understood as the authority to enforce tax laws, that is, to collect taxes, in order to regain de facto control over their tax policies. They increasingly engage in administrative cooperation and information exchange with other governments. On the other hand, they are hardly willing to delegate or pool their *legislative sovereignty*, the authority to make tax policy, that is, to design tax laws. For example, they have repeatedly shunned all proposals to introduce unitary taxation with formula apportionment. However, as I argue in Chapters 8 and 9, only if governments will in the future be willing to share their legislative sovereignty will they be able to regain effective control over the national and international tax system.

The book is structured in three parts. Part I gives an overview of the issues. First, I develop the research questions and present the research design (Chapter 2). After that, I develop a simple baseline model of cooperation in direct taxation on the basis of existing theoretical contributions: I show that 'single taxation' would be the globally optimal policy and then investigate the collective action problems inherent in reaching this outcome. The strategic structure of double taxation is that of a coordination game with a distributive conflict, whereas the problem of double non-taxation is represented by an asymmetric prisoner's dilemma. This model is supplemented by theoretical considerations on the effects of institutional development over time. On the basis of these considerations, I derive hypotheses on the institutional design and the expected reform path of global tax governance (Chapter 3).

In Part II, I present the empirical record of international taxation. After a brief discussion of the fundamental problems and major theoretical concepts of international taxation, I describe the general setup of tax cooperation and give an overview of international tax rules. The rules of international taxation operate on the unilateral (domestic), bilateral (tax treaties) and multilateral (model conventions) levels. Tax governance is based on the principle of non-interference with national tax systems. It consists of the regulation of interfaces of different tax systems (Chapter 4).

I then trace the development of the regime over time, beginning with the history of the avoidance of double taxation. In the 1920s and 1930s, the basic principles of double tax avoidance were developed by the League of Nations and the practice of concluding bilateral treaties originated in continental Europe. While the League's work became very influential and enduring in the history of international tax policy, the practical relevance at the time was low. This changed after the Second World War as the OECD took over the position of the League of Nations. By the early 1960s, the institutions of double tax avoidance were firmly in place. The key mechanism can be described as bilateralism on the basis of multilateralism. As the main multilateral forum, the OECD disseminates 'soft law' in the form of a model convention and other policy advice. On the basis of this, governments conclude bilateral tax treaties. Along with the process of liberalization of trade and investment since the 1960s and in particular during the 1980s, the bilateral tax treaty network grew rapidly – and continues to grow today – so that the institutions of double tax avoidance have become firmly entrenched (Chapter 5).

In Chapter 6, I turn to the history of the fight against double non-taxation. From the 1920s to the early 1960s, under-taxation received very little attention from policymakers. However, since the mid-1960s – as a byproduct of trade and investment liberalization – the problem of double non-taxation has arisen in addition to that of double taxation. As a reaction, there have been efforts aimed at incremental reform of international tax governance, which are driven by the desire to fight international tax avoidance and evasion. At first, anti-avoidance policies are implemented on the unilateral (domestic) level. Nevertheless, as will be shown, they have international ramifications because they represent an implicit challenge to the traditional concepts of tax cooperation. However, governments take great care not to make this explicit. Instead, anti-avoidance policies are reinterpreted to bring them into line with the traditional institutional setup. Since the mid-1990s, double non-taxation has become governments' prevalent concern. The OECD launched a multilateral attack on tax evasion and avoidance (OECD 1998a). The OECD project was a break with established traditions of international tax governance in that it attempted to intervene in countries' national tax sovereignty and tried to create 'hard law'. Ultimately, however, the project was curtailed and the traditional approach continues. As will be argued, this and other developments

can be interpreted as attempts to construct a multilateral support structure for the established framework of international tax governance.

In Part III, I return to my baseline model, refining it on the basis of the empirical material and thereby constructing an explanation for the institutional design and trajectory of international tax governance. By means of a regression analysis, I show that the distributive conflict between residence and source countries, which is determined by the asymmetry of dyadic investment flows between countries, can be accommodated by bilateral bargaining. Since there is no enforcement problem in the avoidance of over-taxation, there is no need to come to a multilateral agreement. Nevertheless, the non-binding model convention can help to economize on transaction costs of bilateral bargains by providing a constructed focal point. The strategic structure of a coordination game can also explain why the institutions of double tax avoidance do not have to be equipped with third party enforcement capabilities. The Mutual Agreement Procedure (MAP), a diplomatic procedure that can be invoked in cases of treaty disputes, is better understood as a device to deal with problems of incomplete contracting (Chapter 7).

In Chapter 8 I construct an explanation for the institutional trajectory of the tax regime. The switch to more hierarchical modes of governance, which is necessary to tackle the problem of double non-taxation effectively, is difficult to achieve because the institutions of double tax avoidance develop in a path-dependent fashion. I reconstruct the mechanisms of institutional reinforcement and those of institutional undermining and argue that the timing and interaction of these two processes can explain why the reform of international tax governance takes place in an incremental fashion. Finally, Chapter 9 concludes and contains speculations on the future development of international tax governance.

Since this book aims at a diverse audience, different readers may wish to skip certain parts of the text. Political Scientists familiar with rationalist institutional design and historical institutionalism can skip some parts of Chapter 2. Lawyers familiar with the rules of double tax avoidance may not have to read all of Chapter 4.

Part I

International Tax Governance: The Issues

2
Empirical Puzzles, Institutional Theory, and Tax Sovereignty

Puzzles of international taxation

Initially, international cooperation in direct taxation was only concerned with avoiding double taxation. Over time, the issue of tax evasion and avoidance was added to the agenda. I first formulate questions concerning the institutional form of double tax avoidance and then turn to the issue of institutional reactions to the problem of double non-taxation. Some of the questions can be considered as 'empirical puzzles' in the sense that the empirically observed features of the regime are in apparent contradiction to what political economy theory would suggest. Other questions are formulated because they need to be addressed to give a complete account of the institutional design.

The institutional characteristic most often noted is the fact that DTAs are, with a few exceptions, bilateral. There is one minilateral treaty among the Scandinavian countries that was signed in 1983 (Mattsson 2000). This treaty is often referred to in the literature, precisely because it has remained the only treaty of its kind. Likewise, there were other multilateral treaties, none of which are in force any longer: There was an unsuccessful attempt in 1922 to conclude a multilateral treaty among Austria, Hungary, Romania, Italy and the Kingdom of Serbia, Croatia and Slovenia. There were multilateral treaties among some countries of the Andean Pact in the 1970s and within the former communist bloc (COMECON). There is also a treaty among eight countries of the Caribbean Community and Common Market (CARICOM) (Loukota 1997, 86–7). None of these treaties left a mark on the development of international taxation; thus, it is fair to say that DTAs are bilateral. Why is this so? The network of tax treaties comprises about 2000 treaties that are roughly similar. Wouldn't it be easier to have one multilateral document instead of 2000?

The bilateralism of tax treaties is in contrast to many other international regimes in the economic sphere. Most prominently, the GATT/WTO

is a multilateral regime with a commitment to achieving progressive, coordinated trade liberalization in simultaneous negotiations. In contrast to this, cooperation in double tax avoidance is organized bilaterally and negotiations take place sequentially. In a classic model, Mundell (1957) shows that the free flow of goods and common prices lead to factor prices being equalized across countries. Likewise, free factor flows and common factor prices lead to equal goods prices. What can be achieved with goods flows can also be achieved with factor flows. Now, the trade regime deals with goods flows and the tax regime influences factor flows, in particular capital flows. Mundell's factor-goods-equivalence could be taken to suggest that the institutional form of the tax and trade regimes should be similar or the same. So the puzzle is: why is the regime of international double tax avoidance not multilateral (Whalley 2001, 17–18)? Posing the puzzle in this way is somewhat imprecise, because there actually are some multilateral elements of tax cooperation. The OECD, as a multilateral organization, deals with double tax avoidance and other issues of international taxation. It publishes a so-called Model Tax Convention (OECD MC) that is negotiated and agreed upon by its member countries. The OECD MC is non-binding. In practice, however, nearly all the bilateral tax treaties are based upon this instrument. Thus, more precisely, the issue is why there is no *binding* multilateral agreement. Why is the MC non-binding? What is its function in international tax cooperation? How can one account for the coexistence of binding bilateral treaties and this multilateral document that serves as a template for them?

The peculiarities of tax cooperation start at an even more profound level. It can be shown that double taxation can effectively be avoided unilaterally by adopting appropriate rules in national tax laws. Most countries in the world have national tax rules providing for exemption, deduction or credit for taxes paid abroad (see Chapter 4). Under such rules, double taxation is eliminated or at least reduced. Given that unilateral relief is in place, why do countries then bother to conclude treaties (Whalley 2001, 14)? There should be no need to cooperate in order to avoid double taxation. The unilateral relief is sufficient to reach this goal. In other words, the question that arises is what the conflict of interest around which cooperation is built actually is. In a situation of harmony, where each actor pursues policies facilitating the attainment of everybody's goals, there is no need to engage in cooperation. If the general good is achieved, even though the actors do not consider the interests of others in their actions, then active cooperation is superfluous. In order to speak about cooperation in a meaningful way, there must be some kind of conflict of interest (Keohane 1984, 51–5). Given that countries actually go through the effort of concluding double tax treaties, that is, engaging in cooperation despite unilateral relief already being in place, such a conflict of interest must exist. But what is it? How can we account for the coexistence of unilateral relief and bilateral treaties (Dagan 2000)?

From a certain theoretical perspective, the very existence of unilateral tax relief itself poses a puzzle. Unilateral relief leads to voluntarily forgoing tax revenue. Assuming that the maximization of tax revenue is the objective of governments, this is in contradiction to their own national interests. Why are countries ready to do this? The most prominent example in economic theory in which the assumption of revenue maximizing governments is made is Brennan and Buchanan (1980). This assumption is, however, highly controversial (see, for example, Buchanan and Musgrave 1999). The answer to this puzzle involves specifying a different objective function. However, as will become clear, countries do care about tax revenue and therefore this question should not be dismissed out of hand.

Another design feature of tax cooperation concerns the fact that there is no external enforcement mechanism in double tax avoidance. As opposed to the judicialized dispute settlement procedure in trade (see, for example, Zangl 2006, 95–100), a typical tax treaty only provides for a diplomatic 'mutual agreement procedure' between the competent authorities of two countries (see Chapter 4). Why is this so?

The international tax regime is not concerned only with the avoidance of double taxation. It also addresses the evasion and avoidance of income taxes. With respect to the latter issue, a number of questions arise that have a bearing on the institutional form. In general, it can be observed that the rules aiming to curb tax avoidance are quite limited in scope and have not effectively addressed the problem. For most of the history of international tax cooperation, the only cooperative instrument that was employed was the exchange of information provided for in bilateral tax treaties, which was limited in its effectiveness by national laws such as bank secrecy provisions. A second feature indicating difficulties in establishing cooperation against double non-taxation is the fact that the majority of anti-avoidance measures, most of which have been set up since the 1960s, are implemented as unilateral (domestic) rather than international rules. Why is it so difficult to implement effective measures to avoid international tax avoidance and evasion?

As will be shown, the issue of double non-taxation is linked to the issue of double taxation. In certain respects, the conclusion of bilateral tax treaties to avoid double taxation even facilitates the possibilities for tax arbitrage and tax avoidance. This linkage between double taxation and double non-taxation could have an impact on the choice between bilateralism and multilateralism in double tax treaties. Many tax experts have argued that the issue of double non-taxation could be addressed more effectively under a multilateral double tax treaty (see, for example, Vann 1991; Lang 1997; Thuronyi 2001). Despite these proposals, there is no sign that governments seriously push for the conclusion of such a multilateral treaty (Vann 1991, 101). Nonetheless, recently there have been efforts to move from unilateral anti-avoidance legislation and bilateral information exchange to multilateral policy responses.

There are multilateral administrative assistance treaties (Council of Europe and OECD 2003a). Likewise, the OECD project against 'harmful tax practices' is a multilateral endeavour (OECD 1998a; Owens 1998). Why has this trend towards multilateralism occurred?

The development of these multilateral elements does not aim at the conclusion of a multilateral tax treaty. To the contrary: the growth of the bilateral treaty network continues uninterrupted (see Chapters 4 and 5). Rather than integrating the avoidance of double taxation and double non-taxation in one institutional solution, the moves towards multilateralism are indirect. The aim appears to be the construction of a multilateral support structure to remedy the deficiencies of the bilateral treaties with respect to the problem of double non-taxation. Why is the bilateral approach not discarded despite its acknowledged sub-optimality with respect to fighting double non-taxation? Why is it resilient to change? What accounts for the particular institutional trajectory of the international tax regime? In addressing these questions, the study investigates the relation between the existing institutional setup that has been almost exclusively concerned with double taxation and the newly emerging international institutions against double non-taxation.

Research design and theoretical framework

How can these questions be answered? In this section, I introduce my research design and theoretical framework. I first introduce the analytic narrative approach and then describe the building blocks of rationalist institutional analysis. I also introduce rationalist mechanisms for the analysis of institutional developments over time.

Constructing an analytic narrative

As pointed out in Chapter 1, the choice between bilateral and multilateral cooperation has not received sufficient attention in theories of cooperation. Some theoretical building blocks are available, but these do not precisely fit the issue of bilateral as opposed to multilateral cooperation. Given this state of affairs, I construct an 'analytic narrative' that blends deductive and inductive reasoning (Bates *et al.* 1998; Levi 1999).[1] I first develop a baseline model of tax cooperation that builds on theoretical contributions to international taxation from the economics and legal literatures. The model consists of simple matrix games that can represent the strategic situation in international taxation. Drawing on the notion 'strategic structure determines institutional form', prior expectations about the institutional design of cooperation can be developed.

The baseline model serves as a heuristic to organize the presentation of the case material on the tax regime. It contains prior expectations about the aspects that should prove important in the explanation to be developed.

Without making explicit such prior notions of what is to be expected from the empirical case, there is no way to distinguish important from unimportant information. Making the prior expectations explicit makes the explanation vulnerable and potentially subject to falsification (Scharpf 1997, 29).[2]

Thus equipped with a baseline model, the empirical material is introduced. Great care needs to be taken not to suppress potentially relevant information simply because it does not fit the baseline model. However, instead of leading to the rejection of the model, such 'intervening' material should be used to *extend* the model. Actors' preferences, the restrictions they face and the interactions they engage in are used to reconstruct the strategic structure in more detail (Bates *et al*. 1998, 16). A close investigation of the resulting international tax game explains the institutional design of the regime. In this sense, the aim is to gain a 'reconstructive understanding' (Johnson 1991, 120) of the social outcomes resulting from the fundamental properties of the situation, as defined by the actors' preferences and their interactions. Hence, the empirical account serves the purpose of subjecting the hypotheses to a first test and getting new input for refining the model of tax cooperation. Since the initial model is too general to allow the derivation of hypotheses on all aspects of institutional choice, I restrict myself to deriving more general expectations. However, once these general effects are understood and are linked with a better understanding of the empirical workings of the institutions, implications emerge that are incorporated into the refined model. In this way a modular model of international tax cooperation is developed that is moved from a rather abstract theoretical level closer to the observed reality of the unique case at hand. At the same time, since it refers to established theoretical mechanisms, it still carries a certain level of generality that distinguishes it from a mere narrative of specific events. A *descriptive* historical account is turned into an *analytic* one that is moved from 'apprehension' to 'explanation' of an outcome (Bates *et al*. 1998, 14). This improved modular model is then 'tested' against *other* evidence from the case material.[3]

Thus, there is a deductive–inductive–deductive sequence that leads to a model that can provide satisfactory answers to the research questions. To paraphrase Bates *et al*. (1998, 11–13), I move from 'thin' reasoning to a rather 'thick' account of the empirical material and then back to thin reasoning, which will eventually be less thin than it was initially. In this iterative process of constructing an enriched model, I use a relatively rich description of history and empirical facts, and pay attention to stories, accounts and context. From the empirical record, I try to understand the actors' preferences and perceptions, their evaluation of alternatives, the information they possess, the expectations they form, the strategies they adopt and the constraints that limit their actions.

The analytic narrative approach is sceptical towards the possibility of uncovering general laws but at the same time does not contend itself with

a mere description of events. The ambition is to 'explain' the institutional design of the tax regime by uncovering *mechanisms* that help to solve the empirical puzzles at hand. A mechanism refers to 'plausible, frequently observed ways in which things happen' (Elster 1989, viii). In this sense, the approach is problem driven, not theory driven. First and foremost, I engage in this effort because I am interested in international taxation. But an explanation always entails making use of certain regularities that can be observed beyond the single case studied. In referring to such regularities, the researcher is invariably engaged in theory generation (George and Bennett 2005, 109–15). Consequently, the reconstruction to be developed can claim a certain, albeit not universal, level of generality. Ideally, such an explanation can contribute to the generation of a theory of the middle range (Hedström and Swedberg 1998).

Nevertheless, in a strict sense the construction of a theory from a single case is not possible, because one can always fit several explanations to the one case. Thus, strictly speaking, I will not end up with an empirical explanation. Instead, I engage in an effort at rational reconstruction. In order to probe the validity of my account, I also consider potential alternative explanations that could be constructed to explain the outcomes of interest.

Rational choice of international institutions

I pursue an approach that can be labelled 'strategic structure determines outcomes', which has been used in many fields of political science and makes up a distinctive field of IR research (see, for example, Stein 1982; Oye 1985; Snidal 1985a, b; Zürn 1992; Martin 1993; Simmons 2001; Holzinger 2003). There has been one attempt to collect all these and other mechanisms and summarize them in the form of several hypotheses about international cooperation (Koremenos *et al.* 2001). Quite in line with the analytic narrative approach, the 'rational design project' is not meant to lead to a general theory of cooperation, but aims instead to collect potential mechanisms that can be used to explain international institutions (Koremenos *et al.* 2001, 780–1). Likewise, Martin and Simmons (1998) propose a research agenda focusing on causal mechanisms and institutional effects. The present study aims to contribute to this field. In the following pages, I sketch this research programme.

'Rational choice institutionalism' asks why institutions exist and why they take the specific form they do. The short answer is that institutions help actors to 'capture gains from cooperation' (Weingast 2002, 670); in other words, institutions are instruments to overcome problems of collective action. Rational institutionalism employs tools developed in game theory and new institutional economics in order to analyse international cooperation. It starts with the presumption of rational individual actors who aim to maximize their individual utilities. They choose among a variety of

alternatives subject to certain restrictions. They are presumed to have fixed preferences over the potential outcomes of their choices. Any change in behaviour is attributed to changes in the restrictions the actors face. In game theory, part of these restrictions are the choices other actors make so that interactions can be analysed.

Based on these core elements of rational choice theory, the 'strategic structure determines outcomes' approach conceives of 'institutional form' as the dependent variable. Institutions are conceptualized as the object of states' strategic choices. The important first step in learning something about the dependent variable is to specify the independent variables. Therefore, one has to consider the characteristics of the object of cooperation (see, for example, Holzinger 2003). Is it a private or public good? Are there positive or negative externalities associated with it? Can uncooperative states be excluded from the benefits? Based on the answers to these questions, a game can be constructed that represents the benefits and costs each actor can realize depending on the choices other actors make. Using formally defined concepts to solve the game (for example, the Nash equilibrium), the problems of collective action in this issue area can be made visible. Examples of such collective action problems are suboptimal equilibria or the existence of several equally efficient equilibria, the selection of which requires active coordination between the players (see, for example, Stein 1982; Zürn 1992).

In a second step, the design of an institution that can resolve the particular problem of collective action is inferred. Thus, there are two crucial links in this argument. In particular, the first link from the characteristics of the object of cooperation to the strategic structure is quite sensitive to changes in the assumptions. Different assumptions about an object of cooperation may lead to different game forms. Thus, it is necessary to be very careful when distilling the important features of the situation (Holzinger 2003, 184). The second link from strategic structure to institutional design may not lead to a unique prediction either, as there might in principle be different institutional solutions for the same problem of collective action (Snidal 1985a, 923). However, in the literature the established hypotheses on the institutional consequences of different strategic structures are quite homogeneous and have been subjected to empirical testing, so that a rather well developed stock of plausible links exists (see, for example, Zürn 1992, Chapter 2).

By trying to explain institutional outcomes in terms of the properties of the situation and actors' preferences, game theory accounts bridge the traditional distinction between structural and actor-centred approaches (Lake and Powell 1999, 25–9). The actors in my case are states or, more precisely, governments. Thus, I use a weak version of methodological individualism that accepts aggregate actors as unitary actors (Hedström and Swedberg 1998, 12). This is a pragmatic shortcut, because the particular institutional choices in the global tax regime stand at the end of long and complicated causal

histories if one tracks them back to the decisions of individuals. To what extent the ascription of preferences to collective entities can be abstracted from the preferences of the individuals forming the collective is an empirical and not a theoretical question (Scharpf 1997, Chapter 3; Bates *et al.* 2000, 698).

Precisely for this reason, it cannot simply be assumed that governments' preferences are given, and the researcher has to consider the preferences of different societal groups that make up the 'black box' of the state and that try to pressure governments. These different interests play a role in the formation of governmental preferences. The preferences of actors, treated as fixed on the system level, are, at least to some extent, dependent variables of domestic and transnational interest constellations (Moravcsik 1997).[4] However, a state's preferences are also influenced by its structural position in the international system. In order to integrate both domestic and international sources of governmental preferences, I pursue the following strategy: in the initial baseline model I start with a theoretical specification of preferences derived from system-level factors. In the empirical chapters, I then also consider domestic interest constellations and how they influence governmental preferences. The insights from this can then be incorporated into the refined model. Thus, if it proves to be necessary, the preferences pursued by states will be amended in a second step. In this way, my approach can incorporate 'two-level' considerations (Putnam 1988).

Accordingly, I stick with the assumption of a unitary actor. Its preferences are co-determined from within (domestic sources) and without (structural position in international system). I maintain that such an approach is useful given that so far there has been no theory-driven account of international tax cooperation. Rational institutionalism can provide a useful first cut at the issue, because it focuses on the structural conditions and prevalent interest constellations. While the game theoretic approach to international relations is not able to capture all the complexities of an issue area, it can help to distil the most fundamental features of it (see, for example, Snidal 1985b, 44).

Another problem of the rationalist variant of institutional choice and the analytic narrative approach that has been acknowledged by proponents of these approaches is that any attempt to explain international cooperation runs the danger of only being a post hoc rationalization of such cooperation (see, for example, Keohane 1984, 80–1; Garrett and Weingast 1993, 177). It is shown ex post that rational actors *could* have selected an institution because it fulfils certain functions for its creators. The cause of an institution is inferred from its effect. Thus, the approach runs the danger of committing a functionalist fallacy (Elster 2000, 693). This danger can be avoided by trying to show that the actors involved do actually pursue the preferences that have been attributed to them (see, for example, Keohane 1984, 81). In a strict sense, however, it is impossible to find out an actor's preferences, since these are internal to the actor. Given that any actor is

situated in strategic settings, any expression of his or her preferences may not be genuine. All behaviour, including any speech acts such as statements of intentions, result from the interplay of the actor's 'true' preferences and the environmental constraints within which she is placed. Thus, preferences are not observable. A scholar will ultimately have to rely on some sort of 'revealed preferences'.

On the other hand, basing an analysis on the presumed revealed preferences of actors in an unreflected way is rightfully seen to be inherently circular (for example, observed cooperation suggests that a state prefers to cooperate, which explains why it cooperated). It may indeed lead into a functionalist fallacy (see, for example, Snidal 1985b, 40–1). But this problem can at least be mitigated by carefully combining theoretical deduction and empirical induction of actors' preferences. As has already been stated, I first develop a rough model of tax cooperation, in which I merely assume preferences based on existing theoretical considerations. The expected behaviour of actors within the model is derived. In a second step, the baseline model is tested against the empirical material, which leads to a refinement of the model. In a third step, the refined model is then tested against other empirical material. Through this process I am explicitly testing for observable implications of the presumed preferences and the model. Since a model provides a set of variables, including the unobserved preferences but also other observable variables and a theory of how the variables relate to each other, this enables the analyst to reason backwards from observed events to unobserved preferences. Thus, rather than naively taking any behaviour as 'true' preferences, we assume that the latter reveal themselves through a specified model. The model helps to substantiate or falsify the initial preference ascriptions. In this way, the 'revealed preferences' are determined in a methodologically controlled way that allows for the generation, accumulation and falsification of systematic knowledge (see Frieden 1999, 61–5).

Building blocks of a model of institutional choice

After this discussion of my research design, I now turn to a brief overview of some of the substantive mechanisms that are used in the 'strategic structure determines institutional outcomes' approach. These deal with problems of *enforcement*, *distribution* and *uncertainty*. While I leave a detailed discussion of the related strategic structures and the expected institutional outcomes to the discussion of my baseline model in Chapter 3, this sketch is meant to introduce fundamental concepts and distinctions that are put to use in the following chapters.

The *enforcement* problem is the most important feature of the *prisoner's dilemma* (PD), which was initially thought to be a useful representation of all kinds of international cooperation. When international relations scholars discovered game theory, they focused almost exclusively on enforcement

problems. In the one-shot PD game, individually rational states are not able to establish cooperation and end up with the worst result, because both have an incentive to defect from the collectively most desirable outcome. The socially desirable outcome, however, can be realized in a repeated game with a long enough 'shadow of the future' (Axelrod 1984). Cooperation 'under anarchy' becomes possible, if actors can reciprocally react to their opponents' moves (Axelrod and Keohane 1985). Nevertheless, even in that situation a single state has an incentive to defect from the cooperative outcome. Thus, the most important hypothesis for institutional design is that 'prisoners' dilemma regimes' have strong and centralized enforcement agencies that rely on binding hard law (Snidal 1985a, 938).

Subsequently, this exclusive focus on the prisoner's dilemma game was challenged, and a class of games that did not feature enforcement problems, so-called *coordination games*, was introduced (for early recognitions that not all situations are adequately captured by PD, see Stein 1982; Snidal 1985a). One generic type of these games is the battle of the sexes. In this game, the decisive conflict evolves around the *distribution* of benefits. In contrast to enforcement problems, where the issue is to ensure that the efficient outcome is realized at all, the problem is to pick one of several Pareto-optimal but distributively divergent outcomes. Since there is no problem of enforcement, any central institution would merely have the task of disseminating information and providing a forum for discussion in order to find a compromise solution for the distributive conflict. Non-binding 'soft law' may suffice for an effective institutional solution. It is quite likely that powerful states are able to force upon weaker states an agreement that is closer to their distributively preferred outcome (Snidal 1985a; Krasner 1991).

These basic ideas of institutional choice have been supplemented by certain elements from transaction cost economics. The basic idea of transaction cost economics, or new institutional economics, is that in addition to the mere production costs of economic goods, the costs of engaging in any kind of transactions also have to be considered. In short, transaction costs have been defined as the 'costs of running the economic system' (Arrow, cited by Williamson 1985, 18). These costs also arise when establishing international institutions so that the concepts used to analyse economic transactions can also be applied to international cooperation. A fundamental distinction in institutional economics is that of *ex ante* and *ex post* problems of contract making (Williamson 1985; Kreps 1990). The ex ante problems consist of negotiating and drafting contracts and the ex post problems are those of monitoring and enforcing them. Fearon (1998) refers to this distinction as the *bargaining* and *enforcement* phases of cooperation. Every problem of international cooperation can be divided into these two stages.[5] I use this distinction and add *agreement* to it. Bargaining refers to the ex ante phase, where the terms of an agreement are negotiated. Agreement is the stage of coming to a binding agreement. It captures the formal conclusion of the

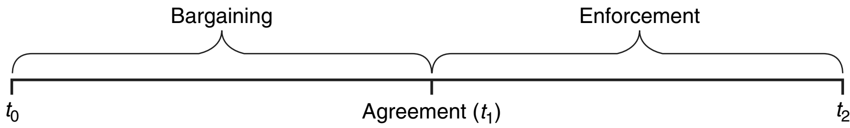

Figure 2.1 Three stages of the cooperation process

bargaining period. It is thus quite simply the natural dividing point between the bargaining and enforcement stages. *Enforcement* refers to the ex post stage of the cooperation process, in which it must be ensured that all treaty partners comply with the agreement. Figure 2.1 shows the three stages of the cooperation process.

In order to get a complete understanding of institutional choice, it is necessary to distinguish between these stages. A differentiation between them helps to adequately *describe* the institutional form. Most importantly, countries can choose between bilateralism and multilateralism in each of the stages. Thus, cooperation need not be bilateral or multilateral as such, but can vary in different stages of the cooperation process. Even within one of the stages there could be a mix of bilateral and multilateral elements; for example, if bargaining takes place both multilaterally and bilaterally. Second, and even more important, the differentiation into ex ante and ex post problems of cooperation is useful, because according to contract theory the typical problems arising in each stage are different and should influence institutional design in predictable ways. The two stages can be linked to the generic problems of *enforcement* and *distribution* that I have introduced above. In the bargaining phase, the actors need primarily to decide what the substantive content of an agreement is. In the classic formulation of the pure bargaining problem, actors have to pick between several self-enforcing agreements (see, for example, Schelling 1980, Chapter 2). The problem to be solved is that of the distribution of benefits: who gets what? The battle of the sexes is the generic model for this. The problem that is addressed in the ex post phase is that of enforcement. Once a deal is struck, partners have to find a way to ensure that no one reneges on the agreement. The PD is the generic model for this.

However, this analytical distinction into pure bargaining and pure enforcement problems cannot capture empirical reality. In reality, the ex ante and ex post phases of cooperation interact. Of course, potential treaty partners consider possible ex post problems in the ex ante phase of cooperation. The future enforcement phase shadows into the present bargaining phase. This means that there is a need to distinguish between (empirical) enforcement and bargaining *phases* and (analytical) bargaining and enforcement *problems*.[6] To the extent that problems of enforcement are foreseeable – for example, if the underlying problem structure is that of a PD – they can

influence the bargaining phase in different ways. For one, treaty partners can try to negotiate effective enforcement mechanisms into the agreement, before they try to decide upon the exact details of the agreement in terms of 'who gets what'. Alternatively, if they know that an agreement cannot be effectively enforced, they may not even commence bargaining, because there is no use to an agreement that cannot be enforced. Or the resolution of bargaining problems might be quite simple, because treaty partners know that the agreement will not stick anyway. Likewise, if enforcement is unproblematic, bargaining might be very tough and thus costly, because the agreement will stick for a long time (Fearon 1998, 270–1). As these different possibilities suggest, the distribution and enforcement problems are intertwined and it is difficult to predict how actors will go about resolving them. It can be expected that (empirical) bargaining somehow switches back and forth between problems of distribution and enforcement (Heckathorn and Maser 1987).[7] While a unified theory does not exist, we can come up with plausible reconstructions of the interaction of enforcement and distribution problems, specifying the precise circumstances and relative strengths of both problems for the case at hand (see, for example, Garrett and Weingast 1993; Morrow 1994).

The main idea pursued in this study is to derive implications for institutional design from the extent to which bargaining and enforcement problems, and possibly their interaction, are prevalent in international tax policy. But in addition to enforcement and distribution, I also consider *uncertainty*. Not all kinds of possible ex post problems, or the absence of problems for that matter, are foreseeable. The future is contingent. *Uncertainty* is a fundamental fact of (international) life that has to be accounted for by rational actors. Therefore, a contract is always an *incomplete contract* (Williamson 1985, 70–1). The more complex a transaction is and the more uncertainty there is about the future environment, the more pressing this problem becomes. Contract theory maintains that parties 'agree ex ante not so much on what will be done in each particular contingency as they do on the procedure by which future contingencies will be met' (Kreps 1990, 119). Rather than providing detailed rules ex ante, which would incur high transaction costs, contingencies are tackled ex post, once they materialize.[8] However, in the bargaining phase treaty partners have to agree on a procedure to be followed in situations of uncertainty regarding the application of their agreement. Thus, in addition to thinking about enforcement and distribution problems, it is necessary to consider the extent of uncertainty prevalent in making agreements.

Building blocks II: institutional development and rigidities

These elements of institutional choice need to be supplemented by considerations of institutional development. In an overly simple rational choice account, an institution must necessarily be efficient, since it is the outcome

of deliberate design by rational actors. The possibility of an institution producing inefficient outcomes is often not seriously explored. The argument given in defence of this view is that even if an institution became inefficient due to changes in the environment, it would quickly and easily be adapted to the new circumstances. Such a view of institutional choice and development is overly optimistic and has been challenged by 'new' or 'historical' institutionalism (see, for example, March and Olsen 1984; Pierson and Skocpol 2002). The general idea of this literature is that institutions, once they have been established, develop a life of their own. Political practice may not be able to 'adjust immediately and uniquely to current, exogenously determined desires and capabilities' (March and Olsen 1998, 959). Institutions impose structure and continuity on the actors and an otherwise chaotic environment. They are inherently resistant to change. Since the institutional setup of tax cooperation evolved over time and was not built as an all-in-one solution, this possibility needs to be explored. While many new institutionalists are sceptical about rational choice, their concerns can be accommodated within a rational choice framework if we allow for *unintended consequences* and the possibility of *path dependency*. In the following, I discuss these issues briefly.

The view that rational choice theorists assumed institutions to be necessarily efficient can be rebutted. First, there is general scepticism in rational choice that the institutional equilibria that obtain from the strategic interaction of egoistic actors with conflicting interests necessarily contribute to the common good. On the contrary, one of the main tenets of rational choice institutionalism emphasizes the conflict between individual incentives and socially desirable outcomes. 'If efficiency and cooperation are the primary goals of the actors involved, then it is not a rational choice model' (Miller 2000, 543). The various kinds of collective action problems that have to be overcome to arrive at socially desirable results are the focus of attention in those theories – and in this study.

Besides this general point, unintended consequences can be accommodated within a rational choice approach if one allows for 'limited rationality' of the actors (Simon 1976). In some applications in economics, the actors are assumed to be 'perfectly rational'. This means that in addition to acting purposefully and self-interestedly, they also possess complete information about the environment, have perfect foresight of future events and unlimited computing capabilities. They can thus unambiguously rank the alternative choices available to them. According to the alternative concept of limited rationality, actors do not have unlimited cognitive capabilities. Neither are they always farsighted, but are prone to react to 'local feedback' only (March and Olsen 1998, 957). Since their understanding of a situation might thus be wrong, or at least prove to be wrong over time, there is the possibility of *unintended consequences* (Merton 1936). Basically all rational choice institutionalists accept the assumption of limited rationality (North 1990, 17–26;

Williamson 1996, 6). Thus, they are perfectly willing to accept the notion of unintended consequences.[9] However, they maintain that actors nonetheless act instrumentally and try to achieve their ends with the means available to them given the level of information they have (Miller 2000, 539).

One aspect that is particularly relevant here is that of the time gap between the institution's inception and its actual effects. Since social processes are often 'slow-moving', the effects of an institution only arise at a much later time (Pierson 2004, 79–102). Under the assumption of limited rationality, and given the substantial degree of uncertainty in the environment, political actors cannot perfectly evaluate the long-term consequences of their choices so that it is easily possible that unintended consequences will arise in the future. Or, even if they might foresee negative effects in the long term, they are not willing or able to tackle them adequately. Faced with 'the pressures of the immediate' they 'may pay limited attention to the long term' (Pierson 2004, 14) and deliberately leave aside issues that might potentially arise in the future in order to be able to arrive at a solution for their immediate concern. An institution that was created to fulfil a certain function, and initially did so, might become dysfunctional over time as the environment changes. The long-term effects of institutional choices are often the 'by-products of social processes rather than embodying the goals of social actors' (Pierson 2004, 15). The possibility of dysfunctional institutions follows quite naturally from bounded rational choice under uncertainty. However, in order to evaluate whether an institution becomes dysfunctional over time, it is necessary not to limit the focus to the initial institutional choice only but to consider the development of an institution over time. Studying institutions 'usually means to analyze processes over a substantial stretch of years, maybe even many decades or centuries' (Pierson and Skocpol 2002, 698). The analytic narrative framework sketched above does exactly that and goes beyond the 'snapshot' view (Pierson 2004, 119) that is often attributed to rational choice institutionalism.

While the possibility of dysfunctional institutions is generally accepted, some rational choice and functionalist accounts underestimate *institutional resilience*. They see institutions as 'presently efficient solutions' to some problem that needs to be dealt with (David 1992, 2). Even if the possibility of unanticipated consequences is acknowledged, it is sometimes assumed that instrumental actors can easily adapt an institution to the changed environment once they have recognized that it is dysfunctional. While the notion that political actors try to reform an institution that does not serve its (and their) intended purposes is sensible, the issue that is contested is the *plasticity* of an institution. Some rational choice scholars appear to be overly optimistic concerning the possibilities of reform. This is unfortunate since, as Pierson (2004, 142) notes, 'many of the key concepts for an understanding of institutional resilience can be found in work of rational choice scholars'. So, what are these mechanisms for understanding institutional resilience?

A first step to seeing that institutions are not entirely plastic is to consider that policymakers are forced to think in alternatives. If an institution is dysfunctional, you do not merely have to abolish it, you must replace it with another one that is better. Usually, the available alternative institutions have other kinds of deficiencies. Thus, the choice is between alternative *feasible* institutions. Part of this feasibility requirement is that it is not sufficient for an institution to be superior to the existing institution if both are newly created. The actors also consider the costs of setting up a new institution. If there is an institution in place it might prevail, simply because the setup costs of the alternative are too high compared to the benefits obtained in sticking with the existing institution (Williamson 1996, 195).

Another rather general reason why institutions can be resistant to change is that they are especially designed to solve the problem of making 'credible commitments'. In those cases where actors seek to realize long-term benefits and can only achieve that goal if they can commit themselves to not realizing short-term gains by cheating on others, institutions are often developed as mechanisms for binding oneself and others. One example of such an institution is a constitution. In such an instance, institutional change is intentionally difficult to achieve (Brennan and Buchanan 1980).

These ideas can be developed further by reference to the idea of *path dependency*. For one, the benefits and costs of alternative courses of institutional development are not only material ones, but also consist of the behavioural adaptations of actors to the existing institutions. The behavioural adaptations of the actors can be understood as specific investments in the continuing existence of the institution. These specific investments are *sunk costs* that increase the opportunity costs of alternative institutional paths. In other words, they provide the actors with 'positive feedback' for institutional continuity (Pierson 2004, 17–53). But not only actors invest in existing institutions. More generally, institutions are often complementary to each other. Such an 'institutional matrix', which exhibits positive externalities, can be a further reason for institutional rigidity or at best incremental change. Such an interdependent web of institutional and individual adaptation produces 'increasing returns', which make radical institutional reform expensive. Accordingly, a path-dependent development of institutions can result (North 1990, 95–6).

The last of these rationalist mechanisms that can explain institutional rigidities – and one that is of particular importance in this study – is connected to problems of coordination. As we have seen, in coordination games the actors' overriding goal is to coordinate with other actors. Even though they might disagree about which of two or more possible institutional equilibria is the best, there is such a high premium on coordinating on an outcome that they would rather choose an individually suboptimal institution than not to coordinate. Once the difficulties in settling on one of these equilibria are overcome, it is difficult to replace that institution with an alternative one,

since no actor has an individual incentive to change the institution (Snidal 1985a, 939–40).

As this sketch of a few mechanisms of institutional resilience indicates, the lessons learned from unintended consequences cannot always be easily incorporated into an institutional redesign. Instead, the existing setup may effectively restrict the manoeuvring room of reformers. They cannot replace or modify the institution based on their updated beliefs about institutional functioning without substantial costs. The institutions are not as plastic as such a model of institutional change would require. But this does not mean that institutional change is entirely impossible. Potential reform processes are examined in Chapter 3.

Sovereignty and taxation

In addition to the building blocks of institutionalist theory it is necessary to introduce different definitions of national tax sovereignty. A common argument about international taxation is that its institutions are weakly internationalized because governments hang on to their sovereignty (Arnold and McIntyre 1995, 3; Li 2003, 31–2). Many observers argue that the absence of an international organization that can impose binding rules on its members (Tanzi 1999, 183), or the bilateral rather than multilateral nature of tax treaties (Abbott and Snidal 2000, 441), can be attributed to the fact that governments hold on to their tax sovereignty. According to this line of reasoning, the costs of internationally sharing sovereignty are particularly high in taxation, because taxation is considered at the core of state sovereignty (Li 2004, 144). If a state shares its tax sovereignty, it is in danger of losing its 'stateness' (Schmölders 1961, 137).

I adopt a somewhat different perspective. The point is not whether the argument about tax sovereignty is true or not. It could well be correct. However, there are two problems with it. First of all, is it really true that national tax sovereignty is still very much intact? Generally, there is no investigation into this question. Instead, it is often simply assumed. Most importantly, often the concept of sovereignty is not even properly defined. However, a broad, and often unspecified, allusion to tax sovereignty may lead an analyst to overlook the finer developments and less dramatic changes in how tax sovereignty is exercised by governments. As will become apparent in Parts II and III, one can indeed observe certain changes in this respect. Second, the argument is usually underspecified. What are the causal mechanisms linking a government's desire to preserve its sovereignty with the particular institutional outcome of interest? Some abstract reference to sovereignty is used as a presumably self-explanatory metaphor for why tax institutions are hardly internationalized. A strongly held but rarely investigated presumption replaces the explanation rather than providing it.

Instead of conceiving of governments' desire to cling on to their sovereignty as the great 'immovable mover' of the structure and development of international tax governance, I take an approach that is more neutral towards the issue. Since I am interested in giving an account of the way in which tax sovereignty is exercised and how that changes over time, I do not make any strong assumptions about the role of tax sovereignty.

In order to be able to adequately capture the development of tax sovereignty, it is necessary to provide definitions for the relevant dimensions of sovereignty. Much could be said about different understandings and the changing meaning of the concept of sovereignty (for overviews, see Krasner 1999, 9–25; Biersteker 2002). Instead of engaging in a detailed discussion of the literature, I proceed with the following working definitions. Sovereignty is a government's power to design and implement rules over its own territory or its own citizens.[10] Tax sovereignty, as used in this book, is thus concerned with the power to tax its territory, citizens and residents. It can be differentiated into *de jure sovereignty* and *de facto sovereignty* (Bull 1977, 8; Palan 1998, 628–9). De jure tax sovereignty is defined as the 'legal freedom of action' (Keohane 1993, 91) to impose taxes. De facto sovereignty is the ability to effectively achieve the desired goals of tax policy (see Keohane 1993), such as efficiency or equity.[10]

A government may have the right to impose taxes, but at the same time it may not necessarily receive the desired tax revenue or attain other policy goals associated with taxation, because taxpayers are able to circumvent paying taxes. For example, international tax competition could be a reason why a government is unable to receive as much tax revenue as it wishes, or it could lead to a change in the tax structure; for example, a shift of the tax burden from mobile capital to immobile labour. In this case, while the government does clearly have de jure sovereignty to design tax laws as it wishes, it has lost de facto sovereignty. The tax policies pursued by other governments exhibit a negative externality that inhibits the achievement of desired policy goals.

This shows that de jure and de facto sovereignty may diverge. My expectation is that governments are interested in achieving their policy goals, such as equity or efficiency; that is, they are intent on being able to exercise de facto sovereignty. Thus, I expect that governments are, in principle, willing to share their de jure sovereignty if necessary to exert de facto influence. While they prefer to retain de jure sovereignty on their own if that leads to satisfactory outcomes in terms of their policy preferences, they are expected to share it with others if the particular problems that have to be addressed require some sort of collective action. Being sovereign in a de jure sense is not an ultimate goal of governments. Instead, the ultimate goal should be the implementation of their preferred policies.

More specifically, under conditions of internationally integrated markets, it is quite possible that governments cannot effectively determine all aspects of tax policy on their own if they want to reach their policy goals. In order to

deal with the problems resulting from international interdependence, they create international institutions that restrict or pool their de jure sovereignty to regain de facto sovereignty. Depending on the particular problem structure, this may require different governance structures – and turn out to be more or less difficult. This is, of course, the usual perspective of (neoliberal) institutionalism on the issue of national sovereignty and effectiveness (see, for example, Keohane and Nye 2000, 19–22; Raustiala 2003, 856–62).

Besides the differentiation between de jure and de facto sovereignty, it is useful to further differentiate de jure sovereignty into legislative and administrative sovereignty. *Legislative sovereignty* is the authority to make tax policy; that is, to design tax laws. *Administrative sovereignty* is the authority to enforce tax laws; that is, to collect taxes (for the same distinction with different terminology, see Cnossen 1996, 77; McLure 1997, 35–6).

These two aspects of de jure sovereignty need not necessarily fall together. National governments may be the only actors deciding on the design of tax systems, including setting tax rates and defining tax bases, and thus have a monopoly over legislative sovereignty. For example, they can decide whether income taxation is based on a progressive tax schedule or a proportional one. Or they may decide to tax capital income at a lower rate than labour income (dual income tax). They can also choose the precise parameters of any tax system: for example, the top personal rate, the income levels at which different tax brackets start, or the integration or non-integration of corporate taxation into the personal income tax of shareholders. At the same time, a national government that holds legislative sovereignty over the design of tax laws may not exercise administrative sovereignty on its own. The conditions of a globalized economy may require tax administrations of different countries to pool administrative sovereignty in order to effectively enforce national tax laws. For example, the tax laws of many countries proscribe the taxation of savings income. However, effectively enforcing this claim to tax requires tax administrations to get information from other countries about bank accounts of their residents abroad. Likewise, effectively enforcing transfer pricing rules in order to determine the national share of the income of multinational enterprises (MNEs) will often require the administrative assistance of other governments. Legislative sovereignty and administrative sovereignty may be internationalized to different degrees. Since the assumption is that governments wish to implement their own policies, and since these desired policies may vary across countries, an agreement on common tax laws could prove more difficult than helping each other enforce existing national laws. It is conceivable that governments are less willing to share their legislative sovereignty than they are to share their administrative sovereignty.

This conceptualization has the advantage of enabling me to capture potential changes in the way tax sovereignty is exercised over time. It provides a categorization to assess which dimension of sovereignty is internationalized or not and to what extent. Instead of simply assuming that national

governments do not share their tax sovereignty, the issue becomes the subject of my investigation. The general expectation is that the development of international tax institutions and thus the degree of (non-) internationalization can be explained by the underlying problem structure. However, since the argument that particular institutional outcomes can be explained by national governments' desire to preserve de jure sovereignty features prominently in the literature, I explicitly address this argument as a potentially competing explanation in Chapters 7 and 8.

3
A Baseline Model of Tax Cooperation

In this chapter, a simple model of tax cooperation is developed. The basic model is not meant to capture all the relevant characteristics of international tax policy; instead, the intention is to develop first predictions about countries' strategic concerns in international tax policy. I first discuss why single taxation is the *collectively* optimal choice. Then I consider to what extent it is also *individually* rational for a government to pursue a policy of single taxation. Achieving single taxation involves the avoidance of both over- and under-taxation of international income. I first derive the strategic structure for avoiding over-taxation and then turn to under-taxation. As will be shown, both issues involve different kinds of collective action problems. From the close analysis of the strategic structures, I derive hypotheses on the institutional design that may help to overcome the respective problems of collective action. Finally, I consider the issue of institutional development over time and derive hypotheses on the expected institutional trajectory of the tax regime.

Single taxation as the global optimum

Which tax treatment would maximize worldwide welfare? To answer this question, I set up a very stylized and simple thought experiment that builds on the basic insights of welfare economics and optimal tax theory. It operates under the following assumptions: national income consists of two elements, public income (*tax revenue*) and income that accrues to citizens (*private income*). Tax revenue is necessary to provide public goods and thus finance public consumption. Private income is used to finance private consumption. Governments maximize a social welfare function that prescribes the optimal mix of private and public consumption according to their citizens' preferences.[1] Furthermore, I assume that all countries are equal in all relevant aspects, so that the optimal level of public good provision and the effective tax rate are the same everywhere. In other words, the assumption is that all national tax systems are optimized and this solution is the same in

all countries. Starting from this situation, what is the effect of introducing the possibility of international investment? Under the assumption that all governments pursue the maximization of worldwide welfare, it is intuitively clear that it would be best to implement the same treatment for international investment as for domestic investment. In order to see this, consider the effects of treating international investment differently from domestic investment.

First, there could be double taxation of international investment income. If an economic activity is international, absent any countermeasures, the tax claims of different countries overlap. More precisely, in the area of direct taxation it consists of an overlap of tax jurisdiction of the so-called *residence* and *source* states. The residence state is the country where the investor, and thus the recipient of the income, resides. She invests in the source state, from which she receives investment income. If both countries exert their power to tax, the income is taxed twice and the overall tax burden is higher than it would have been for purely domestic investment. Thus, an investment that would have been profitable does not take place because of double taxation. If, on the other hand, the increased burden on international investment is avoided by providing double tax relief, then an efficient worldwide allocation of capital results. Consequently, worldwide private income would increase. At the same time, worldwide tax revenue would also increase. Even though relieving double taxation entails a lower tax burden, this is more than compensated by the increase in international investment. The positive revenue effect of increased investment cancels out the negative effect of a reduced effective rate. Thus, providing double tax relief increases worldwide private income and tax revenue.

Second, consider the preferential tax treatment of international investment income; that is, under-taxation. If foreign investment is subject to a lower tax burden than domestic investment, capital allocation is not efficient but is driven by tax considerations. Investors invest abroad rather than at home, even though the pre-tax rate of return may be lower in the foreign country. The tax concessions lead to an increase in private income, but they must lead to a loss in worldwide tax revenues that is bigger than the private gain. This is so because of the assumption that all national tax systems initially operated at their optimum. Thus, any preferential treatment for international investment must necessarily decrease worldwide welfare. In consequence preventing the under-taxation of international investment helps to maximize worldwide welfare.

Combining these aspects, we can define the ideal of *single taxation*, which is given if there is neither over- nor under-taxation. If all activities are given the same tax treatment, whether domestic or international, locational decisions are not distorted by tax differentials between countries. In this situation, all factors are put to the most productive use from a worldwide perspective. Private income and tax revenue are at their global optimum so that the global

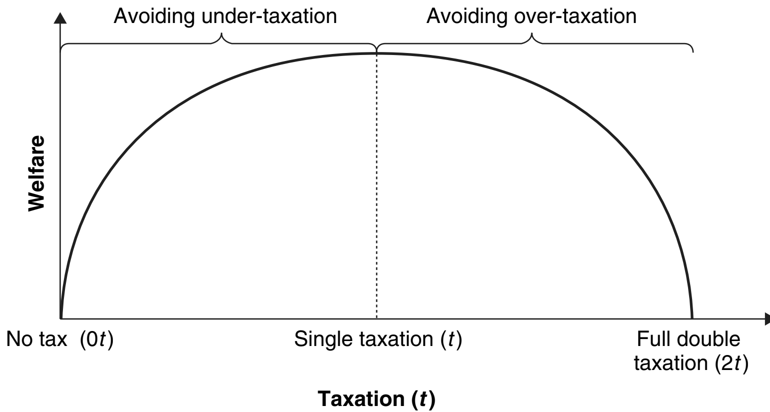

Figure 3.1 Single taxation as the global optimum

welfare pie is maximized. Figure 3.1 depicts this 'Laffer curve' of international taxation.

Stating that worldwide welfare would be maximized under single taxation, and thus be collectively desirable for all countries, certainly does not mean that it is necessarily achieved. The previous discussion has assumed that countries are interested in maximizing worldwide income. In the following sections and indeed the rest of the book, I drop this assumption and replace it with the more realistic assumption that governments maximize national welfare. Is single taxation also in their national interest, rather than only their common interest? To what extent are self-interested governments willing to contribute to the achievement of single taxation? Assuming self-interested actors reveals whether and which kinds of collective action problems are involved in achieving the maximization of worldwide welfare.

Avoiding over-taxation as a coordination game

In the following, I develop a model of countries' strategic interaction in double tax avoidance and derive hypotheses on institutional design following from the strategic structure of this issue.

Deriving the problem structure of avoiding double taxation

The model considers the interaction of a residence and a source country in a two-country world. Governments' goal is to maximize *national* welfare. The decision to assume national welfare maximization is made because it seems to contain various elements that countries allegedly care about: 'The principal competition, however, is for revenues, investment, markets, and jobs' (Kingson 1981, 1156). If this is correct, then the maximization of

national welfare is a useful starting point for the development of a baseline model.[2]

Apart from this, the assumptions that have been made in the previous section remain unchanged. National tax systems are assumed to be optimal and equal in the two countries. In the original situation, where no double tax relief is granted, both countries are at a certain level of national welfare. In their decisions to grant relief from double taxation, governments have to consider the effects of an increase of investment flows into and out of their countries. However, they cannot determine the level and direction of investment flows on their own because these do not depend only on their own choice of tax treatment. Instead, they depend on the interaction of governments' decisions (see, for example, Kingson 1981, 1153; Dagan 2000, 948–77). Game theory is an appropriate tool for investigating these interdependent choices. In a first take, I assume that only the residence country can relieve double taxation. This is an assumption that is generally made in the theoretical literature discussed below. I thus consider whether a country grants tax relief for income that its residents receive from investment abroad. However, in principle, it is also possible for a source country to relieve double taxation. While this is not discussed in the literature, this possibility needs to be considered and will be dealt with below.

First I assume that the responsibility for double tax relief lies with the residence country. Thus, it has four possible choices for its tax treatment of outgoing capital (Musgrave 2006, 169). First, it can choose to provide no relief of double taxation at all. Or it can choose among three possible ways of granting relief. Under a *foreign tax credit* system, the residence country taxes the worldwide income of its residents whether it was earned at home or abroad. In order to prevent double taxation, it grants a credit for taxes paid in the foreign source country on the tax due at home. Thus, the recipient's effective tax rate on his foreign investments is equal to the residence country's tax on domestic investment. Under *an exemption system*, the residence country only taxes domestic source income of its residents. All income that has already been taxed abroad is exempted from taxation. Since, by assumption, the tax rate in both countries is identical in this model, the credit and exemption system are equivalent. Under neither system is there any residual tax in the investor's home country. The third relief method, *deduction*, is a partial tax credit. The tax paid to the source country is considered as a cost in the calculation of the tax due in the residence country. It only diminishes the tax base on which home taxation is assessed and not the tax due, as in the case of the credit system. Consequently, the investor pays some tax on the international income in addition to the tax paid at the source. Under the deduction method, double taxation is only partially relieved.

The following example illustrates the different aspects of this choice. If one country (A) provides a tax credit for foreign investment income and the other country (B) does not, this has the following effects. Investment flows

from A to B; B gains investment. This is beneficial for B because there are economic benefits attached to this investment; for example, the creation of jobs, and it can be taxed and thus increases tax revenue.[3] The situation for A is the following: It forgoes tax revenue but will gain private investor income, since the investment abroad is more profitable than that at home; otherwise, investors would not have undertaken it. However, this gain cannot compensate for the loss of tax revenue and other positive economic benefits attached to the investment that had previously been undertaken at home. In other words, by providing tax relief while B taxes, A puts itself in a worse situation than it had been before and B's situation is ameliorated. The situation would be the other way around if B provided relief and A taxed. This is the basic reasoning used by countries to carry out their decision to provide double tax relief unilaterally or not.

Table 3.1 shows this for every combination of strategies countries can choose. There are three possible strategies for each country: (1) to provide credit or exemption, which are equivalent under the assumption of identical tax rates in both countries (C/E); (2) to provide a deduction (D); or (3) to provide no relief (NR). It summarizes the basic trade-offs inherent in the choice of providing unilateral double tax relief and ranks all possible outcomes for both players. The ordinal ranking summarizes the basic insights of the theoretical contributions on this question. There is one major disagreement, however, in this literature on the individual rationality of providing credit/exemption rather than a deduction; this disagreement has consequences for the ordinal ranking of one combination that is indicated in the table by showing the alternative payoff in parentheses.

On the basis of the information contained in Table 3.1, we can derive the 3×3 game matrix depicted in Table 3.2. This strategic structure represents the basic insights of the small body of the economics literature on 'home–host tax competition' (Davies 2004, 777).[4] There is broad consensus in this literature that it is individually rational for a residence country to provide a deduction for taxes paid to the source country rather than not to provide any double tax relief. As is visible in the matrix in Table 3.2, the strategy NR is dominated by the strategy D. The intuition behind this result is that a deduction leads to a situation where the after-foreign-tax (but before-domestic-tax) return on foreign investment is equal to or above the before-tax return on domestic investment. Thus, the only foreign investments made are those that unambiguously increase both private and public income in the residence country. The 2×2 game in the lower right part of the matrix that depicts the choice between NR and D is a pure *harmony* game. Both countries have an incentive to grant a deduction unilaterally rather than not relieve double taxation.

Since the strategy NR is dominated by D, we can concentrate on the 2×2 game in the upper left part of the matrix. Here, the situation becomes more complicated. The early literature, which is still perceived as the 'conventional wisdom' (Rousslang 1999, 164), postulates that, while a *coordinated* move

Table 3.1 The problem of over-taxation: credit/exemption, deduction or no relief

	Strategies		Description of outcome	Ordinal ranking	
	A	B		A	B
Case 1	NR	NR	Status quo of both countries taxing to the full.	0	0
Case 2	C/E	C/E	Capital (and tax base) flows from A to B and vice versa. Private income in both countries increases. Tax revenue in both countries increases. Capital is allocated efficiently. Single taxation is achieved.	4	4
Case 3	C/E	D	Capital flows in both directions. But there is more capital going from A to B than from B to A, because investors from A face single taxation. Thus, private income in A goes up. At the same time, A can tax the investment flowing from B to A. Since this is not as much as is flowing out (B only provides a deduction), tax revenue goes down. The welfare effect in A is slightly negative. In B the welfare effect is positive. It gains investment. Private income increases. Tax revenue increases because B can tax the investment coming from A and also gets some revenue from the investment going out. Depending on the elasticity of capital supply, the welfare effect is either better or worse than in case 1. The possibility of a welfare increase is indicated by the bracketed payoff.	−1	3(5)
Case 4	C/E	NR	There is investment going from A to B (A's investors face single taxation for their foreign investments), but none going from B to A (A's investors face full double taxation). Thus, A loses investment, gains some private income and loses tax revenue. B gains investment and tax revenue. Overall, the situation is positive for B and very bad for A.	−2	2
Case 5	D	C/E	Reverse of case 3.	3(5)	−1
Case 6	D	D	Capital (and tax base) flow from A to B and vice versa. Private income in both countries increases modestly, since the level of investment flows is modest and capital is not allocated efficiently. Tax revenue in both countries increases (they can tax the investment from abroad and receive some revenue from investment flowing out).	3	3
Case 7	D	NR	There is investment going from A to B (A's investors face less than full double taxation for their foreign investments), but none going from B to A (A's investors face full double taxation). Thus, A's loss of investment is more than compensated by its gain in private income and tax revenue. B gains investment and tax revenue. Overall, the situation is positive for both, but better for A than for B.	2	1
Case 8	NR	C/E	Reverse of case 4.	2	−2
Case 9	NR	D	Reverse of case 7.	1	2

Table 3.2 The strategic structure of avoiding over-taxation

A \ B	**C/E**	**D**	**NR**
C/E	**4 ; 4***	*−1 ; 3 [5]*	−2 ; 2
D	*3 [5] ; −1*	**3 ; 3***	2 ; 1
NR	2 ; −2	1 ; 2	0 ; 0

from (D ; D) to (C/E ; C/E) would be a Pareto improvement, a country would run the danger of being exploited if it played C/E (Bond and Samuelson 1989; Hamada 1966, 370–4).[5] In other words, unilaterally providing a credit or exemption would not be individually rational. The level of outgoing investment would be higher than that under a deduction. Thus, private income in the residence country would increase, but not enough to compensate the tax revenue that would be given up by the more generous relief method. Additionally, more investment would flow out than would flow back from the rest of the world, providing only a deduction. The implication is that a deduction is seen as the individually rational policy, a result that was first derived by Peggy Musgrave (1963, 1969). This result is incorporated into the matrix as the payoff in brackets. If the payoffs for (D ; C/E) and (C/E ; D) were (5 ; −1) and (−1 ; 5), then there is an incentive to defect from a potential outcome (C/E ; C/E). In other words, if one subscribes to the conventional wisdom, the choice between C/E or D has the structure of a prisoner's dilemma. The outcome (D ; D) is the only Nash equilibrium of this game. If this payoff structure were indeed a good representation of the situation countries face, then we would expect countries not to provide a credit or exemption unilaterally but only to grant partial relief by deducing foreign taxes.

However, the models underlying the conventional wisdom have been challenged for their restrictive assumptions. The assumption of a fixed capital supply has been questioned and modified. Outbound investment does not necessarily have to occur at the expense of domestic investment as the early literature assumes; it might also be financed by a decrease in consumption (that is, increased saving) instead of reduced domestic investment. Under this assumption, promoting a higher level of outbound FDI leads to a drop in neither domestic investment nor tax revenue, but may instead simply increase investors' private income and thus national income overall. If the supply of capital is sufficiently elastic, providing credit or exemption may then be in a country's national interest (Feldstein 1994). Furthermore, the early models only consider one-way capital flows from the residence to the host country. Under the more realistic assumption that capital flows in two directions, countries are both residence and source countries at the same

time. Davies (2003) shows that under this assumption, several Nash equilibria, for example, both countries using credits, are possible.[6] In a similar model, Janeba (1995) obtained the result that the choice of any relief method can be a Nash equilibrium.

In essence, this means that many of the newer models consider the upper left hand game to be not a prisoner's dilemma but an *assurance game*, which is characterized by the existence of two possible equilibria. These occur at the strategy combinations (D ; D) and (C/E ; C/E). The decisive feature of this latter equilibrium is that it is a Pareto improvement over the first. However, in order to move from (D ; D) to the collectively preferred equilibrium (C/E ; C/E) players have to coordinate their actions. In order to see this, imagine that A chooses C/E. If B is not entirely rational and does not choose its preferred answer C/E but stays at D, then A receives a payoff of only −1. Thus, a minimum degree of trust is necessary. A game of this form is called *assurance*, because the players have to assure each other of their rationality. It belongs to the class of so-called coordination games, in which the players have to coordinate on one of several possible equilibria (see, for example, Scharpf 1997, 73–5).

Overall, the substantial disagreement about this question in the theoretical literature has not been settled. Depending on the exact specifications and assumptions that are made, different results are derived. Accordingly, both scenarios must be accounted for. The choice between credit/exemption and deduction may have the structure of an assurance game or it may be a prisoner's dilemma.

However, what is discussed neither in my simple representation of the interest constellation nor in the literature on which it builds is that relieving double taxation is not necessarily the task of the residence country. The literature assumes that the country where an investment occurs always exerts its right to tax this income. Choosing credit/exemption in the game considered above is equivalent to a country restricting itself to the source principle – that is, only taxing income in the country of investment[7] – whereas the choice of deduction means that a country partially retains the residence principle – that is, taxing some of its residents' foreign income in addition to the source principle. Thus, the setup so far assumes that source taxation is given, and the only choice that is considered is that of the residence country to forgo taxation entirely, partially or to a limited extent. This assumption is not derived from theory, but is based on what is observed in reality: the source country is given 'first crack' at the income (Eden 1998, 76–9). However, in contrast to the model specification considered so far, this does not mean that the source country employs that right. And, even more importantly, the first crack rule is not naturally given, but was decided upon in the 1920s (League of Nations 1923). Thus, for the purposes of this book, which aims at a reconstruction of the rationales of the existing institutional design, it is necessary to consider the possibility that the source country forgoes this

Table 3.3 The problem of over-taxation: residence or source

	Strategies		Description of outcome	Ordinal ranking			
				Symmetric flows		Asymmetric flows*	
	A	B		A	B	A	B
Case 1	R	R	Capital and tax base flow from A to B and vice versa. Private income in both countries increases. Tax revenue in both countries is stable or increasing. Capital is allocated efficiently; single taxation is achieved. In the case of asymmetric countries, more tax revenue ends up in A.**	2	2	4	3
Case 2	R	S	There is no capital flowing from A to B, but a lot of capital flowing from B to A, because investors can achieve zero taxation (thus: no additional tax revenue in either country). The welfare effect in B is disastrous. In A it is positive, but difficult to evaluate. For one, B gains because of the positive benefits connected to the additional investment. However, the rate of return on all investments goes down. Overall, the effect is positive in A. I assume it is better than in case 3, but worse than in case 1.	1	−1	1	−1
Case 3	S	R	Reverse of case 2. For the case of asymmetric flows, it is even less advisable for a capital exporter to employ the source principle. Consequently the situation for country B using the residence principle is slightly better than in case 2.	−1	1	−2	2
Case 4	S	S	Same as in case 1. But for asymmetric countries, more tax revenue ends up in B.	2	2	3	4

*It is assumed that more capital is flowing from country A to country B. Thus, A is a net capital exporter.
**The ordinal ranking assumes that the welfare effects of the pure residence and source principles are identical. This need not be true. Proponents of capital export neutrality – that is, the majority of economists – would maintain that the residence principle is preferable to the source principle. If this were true, then in the case of symmetric countries, where distributive considerations do not matter, both players would rank the outcome (R ; R) above the outcome (S ; S) (see, for example, Cappelen 1999, 435). However, not all economists agree with this proposition, and some even maintain that pure source taxation would be preferable. In that case, the ordering should be the other way around. For purposes of deriving this model, it is not necessary to decide this question. (R ; R) and (S ; S) are considered to be equally desirable.

right partially or entirely; by doing so it would contribute to the avoidance of over-taxation.

In order to investigate the strategic structure of the choice between either the residence or the source country relieving double taxation, we can consider the two pure alternatives that are possible. Either any income is only taxed at the source, that is, in the country where it originates (source principle), or it is taxed only in the residence country, where the investor resides (residence principle). Here I do not include the strategy of providing no relief (NR). As shown above, it is dominated by at least providing partial relief (deduction). The following example demonstrates the reasoning that is used. If, for example, country A employs the residence principle and B the source principle, then there is no capital flowing from A to B, because the investors of A still face double taxation. They are taxed on the income in B at the source and also in A as residents. The situation for B's investors is quite different. They can achieve zero taxation by investing in A. A does not tax them at the source and neither does their country of residence, which employs the source principle. Consequently, the welfare effect in B is disastrous, as virtually all capital flows out and B does not receive any tax revenue. In A, the welfare effect is positive, but somehow difficult to evaluate. A gains because of the positive benefits connected to the additional investment, but the rate of return on all investments goes down because the country receives too much capital. Capital is allocated very inefficiently. In addition, A does not receive any tax revenue from incoming investment, since it does not tax at the source.[8]

Considering the pure alternatives of either residence or source taxation helps to put another issue into perspective. Until now, I have focused on a situation of *symmetric* capital flows. Provided investors from both countries face the same tax treatment, for example, both countries use the same method of double tax relief, there is as much capital going from A to B as in the other direction. Under such an assumption, it does not make a difference whether income is taxed only in the source or in the residence country. Since capital flows both ways, both countries are residence and source states to the same extent. Thus, not only are both systems equally efficient, the choice between them has no implications for revenue. This changes if capital flows are *asymmetric*. If there is more capital going from A to B than the other way around, the choice between residence and source principle is not revenue neutral any more. The *net capital exporter* A would receive more tax revenue under the residence principle without any negative impact on allocative efficiency. The *net capital importer* B would prefer the source principle for the same reasons. Table 3.3 depicts the strategy choices between the residence (R) and source (S) principle and their ordinally ranked payoffs under symmetric and asymmetric capital flows.

Translating the strategy choices for symmetric and asymmetric capital flows into 2×2 matrices, we get the two games depicted in Tables 3.4 and 3.5. Both games are *coordination games*. These situations are characterized by

Table 3.4 Avoiding over-taxation: symmetric capital flows

A \ B	**R**	**S**
R	**2 ; 2***	1 ; −1
S	−1 ; 1	**2 ; 2***

Table 3.5 Avoiding over-taxation: asymmetric capital flows

A \ B	**R**	**S**
R	**4 ; 3***	1 ; −1
S	−1 ; 1	**3 ; 4***

the fact that neither of the players has a dominant strategy. Instead, both players' dominant interest is to make the same choice. No player can realize a good outcome without knowing what the other player does. They want to coordinate on one outcome. In the case of symmetric countries, they are indifferent to whether the residence or source principle is employed. In the case of asymmetric countries, the net capital exporter prefers the residence principle, whereas the net importer prefers the source principle. However, they nevertheless have an overriding interest in coordinating on the same strategy. Even if they cannot realize their first best outcome, they will agree to the preferred outcome of the other player rather than not reaching an agreement. This is the case of a *coordination game with a distributive conflict*. In reality, there are many possible intermediate outcomes. Governments could also coordinate on a mixture of these principles in such a way that double taxation is avoided. While the simple 2×2 matrix does not depict intermediate solutions but only pure alternatives, it captures the fundamental idea that countries have to coordinate their actions. The dominant interest in coordination means that both countries want to avoid double taxation. Nevertheless, given that double tax avoidance is in place, a country will want more of the tax revenue for itself rather than leaving it to the other country.

Overall, the following strategic structure of double taxation emerges: countries have an interest in unilaterally relieving double taxation. There is consensus in the theoretical literature that all countries at least provide a deduction, but many newer contributions claim that countries unilaterally provide full relief in the form of credit or exemption. Following this latter view, granting relief nonetheless involves coordination problems. In addition, there is a distributive conflict in the case of asymmetric capital flows that makes the coordination problem more severe. While both countries have an overriding interest in choosing the same strategy, they have conflicting

preferences about which strategy is best. This is represented by a *battle of the sexes* game.

As an alternative interpretation, I also have to consider the possibility that both countries providing full relief is not a Nash equilibrium but is dominated by the outcome of both countries granting only a deduction, as the earlier literature maintained. While this equilibrium may be individually rational, it is Pareto inferior because double taxation is only partially relieved. This raises the possibility that countries face an enforcement problem if they want to implement the collectively preferred solution of single taxation. Nonetheless, even in this interpretation countries do not have an incentive to stick to a policy of no relief. Governments should at least partially contribute to the achievement of single taxation by providing a deduction.

Hypotheses on institutional choice

From the strategic structure just described, hypotheses can be derived on the expected design of institutions dealing with the issue of over-taxation.

Since there is no *enforcement problem* in coordination games, the institutional solution does not focus on issues of surveillance and the prevention of cheating; it need not be equipped with the capability to enforce rules on governments (see, for example, Martin 1993, 101). Instead, there is the possibility that no collective agreement is necessary at all, because it is in everybody's interest to unilaterally avoid double taxation. If there are any formal agreements, they can be expected to be *self-enforcing*. In the alternative interpretation, there could be a minor enforcement problem. While states have a common interest in ruling out the deduction method, it is, according to the conventional wisdom, individually rational to use it. So, to the extent that this is correct, I expect to find institutions that effectively rule out the use of the deduction method.

Leaving this ambiguity aside, in any interpretation there are problems to be dealt with that leave a role for institutions. For one, players have to coordinate on the preferred outcome of providing credit/exemption rather than deduction or no relief. As shown, this situation can be represented by an assurance game. While it is often believed that in such situations there is no need for a regime and players automatically coordinate on their desired outcome, there is a potential role for an institution to mitigate the problem of uncertainty and provide information about other players' strategies. Thus, if institutions are created, I expect them to specialize in the creation and provision of information to actors (Stein 1982, 302–3; Koremenos *et al.* 2001, 787–8).

In addition to that, for the case of asymmetric countries the problem of avoiding over-taxation involves a distributive conflict. Since actors have conflicting interests over the choice of either equilibrium, this situation makes the existence of formal agreements more likely. In such cases, precisely because there is no enforcement problem, it can be expected that

bargaining over the point on which to coordinate will be very tough, because agreements remain in place for a long time. Thus, bargaining might be costly, because it pays for actors to hold out (Martin 1993, 101; Fearon 1998). Therefore, I expect institutions dealing with double taxation to focus mainly on ameliorating bargaining problems.

In general, bargaining problems very often find their solution in a 'focal point' (Schelling 1980, 53–80) that is regarded by all players as a salient solution for the problem at hand. According to Schelling, salience can have several sources, among them the existence of historical precedents or the fact that one of the players, simply by moving first, forces the other player(s) to make the same choice. In the context of international relations, the 'first-mover advantage' inherent to coordination games is an advantage to powerful actors. If a powerful actor can commit itself to a solution then it is in the interest of others to simply go along (Krasner 1991, 340–1; Martin 1993, 102). Second, a focal point may also come from generally accepted social norms or conventions that most actors accept simply because they have always done so (see, for example, Sugden 1989).

However, such a generally accepted focal point does not always exist. Thus, a third possibility is that of a 'constructed focal point' (Garrett and Weingast 1993, 183–5; Martin and Simmons 1998, 745). This idea stresses the role that institutions can play in the 'construction' of a focal point. A centralized institution may provide a forum for discussion that enables actors to create such a focal point. However, precisely because there is no problem in enforcing such agreements, such an institution is not expected to be formally strong. Instead, it should be specialized on the production of 'soft law' (Abbott and Snidal 2000, 443). In coordination regimes, there is room for 'conventions' that guide actors' choices without being legally binding. Therefore, any centralized institutional structures would merely be specialized in collecting, producing and disseminating information on one of the possible equilibrium solutions. There will not necessarily be binding agreements on the centralized level. Agreement can well be decentralized (Snidal 1985a, 932). This is so because once a focal point is established, it is in the individual self-interest of all actors to adhere to that solution. The constructed focal points serve a signalling function for decentralized agreements (Martin and Simmons 1998, 746). They also mitigate the problem of hold-out because they pre-structure decentralized agreements. In consequence, if there is the need to settle a bargaining problem by constructing a focal point, one may expect multilateral negotiations, but not binding multilateral agreements, to play an important role (see, for example, Martin 1993, 102).

It should be noted that in the process of constructing a focal point, powerful actors could again play a central role. While the possibility mentioned above – that powerful actors simply implement one of the possible solutions without bargaining – is an alternative hypothesis to that of constructed focal points (Martin 1993, 92), this does not mean that power differentials will not

play any role in the construction of focal points. Due to the overall nature of the problem, they can play out their superior power easily because it is in everybody's interest to coordinate choices. In other words, the expectation is that the *relative power* of bargaining parties may be an important determinant of the outcome (Krasner 1991), both on the level of actual agreements and on the level of constructing focal points. Consequently, the hypothesis is that the solution found to the distributive problem reflects *power asymmetries* between countries.

However, while these hypotheses suggest that agreements may be decentralized, I cannot predict whether they will be bilateral or involve more than two players. In cases of distributive conflict, actors may be able to come to an agreement by increasing the number of cooperators in order to increase the scope for side payments (Sebenius 1983, 309–12; Koremenos *et al*. 2001, 784–5). However, it is not possible to derive definite hypotheses on the choice between bilateralism and multilateralism on the basis of this consideration.

Avoiding under-taxation as an asymmetric prisoner's dilemma

So far, I have analysed the problem of both countries exerting their power to tax to the full so that income from international investment is subjected to overlapping tax claims and thus over-taxed. Now, I consider the opposite problem of a potential under-taxation of capital. In order to understand the basic strategic structure of this problem, I drop the assumption of a fixed and identical tax rate in all countries.

Deriving the problem structure of avoiding under-taxation

Individual states have an interest in attracting international capital (and tax base) over and above the situation in which the problem of avoiding over-taxation has been solved. Attracting foreign capital by providing favourable tax treatment is individually rational because of the positive economic benefits attached to the tax base, which include private benefits, such as the creation of jobs, and potentially also tax revenue. Lowering the tax rate can result in increased tax revenue, if the negative tax rate effect – that is, less revenue from the existing base – is outweighed by the positive tax base effect – that is, more revenue flowing in from the additional capital tax base. Overall, a country can increase its national welfare by lowering its tax rate and thus attracting capital from those countries not cutting their rates. This is the basic logic of *tax competition*: countries have an incentive to undercut each other's tax rates.

There is a vast theoretical literature on international tax competition. As opposed to the literature on home–host tax competition, the basic functioning of host–host competition is far less disputed.[9] According to the standard model (Wilson 1986; Zodrow and Mieszkowski 1986) to be used here, tax

competition is collectively harmful. If all countries try to undercut their competitors' tax rates, the ultimate result is that tax rates in all jurisdictions will be too low. The result is an under-provision of public goods. Overall, national welfare in all countries goes down. In this respect, the strategic structure of international tax competition is that of the well known prisoner's dilemma (Hallerberg and Basinger 1998; Bernauer 2000, 215–24): it is individually rational to engage in tax competition but collectively harmful. In an extension to this basic model, one potential asymmetry comes into play. It can plausibly be assumed that small countries, in terms of population, can profit from tax competition. The intuition behind such models of 'asymmetric tax competition' (Bucovetsky 1991) is that small countries can more easily compensate the negative tax rate effect than big countries. They do not have a lot of per capita tax revenue to forgo in their own tax base, but there is a lot of tax base they can attract from abroad. In contrast, a large country imposes a higher tax burden on capital in order to maintain its per capita tax revenue even if that leads to an outflow of capital. In this sense, small countries can 'win' tax competition; their welfare increases compared to a situation of no tax competition. However, the gain by small countries is less than the loss incurred by big countries (Bucovetsky 1991). The model of asymmetric tax competition can explain why almost all tax havens in the world are small countries. Table 3.6 shows the possible strategy choices of either under-taxing (U) or taxing at the regular effective rate (T) and their respective payoffs for symmetric and asymmetric countries under the assumption that the problem of double taxation is solved.

Tables 3.7 and 3.8 depict the strategic structures of the problem of under-taxation. In both games, the dominant strategy for each player is to under-tax. The games have a unique Nash equilibrium in the strategy combination (U ; U). However, at least for the symmetric case, this Nash equilibrium leaves the players in a worse position than if they both played T. Therefore, there should be a common interest in avoiding under-taxation and arriving at (T ; T). According to the 'folk theorem', any equilibrium can be stabilized in repeated games because countries can punish the move of their opponent in the previous round. This can make the cooperative move the individually rational strategy (see, for example, Axelrod 1984). Thus, it is theoretically possible to attain the collectively desirable outcome (T ; T). However, even in a repeated game the incentive to defect from the cooperative strategy T is present in any single round of the game. Thus, arriving at the collectively desirable outcome is problematic. For the asymmetric case, which I refer to as an *asymmetric prisoner's dilemma*, the situation is even worse. Here, the small country would be in a worse position if the outcome (T ; T) resulted. Even in a repeated game the small country would choose to under-tax. However, there is room for *side payments* from country B to A. As is visible in the matrix, if the players agreed on (T ; T) then A would gain more than B lost, so it could compensate B. Thus, even in this case, it is, in principle, possible to reach the

Table 3.6 The problem of under-taxation: under-tax or tax

	Strategies		Description of outcome	Ordinal ranking			
				Symmetric countries		Asymmetric countries[a]	
	A	B		A	B	A	B
Case 1	T	T	Status quo of single taxation.	0	0	0	0
Case 2	T	U	Capital flows from A to B. B gains and A loses investment. Tax revenue in A goes down; it goes up in B. Private income in A goes up (foreign investors gain), but by far less than the loss in tax revenue. Welfare in B increases and goes down in A. This is also true for the case in which B is small and A is large.	–2	1	–3	2
Case 3	U	T	Reverse of case 2. For the case of asymmetric countries, A cannot gain as much from this strategy as B could in case 2. While the positive tax base effect outweighs the negative tax rate effect, it does so to a lesser extent than it did for B in case 2.	1	–2	1	–1
Case 4	U	U	Capital flows in both directions. For the case of symmetric countries, tax revenue in both countries goes down. Private income goes up, but by less than the loss in tax revenue. Welfare decreases in both countries. For asymmetric countries, neither tax revenue nor private income goes down in B, because the negative tax rate effect is compensated by the positive tax base effect. For A, tax revenue goes down and cannot be compensated by the increase in private income. Welfare decreases in A, but it increases in B.	–1	–1	–2	1

[a]B is assumed to be small in terms of population.

Table 3.7 Under-taxation game: symmetric countries

A \ B	T	U
T	0;0	−2;1
U	1;−2	**−1;−1***

Table 3.8 Under-taxation game: asymmetric countries

A \ B	T	U
T	0;0	−3;2
U	1;−2	**−1;1***

cooperative outcome. By allowing for side payments, I move from the theory of uncooperative games to that of cooperative games. The collectively desirable outcome in the asymmetric case would have to be a bargaining solution (Coase 1960). The under-taxation strategy of small countries creates a negative externality for the big countries that can be internalized by compensating them for abstaining from it.

In addition to host–host tax competition, there could also be home–home tax competition. A country that is home to multinational companies may be hesitant to tax on a residence basis for fear of losing 'competitiveness' with respect to other countries (see, for example, Avi-Yonah 2004, 377). In reaction to high taxes, MNEs may dislocate jobs and be less successful economically, with potentially adverse effects on national income. As a result, governments could have an incentive to under-tax 'their' MNEs. The strategic structure of this home–home tax competition is also that of a prisoner's dilemma. While countries may individually profit from granting tax preferences to their multinationals, they would be collectively better off if they could coordinate on taxing regularly. Since most countries that are 'home' to large multinational companies are big countries, the situation is best understood as a symmetric dilemma among big countries, as shown in Table 3.7.[10]

Hypotheses on institutional choice

In contrast to the problem of avoiding over-taxation, there is an *enforcement problem* in avoiding under-taxation or curbing tax competition. Because of the individual incentive to defect, an adequate solution to the problem of under-taxation is institutionally more demanding than the problem of over-taxation. Moreover, the entire process of agreeing on an institutional

solution can be expected to be far more conflictive. Nevertheless, it should in principle be possible to implement adequate institutions that need to meet the following requirements.

It can be hypothesized that in order to establish cooperation, players will employ a strategy of *reciprocity*. They reciprocate cooperative as well as uncooperative behaviour. In other words, they make their own cooperation conditional on that of other players (Oye 1985, 14–16). The chances for a strategy of reciprocity increase if the shadow of the future is long (Axelrod 1984, 126–32); only then will the long-run benefits of cooperation outweigh its immediate costs, which consist in forgoing the strategy of defection; that is, under-taxing. A formal organization could be seen as a credible commitment to enduring cooperation. As opposed to the case of avoiding over-taxation, such an organization should be preoccupied with the *ex post* phase of cooperation, its 'maintenance' or enforcement (see, for example, Martin 1993, 96).

The situation in reality is not that of a two-player game but one of many countries. The many-player situation makes the enforcement problem more severe, since employing a strategy of reciprocity is more difficult. It is costly to identify defectors and thus target retaliatory action at the right country. Because of that, an effective institutional solution focuses on issues of *monitoring* and the assessment of compliance with the established rules. In order to be able to handle the enforcement problem adequately, the solution must consist of binding 'hard law' (Abbott and Snidal 2000, 427). Accordingly, agreements must be enforceable upon countries; the institution must be able to impose sanctions against defectors. Enforcement problems usually require more hierarchical modes of governance. A strong, formalized and centralized institution that is equipped with the capacity to monitor and punish defectors could meet these requirements (see, for example, Stein 1982, 312–13).

Because the international tax base is very mobile, it is necessary to ensure the cooperation of all players. In the extreme, the abstention of only one country from the cooperative solution of regular taxation is sufficient for cooperation to break down completely. In this case, the mobile tax base would simply move to that country and the cooperative venture of all other countries would be undermined; the cooperators would harm themselves. In this sense, the international tax base is a common-pool resource that can be depleted. This means that the form of cooperation should be *multilateral* and encompassing, so that no country can take a *free ride* and exploit the countries abstaining from under-taxation: 'the key to finding a solution to the tax competition problem is to attack it on a broad multilateral basis' (Avi-Yonah 2005, 125). Cooperation cannot be initiated by a 'minilateral' coalition, which is then gradually enlarged. The group of cooperators needed to initiate cooperation, the so-called k group, is very large or even all-inclusive (Genschel and Plümper 1997, 635–6; Holzinger 2005, 480).

We can expect the decisive conflict of interest in potential efforts to arrive at a cooperative solution to be between large and small states, with the latter opposing efforts to curb tax competition and the former promoting them. Since small countries can win tax competition, they should be in a stronger position. On the one hand, the cooperative venture has to include them to be effective. At the same time, they are only willing to contribute to the avoidance of under-taxation if they are compensated. Consequently, they should be less willing than the large states to agree on any measures to curb tax competition.

Because of all these demanding requirements, the expectation is that establishing cooperation against double non-taxation is more difficult than in the case of avoiding over-taxation; it is conceivable that actors cannot come to a collectively binding agreement to avoid under-taxation. Besides the more detailed expectations on the form of governance, the general hypothesis to be derived from this is that attempts at building institutions capable of achieving the task successfully may very well fail.

Linking the games: from institutional choice to development

Governments have to solve both the enforcement problem that is fundamental to avoiding under-taxation and the coordination problem of avoiding over-taxation. It is therefore not enough to hypothesize on adequate solutions to either of the two problems: it is also necessary to determine the linkage between the two games. I first show that the institutions of double tax avoidance are ultimately sustainable only if a solution to the problem of double non-taxation is found. I go on to argue that this finding cannot be used to derive precise hypotheses for the institutional form that may result, since the two problems of over- and under-taxation emerged sequentially. There is reason to believe that the coordination regime dealing with double taxation only is subject to institutional rigidity and cannot be easily adapted to the demands of avoiding double non-taxation. I derive hypotheses on potential institutional trajectories of the tax regime.

Comparative statics: distributive bargaining within a prisoner's dilemma

A first possibility of a potential linkage between the two games is to consider what the situation looks like if both problems have to be solved simultaneously. This can be represented by nesting the coordination game within the prisoner's dilemma. The 3×3 matrix in Table 3.9 depicts this situation under the same assumptions that have been made above in the derivation of the isolated strategic structures.[11] The unique Nash equilibrium of the game is (U ; U). This is the same result as in the simple under-taxation game. In this sense, the enforcement problem is more fundamental than the coordination

Table 3.9 Coordination game nested within an asymmetric prisoner's dilemma

A \ B		T: R	T: S	U
T	R	**4;3**	2;−1	0;5
	S	−1;2	**3;4**	0;5
U		5;0	5;0	**2;2***

problem. A solution of the enforcement problem is necessary for any solution of the coordination game to be sustainable (Heckathorn and Maser 1987, 160).[12]

Accordingly, one would expect the resulting governance structure to entail strong multilateral enforcement mechanisms if it is to provide an efficient solution to the joint problems of over-taxation and under-taxation. It would have to have the same properties as those derived in the previous section on the problem of under-taxation. This would not preclude the existence of any bilateral elements in a regime that deals with both problems. There might, for example, still be bilateral bargaining or other bilateral elements. But the entire regime should ultimately be based on a *multilateral enforcement structure*.

From 'comparative statics' to process

The model of a nested game is useful to derive the functional requirements that the institutional solutions have to meet. By way of comparative statics, I hypothesize that a regime dealing only with over-taxation needs no enforcement capabilities, whereas one that is supposed to solve both problems – over- and under-taxation – needs them. But this model cannot illuminate the *process* through which an institutional solution is ultimately brought about. However, there may be several different paths to the new equilibrium. Understanding this process of institutional change is not only inherently interesting, but, as explained in this section, it may well be necessary for a complete understanding of the resultant institutional design of the tax regime.

The first step in illuminating the process of institutional change is to realize that the two games have to be understood as *sequential*. At the inception of the tax regime, while the actors have identified both problems, they have quite clearly not received equal attention. In the initial phase, countries were only interested in relieving double taxation, because they did not foresee the importance that the problem of double non-taxation would gain over time. In a perspective that considers sequence, governments first solved the coordination problem. The resulting setup should reflect the

functional requirements of a coordination regime that is specialized in helping actors choose between multiple possible equilibria but is not equipped with enforcement capabilities. Then, with increasing economic liberalization, the prisoner's dilemma inherent in tax competition should be felt more severely. Over time, the prisoner's dilemma matures within the coordination game and requires reform. Since the enforcement problem inherent in the double non-taxation game needs to be solved to make the solution to the coordination problem sustainable, the theoretical expectation is that the emerging problem of under-taxation will be the driver of institutional reform of the double tax regime.

Significantly, the linkage between the two problems may not only be that of a temporal sequence, there could also be causal links between the two problems. First, the institutions of double tax avoidance are one element of the liberalization policies that governments pursued and that created tax competition. Second, as explained in the following chapter, the particular construction of the institutions of double tax avoidance creates certain possibilities for tax avoidance that would not exist had another setup been chosen: the under-taxation problem that challenges the institutional setup of the double tax regime is an unintended consequence of its own success. Accordingly, under-taxation is at least partly endogenous to the institutions of tax governance. In that sense, any observed institutional change would be *endogenous change*.

There is reason to believe that such change would not be smooth but have to overcome considerable rigidities. Institutions that are designed to cater to problems of coordination may be quite inert. Generally, coordination regimes are stable because of the underlying incentive structure, which makes it individually rational to follow the convention once it has been established (see, for example, Sugden 1989; David 1992, 8–11). Even if the institutional solution becomes suboptimal, actors may not want to deviate from it. The stability of coordination equilibria can lead to a regime's inflexibility in responding to new conditions affecting an issue area. In the extreme, a coordination regime may become 'dysfunctionally stable' (Snidal 1985a, 939). This problem may be even more severe in cases where no natural focal point exists and actors had to construct one. Given the fundamental obstacles in terms of bargaining costs that had to be overcome in creating the focal point in the first place, actors may shy away from engaging in disputes over which new convention to adopt. The actors are invested in the institution. Due to these sunk costs, they stick with a suboptimal institution rather than risk being left with no coordinating agreement whatsoever (Pierson 2004, 143–4). The existing setup – the network of double tax treaties, the model convention and the committees at the OECD – may present a relevant (local) constraint on further state action against under-taxation. In this sense, the historical precedent that has been set by constructing the focal solution may prove to be very influential and hard to overcome. Building on these properties of

coordination regimes, I expect to find resilience in the institutions of double tax avoidance.

But the notion of institutional rigidity should not be misconstrued to predict that institutions cannot be changed at all (Thelen 2003; Pierson 2004, 153–7). Quite the opposite is true: since it is necessary to solve the enforcement problem inherent to under-taxation in order to make the tax regime sustainable, the theoretical expectation is that institutional change will occur. However, there may be several functionally equivalent reform paths, among which I can only discriminate by moving beyond institutional choice and considering institutional development. Two possible trajectories are discussed now.

Hypotheses on institutional reform

Institutional theories offer two possible modes of change, which can be labelled 'creative destruction' (Genschel 1997, 44) or incremental reform (Thelen 2003). It is acknowledged in the literature that testable propositions, under which conditions either creative destruction or incremental reform can be expected, do not yet exist (Pierson 2004, 139). This part of my study, which deals with institutional development, therefore proceeds in a more inductive mode. Here I introduce the mechanisms that have been observed and conjecture how they might relate to the development of the institutional setup of international taxation.

The literature on 'new institutionalism' refers to creative destruction as the most common mode of reform. In general, these accounts emphasize stasis rather than change. In making their case for inherently inert, rigid and change-resistant institutions, theorists were forced to come to grips with the empirical fact that institutional change occurs nevertheless. Many of the accounts of institutional dynamics therefore combine the notions of inertia and change by relying on 'punctuated equilibria' (Krasner 1984), or 'critical junctures' (Thelen 1999, 388–92). The general idea is that institutions are stable and institutional change is difficult in periods of normal history. Institutions only change if the pressure becomes very high; that is, if an institutional structure is stressed beyond its capacity to absorb or resist external developments that it cannot deal with appropriately. In such a moment of crisis, we will then observe rapid and fundamental institutional change.[13] This conception of discontinuous institutional development has intuitive appeal. Looking at major events such as revolutions, the demise of the Soviet Union or the breakdown of a system of fixed exchange rates, the idea that 'institutional history is characterized by long periods of stability punctuated by periodic episodes of rapid and substantial change' makes immediate sense (Genschel 1997, 45). To summarize this conception pointedly: the only way to reform an institution is to engage in creative destruction of the institution.

Conceiving of the problem of under-taxation as a shock to the institutions specialized in avoiding double taxation, the emergence of the enforcement

problem might be conceptualized as a critical juncture for the tax treaty regime. It is conceivable that an efficient solution to the enforcement problem entails dismantling the existing solution to the coordination problem and replacing it with a new one. If this were the case, the enforcement problem would lead to a transformation of the existing institutional setup itself. One possible hypothesis for institutional development is that multilateral cooperation could replace bilateral cooperation because the latter is suboptimal with respect to the enforcement problem of under-taxation.

Notions of path-dependent development interrupted by drastic change at critical junctures capture something important about institutional development over time. However, they sometimes obscure 'surprising institutional continuities' through periods of apparent crises. On the other hand, they also disregard 'subterranean' but highly significant changes in periods of apparent institutional stability (Thelen 2003, 233). Because of these shortcomings of conceptions of rapid and discontinuous institutional evolution, some scholars have stressed that in reality institutional change may also occur *incrementally*. Institutional designers need not necessarily engage in creative destruction. Instead, they might perceive the costs of fundamental reform to be too high and try more incremental efforts at reform.

Two possible logics of incremental change have been suggested in the literature. The first potential mechanism is that of 'transposition' (Genschel 1997, 58–61) or 'conversion' (Thelen 2003, 228–30). The general idea is that an institution that was designed to pursue one set of goals is redirected to a different set of goals. Such processes can be set in motion by external pressures, which lead actors to use existing arrangements in new ways and for different purposes. Over time, the institution fulfils other or additional functions rather than those to which it was initially assigned, while remaining unchanged in its basic setup. Transposition is a technique that is backward looking. Rather than searching for new answers to new problems, the actors try to locate old institutions that might be able to handle new problems.

The second logic of incremental change is called 'layering' (Thelen 2003, 226–8) or 'patching up' (Genschel 1997, 53). In this mode of institutional change, a new arrangement is layered on top of existing ones. Institutional entrepreneurs may lack the capabilities to reform an institution directly, because, for example, of sunk costs invested in the institution. In such a situation, actors may have an incentive to work around the existing institution in order to exact at least some kind of change. The actors neither try to dismantle or transform the existing institution directly, as the punctuated equilibrium model would predict, nor push developments further along the same institutional trajectory, as path dependency arguments suggest (Thelen 2003, 226). Layering works through bypassing the existing arrangement, and thereby may slowly change its institutional trajectory. Depending on the goals of the designers of the layered institution, it may provide external support to an existing institution or it may slowly subvert it.

The two modes of incremental reform are not necessarily mutually exclusive. It is conceivable that we can observe both at the same time. Applying the notion of functional conversion to the tax regime, actors could try to use bilateral tax treaties not only to avoid double taxation, which is their main purpose, but also to include rules that make under-taxation less likely. For example, states could try to introduce effective clauses on information exchange.[14] Independent from that, there could also be efforts to implement a layered institution on top of the existing institutional setup. Attempts to conclude multilateral agreements on information exchange that are distinct from the network of bilateral tax treaties might be a possible avenue. Such an agreement would be specifically designed to deal with the problem of under-taxation only and it leaves the bilateral double tax treaty network untouched. Nonetheless, the introduction of such an institution would indicate institutional change in that the mode of cooperation is multilateral. It would represent an attempt to support the existing bilateral setup with layered multilateral elements.

Note that creative destruction and incremental reform, while they are both functionally adequate responses, may lead to different institutional outcomes. If the path of creative destruction is chosen, a new institution replaces the existing institutions of double tax avoidance. In the case of an incremental reform path, the existing institutions would persist and would take on board new functions or be supported by a set of distinct institutions. The first case could be labelled a *direct* reform, since it confronts the institutions of double tax avoidance directly, whereas in the other case the route taken would be *indirect*.

However, it is also conceivable that creative destruction and incremental reform are merely two different paths ultimately resulting in the same institutional outcome. It is conceivable that actors first engage in efforts at incremental reform, and in a second step, if such reforms are not sufficient to solve the problems at hand, fundamental reform occurs. Such a sequence of fruitless efforts at incremental reform followed by radical reform is actually what many 'new institutionalists' expect in general. They do not deny the possibility of incremental change but maintain that it is ultimately 'limited, path-dependent, and ineffective' (Genschel 1997, 46). A recurrent theme is that 'incremental change will not succeed but leaves institutions susceptible to radical change' (March and Olsen 1989). Empirically, however, there are examples of successful incremental reform. It is conceivable that incremental reform may be successful, or at least sufficiently functional to prevent a wholesale redesign of the institutional setup. The literature on institutional change acknowledges that it is not well understood when one or the other model of change is more likely to capture reality (Pierson 2004, 139).

The best I can offer in terms of a theoretical expectation is the rather general statement that creative destruction occurs if the net benefits are higher than those under the indirect solution, where this calculation certainly has to

take into account sunk costs of the existing setup, the uncertainty involved in fundamental reform and similar factors. Thus, the position taken here is that, in principle, incremental reform leaves institutions open to radical change but only if incremental reform is not sufficient. In order to get a better feel for these benefits and costs, we need to know more about the precise setup of international tax governance. Since there are no well established theoretical grounds on which I could discriminate between the different potential developments that have been sketched here, I leave this question open and return to it after the presentation of the empirical part. The preceding discussion may alert us to different possible mechanisms that can plausibly be expected to play a role.

In this chapter I have developed the strategic structures that characterize the twin problems of over-taxation and under-taxation and have derived hypotheses for the institutional setup chosen in order to solve these problems. Over-taxation is represented by a coordination game with a distributive conflict. The main problem is to provide a focal point for the selection of one of the multiple possible equilibria. The expectation is that a decentralized institutional solution is sufficient; any centralized institution would merely specialize in the dissemination of information and provision of a forum for bargaining. Under-taxation is represented by a prisoner's dilemma or even an asymmetric prisoner's dilemma. This has led me to conclude that arriving at a cooperative solution is difficult. An effective solution must ultimately be multilateral and contain strong enforcement mechanisms. I then went on to consider the relation between the two problems. Arguing that the relation between them is sequential, I have discussed several potential modes of institutional development. The general expectation is that the problem of under-taxation represents a challenge for the institutions designed to deal with the problem of over-taxation and is thus the driver of reform. However, the existing institutional setup may constrain institutional reform, which may be either incremental through layering or conversion, or rapid and fundamental. In the following chapters I submit these stylized expectations to a test.

Part II

The Empirical Record of Global Tax Governance

4
The Institutional Setup of International Taxation

In international tax policy, countries follow the twin goals of eliminating double taxation and double non-taxation. According to the first goal international transactions should not be disadvantaged in relation to purely national transactions so that states can realize the benefits of international economic liberalization.[1] The problem in this case is an *overlap of jurisdiction to tax*: double taxation results from two or more jurisdictions exerting their power to tax to the full. The second goal is to ensure that international transactions do not remain tax-free or under-taxed in either jurisdiction. International transactions should not be advantaged in relation to purely national ones and tax revenue should not be eroded. Rather than a jurisdictional overlap, the problem consists in a *'jurisdictional vacuum'* (UNCTAD 2000, 12).

The two problems are treated within the international tax regime. This chapter provides an overview of the institutional setup of international tax cooperation. I first sketch the theoretical concepts of international taxation and then turn to a description of the rules of international taxation and introduce relevant actors. A brief evaluation of the actual rules against the theoretical benchmarks concludes the chapter.

Theories of international taxation

In this section, important concepts of international taxation that are employed in academic and policy debates are introduced and briefly discussed. I first define the problem of double taxation. Then the residence and source principle and their merit in terms of *fairness* are discussed. Finally, I discuss established conceptions of international tax *neutrality*.

Double taxation and overlapping jurisdictions

The problem of international double taxation arises from an overlap of tax jurisdiction. Consider the case of an investor from country A, investing in a profitable project in country B. Absent any measures to avoid double taxation, the income generated by the investment is taxed by country B and,

once it is repatriated to the investor, also by country A. Thus, the tax burden on the transnational investment is higher than it would have been for a purely domestic transaction. The decisive problem is the *over-taxation* of international income. The term 'double taxation' for this problem is somewhat misleading, since the very fact that an item of income is taxed twice or even more often is not objectionable as such. The decisive point is the extra tax burden.[2] Nevertheless, since the term 'double taxation' is established, I use it in this study. The term 'over-taxation' is used synonymously.

In general, there is no obligation in international law, formal or customary, for states to restrict their taxation: 'No territoriality principle of international law prohibits application of domestic law for domestic purposes to situations arising in other countries' (Vogel 1991, 4). A state is free to 'tax anything under the sun' that is vaguely connected to its territory (Li 2003, 32). Therefore, absent any countermeasures, the tax claims of the *residence state*, the state in which the recipient of income resides, and the *source state*, where the income has been generated, overlap. Two or more different countries tax the income to the full extent, and the overall tax burden is thus considerably higher than it would have been for a domestic transaction. It is this difference to the purely national transaction that is regarded as excessive over-taxation and that is to be remedied by double tax relief.

In principle, there would be two pure solutions to this problem. In the hierarchical variant, states could delegate the power to tax international income to a supranational authority and thus tax it conjointly. In the 'horizontal' variant, they have to agree on some rule to share the jurisdiction to tax between them. Apart from these two pure forms, one can also conceive of mixed solutions where certain elements of tax systems are decided upon in the vertical mode and others horizontally. A system of unitary taxation with formula apportionment, explained below, under which countries agree on a common tax base but apply their own tax rates, would be an example of such a mixture. The problem of double taxation has been dealt with along the lines of the horizontal option. Thus, if the problem is the overlapping of tax claims and it is to be addressed internationally rather than supranationally, the 'fundamental dilemma of international taxation' (Graetz and O'Hearh 1997, 1033) that has to be answered is: which country has the right to tax the income, and which country – the residence or the source state – has to restrict its tax claims (see, for example, Spitaler 1936, 427; Li 2003, 32–3)?

Residence versus source

This question is at the very core of theoretical and policy debates in international taxation. The traditional debate is couched in terms of normative claims about *equality* or *fairness* between individual taxpayers and between nations. All theoretical arguments about the jurisdiction to tax try to establish some legitimate link between the country that wishes to exert jurisdiction to tax and the particular base on which tax is to be levied. I give a brief overview

of the main theoretical justifications that have been put forward in favour of residence and source taxation.

The first argument that is brought forward in favour of residence taxation is based on the notion of *ability to pay*. Ability to pay is the core principle of personal income taxation, prescribing that citizens should contribute to the provision of public goods in proportion to their respective incomes. In order to determine correctly the ability to pay, it is necessary to assess the income on a net basis, so that the costs incurred in generating it are subtracted from the tax base. It is also necessary for the tax base to include all income of the taxpayer, no matter whether it was generated at home or abroad. A tax based on ability to pay must be inherently global. The residence state, the argument goes, is able to assess the individual on this worldwide net basis, because, compared to the source state, it is in a better position to consider his personal situation in its entirety. This solution, it is argued, is preferable on grounds of justice between individuals. Two citizens with the same net income carry the same tax burden, irrespective of the source of the income. In addition to this horizontal dimension of equality, the ability to pay principle is also invoked in the vertical dimension. The taxpayer with a higher income should also have a higher tax burden. This would be undermined if foreign income were exempt from residence taxation (see, for example, Avi-Yonah 1996, 1311–12; Musgrave 2001, 1338–40).

The most important argument in favour of source taxation is based on the *benefit theory*. The underlying idea of this principle is that a tax can be viewed as a price paid for the benefits received (see, for example, Buchanan 1976). According to this argument, since the infrastructure and other public goods are a vital input that enables the generation of income in the first place, tax should be paid in the source country (Vogel 1990; Musgrave 1991).[3] However, if a source jurisdiction were in fact to base its claim to tax on actual services provided, the tax would have to vary, since different taxpayers rely on public services to different degrees. This is generally not the case. In addition, it is next to impossible to determine the right price for the public goods provided because their contribution to the quality of the business environment is difficult to determine. Thus, while the general idea that corporations' use of public services is a legitimate basis for source taxation is convincing, the benefit theory cannot help in determining the exact share of taxation at source (see, for example, McLure 2000, 6:4). Therefore, the case for source taxation has also been made by reference to the *entitlement theory*, which is similar to the benefit theory, but does not rest its case for taxation at the source on a price that is difficult to quantify. The entitlement theory goes beyond the benefit theory in that not only services provided by the government legitimize taxation, but also factors such as allowing access to natural and other productive resources or to lucrative markets. While the economic advantages for the enterprise are admittedly difficult to quantify, it is maintained that their existence is so obvious that the source country is entitled to

a 'fair share' of the income that is created within its borders. Thus, the entitlement theory is not based on more or less quantifiable benefits, but relies on the normative idea of a fair share of international tax revenue to satisfy the demands of 'inter-nation equity' (Musgrave and Musgrave 1972). Thus, while the case for the residence principle is based on the requirements of equity among individual citizens in one country, the case for the source principle is based on considerations of equity among nations (see, for example, Cappelen 1999).

Often, the entitlement and benefit theories are not differentiated. Instead, the label 'benefit theory' is used to express the general idea that taxes should be paid where the taxpayer enjoys public benefits, even though there may not be a strict equivalence between taxes paid and benefits received. This somewhat relaxed version can also be reconciled with the ability to pay principle, and can be invoked in favour of residence taxation. If taxation is based on the benefit a taxpayer receives from the provision of public goods, then an individual citizen, generally enjoying the public goods in her country of residence, should be subject to tax in this country. Thus, while the benefit theory is usually mentioned only in the context of a source country's right to tax, the theory as such also provides a basis for residence taxation (see, for example, Li 2003, 52).

The theoretical debate about the merits of residence versus source taxation has never been resolved. This is because both lines of argumentation succeed in establishing legitimate links between the jurisdiction and the tax base.[4] Thus, the debate is best understood as a dispute about the *relative* priority of either principle. Basically, nobody proposes relying solely on either the residence or the source principle. This was shown by the first contribution to modern international tax theory – the doctrine of 'economic allegiance' developed by Georg Schanz (1892). The theory already contains and discusses the major arguments that have since been brought forward in the debate about the respective advantages of residence and source taxation. According to Schanz, an individual has an economic allegiance to the country in which he resides and consumes his wealth, and also to the country where his wealth originates. First, Schanz argues that every tax should be a personal tax and that an individual's 'whole faculty' is to be taxed. This is the notion of 'ability to pay'. He also subscribes to the notion that the right to tax should be linked to the provision of public goods to the taxpayer; that is, the 'benefit theory'. Schanz then goes on to argue that both aspects – the ability to pay and the benefit theory – have to be synthesized (Schanz 1892, 8–12). He suggests, without rigorously deriving this rule, that about three-quarters of the income should be taxed by the source country and only one-quarter by the residence country (Schanz 1892, 11). While this sharing rule may be criticized for its arbitrariness, the theory of economic allegiance is important because it contains the main intuitions around which discussions have evolved and argues quite convincingly for settling

on a combination of the residence and the source principle. As shown below, the solution that was ultimately implemented does indeed rely on such a combination.

Besides the equity arguments for or against residence or source taxation, several pragmatic considerations can be brought forward. A common argument in favour of source taxation rests on considerations of *administrative efficiency* (see, for example, Tanzi 1995, 81–3; Cnossen 1996, 80). Source countries are generally in a better position to enforce taxes on the income that has been generated in their territory. They can require enterprises within their jurisdictions to report payments that leave the country and then withhold taxes on these payments. In terms of administrative efficiency, residence taxation does not have much to offer. Very often tax authorities have to rely on the reports of taxpayers themselves, who have an economic incentive to under-report their true income. Because of this the enforcement of residence taxation must rely on intense exchange of information between tax administrations. As long as this is difficult to achieve, the source principle is seen to be an efficient way to prevent 'double non-taxation'. This pragmatic solution may even be superior in terms of equity. It may be better to tax the income at source than to not tax it at all because of the enforcement problems of residence taxation.

But the debate about the relative merits of residence or source taxation is not only about equity but also about economic efficiency.

International tax neutrality

The basis for all discussions of economic efficiency is the concept of tax neutrality. Neutrality is realized if the optimal allocation of goods and factors on a perfectly competitive market is not distorted. In other words, neutrality requires that the tax does not interfere with the decisions of economic agents.[5] However, perfect neutrality cannot be attained, because any kind of taxation leads to distortions. The goal can only be the minimization of distortions.[6] This is true for national tax systems but it also applies to the international setting, where it refers to neutrality between choices such as investing at home or abroad, consuming domestic or foreign goods or working at home or abroad. The normative criterion of international tax neutrality takes national distortions as given and only asks whether the fact that the transaction is international adds further distortions (Eden 1998, 74).

There are three different concepts of international tax neutrality (see, for example, Frisch 1990; McIntyre 1993). *Capital export neutrality* (CEN) is realized if the allocation of investments among countries is not influenced by the tax treatment of capital income in the countries that receive the investment (source countries). CEN describes the situation of an investor being indifferent towards an investment at home or abroad with the same pre-tax dividend. CEN would be attained if countries followed the residence principle

and granted a *foreign tax credit* for source taxes paid abroad. In such a situation, an investor faces the same tax rate, whether he invests at home or abroad. A policy of CEN ensures that all investors resident in a country receive the same tax treatment.[7] *Universal CEN* would be attained if this condition were fulfilled in all countries. *National CEN* describes the situation if this condition holds in a particular country.

Capital import neutrality (CIN) refers to indifference towards capital acquisition at home or abroad. While CEN refers to equal treatment between taxpayers in their residence country, CIN refers to equal treatment between investment objects in the source country. CIN will be realized if a country taxes income at source and grants an *exemption* for income received from abroad. National CIN is thus achieved if this holds in a particular country. Universal CIN would be realized if all countries followed the source principle of taxation.

Global (worldwide) neutrality is defined as a situation in which international investment decisions are entirely independent of tax treatment. Neither CEN nor CIN attains global neutrality. Under a system of residence taxation with foreign tax credit (that is, in which universal CEN is realized), an individual can still affect his tax treatment by changing residence. Likewise, even if all countries applied the source principle and universal CIN was realized, an investor might still care in which source country she invests. The tax burdens between the source countries could still differ. To reach global neutrality would require the simultaneous realization of CIN and CEN. This would be the case if all countries followed the residence or source principle (or the same combination of the two), levied the same tax rates and used the same methods of double tax relief. Global neutrality would be a first-best situation from the perspective of welfare economics (Homburg 1999, 1).

In addition to these three normative principles, there is the concept of *national neutrality* (NN). Despite its name, it is not about neutrality but about the maximization of national income, which is achieved, according to this concept, by pursuing a policy that favours domestic over foreign investment. Thus, the rules of taxation should be such that investments abroad are made up to the point where return net of foreign tax is equal to domestic return before tax. Only under this condition can it be ensured that the entire national income of the investment is higher than that from an alternative investment at home. Accordingly, the government will not strive to relieve double taxation fully, but will instead only allow the *deduction* of taxes paid abroad (Musgrave 1963; 1969). As has already been discussed in Chapter 2, there are divergent opinions on whether such a policy really maximizes national income.

As this overview shows, the methods of double tax relief introduced in Chapter 2 are associated with different concepts of tax neutrality. It is generally believed that CEN is associated with the credit method, whereas CIN is linked to exemption and NN to deduction. However, as explained, if

countries individually pursue credit or exemption policies this does not necessarily lead to the attainment of universal CEN or CIN, let alone global neutrality. As long as countries follow different conceptions of neutrality, neither kind of universal neutrality can be achieved.

Since the attainment of global neutrality seems quite unrealistic at present, there is a dispute among economists about the question of whether CEN or CIN should be given priority if the goal is to get closer to worldwide efficiency. The majority of economists agree that CEN is more important than CIN. If the decision to invest in a particular country is made irrespective of the source tax rate in that country, then the capital will be invested in those locations where it is put to the most productive use. In equilibrium, the pre-tax rates of return to investment across countries are equalized. Thus, the realization of CEN leads to so-called production efficiency. In contrast to that, under CIN investment goes to those countries in which the post-tax rates of return are highest. In equilibrium, while pre-tax rates of return could be different, post-tax rates of return are equalized, leading to a tax-neutral allocation of savings. Assuming that the interest elasticity of saving is low and the interest elasticity of investment is high,[8] distortions in the allocation of savings should be less costly than distortions in the allocation of investments. Thus, from the perspective of efficiency, violating CIN should be less harmful than violating CEN (for further details and discussion of this, see also Slemrod 1990b; 1996; OECD 1991, 271–80; Homburg 1999).

The institutions of international taxation

After this brief overview of the major normative concepts of international taxation, I now turn to a description of the actual rules of the regime. I first describe the basic mechanics of double tax avoidance. Then I turn to a more detailed description of the rules as they are embodied in multilateral model conventions (MC), bilateral DTAs and national tax laws. As will become apparent, the three levels on which international tax policy takes place – unilateral, bilateral and multilateral – are interrelated.

Sovereignty-preserving cooperation

The rules of international taxation operate to *disentangle national jurisdiction to tax* by allocating the international tax base to the residence and source countries involved. A nexus has to be established between the transnational income and the jurisdiction in order to legitimately claim the right to tax. This function is fulfilled by a series of legal constructs establishing the required link between the country and its share of the transnational tax base (Bird and Wilkie 2000, 91–8). These constructs, such as permanent establishment (PE), residence, source, the separate entity norm and the distinction among several kinds of income, are described in more detail below.

The important general point about the rules to prevent double taxation is that they have been chosen so as to ensure that countries are as free as possible to apply their own national tax laws. The legal constructs represent plausible assumptions – and have made them legally tractable – about the correspondence between transborder financial flows and the territorial base of the underlying economic activity (Bird and Wilkie 2000, 93–4). In other words, the rules contain '(1) some notion of what is going on where and (2) a concept of who has what right to share in the fruits of international economic activity' (Bird and Mintz 2003, 421). They define a nexus between a person or entity and the respective jurisdiction and thus establish *jurisdiction to tax*. Once jurisdiction to tax is established, a country is then basically free to use its own domestic rules on its share of the respective income. This generally includes the rules specifying the calculation of taxable income and the tax rates.[9] Governments retain full de jure sovereignty over the taxation of 'their' share of the transnational tax base. In this sense, the term 'international tax' 'is a misnomer, since there is no overriding international law of taxation' (Li 2003, 31), but only rules of allocation that operate at the *interfaces* of different national tax systems (see, for example, Debatin 1962). The idea is that of *territorial disentanglement* of different tax systems. The approach aims at 'preserving national sovereignty in tax matters by the least interference possible with national tax rules' (Vann 1991, 102). In this sense, international tax cooperation is *sovereignty-preserving*.

Emblematic of this approach of territorial disentanglement of tax claims are the rules for allocating expenses and profits among different parts of an MNE. According to these rules, the branches or subsidiaries of an MNE in different countries are to be taxed as if they were *separate entities*. For tax purposes their operations with each other are treated as if they were independent market participants – exchanging goods and services at arm's length prices (see, for example, Eden 1998, 32–52). The separate entity approach provides a way of splitting the tax base among several countries in which income was generated. With this approach, countries circumvent the problem of directly agreeing on a common definition of the tax base. Such a definition would be needed for so-called *unitary taxation* and *formulary apportionment* – the grand alternative method of taxing globally integrated companies (see, for example, Bird 1986; McIntyre 2004). Under the latter system, MNEs would be treated as integrated businesses and would have to report their worldwide profits. The profit is then apportioned to jurisdictions according to some predetermined formula that reflects the economic contributions of each part of the MNE to the overall profits. It should contain a combination of 'real' economic factors, such as sales, property and payroll, in each jurisdiction. Each country is allocated its share of the profits depending on what percentage of the overall payroll, revenue or property of the MNE is located there. Thus, under unitary taxation, the profits of the MNE would be apportioned directly to the various jurisdictions involved. In contrast, the *arm's length standard* (ALS) under the

separate entity approach is an indirect approach. According to the ALS taxpayers have to put a price on individual transactions between different parts of an MNE for tax purposes that should be the same as the price two independent market participants would have agreed upon. The ALS has the benefit of *de-politicizing* the issue of the distribution of the tax base by referring to the seemingly natural solution of market prices, instead of having to interfere with national definitions of tax bases (Picciotto 1992, 172). The ALS carries the idea of territorial disentanglement to its most extreme incarnation.

Another embodiment of the idea of territorial disentanglement and the preservation of de jure sovereignty is the fact that the rules are set up in a way that generally accepts the legal form awarded to a business entity by a country. Thus, even if a company is a wholly owned subsidiary of a domestic parent company, the home state of the parent considers it as an independent entity. Thus, if it taxes foreign source income at all – that is, if it does not operate an exemption system – it only taxes the subsidiary's income if it is repatriated to the parent company. Residence taxation is deferred (Green 1993, 24–5). *Deferral* is a natural corollary of the idea that countries with potentially overlapping tax claims do not tax foreign entities in other countries' territory (Graetz 2003, 217).

In general, bilateral tax treaties do not contain comprehensive rules of taxation and do not constrain national tax policy. They do *not aim at harmonization* of national tax systems but merely *coordinate* divergent national tax systems by disentangling them (Li 2003, 33). The regime setup leaves a lot of manoeuvring room for nation states. They are entirely free to design their tax laws according to their national policy objectives, and they are not supposed to interfere with the legal independence of other countries' tax systems.

The allocation of taxing rights

In a broad and imperfect way, the general pattern of allocation is the following: the corporate tax base (active business income) is assigned to the country of source and the personal income and investment tax base (passive income) to the country of residence (see, for example, Avi-Yonah 2006). This allocation is realized on the basis of the concepts of residency and permanent establishment. In general, the right to tax is granted to the country where a taxpayer is considered to be resident. For private citizens, this is generally easy to determine by reference to the national rules of residency. Corporations are often considered to be resident in the country where they are incorporated or where their management is located. However, for dependent foreign branches of a corporation liability to tax is created through the concept of a permanent establishment (PE). If some activity passes the threshold of being considered a permanent establishment, the profit derived from it is subject to business taxation in the country of source – according to the rules of that country. Basically, factories, offices, warehouses, depots and building sites are considered PEs and thus are subject to tax in the respective country,

even if not incorporated there. If some economic activity passes the permanent establishment threshold, this creates the necessary nexus to warrant taxation by the source country. Overall, these rules ensure that the source country can tax foreign (corporate) active business income, either because a company is considered to be resident there or because it has a PE.[10]

In return, the residence country is given the primary (or exclusive) right to tax passive investment income, such as interest, dividends or royalties, and personal income. Despite this, the source country has the right to the *first crack* at the income; that is, it can impose tax before the residence country does. The source country's right to first crack rests on the practical fact of life that the activity takes place within its borders enabling it to impose tax before the residence country can (Avi-Yonah 1996, 1306). This gives the source country a structural advantage. It is important to note, however, that in general a country is both a residence and a source country at the same time. A country's residents receive income from abroad and at the same time foreign income is generated within its borders. In this sense, the right to first crack is a bargaining chip available to all countries: countries may restrict their taxation at source in return for the other country restricting its taxation at source (Eden 1998, 82). This indicates that there is a role for *reciprocity* in the making of double tax treaties (OECD 1991, 17). The residence country, which is awarded the primary right to tax the passive income, is obliged to provide double tax relief by giving a credit or an exemption for tax paid abroad.

Figure 4.1 depicts the general mechanics of double tax avoidance. While, as a rule of thumb, active income is allocated to the source country and passive as well as personal income to the residence country, this is not consistently put into practice (Avi-Yonah 1996, 1307). The sharing rules that are contained in tax treaties do not entirely conform to the division into active and passive income. Most importantly, the PE concept is defined in such a way that most but not all active business income is taxed at the source. Likewise, the right to first crack subjects passive income to (limited) taxation at source. In order to further specify the mechanics of tax cooperation, I now turn to a more detailed account of the rules of international taxation.

Bilateral double tax agreements

At the heart of the institutional setup of international taxation are the bilateral tax treaties, and the OECD MC, which was developed in a multilateral setting. Basically, all bilateral treaties follow this convention, with some deviations in crucial provisions. In addition to the OECD, the United Nations also sponsors a model convention. However, the UN model is identical in structure to the OECD MC. In practice, most countries have developed national models, which are not publicly available. These are also tailored after the OECD MC and sometimes the UN MC, and contain the countries' preferred provisions for their bilateral treaties (Vann 1991, 102; Arnold and McIntyre 1995, 93).

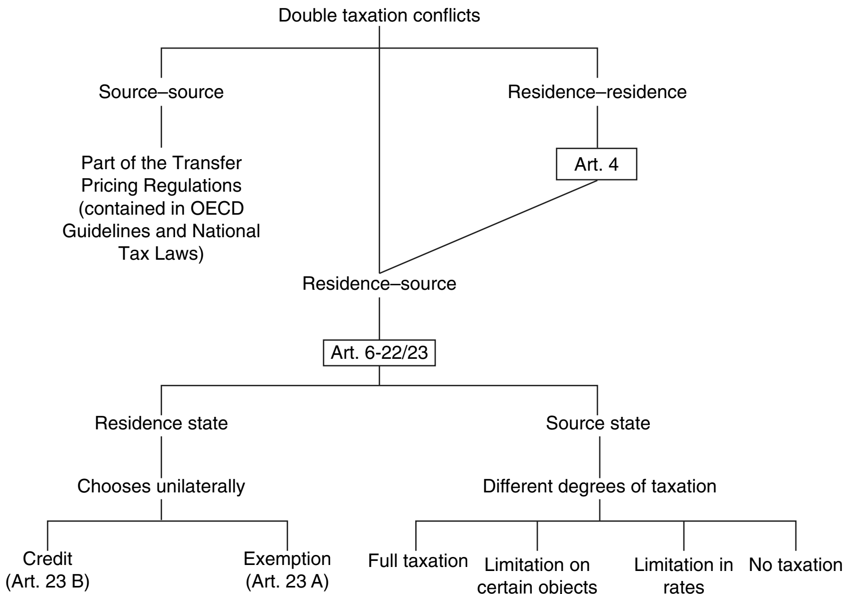

Figure 4.1 The mechanics of DTAs according to the OECD MC

The OECD MC, and thus the typical 'Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion', serves three purposes. First, it allocates taxing rights between states and eliminates double taxation. Second, a tax treaty targets certain forms of tax discrimination and facilitates the resolution of tax disputes. Third, tax avoidance and evasion by taxpayers is to be avoided.

The OECD MC is structured in seven chapters. Chapter I defines the scope of the convention. According to Article 1, the convention applies to residents of either of the contracting states. It usually also contains general 'bona fide' provisions that are to prevent the improper use of the convention. Most importantly, the convention is not be used in order to evade or avoid taxation. In Article 2, the taxes covered under the convention are described. These are direct taxes; that is, those on capital and income. States can list the specific direct taxes contained in their national tax codes (OECD 2005b, Art. 2, para. 3).

After this, Chapter II contains several definitions. Article 3 defines terms such as 'person', 'company' and 'enterprise'. It also specifies treaty partners' 'competent authorities' (OECD 2005b, Commentary on Art. 3, para. 7); that is, those bodies negotiating and administratively implementing the treaty. In most countries, these are the Ministries of Finance (Vogel 1991, 13).

Article 4 defines the term 'residents' by reference to the national laws of the countries involved. In general, double tax treaties do not concern themselves with the domestic tax laws of contracting parties. They accept them as given (OECD 2005b, Commentary on Art. 4, para. 4). The domestic definitions may vary. For example, with respect to corporate residence, the USA generally employs the criterion of incorporation. Wherever an enterprise is incorporated it is considered to be resident. In contrast to that, the UK and many Commonwealth countries have for a long time used the criterion of the place of central management and control – often the place where the board of directors meet. In the meantime, the UK has implemented a rule that effectively uses a mixture of the formal incorporation criterion and the test of central management. Japan determines corporate residence by referring to both a formal test of incorporation and the principal location of business (IBFD 2004, 357–607). Such differences in the domestic definitions can lead to cases of multiple residences and potentially result in double taxation. For such residence–residence conflicts, the convention contains rules to transform it into the well known residence–source conflict. For corporations, the MC suggests reverting to the principle of effective central management (OECD 2005b, Art. 4, para. 3). For individuals with multiple residences, the situation is resolved through tiebreaker rules such as the 183-day rule, which determine legal residence for purposes of the convention (OECD 2005b, Commentary on Art. 4, paras 10–20).

Article 5 defines a permanent establishment (PE) as a 'fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD 2005b, Art. 5, para. 1). The definition of a PE is casuistic in that it enumerates certain characteristics (and explicitly excludes others). Generally, a 'place of management', a branch, an office, a factory or a 'place of extraction of natural resources' are PEs (OECD 2005b, Art. 5, para. 2). The definition of a PE has to be viewed in connection with Article 7, which states that a (source) country has the right to tax the business profits of a PE. This means that business activity that does not meet the criteria of a PE cannot be taxed by the source state. The concept is thus very central for the division of the tax base between treaty partners. Due to its importance for the allocation of tax jurisdiction, it has proven quite difficult to come to a consensual definition of a PE. Accordingly, one often finds that the definitions used in bilateral treaties vary from the one suggested in the MC. Typically, the residence country should prefer a narrow definition, so that the right to tax of source countries is limited, whereas source countries should prefer a broad definition in order to be attributed a larger tax base (Prang 1982, 59–60).

Chapter III contains the central provisions of the convention. The so-called *source rules* of Articles 6 to 22 deal with the apportionment of tax shares. They grant jurisdiction to tax to either the source or residence country or propose a certain division of the right to tax. The DTAs follow a so-called 'schedular structure' (Vogel 2002), under which income is divided into a

number of categories subject to different tax treatment. As shown in the following chapters, the source rules are 'a set of arbitrary rules that were carefully crafted to support a specific compromise' (Brauner 2003, 279) on the difficult question of the allocation of the right to tax.

Article 6 provides that income derived from immovable property – for example, rent for a piece of land – is to be taxed in the country of source. Articles 7 and 9 are more relevant and deal with the taxation of business profits. Generally, profits are taxed in the country of residence only, unless there is a PE in the source country (OECD 2005b, Art. 7, para. 1). Thus, if a multinational corporation from country A has a factory in country B and a research and development branch in country C that meet the PE criteria, the profits that can be attributed to B and C are subject to tax in these respective source countries. However, since the earnings of dependent branches are also included in the tax base of the parent company, country A either credits or exempts the tax paid by the branch at source in order to mitigate double taxation (see below, Article 23).[11] In order to determine which profits are to be taxed in which country, the article also contains rules for the apportionment of profits between different parts of a corporation. Generally, the profits attributed to a PE shall be determined in such a way as 'if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment' (OECD 2005b, Art. 7, para. 2). This is the famous 'arm's length' criterion that requires taxpayers to set prices for transactions with related persons or entities as if they were uncontrolled market transactions. Article 9 basically contains the same rule for 'associated enterprises'; that is, the activity at source is not carried out by a dependent branch but by a legally independent subsidiary.[12] Article 9 also empowers contracting parties to correct the stated profits of associated enterprises if these are not in accord with the arm's length method. Countries are requested to ensure 'corresponding adjustment' of transfer prices in order to ensure that double taxation is avoided. It is actually quite difficult to implement the ALS in practice because comparable unrelated transactions are often hard to find. How this can and should be done is explained in separate and very detailed transfer pricing guidelines. As I will show in Chapter 6, the entire complex of transfer pricing is the subject of important controversies.

Article 8 contains special rules for the tax treatment of shipping and air transportation. Income derived from such activities is to be taxed in the country of effective management.

Article 10 on dividends and Article 11 on interest payments grant the primary right to tax these kinds of passive income to the residence state, but the source country has the 'first crack' and may apply a moderate withholding tax. The rate of this tax can be determined by the source state, but the bilateral treaties set a maximum ceiling, which must not be exceeded for payment flows between the contracting states. The maximum rates proposed in the

MC are the following. If the recipient of the dividend holds at least 25 per cent of the capital of the paying company – for example, a payment from a subsidiary to a parent – the maximum rate is 5 per cent. In all other cases, the maximum rate is 15 per cent (OECD 2005b, Art. 10, para. 2). In the case of interest payments, the maximum rate is 10 per cent (OECD 2005b, Art. 11, para. 2). These maximum rates are considerably lower than the unilateral withholding rates imposed by countries in the absence of a treaty (see Table 4.2).[13] Article 12 on royalty payments provides that they are to be taxed in the state of residence only. According to the MC, the source country does not have the right to levy a withholding tax. However, in practice many tax treaties contain a maximum rate of withholding at the source of 5 or 10 per cent. Besides that, the source country can impose a tax on royalties if these are connected with a PE situated in the source state (OECD 2005b, Art. 12, para. 3).

Importantly, withholding taxes on all three kinds of passive investment income are taxed on a *gross basis*, for reasons of administrative ease (Brauner 2003, 288). The source country does not generally have access to all the information necessary to calculate tax correctly on a net basis.

Article 13 states that capital gains from the alienation of immovable property or property that is connected to a PE are to be taxed in the source country. Other capital gains are taxable in the country of residence. Articles 15 to 21 deal with the taxation of salaries, wages and similar remuneration. Article 15 establishes the general rule that income from employment is to be taxed in the country of residence if the employee stays in the source country (that is, the country where she is employed) for less than 183 days and the remuneration is paid by an employer who is not a resident of the source state and does not have a PE there. Otherwise, the source country may tax the income (OECD 2005b, Art. 15, paras 1 and 2). Several articles contain special cases of this general rule. Article 16 states that 'directors' fees' are to be taxed in the state in which the corporation is a resident. According to Article 17, artists and sportsmen can be taxed in the state of source. None of the qualifications of Article 15 apply. Pensions are generally to be taxed in the state of residence (OECD 2005b, Art. 19). Income received from government service is taxed in the paying state. This is also true for pensions received with respect to past public service.[14] According to Article 20, students or apprentices staying in a state solely for purposes of education are to be taxed in the country from which they receive their income. All other income not dealt with in the preceding articles is taxed in the state of residence (OECD 2005b, Art. 21). Chapter IV, containing one article, deals with the taxation of capital. Article 22 provides that it is to be taxed in the residence state, unless it is immovable property or property connected to a PE, in which case the source state may tax it.

Table 4.1 sums up the respective rights to tax for different kinds of income according to the OECD MC from the perspective of the source country. On

Table 4.1 Source rules according to the OECD MC

	Full taxation at source	Taxation limited to certain objects	Limited taxation at source	No right to tax
Art. 6: Income from immovable property	X			
Art. 7: Profits		X (PE only)		
Art. 8: Shipping and air transport		Special regulations (taxation in state of effective management)		
Art. 9: Associated enterprises		Special regulations (transfer pricing rules)		
Art. 10: Dividends			X (generally 15%; 5%, if substantial holding)	
Art. 11: Interest			X (generally 10%)	
Art. 12: Royalties				X (but can be taxed if attributable to PE)
Art. 13: Capital gains	X (gains from the alienation of immovable property, PE)			X (Gains from the alienation of shares or securities)
Art. 14: Independent personal services	Deleted in 2000. Independent personal services are now subsumed under Articles 5 and 7 (OECD 2005b, Commentary on (Article 5, para. 1.1).			
Art. 15: Income from employment	X			X (<183 days)
Art. 16: Director's fees	X			
Art. 17: Artists and sportsmen	X			
Art. 18: Pensions				X
Art. 19: (Income from) government service	X (payment from source state)			X (payment from resident state)
Art. 20: Students				X
Art. 21: Other income				X
Art. 22: Capital taxation	X (immovable property, PE)			X (shares and securities)

the basis of these rules for the taxation of different incomes, double taxation is only avoided in those cases where jurisdiction to tax is given exclusively to either the residence or source state. In all other cases, where both states share the right to tax, the residence state is responsible for taking measures to avoid double taxation of the respective income. This can be done by either of two methods specified in Chapter V of the OECD MC. The residence state can choose between a credit for the tax paid at source (Art. 23B) or an exemption for that income from home tax (Art. 23A). The states are free in their choice between the two double tax relief methods; they do not have to negotiate their choice and can set it independently of whether the other state makes the same choice. However, according to the model, the deduction method is not permitted (OECD 2005b, commentary on Art. 23, paras 28–9). The exemption rule suggested in the MC is actually an 'exemption with progression', which is meant to preserve a country's progressive tax rate structure. Under such a system, the foreign source income is initially included in the taxable income for the limited purpose of determining the average tax due on the income; this average tax rate is then applied only to the domestic source income. If the foreign source income was excluded from the calculation of the tax base, the taxpayer might end up in a lower tax bracket of the progressive tax schedule (Arnold and McIntyre 1995, 37).

Under the credit method, the foreign taxes are subtracted from the tax due at home. However, the credit is limited to the tax that would be due at home. Thus, the residence state is not required to refund 'excess credits' (OECD 2005b, Art. 23B, para. 1). As a general rule, foreign income is only taxed in the residence country upon repatriation and not in the same period in which it is generated. This fact allows taxpayers to make use of *deferral*; that is, to accumulate profits in the foreign country and thus realize a tax advantage due to the time value of money. Therefore, the difference between credit and exemption may not be as stark as it may seem at first (McLure 1997, 32). If the tax rate of the foreign source country is low or the deferral of residence taxation is sufficiently long, the present value of residence taxation can approach zero, which is equivalent to an exemption (see, for example, Arnold and McIntyre 1995, 44–5).[15] As will be shown in Chapter 6, the deferral rule has been politically contested and there are important deviations from it. The relief methods chosen by OECD countries in their bilateral tax treaties are listed in Table 4.2.

The 'special regulations' of Part VI of the MC contain procedures for the application of the tax treaty and provisions that go beyond the purpose of double tax avoidance narrowly defined. Article 24 establishes the rule of *non-discrimination*. The treatment of non-resident taxpayers and residents must be equal. For example, a PE cannot be taxed at a higher rate than a home company. Generally, this rule also provides that any subsidies or tax breaks that are granted to home companies have to be extended to foreign-owned PEs as well. However, there is a list of exceptions to this rule (OECD 2005b,

Table 4.2 Comparing unilateral and treaty rules, OECD countries, 1991

	Unilateral relief		Treaty relief		Unilateral withholding rates (%)	
	Dividends	Interest	Dividends	Interest	Dividends	Interest
Australia	Credit	Credit	Exemption	Credit	30	10
Austria	Exemption	Credit	Exemption	Credit	25	0
Belgium	Exemption of 90%, deduction on rest	Credit	Exemption of 90%	Credit	25	10
Canada	Credit	Credit	Exemption	Credit	25	25
Denmark	Credit	Credit	Exemption	Credit	30	0
Finland	Credit	Credit	Exemption	Credit	25	0
France	Exemption of 95%, deduction on rest	Credit	Exemption of 95%	Credit	25	0
Germany	Credit	Credit	Exemption	Credit	25	0
Greece	Credit	Credit	Credit	Credit	42	46
Iceland	Credit	Credit	Credit	Credit	20	0
Ireland	Deduction	Deduction	Credit	Credit	0	30
Italy	Credit	Credit	Credit	Credit	32.4	15
Japan	Credit	Credit	Credit	Credit	20	20
Luxembourg	Exemption	Credit	Exemption	Credit	15	0
Netherlands	Exemption	Deduction	Exemption	Credit	25	0
New Zealand	Credit	Credit	Credit	Credit	30	15
Norway	Deduction	Deduction	Credit	Credit	25	0
Portugal	Deduction	Deduction	Credit	Credit	25	25
Spain	Credit	Credit	Credit	Credit	20	25
Sweden	Credit	Credit	Exemption	Credit	30	0
Switzerland	Exemption	Deduction	Exemption	Credit	35	0
Turkey	Credit	Credit	Credit	Credit	0	10
UK	Credit	Credit	Credit	Credit	0	25
USA	Credit	Credit	Credit	Credit	30	30
OECD MC			Choice between credit or exemption		Maximum rates of 5% (associated), 15% (other)	Maximum rate of 10%

commentary on Art. 24, paras 24–8). Thus, non-discrimination in the tax treaty area essentially amounts to *national treatment* in the source country.[16] Most importantly, there is no obligation to grant most-favoured nation (MFN) treatment to third parties (Lennard 2005, 97–100). Further, the article does not restrict a country's right to positive discrimination. A source country is generally free to hand out special benefits like tax holidays to foreign investors (OECD 2005b, commentary on Art. 24, para. 9).

Article 25 lays out the *mutual agreement procedure* (MAP), sometimes also referred to as the 'competent authorities procedure'. It serves to resolve any conflicts that arise between treaty partners in the application of the DTA. Often, the procedure is initiated when a taxpayer claims to have been double taxed or otherwise disadvantaged by either state. In this case, she can ask the competent authorities of her home country to enter into a MAP with the other contracting party. In addition, the taxpayer may call on the national courts to eliminate the extra burden. The choice between MAP and national courts is not mutually exclusive. However, national courts are not in a position to enforce anything in another country but can only force their own tax authorities to remedy the double taxation. The government may still enter into a MAP with the other country in order to adjust the treaty provision if it considers that to be necessary. Thus, the advantage of the MAP for the taxpayer may be that she does not have to rely solely on the national laws of countries but is granted legal protection under an international instrument (Sasseville 1996, 12). The disadvantage of the MAP from the taxpayer's perspective may be that governments are not requested to necessarily come to an agreement. In addition, the procedure is not public, and not even the taxpayer concerned is allowed to be present. If they do not reach agreement, the double taxation persists. However, in the overwhelming majority of cases an agreement is obtained (Sasseville 1999; 2002).

The issues that are the subject of MAPs 'fall into two broad categories: interpretive questions of general applicability and problems specific to a particular taxpayer' (Guttentag and Misback 1986, 350). According to the OECD Commentary, the 'most common cases' involve transfer pricing disputes, determining the taxable profits of a PE, the tax treatment of associated enterprises, the classification of payments as interests or dividends[17] and lack of information of the authorities about taxpayers' actual situations, especially concerning their residence or the existence of a PE (OECD 2005b, commentary on Art. 25, para. 8). The common feature of all these cases is that double taxation results from domestic bodies interpreting certain facts or treaty provisions in a different manner (Züger 2001, 2). Through the MAP, these differing interpretations are to be brought into line with each other. The competent authorities, usually representatives of the Ministries of Finance, negotiate with each other to resolve the conflict. Generally, the MAP is a 'political rather than a judicial procedure' (Züger 2001, 15). With this, the MAP also serves as an instrument for governments to establish a consensual

treaty interpretation and to develop further the application of treaties to temporary or unforeseen circumstances (OECD 2005b, commentary to Art. 25, paras 32–7).

Articles 26 and 27 are the only articles that concern the other important issue, which is, according to the title of the convention, addressed by DTAs – the prevention of fiscal evasion. Article 26 foresees the exchange of information to help enforce the provisions of the DTA or the domestic laws of the contracting states. There is either a 'broad' or a 'narrow' exchange of information clause. The former relates to the right to demand information on a particular taxpayer only with respect to the taxes actually covered in the treaty, whereas the latter relates to information exchange on all taxes, not only those covered in the treaty (Tanzi 1995, 85). Today, most treaties between OECD countries contain the broad clause.[18] Information exchange generally takes place in one of three different ways. It can be exchanged by the *specific request* of one authority concerning a certain taxpayer, a specific transaction and the fiscal year in question. Second, information exchange can be *automatic*. In this case, tax authorities exchange information about routine, periodic payments – for example, interest and dividend payments – within multinational corporations. The third possibility is *spontaneous* exchange of information, which typically takes place in the course of an audit, if one authority considers some piece of information to be of interest for another country's authority. Spontaneous exchange of information might also occur with respect to sharing general experiences made by authorities in auditing a certain industry (OECD 2005b, commentary on Art. 26, paras 9–13).

Despite its label as 'broad', the typical tax treaty article on information exchange is quite limited. A country is not expected and not obliged to supply information that goes beyond its own or the other country's national laws or administrative practices. Thus, the lowest revelation standard sets the upper limit on information exchange (OECD Secretariat 1996, 132). This amounts to a situation in which information exchange is basically voluntary, because a country is free to design its national laws so that they do not allow the exchange of information. For example, it can implement bank secrecy laws, as many tax havens have done. Besides that, countries must not make a speculative request that fails to identify all the necessary details of the case in question. Imprecise or very broad requests do not have to be answered by the other country. So-called 'fishing expeditions' are not permitted. The rationale for these restrictions is to protect taxpayer privacy and to prevent countries from overburdening each other's tax administrations (OECD 2005b, commentary on Art. 26, paras 14–19).

These limits to an effective exchange of information are particularly relevant to the problem of taxing international portfolio income. Individuals wishing to escape tax on their portfolio income may choose to shift their assets to accounts or foreign investment funds in tax haven countries. Knowing that the tax haven country would not notify their residence jurisdiction

even if there were a tax treaty, they fail to report the income from these investments and can thus enjoy it tax-free. In addition, even if bilateral information exchange is in place, taxpayers can easily circumvent it by simply routing the money through a tax haven with which their residence country does not have a treaty (Avi-Yonah 2000, 1583–5).

Article 27 was newly introduced in 2003. It deals with assistance in the collection of tax claims. If either of the contracting states cannot recover a legitimate tax claim without the help of the other state, it can request assistance from the other state. The requested state is then supposed to collect the tax in the name of the other state. States wishing to do so can include this provision in DTAs, if their legal systems allow them to conclude such agreements with other states (OECD 2005b, commentary on Art. 27, para. 1). In addition to these provisions, many bilateral treaties contain special rules that aim at the prevention of tax avoidance and evasion. I turn to this issue below.

Article 28 introduces special rules for the taxation of diplomats and consular personnel. Article 29 clarifies the exact territorial extension of the treaty; for example, in cases of dependent territories, the states can clarify whether the treaty is to be extended to that territory or not. Finally, Chapter VII determines the date of entry into force (Art. 30) and sets the procedure through which the treaty can be terminated (Art. 31).

Unilateral rules against over-taxation

In addition to the rules contained in bilateral tax treaties, countries also have domestic tax rules dealing with the tax treatment of transnational income in the absence of a DTA. Most countries tax the *worldwide income* of their residents. However, they unilaterally provide double tax relief by exempting, crediting or at least deducting the foreign source income from the tax due in the home country.[19] Table 4.2 provides an overview of the relief methods used in the national tax codes of OECD countries in 1991 and compares them to the relief methods generally used in those countries' treaties (data source: Yoo 2003).[20] All countries provide unilateral tax relief. For most countries the method used unilaterally is the same as the method contained in bilateral treaties. In some cases, the relief methods implemented through bilateral treaties are more generous than those contained in national law.

With respect to source taxation, foreign corporations are generally taxed on their profits at the usual rate applicable to domestic corporations. In addition to the tax on the corporate level, most countries unilaterally impose a withholding tax on the investment income – that is, interest, dividend or royalty payments – when it is repatriated to the foreign investor. The last two columns of Table 4.2 depict the unilateral withholding tax rates on dividend or interest payments in OECD countries. As shown, these unilateral withholding taxes can be quite high when compared to the rates suggested in the OECD MC.

Unilateral rules against under-taxation

The combination of differences in domestic tax rules and DTAs provides ample possibilities for international taxpayers to 'optimize' their tax payments (OECD 2005b, commentary on Art. 1, para. 8). Therefore, in addition to the domestic rules on double tax relief, countries developed unilateral rules to prevent tax avoidance and evasion when this problem became apparent. There are many ways in which tax avoidance and evasion can take place. Here I give a broad overview of only the main avoidance techniques and the general functioning of the rules against them.

As explained above, residence countries generally only tax foreign source income upon repatriation. This fact allows taxpayers to make use of *deferral*. In order to do so, taxpayers set up a 'corporate shell' in the low tax country. Since countries generally accept the legal form of foreign entities, the corporation that is owned fully or to a large extent by a foreign taxpayer has established corporate residence there. Instead of transferring the income back home, the taxpayer can now divert income from all sources to this 'controlled foreign corporation', colloquially often referred to as a 'mailbox company', in the tax haven and thus realize a tax advantage. Such a manipulation of the 'tax address' (Tanzi 1995, 79) enables two typical methods of tax avoidance. For one, income can be retained in these tax haven entities. The tax haven entity is used as a *base company* (OECD 1986a). Even if the income is repatriated at a later point, there will be substantial tax savings due to the interest received on the non-repatriated profits.[21] Second, CFCs can also play a role in so-called *treaty shopping* activities or 'triangular cases'. Treaty shopping is the 'accessing of treaty benefits by persons who are not resident in either treaty state through the use of an entity that qualifies as a resident of one of the states' (Li 2003, 106). In triangular cases the CFC is used as a pass-through entity (*conduit company*) in order to enjoy the benefits of a DTA to which one would not otherwise have access. The DTA between the USA and the Netherlands, which was extended to the Netherlands Antilles, can serve as an illustration. In 1955, when the treaty entered into force, the USA had a (unilateral) withholding rate on interest of 30 per cent. This withholding tax made it difficult for American corporations to get capital from abroad. Therefore, many US companies used a financial subsidiary in the Netherlands Antilles to issue bonds on the Euromarket. Investors are fond of Eurobonds because of their anonymity. The borrowed funds were passed from the Antilles to US corporations. Subsequently, the interest payments flowed out of the USA withholding tax-free to the Antilles, since the USA–Netherlands treaty provided a withholding tax of 0 per cent. From the Antilles, the money then flowed on to international investors. Thus, foreign investors from countries without a favourable tax treaty with the USA were able to treaty shop through the Antilles.[22]

Countries do not wish to accept the setting up of foreign entities for the sole purpose of avoiding taxation of the income. In order to mitigate some of the problems of base and conduit entities, most OECD countries have introduced so-called controlled foreign corporation (CFC) rules. The CFC rules of different countries broadly follow the same pattern: resident shareholders that control or have a substantial interest (usually 50 per cent of shares owned) in a CFC in a tax haven are taxable *currently* on the proportionate share of income of the foreign corporation, whether or not the income is actually distributed to them. Thus, the tax is not due upon repatriation as is usually the case, but in the actual period of earning the income. CFC rules are not meant to disable 'legitimate active business operations offshore' (Arnold 2000, 17:13), but are targeted only at the accumulation of *passive* income in a CFC in order to defer tax. Active business income is usually exempted from the rules (except in New Zealand and Sweden). The reason for this is that the diversion of passive income to a tax haven corporation is particularly easy. It often merely consists of artificial paper transactions that cannot be justified on economic grounds. Countries with CFC rules attempt to tax their residents on their worldwide income. They refuse to permit them to avoid residence-country tax by obtaining an 'inexpensive and readily available piece of paper (a certificate of incorporation)' (Arnold 2000, 17:22). CFC rules are most often aimed at particular jurisdictions with preferential tax regimes or tax havens. Usually the targeted countries are identified by reference to low tax rates, either in absolute terms or, more often, relative to the tax rate in the residence country. Often, lists of countries deemed to be tax havens or to offer preferential tax regimes supplement these definitions (IBFD 2004, 357–607).[23]

Some countries have passed foreign investment fund (FIF) regimes in addition to CFC rules. They are supposed to achieve for portfolio investments what CFC rules do with respect to direct investment (Arnold and McIntyre 1995, 86–8). With their focus on portfolio income, they are also relevant for individual taxpayers keeping their assets in offshore funds to evade taxation (OECD 1998a, para. 101). However, a prerequisite for effective application of both CFC and FIF rules is that the residence country needs to know whether a taxpayer keeps funds offshore. Thus, they hinge on effective exchange of information in order to be effective.

Another common method of tax avoidance is the manipulation of transfer prices. Generally, the goal of such manipulations is to ensure that gains are assigned to low tax countries and costs to high tax countries. Often, MNEs try to shift the profits attributable to patents, trademarks, know-how and other intangibles, which generate the major part of large and profitable multinationals' income, to low-tax countries. While the formation of these assets most often takes place in high-tax countries, the manipulation of transfer prices enables MNEs to shift the profits abroad. As in the case of CFCs, this does not require the relocation of jobs or direct investment (see, for example,

Sullivan 2004b, 117–18). Importantly, setting transfer prices in a tax-optimal way is not necessarily illegal. The accepted intervals of such prices under the methods described below are often quite substantial.

In order to curb such abuses, most countries have introduced transfer pricing regulations that are based on guidelines issued by the OECD (1979; 1995; 2001b). The regulations are not only about avoiding under-taxation but also a crucial building block of double tax avoidance (OECD 1979, 8–9). The guidelines lay down different methods for how to determine the arm's length price that is required under Articles 7 and 9 of the OECD MC. Based on these rules tax administrators may reassess the 'right' price for a transaction within a multinational enterprise. The preferred and ideal-typical method is finding a 'compared uncontrolled price (CUP)'. The other two methods are the so-called 'cost-plus' and 'resale-price' methods, where the transfer price is determined either by adding an appropriate margin to the costs borne by the seller or by calculating the price for the intrafirm transaction from a resale price to an independent entity minus an appropriate profit (OECD 1995, paras 2.6–2.49). These three methods are so-called 'traditional transaction methods'. In addition there are the 'comparable profits method (CPM)' and the 'profit split method'. Instead of determining the price for a transaction in isolation, the transfer price is determined by working backwards from profits under these methods (for a more precise description of the different methods, see Li 2003, 108–16). Only the three transactional methods can be subsumed under the established interpretation of the ALS, as laid down in the 1979 OECD guidelines. In contrast, profit-based methods have some features of unitary taxation, since they assess the combined profits of the enterprise and then allocate them in a formulary fashion. However, they are not identical to formula apportionment, since transfer prices are still determined on a flexible case-by-case basis instead of relying on a fixed predetermined apportionment formula for all profits.

A further means of tax avoidance, which is also used domestically but which is particularly attractive in international transactions, is the practice of *thin capitalization*. A company finances itself by debt rather than equity because interest gets a preferred tax treatment over dividends (see, for example, McLure 1997, 33–4). To finance the debt the resident corporation pays interest to a non-resident. This is advantageous for the corporation, because dividends paid out are not deductible as costs, whereas interest payments are. It is also advantageous for the investor because his investment is only subject to one level of source tax – the withholding tax on the interest, if there is any – whereas an investment in the form of equity would be subject to source taxation through both corporate tax on the profits and withholding tax on the dividend payment.[24] In many countries so called thin capitalization rules have been introduced to prevent this practice. The rules quantify what is considered to be excessive debt by looking at the debt/equity ratio. The rules only apply to non-resident lenders holding a significant

percentage of the shares of the resident corporation. If the criteria are met, then the debt is treated as 'hidden equity' and the interest payment is not deductible (see, for example, OECD 1986c, paras 20–2).

Besides these rules aimed at specific avoidance techniques, the tax codes of most countries contain general rules aimed at correcting 'fake' transactions that are purely tax-driven. General *'substance over form'* or 'look through' provisions provide that any transaction with no identifiable economic purpose can be reclassified for tax purposes. General provisions to this effect can be found in the tax codes of almost all countries (see, for example, Prebble 1997, 396). Some countries also have general tax haven provisions. For example, Germany imposes a special tax on persons who move to a tax haven. France doesn't allow a deduction on interest and royalty payments made to a tax haven entity, unless the taxpayer can prove that the transaction is genuine (Arnold and McIntyre 1995, 70).

Taxpayers can also exploit the possibilities for tax avoidance created by tax treaties themselves. Treaty shopping is an obvious example of how tax treaties, contrary to their intentions, can be used as devices to achieve double non-taxation (OECD 1986b; 1992). Therefore, countries try to safeguard themselves against an 'improper use' of treaties by including certain anti-abuse clauses, such as 'look-through', 'subject-to-tax' or 'limitation-of-benefits' provisions in the text (OECD 2005b, commentary on Art. 1, paras 7–26).[25]

Note that all the strategies of tax evasion and avoidance would be impossible if transnational tax bases were taxed conjointly. Tax evasion and avoidance are possible because countries rely on a sovereignty-preserving approach to international tax governance that, as a general rule, is based on legal form rather than economic substance. Therefore, international *tax planning* generally does not involve the relocation of economic hardware like direct investments or jobs, but often consists of merely booking certain transactions in other countries. Only because every country is free to design its own rules of national taxation can a mailbox company in a tax haven that is under full control of another country's residents be treated as an independent taxpayer, and thus profits diverted to it be subject to privileged tax treatment. Likewise, if different branches of one company are treated as if they were separate, there is a quite natural incentive for MNEs to use the leeway that this creates. While the rules deny the 'unity of the subject' (Palan 2003, 105), the real subjects remain whole and 'take advantage of the fiction of their fragmentation by rearranging their legal existence in whatever ways they see fit' (Palan 2003, 108). The unifying characteristic of all tax planning schemes is that they divert income into jurisdictions with only an artificial connection to the real economic activity that should be the correct target for taxation. At the same time, they strip the income from those entities that are in fact its real origin.[26] Thus, the sovereignty-preserving approach to international taxation presents an opportunity-structure to taxpayers and to governments.

The taxpayers demand possibilities for tax evasion and avoidance, and certain jurisdictions can supply these possibilities because the sovereignty-preserving approach leaves them free to design their national laws in the required ways. In consequence, tax competition between countries is created.

The important point about the unilateral anti-avoidance rules is that they interfere with the sovereignty-preserving approach. They attempt to base tax assessment on economic substance rather than on legal form. For example, CFC legislation effectively pierces the 'corporate veil' by ignoring the formal residence status of a corporation and instead basing taxation on the actual residence of the owner of the corporation. Such integrated treatment of a foreign entity and its resident shareholders is an 'aberration' in the current tax regime, which is based on the concept of separate entities (Li 2003, 105). While by now the unilateral anti-avoidance rules have been generally interpreted to be acceptable (OECD 2005b, commentary on Art. 1, paras 9–9.6), there is a tension between the sovereignty-preserving setup and these unilateral attempts at curbing tax evasion and avoidance. In order to formally circumvent this problem, most countries safeguard their unilateral anti-avoidance rules by explicitly stating in their treaties that they are to be interpreted in line with their unilateral rules (OECD 2005b, commentary on Art. 1, paras 9–12). As detailed in Chapter 6, the unilateral anti-avoidance rules were and are controversial precisely because they contradict or at least stretch the original understanding of international tax institutions based on the idea of territorial delimitation. The unilateral rules marked an important de facto change in the institutions of international taxation.

A brief evaluation of international tax governance

The general picture that emerges is that international tax cooperation is mainly focused on the avoidance of double taxation. This goal is achieved by an approach that tries to disentangle the overlapping tax claims of countries through an approach of territorial delimitation. This can be seen from the fact that most countries have their own national rules of international taxation. They provide double tax relief unilaterally. In addition to that, governments conclude bilateral tax treaties. These treaties are based on legal constructs that function to minimize the need for international interference with national tax laws.

Most rules on avoiding double non-taxation are situated at the unilateral level. Countries have national tax laws that contain general substance over form requirements but also CFC, thin capitalization and transfer pricing rules. In addition, the bilateral treaties contain provisions on the exchange of information and administrative assistance, but also general safeguards to prevent treaty abuses and preserve the application of unilateral anti-avoidance rules.

The existing rules do not conform to established normative concepts . . .

Even a cursory look suffices to show that the actual rules of international taxation are not in line with the normative ideals of international tax theory. With respect to equality as well as fairness, the rules are not coherent. For example, the kinds of source taxation that can be found in reality follow neither benefit nor entitlement theory. If taxation was based on the benefit principle, then tax should be levied independently of the profits a corporation makes but should be some kind of direct charge for certain services received (Musgrave and Musgrave 1972, 70–1). If source taxation was based on entitlement, then the tax should be based on net income, which is not the case for withholding taxes (McLure 2000, 6:4–5). The same is true for residence taxation. For example, if residence taxation was really based on ability to pay, the exemption method, under which income that has been taxed abroad is not taxed at home, could not be used, because income earned abroad certainly increases the ability to pay just as much as domestic income does. This is also true for credit with deferral. Under current rules, the issue of equal treatment of taxpayers in the residence country is left to the government's discretion. It is free to strive to achieve it or not (Eden 1998, 76).

Similar criticism can be raised concerning the conceptions of neutrality. As we have seen, there is not even consensus on the theoretical level about whether CIN or CEN is more desirable. Whatever the right answer is, it is certain that the coexistence of both credit and exemption, as currently practised, does not satisfy the demands of neutrality.

Due to the fungibility of income the schedular approach of differential tax treatment for different kinds of income creates inefficiencies. The ease with which, for example, dividends can be transformed into interest income goes counter to a uniform tax treatment that would be desirable under an efficiency perspective (Bird 1988, 294). Furthermore, the basic source rules 'turn on the legal nature of a transaction rather than its economic substance' (Graetz 2001, 317). Besides the fact that this creates opportunities for tax avoidance – running counter to equity considerations, because internationally active taxpayers are given opportunities, not open to other taxpayers, to minimize their tax payments – it also creates inefficiencies. Actors structure their activities according to tax and not efficiency criteria. Likewise, the rules only prohibit negative discrimination in the source country. Positive discrimination – that is, granting favourable tax treatment to foreign investors – is generally allowed. Such preferential treatment for foreign capital – besides violating equality among taxpayers – leads to an inefficient allocation of capital from a global perspective. Thus, the conclusion is that the 'present treatment of international capital flows is inefficient and inequitable, almost irrespective of how one defines those words' (Bird 1988, 295). Other scholars come to similar conclusions (see, for example, Graetz 2001; Li 2003, 509–11).

The international tax system 'is a patchwork structure that makes little sense in terms of its purported objectives' (Bird 1988, 293).

... But are still better than the absence of any tax governance

The regime's imperfection is actually not surprising. Even if all actors pursued fairness and neutrality as their ultimate goals, the competing theories of what is fair and efficient proscribe different kinds of solutions. If all these aspects deserve recognition, then the actual rules certainly have to balance the different ends. Actually, the trade-offs inherent in designing 'optimal tax systems', such as that between equity and efficiency, are widely known. There is no national tax system following the second-best prescriptions developed by optimal taxation theorists. If this is so in the national context, it can come as no surprise that it is also true for international tax governance.

Besides this, the more decisive point is that it cannot simply be assumed that actors pursue the goals of equity and efficiency per se. Is it not more appropriate to assume, as I do in my baseline model, that governments aim at the maximization of national welfare? Or try to maximize tax revenues? Or try to hand out tax concessions to big business? If governments pursue one or a mix of these goals, then it should come as no surprise that international tax rules fall short of the very demanding ideals of efficiency and equality.

However, this does not mean that the consideration of normative concepts is useless. It is plausible that the goals of neutrality and equity do play a role in governments' policies as an intermediary goal to achieve, for example, the maximization of national income. It may well be in a country's own national interest, as the baseline model suggests, to remove the barriers that double taxation presents to international capital flows. This enhances the neutrality of the international tax system, even though it does not lead to total neutrality, for example, if other countries employ different relief methods. Statements such as 'country X pursues a policy of CEN' or 'country Y pursues a policy of CIN' can be found quite frequently in the literature (see, for example, Frisch 1990; Dagan 1998). This makes sense to the extent that either policy is in line with national interest however it is defined, but it is flawed if it is meant to suggest that a country pursues such policies as an end in itself.[27]

Furthermore, at least the bilateral and multilateral rules result from bargains between governments and therefore generally do not reflect the interests of one country only. Assuming a need to compromise, it is thus theoretically conceivable, although by no means necessary, that the resultant rules are closer to some ideal of neutrality or equity than they would have been had one country dictated the rules. Therefore, even though there should not be any prior presumption that the international rules are in accord with the normative prescriptions of international tax theory, it is important to know them.

And, indeed, when we compare the existing regime with a situation where no international institutions and rules were in place, it becomes clear that the regime does actually make a difference. With respect to equality, the division of the tax base roughly balances the ideas inherent in the benefit and entitlement theory with those of ability to pay considerations. By assigning active business income to the source country, it is acknowledged that the production of this kind of income draws heavily on the public resources of the source country. In contrast to that, the production of passive income hardly burdens the public resources of the source country but adds substantially to the investors' ability to pay, justifying the assignment to the residence country (see among many Brauner 2003; Avi-Yonah 2006). Moreover, the rules increase the efficiency of international capital allocation as compared to a situation in which the rules are absent. While the regime does not consistently promote either CIN or CEN but leaves the decision between these neutrality conceptions open, it is nonetheless true that avoiding double taxation as such promotes neutrality broadly defined as compared to a situation without any double tax relief.

At the same time, it remains true that the existing rules have important deficiencies. In particular, it will become apparent in the following chapters that some of the solutions were workable at the time of their inception but became dysfunctional over time, causing inefficiencies and inequalities. Thus, as will be shown, important aspects of the regime's dysfunctionality stem from maladaptation to economic realities.

Bilateral and unilateral rules in interaction with multilateral cooperation

Even the critics agree that the rules of international taxation, as sketched in this chapter, sustain a widely accepted consensus on the coordinated sharing of the international tax base (see, for example, Bird 1988, 293; Bird and Mintz 2003, 406). Focusing on the fact that many of the binding rules are set on the unilateral level and that the bilateral DTAs only regulate the interface of national rules, this conclusion may come as a surprise. One could think that international tax governance must be ineffective, because national tax rules are hardly restrained.

However, this conclusion would be misleading. The international tax consensus had to be actively manufactured. As shown in the next chapters, substantial multilateral cooperation played a major role in the dissemination and coordination of unilateral and bilateral rules. There are non-binding model conventions – developed and sponsored by multilateral organizations – that are used as templates for bilateral tax treaties on the avoidance of double taxation. Countries do not have to stick to the provisions contained in the model in their bilateral treaties. In practice, however, the MC has led to a substantial homogenization of bilateral tax treaties. While only the unilateral and bilateral rules are legally binding on the states, the bilateral

negotiations basically consist of the treaty partners agreeing on the MC and adapting a few, even though central, provisions of the model to their needs. Thus, the MC embodies a widely shared consensus on the rules of allocating the transnational tax base to different countries. Further, the OECD serves as the firmly institutionalized forum for tax policy discussions. Countries can share their experiences with respect to different unilateral and bilateral rules. The OECD is engaged in monitoring international tax developments and diffusing information about successful tax policy innovations that are often implemented in unilateral and bilateral tax rules. Thus, what is observed is an *interaction of unilateral, bilateral and multilateral elements*. Overall, while being less visible, the extent of 'effective multilateralism' (Vann 1991, 152) in the tax regime is much higher than many commentators think because they are focusing only on the legally binding unilateral and bilateral rules.

This brief description of the way in which unilateral, bilateral and multilateral elements interact provides a status quo summary of the institutional infrastructure of international taxation. The rules of the game developed on a piecemeal basis through many unilateral legislative acts and multilateral and bilateral negotiations in which actors have pursued various goals, not all of which necessarily contribute to achieving equity and neutrality. In the following chapters, I focus on how this setup originated and how it developed over time. I describe how the institutions were intentionally designed and how they (unintentionally) developed, and thus provide a political history of the international tax regime.

5
Eradicating the 'Evils of Double Taxation'

In this chapter and Chapter 6, I describe how international tax governance emerged and developed over time. In doing so, I cover the entire history of international taxation. Since this is a period of almost a century, I concentrate on the most important developments on the multilateral, bilateral and unilateral levels. With respect to unilateral policies in particular, I cannot detail the development in all countries. Instead, I mostly focus on domestic policies in the United States, which is the most important player in international tax policy. In this chapter I cover the issue of over-taxation and describe why it was put on the political agenda, how the principles for its solution were developed by the League of Nations and how the institutions became entrenched under the tutelage of the OECD. I also present empirical material on the growth and geographical extension of the bilateral tax treaty network. Chapter 6 focuses on under-taxation.

The emergence of international double taxation

Before the First World War, the subject of this study was a non-issue. While the economy was internationalized in the pre-war era to an extent comparable to today (Baldwin and Martin 1999; Bordo *et al.* 1999), the problems of over-taxation or under-taxation hardly existed. The reason for that is the absence of comprehensive forms of direct taxation during the first wave of globalization. Around 1900 the most important revenue sources were tariffs, followed by taxes on land and real estate. Income taxes, if any, were mostly imposed upon property and wealth. The public sectors of most countries were small (Webber and Wildavsky 1986, 307–10, 343–57). Besides that, there were taxes on transactions and expenditures, in the form of excise duties or commodity taxes. The proper place to tax these was considered to be the spot on which the transaction took place. This solution was generally seen to be uncontroversial due to the 'impersonal' nature of the tax base (Seligman 1928, 11–16). Apart from that, governments' tax take was generally quite low during this period. Tax ratios, measuring tax revenue as a percentage of the

respective national product, were less than a quarter of what they are today (see Figure 5.2).

Accordingly, in the 1860s and 1870s the issue of double taxation was not pressing and there were thus only a few agreements dealing with international tax issues, the most important being the international tax treatment of inheritances. In addition, there were a few treaties addressing particular issues such as the international tax treatment of railway companies or of traveling salesmen. In other words, the problem of double taxation was restricted to rather special and narrowly circumscribed fields (Seligman 1928, 37–57; Spitaler 1936, 2–4). Apart from these non-comprehensive international agreements, the problem of double taxation only became virulent after some countries had put taxation, including general income taxes, on a broader basis.

The problem of double taxation was brought to the attention of authorities by taxpayers' complaints (Hemetsberger-Koller 1999, 23–4). In reaction, many countries in continental Europe introduced unilateral legislation to prevent over-taxation (Lippert 1912, 599). Due to the divergent national laws, this legislation could not prevent all forms of double taxation. Therefore, some countries supplemented it with bilateral treaties. The first international double tax agreement was that between Prussia and Austria-Hungary in 1899. At the time, there was some opposition to the idea of double tax relief. Opposing the conclusion of this treaty, some members of the Prussian parliament argued that double taxation was not unfair and should not be relieved (Hemetsberger-Koller 1999, 28–31). A similar view prevailed in England before the First World War. The general idea was that for the receipt of public goods in two states, that is, a double benefit, a double tax burden was quite appropriate (Dorn 1927, 197–8). However, in continental Europe these voices were not heard and subsequently a handful of agreements were concluded between different states of the German Reich, the Austrian-Hungarian monarchy and Swiss cantons (Spitaler 1936, 11). Nevertheless, this was a very regional phenomenon.

The League of Nations and the inception of basic principles

With the need to finance the war, many countries introduced income taxation (Webber and Wildavsky 1986, 436–45; Steinmo 1993, 50–79). At the same time, many policymakers and businesses successfully pressed for a resurrection of the liberal economic order of the pre-war era (see, for example, Helleiner 1994, 26–7). In this situation, the overlap of different national tax systems became a more pressing issue. Double taxation was identified as a relevant burden on international economic activities. The International Chamber of Commerce (ICC), representing the business community, brought the issue onto the international agenda and called upon the League of Nations to ameliorate it (Picciotto 1992, 14). From 1919 on,

the ICC urged the League of Nations to prepare measures to eradicate the 'evils of double taxation'. The ICC constantly accompanied the activities of the League of Nations and officially participated in deliberations and negotiations. Some leading academic figures and decision-makers in international tax policy were closely affiliated with the ICC.[1] The ICC favoured a multilateral solution, arguing that all states should agree on one general principle of avoiding double taxation and revenue sharing. It was very optimistic to believe that such a solution could easily be found:

> If only the principle that the same income should only be taxed once is recognized, the difficulty is solved, or very nearly so. It only remains then to decide what constitutes the right of one country to tax the income of a taxpayer in preference to any other country. It does not seem probable that there would be any serious difference on the matter. (Statement from the ICC's Committee on Double Taxation from 1923, cited by Picciotto 1992, 15–16)

According to the ICC, the multilateral solution should be based on the principle of residence taxation, even though it acknowledged that some taxation at source was justified but should be limited (Wang 1945, 99). However, this 'simple faith that an evident wrong could be simply righted' (Picciotto 1992, 15) by finding a multilaterally acceptable principle was soon destroyed, when it became apparent that there were important conflicts of interest over the jurisdictional attribution of the tax base.[2]

From the 'four wise men' to the first model convention

As part of its larger strategy of cultivating peace by fostering international trade and investment, the League of Nations responded to the calls of the ICC. It proposed a collective search to find an answer to the problem of double taxation and intended to implement it in a multilateral double tax avoidance treaty. It succeeded with the first but failed with the second half of its venture. In September 1921, the economists Bruins, Einaudi, Seligman and Stamp were asked to investigate (a) the economic consequences – that is, the welfare effects – of double taxation, (b) general principles and (c) practical rules on which the international allocation of taxing rights should be based (League of Nations 1923, 3).

The economists' consultations came to a conclusion in March, and their report was published in April 1923. In their welfare analysis, they emphasized that double taxation is not only an issue of a potentially unfair burden on taxpayers but also, and more importantly, an obstacle to a liberalized world economy. They differentiated the aspect of the 'burden' imposed by double taxation on investments already undertaken from the 'barrier' it represented to additional future investments that could enhance national and worldwide

welfare. They argued that governments could be interested in relieving double taxation, even if that entailed an immediate sacrifice of tax revenue, since this might be compensated for by increased future investment (League of Nations 1923, 7–8; Seligman 1928, 118–21).

With respect to the allocation of taxing rights, the economists discussed the various theories that had been used to justify either source or residence taxation. They came to the conclusion that, in theory, the principle of residence taxation was preferable to the source principle (Schanz 1923, 362). The reason for this preference was their predominant concern with the ability to pay principle (League of Nations 1923, 18–20). On the other hand, they conceded that it would be unrealistic to implement the residence principle in a pure form, since this would require the source state unilaterally to give up any right to tax. As a solution to this basic problem of allocating taxing rights, they ultimately arrived at Schanz's theory of 'economic allegiance'. However, since no pure principle was in line with this theory, the economists opted for a system of 'rough justice' in accordance with what the principle of economic allegiance would have suggested if it could have been quantified (League of Nations 1923, 28). In practice, this led to a classification of tax treatment according to types of income. Income from immovables and other active income should be taxed at source, whereas personal and passive income should be taxed in the residence country (League of Nations 1923, 39–51). For the case of symmetric capital flows, they suggested the reciprocal exemption of non-residents at the source; that is, pure residence taxation (League of Nations 1923, 48–9).

The economists' report of 1923 was the starting point for the deliberations of a group of 'Technical Experts to the Financial Committee of the League of Nations', which was initially made up of tax administrators only from European governments – Belgium, Czechoslovakia, France, Italy, the Netherlands, Switzerland and the UK. Subsequently, this group was joined by the USA and two years later by Argentina, Germany, Japan, Poland and Venezuela (Spitaler 1936, 16–17). Private interest groups such as the ICC participated in the discussions (League of Nations 1925, 7–9; Graetz and O'Hearh 1997, 1075). Since the technical experts were tax administrators from different countries, their negotiations were of a political and pragmatic nature. They went beyond the rather abstract treatment by the four economists and also considered actual conflicts of interest and real-life features of existing tax systems and bilateral tax treaties (Sasseville 2000, 5:3).

As the economists had, the technical experts deemed the adoption of the pure residence principle unrealistic. Even though they favoured it on theoretical grounds, they observed three aspects in the real world that favoured taxation at source. First, in practice most states taxed foreigners at source. Consequently, source taxation must play a role in any solution to the problem of double taxation.[3] Accordingly, it was often the residence country that had to provide double tax relief. As the committee noted – and in contrast to

the situation before the First World War – many states were actually willing to do so. In 1918, the USA had introduced the unilateral foreign tax credit. Belgium had had a system of partial deductions from 1906 and then a general deduction from 1919; the Netherlands had even introduced a credit before the USA did so. Several Swiss cantons operated deduction systems. Great Britain allowed a deduction, but only for income earned in the dominions (League of Nations 1925, 11; Dorn 1927, 232–6; Picciotto 1997, 1026 n. 22). Australia, New South Wales and South Africa employed an exemption system (Graetz and O'Hearh 1997, 1046 n.103). Governments argued that the introduction of unilateral tax relief was in the national interest, because they wanted to stimulate foreign trade and also believed there to be long-run fiscal advantages from providing double tax relief (Rosendorff 1937, 2–3). While there were a few critical voices, the domestic opposition to unilateral tax relief remained unsuccessful.[4]

The second reason brought forward by the technical experts was the conflicting fiscal interests of 'creditor' and 'debtor' states, with the debtor states generally favouring the source principle and the creditor states favouring residence taxation (Wang 1945, 73).

A final reason was the fact that some countries still operated systems of 'impersonal' or 'schedular' taxes that were more appropriately levied at source (League of Nations 1925, 14–20). In consequence, they suggested allocating jurisdiction to tax impersonal income to the source country, whereas jurisdiction to tax personal income should lie with the residence country (League of Nations 1927, 13, 16, 20–1). A survey of existing bilateral treaties showed that this solution was also in line with the treaties that had already been concluded in central Europe after the war (Carroll 1978, 54). At the time, most continental European countries tended towards the principle of source, due to their position as capital importers and schedular tax systems, whereas the USA and UK, as capital exporters with global personal income tax systems, favoured the principle of residence (Wang 1945, 102–14). Overall, the recommendations were similar to those of the economists; in 1927, they were published in the form of a draft for a model convention (League of Nations 1927).

The experts also considered the possibility of concluding a multilateral double tax treaty. Their rejection of a multilateral DTA is worth quoting at length:

> It would certainly be desirable that the States should conclude collective conventions, or even a single convention embodying all the others. Nevertheless, the Committee did not feel justified in recommending the adoption of this course. In the matter of double taxation in particular, the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to draft a collective convention, unless it were worded in such general terms as to be of no practical value. In the matter of tax evasion also, although unanimity would not seem

> to be unattainable, there is no doubt that the accession of all countries to a single Convention could only be obtained as the result of prolonged and delicate negotiations, while there is no reason to delay the putting into force of bilateral conventions which would immediately satisfy the legitimate interests of the tax-payers as well as those of the Contracting States. … For this reason, the Committee preferred to draw up standard bilateral conventions. If these texts are used by Governments in concluding such conventions, a certain measure of uniformity will be introduced in international fiscal law and, at a later stage of the evolution of that law, a system of general conventions may be established which will make possible the unification and codification of the rules previously laid down. (League of Nations 1927, 8)

In their final conclusions, the experts suggested the creation of a Fiscal Committee that should facilitate the tax treaty process on a permanent basis. The committee should produce 'periodical investigations and reports' on international tax issues, prepare 'model bilateral conventions or collective conventions' and be responsible for the timely refinement of these. It should further collect bilateral double tax treaties and 'memoranda' on different countries' tax systems (League of Nations 1927, 31–2). In brief, the idea – subsequently put into practice – was to install a body responsible for the collection and dissemination of relevant information on international tax issues.

It soon became apparent that the technical experts were right in their scepticism concerning a multilateral tax treaty. On the occasion of a meeting of government representatives, all countries argued for a bilateral approach. Equally, almost all countries were in favour of developing a model convention to serve as a template for bilateral treaty negotiations (League of Nations 1928, 1–4).

Whereas the rejection of a multilateral solution was unanimous, the opinions with respect to the apportionment of the tax base to be laid down in the model convention were far more varied. In the discussions of both the technical experts and the government representatives, Italy, France and some other continental European capital-importers opposed the adoption of the pure residence principle. They put more emphasis on the source principle, since that better suited their schedular tax systems and revenue interests. The original draft convention produced by the technical experts embodied their interests. They initially succeeded in isolating the UK, which was very much in favour of pure residence taxation due to its personal income tax and position as a capital exporter.[5] With the entrance of the USA into the committee, the British position gained an influential supporter (Picciotto 1992, 21–2). However, in contrast to the British position of total abandonment of source taxation, the USA recognized a limited right of source countries to tax. Their unilateral policy of providing a credit for taxes paid at the source embodies

this policy, because it acknowledges source countries' right to first cut (Graetz and O'Hearh 1997, 1072).

Due to governments' differences of opinion, two further models were produced. These could be used if both potential treaty partners had a single personal-type tax. The first of the additional conventions was proposed by the USA and UK. While it was generally based on the residence principle, it allowed for source taxation of income from immovable property and business profits of permanent establishments, together with a foreign tax credit in the country of residence. However, dividends, interest and royalties were to be exempted from source taxation. The second version, proposed by European countries with systems of personal income taxation, additionally allowed a source withholding tax on dividends, interests and royalties, subject to a restriction on the rate (Graetz and O'Hearh 1997, 1086–7). Agreement on either of the model versions proved to be elusive. The most contentious issue was the allocation of jurisdiction to tax dividends and interest (Graetz and O'Hearh 1997, 1070). According to T. S. Adams, who had drafted the British and American version of the model (Wang 1945, 89), it was this dispute that prevented the conclusion of a multilateral convention (Graetz and O'Hearh 1997, 1105). So all three versions were adopted as non-binding model conventions to be used by governments as a basis for their bilateral negotiations (Carroll 1939, 21–5; 1978, 54–5).

Although the conference resulted in three models instead of one, these embodied a consensus concerning important basic principles of international taxation that had so far been elusive. For example, the concept of *permanent establishment* had been born, figuring prominently in all three versions (Carroll 1939, 24). Even though the exact definition of a PE would continuously prove to be controversial, it became one of the key concepts in international taxation. It facilitated a compromise between capital importers and exporters and thus the residence and source principle, and also between systems of 'personal' and 'impersonal' taxation. Corporate profits could be taxed at source provided they were attributable to a PE, whereas investment profits that could be categorized as personal income were taxed in the residence country (Graetz and O'Hearh 1997, 1087–9).

Thus, even if there was no consensus on the issue of personal versus impersonal conceptions of taxation, governments effectively settled on a schedular structure that was also acceptable to countries with personal tax systems. This conception served as a means of facilitating a compromise on the division of the international tax base between residence and source states. Instead of either pure residence or source taxation, it had become apparent that any solution to the problem of double taxation could only lie in a compromise of the two principles. However, the cost of this compromise was the rejection of a multilateral solution: 'It had become clear that a single collective agreement was impossible, once the idea of allocation of tax jurisdiction according to a general principle (such as residence) was rejected' (Picciotto 1992, 23).

While the drafts set the stage for a compromise between residence and source, the more specific aspects of the distribution of taxes were left unanswered. As has been described above, all three versions of the 1928 model convention concede some taxation at the source in return for limiting its scope. But the different model versions are also a testament to the fact that there was considerable disagreement on what the 'correct' restriction on source taxation should be. It was believed that finding such a solution was better left to bilateral negotiations, where countries were in a better position to bargain for a compromise that suited their economic circumstances and tax systems (League of Nations 1927, 4).

The allocation convention and the London and Mexico models

On the recommendation of the 1928 conference, the League established a permanent Fiscal Committee with eight country representatives (later nine) and one observer from the ICC to replace the group of technical experts. Representatives also came from non-member countries (for example, the USA) and further non-member states were asked to regularly submit their views on the committee's work (Carroll 1939, 27). The Fiscal Committee focused on two issues: it aimed at further developing the 1928 MCs and the compromise on the division of the tax base, and focused on the question of the allocation of business income of multinationals among several source countries in which the MNE operated. This led to discussions about the possibility of principled solutions to both issues considering the diversity of national tax systems. The committee tackled the questions very thoroughly and conducted an ambitious study of the tax systems of 35 countries (League of Nations 1932; 1933) that was coordinated by Mitchell B. Carroll and became known as the 'Carroll Report'. It formed the basis of the committee's efforts during the inter-war years (Langbein 1986, 631–2).

Aiming at an improvement of the 1928 MCs, the Committee drafted a proposal for a multilateral treaty on the prevention of double taxation. Since it had become apparent that consensus could not be achieved with respect to the distribution of certain classes of 'passive' income, most notably interest and dividends, the idea was to have a multilateral treaty at least for those incomes, where agreement seemed possible. Three versions of this 'Plurilateral Convention for the Prevention of Double Taxation of Certain Categories of Income' were drafted, which differed in form but not in substance (Loukota 1997, 86). While the drafts reflected 'a development in precision of expression' (Carroll 1939, 36), they did not significantly change the 1928 models (Wang 1945, 92). The convention was never adopted by member countries and thus never entered into force. In the course of drafting the convention, the Committee had also discussed the question of including *most-favoured nation clauses* (MFN) in double tax treaties. However, it concluded that, since DTAs are 'based on the principle of reciprocity, they involve reciprocal concessions for the nationals of the contracting parties'. Therefore, 'the

most-favoured-nation clause should not be applied to the nationals of a country which had not acceded to the said agreement' (Carroll 1939, 37–8). The committee suggested explicitly excluding MFN treatment in double taxation by inserting an appropriate clause in bilateral DTAs.

In its other main area of activity – the allocation of business income among a group of associated enterprises located in different countries – the committee's work would prove to be more influential in the long run. The Carroll Report had surveyed the methods used in various countries. While there was very little legislation or jurisprudence in national tax systems on this question, some countries had established methods of dealing with this issue on the administrative level. The survey showed that both separate accounting and formula apportionment were used in different countries, with separate accounting being more common. Thus, the resultant '1935 allocation convention' that was developed by the Committee suggested the separate accounting method based on the arm's length standard (Picciotto 1992, 31).

However, the decision in favour of separate accounting was not self-evident but was made by seriously considering the pros and cons of separate accounting and formula apportionment. In fact, the Carroll Report marked a change in the law of double tax avoidance. While the 1928 model had ultimately left open the question of which allocation method is preferable, one can find a preference for formulary apportionment in the discussions that preceded the conclusion of the model and also in the accompanying commentary. This would also have been in line with the double tax treaties that had been concluded between Central European states (Langbein 1986, 631–4). In addition, Carroll has been criticized for understating the extent to which formula apportionment methods were actually in use in, for example, Spain, Switzerland and some US states (Langbein 1986, 632). Furthermore, even the USA, at the time the most important proponent of separate accounting, had only recently adopted the arm's length standard. As early as 1921, the USA had introduced legislation that allowed tax authorities to adjust the reported profits of associated enterprises. Interestingly enough, the 1921 act initially authorized the tax authorities to prepare 'consolidated accounts' for the purpose of these adjustments. The concern at the time was, as it is today, to make it impossible for companies to 'milk' parent corporations of their profits for tax purposes. Subsequently, however, the arm's length criterion was adopted (Graetz 2003, 403–5). Accordingly, the report's conclusion that separate accounting was by far the more common method used in most countries is subject to debate.

Nevertheless, the committee ultimately believed that governments would be unwilling to agree on formula apportionment for the distribution of business income among them. In order to do so, it would have been necessary in a first step to agree on a common method for determining the tax base of businesses. This would have required a degree of harmonization that was regarded as unrealistic and was not envisaged by countries eager

to maintain their de jure tax sovereignty (Rosendorff 1937, 13). In contrast, as explained in Chapter 4, the arm's length standard does not require such far-reaching harmonization. But even at the time, it was already recognized that the determination of an arm's length price for purposes of tax assessment might cause problems, since comparable uncontrolled prices would not always exist. Accordingly, the allocation convention allowed tax authorities to use 'fractional methods' – that is, formulary apportionment – as a last resort (Wang 1945, 77–81; Langbein 1986, 634). This meant that while there was no possibility of an agreement on a general formula, tax administrations were willing and prepared to tackle the problem of assignment to different branches and subsidiaries on a case-by-case basis, whenever the problem arose (Picciotto 1992, 35). The flipside of de jure sovereignty over national tax systems with respect to the allocation of expenses and income of MNEs is intensified administrative cooperation between revenue authorities (UNCTAD 2000, 13).

The format of the allocation convention meant that it could be either integrated into bilateral treaties or adopted as a single multilateral convention on its own, to which bilateral treaties would simply refer. The Fiscal Committee preferred the multilateral option, and planned to pass it at a formal government meeting. However, governments' written replies to the draft, while agreeing with the material content of it, were against the multilateral solution. Instead, they wished to integrate the provisions into their bilateral tax treaties (Carroll 1939, 28–33). Nevertheless, the allocation convention is of major importance in the development of international taxation because it effectively made the arm's length concept the decisive principle in allocating profits of associated enterprises. The provisions of the 1935 draft, while they have been developed further, are still the essence of today's transfer pricing rules (Langbein 1986, 633–4).

The allocation convention was the first instance in which US leadership in international tax issues became obvious. The USA was one of the first countries with established practices of transfer pricing, and put these practices into codified national transfer pricing regulations in 1935. The League's allocation convention basically copied the US rules. One of the provisions of the convention could also be traced to a bilateral treaty the USA had concluded with France in 1932 (Li 2003, 43).

In its last meeting before the war, the Fiscal Committee had decided that – if multilateral treaties did not find governments' approval – it wanted to develop a modernized MC that would collect all the provisions it had drafted. The committee continued its work during the war informally from a base at Princeton University and delegated the work of revision and codification to a sub-committee meeting at The Hague in April 1940 and to two regional tax conferences that it sponsored. Experts and government representatives from Latin America and Canada also attended these conferences. These capital-importing countries developed a model convention that merged the 1928

model, the allocation convention of 1935 and the lessons learned from bilateral treaties concluded in the meantime. However, as could be expected from capital-importing countries, while they kept the basic structure of the 1928 models, the division of tax revenues tended towards the source principle (van den Tempel 1967, 9).

After the war, the Fiscal Committee reconsidered the Mexico model at a meeting in London. On this occasion, the so-called London model convention was drafted. In its structure it was identical to the Mexico model. A few articles that were supposedly redundant were deleted, and a few innovations taken from the 1945 bilateral treaty between the USA and UK were inserted. This treaty was important because, for the first time, the UK was willing to grant a credit for foreign taxes paid at source on the basis of a treaty. Two key international actors were consecutively aligned in their tax treaty policies. Both concluded their post-war bilateral treaties on the basis of the tax credit method (Picciotto 1992, 39–41). Consequently, the London model also suggested the credit method as the double tax relief method of choice and generally put more emphasis on the residence principle. As before, the conflict between residence and source was most intense in the area of dividends, interest and royalties: 'Virtually, the only clauses where there is an effective divergence between the views of the 1943 Mexico meeting and those of the 1946 London meeting are those relating to the taxation of interest, dividends, royalties, annuities, and pensions' (League of Nations 1946, 6). Explicitly recognizing that the division of the tax base implied by the two models was favourable to different groups of countries, the committee published them together and stated that both could be used as guidance for negotiators of bilateral treaties (League of Nations 1946, 6). Consequently, neither the Mexico nor the London Convention gained full and unanimous acceptance (Li 2003, 45). The publication of the models was the Fiscal Committee's legacy to the international tax world. It provided the technical basis for the post-Second World War growth in tax treaties, and at the same time it explicitly revealed the significant disagreement on the principles of tax base division between countries with 'source interests' and 'residence interests'.

The torch is passed on to the OECD

In its final publication, the Fiscal Committee explicitly stated the expectation that it could further pursue its efforts 'when the League work on international tax problems is taken over by the United Nations' (League of Nations 1946, 6). This expectation initially fulfilled itself. In 1946–7 the United Nations (UN) established a Financial and Fiscal Commission made up of 15 national experts within the Economic and Social Council (ECOSOC). However, debates proved to be very politicized because membership was broadened to include developing countries and the Soviet block. Instead of there being an improvement on the compromise between the residence and source principles, the conflict over the two principles re-emerged with full force. In consequence,

the Commission ceased to meet after 1954. Its secretariat continued the purely technical work of compiling bilateral tax treaties and documenting fiscal developments (Picciotto 1992, 50–1). Therefore, the years 1947–55 saw no significant new developments in the field of double taxation (Messere 1993, 246). The UN did not re-enter the field of international taxation until the 1970s.

During 1954 and 1955, several initiatives were brought to the OEEC (Organization for European Economic Co-operation), the predecessor organization of the OECD. The ICC urged the OEEC to promote provisions for the avoidance of double taxation through unilateral means or bilateral DTAs. It also asked the organization to investigate the possibility of adopting a multilateral agreement, which it still saw as the best solution to the problem of double taxation. Likewise, OEEC members the Netherlands, Switzerland and Germany, in a memorandum from December 1955, advocated the creation of a 'permanent committee of tax experts consisting of high-ranking government representatives' within the OEEC (van den Tempel 1967, 10). In reaction to this, the Fiscal Committee of the OEEC was established in March 1956. It was made up first of ten and later 18 representatives from the organization's member countries. Business representatives from the organization's Business and Industry Advisory Committee (BIAC) and the ICC attended the meetings as observers.

When beginning its work, the Committee explicitly referred to the pioneering work of the League of Nations. It noted that many of the bilateral treaties followed the Mexico or London models. However, it also noted that neither of these conventions was unanimously accepted and that some of the provisions would have to be modernized (OECD 2005b, Introduction, para. 4). As opposed to the League of Nations, the consultations of the OECD were initially intended to create regional law for Europe alone. The USA, which was only an associate member, participated in the discussions but only to a limited extent. Canada did not participate. Initially, the 'old' goal of developing one multilateral tax treaty to replace the existing bilateral treaties was taken up again. However, many countries rejected it and it was concluded that continuing the policy of facilitating bilateral treaties was the appropriate way to go (Debatin 1962, 7; Phillips 1988, xi). The committee strived to develop further the League models with reference to the 'recent treaty practices of its member countries' (Sasseville 2000, 5:3) and to promote the extension of the network of bilateral tax conventions between member states. Nonetheless, the resultant draft convention also contained a suggestion to consider concluding minilateral conventions among themselves (OECD 2005b, Introduction, para. 37). Apart from the Scandinavian countries some 20 years later, no government took up this suggestion.

The committee proceeded on the basis of reports from working parties, usually consisting of two or three members selected to represent the different tax structures and interests. Each working group dealt with a specific problem

and fed its results back into the committee (van den Tempel 1967, 11). From 1958 to 1961 four interim reports were prepared; finally, in 1963 the 'Draft Model Convention on Income and Capital' was published (OECD 1963). The draft convention was expressly not intended for use in treaty negotiations with non-member countries unless it was appropriately adapted (van den Tempel 1967, 14).

The model is similar in structure to the Mexico and London models but contains more detailed provisions. It was published together with a quite comprehensive legal commentary on an article-by-article basis as a reference for governments, taxpayers and the judiciary. The structure of the model is the same as the one presented in Chapter 3; almost all articles that are in use now were present in the 1963 draft. In terms of the allocation of jurisdiction to tax, it was closer to the London model; that is, it gave preference to the residence principle. Nevertheless, the model was intended to leave more flexibility to bilateral negotiations. The withholding rates on dividends, royalties and interest were explicitly meant to be maximum rates that could be amended in bilateral treaties. Furthermore, whereas the London model had only foreseen the foreign tax credit as a method to avoid double taxation, the OECD draft left countries with a choice between exemption and credit (OECD 1963, para. 32). This choice was intended to accommodate both continental and Anglo-American preferences. Continental countries like Germany and France favour exemption, whereas the UK and USA prefer the credit method.

A further aspect of flexibility was introduced by allowing countries to enter reservations and observations about the model in the accompanying commentary and indicate which rules they would have preferred. This makes it possible for countries that are in line with most aspects of the model to continue supporting it, but at the same time to inform potential treaty partners of adaptations they will bargain for in bilateral negotiations (OECD 2005b, Introduction, paras 31–2). The 1963 model convention actually faced a number of reservations. The USA and Canada, which had become members just before the draft was finished, entered some minor reservations. The other member countries entered 22 reservations altogether. Out of these, 20 concerned the taxation of dividends, interest, royalties and capital gains on movable property. Due to its bank secrecy laws, Switzerland entered a reservation on the exchange of information (van den Tempel 1967, 24).

The OECD proved to be well suited to tackle effectively the problem of double taxation and the division of the tax base. In contrast to the UN and the League of Nations, it specializes in economic policy and its member states are more homogeneous and at comparable levels of economic development. Additionally, the objective of the OECD was more pragmatic. Whereas during the League years the ambition was to settle on one international doctrine that would find worldwide approval, such as the residence principle, the OECD pursued an approach that was acceptable to the members of its rather exclusive club. It also allowed governments more flexibility in their

bilateral treaty negotiations. One reason for this may be the fact that the Fiscal Committee was made up of government officials, who were also negotiators of bilateral treaties for their countries. This obliged them to pursue their real preferences and consequently the emphasis in the negotiations was on finding pragmatic solutions. This contrasts with the League of Nations Committee, which, although some negotiators of bilateral treaties were also present, had relied mostly on independent experts, who were more likely to search for universally acceptable principles. As a consequence, the negotiations in the OECD focused more on crafting intergovernmental compromise. While this meant giving up some uniformity and instead allowing more flexibility, it ensured that the solutions found were more likely to be used in bilateral treaties (Prang 1982, 46–8).

The consolidation of the institutions of double tax avoidance

From the 1960s on, the institutional setup of double tax avoidance has been consolidated and since then has become more and more entrenched. As is described in the following sections, the OECD became the main multilateral forum in international tax policy. It has continuously implemented further technical improvements to the MC and continues to do so today. The UN could not challenge the dominant role of the OECD. It developed a model convention that was identical in structure to the OECD model but more favourable to the interests of developing countries, and thus facilitated a pragmatic solution to the distributive conflict between residence and source taxation that continued to be of major importance.

Further development of the OECD Model Convention

In 1965, very soon after the adoption of the 1963 MC, the OECD set out to refine it. The increased organizational complexity within multinational corporations and the general increase in international economic activity formed the background of the discussions. These issues were seen to pose technical problems to the conclusion of tax treaties and made further progress in the harmonization of these instruments desirable. In addition, the USA, Canada and Japan had in the meantime become full members of the OECD, and their views could be more fully incorporated into the MC (Baker 2001, A-2ff.). The revisions turned out to be very comprehensive and took 12 years. The committee came together five to six times a year, whereas previously it would only meet twice a year. During this period, in 1971 the Fiscal Committee was renamed the Committee on Fiscal Affairs (CFA). As before, private interest groups, in particular international business, participated in CFA discussions (Messere 1993, 248).

Once again, the CFA dealt with the question of a multilateral agreement to replace the existing network of bilateral treaties. However, 'After hundreds of

pages of documentation and hundreds of hours of discussion' the committee once again came to the conclusion that a multilateral convention was 'quite unrealistic' given the significant differences among national tax systems and the conflicting interests between capital importers and exporters (Messere 1993, 249). Accordingly, the decision was made to stick with the established approach of concluding bilateral treaties on the basis of a non-binding model. But, as before, the CFA encouraged member countries to consider concluding minilateral agreements, also on the basis of the MC (OECD 1977, para. 32).

In the process of revising the model, the CFA extensively reviewed the existing bilateral DTAs. The Committee had planned to revise the model if the bilateral provisions varied systematically from the draft. However, such revision proved to not be necessary, since almost all treaties conformed to the 1963 draft (Messere 1993, 248). Nevertheless, the elements of flexibility that had been included in the 1963 draft remained in the 1977 text. The CFA explicitly recognized that member countries apparently wished to diverge from the model provisions with respect to the withholding tax rates on dividends, interest and royalties, the allocation of profits to a PE and the choice of the relief method (OECD 1977, para. 24). Again, member countries could enter reservations to the MC. At the end of these long, intense and more technical than conflictive discussions, the OECD Model Tax Convention of 1977 was drafted. The text of the model itself does not differ significantly from the 1963 text. Most work went into the commentary to the MC, which has been the 'subject of additions, clarifications, or updatings' (OECD 1977, paras 11–12).

The commentary's primary function is to assist in the judicial application of bilateral treaties. Just as in the model, it is not legally binding. However, its factual influence over time has become very significant. Tax courts regularly use it in interpreting and applying double tax treaties (Baker 2001, E-11). According to the views of the CFA, the commentary, which is continuously updated, can also be used in interpreting DTAs that were concluded before the latest version of the commentary (OECD 1977, para. 30). The commentary is a tool through which the OECD attempts to establish new interpretations of international tax issues if it believes that external developments make such reinterpretation necessary. It is subject to debate among international tax lawyers whether such ex post use is acceptable from a legal dogmatic perspective (Baker 2001, E-15ff.; Avery Jones 2002). In any case, amending the commentary serves at least a political function in that it allows OECD countries to publish their views on certain issues. Even if the new commentary may not be applied in legal disputes over existing treaties, it certainly guides negotiations of new treaties or renegotiations of old ones. The commentary is the most flexible instrument available to governments trying to induce changes to a series of bilateral treaties that cannot easily and quickly be renegotiated.

In the 1980s, further amendments to the MC and commentary were deemed necessary. Given the frequency of changes to the convention and commentary, it was decided in 1991 to change the MC to an 'ambulatory' model. The MC and the commentary should reflect the consensus among OECD member countries at every point in time. From then on, the model was published in a loose-leaf format, allowing easier revision and adaptation. The first revised version of the 1977 MC was published in September 1992. Unlike the 1963 and 1977, models it was not the result of a comprehensive review process but, in accordance with the ambulatory approach, the 'first step of an ongoing revision process' (OECD 2005b, Introduction, para. 8). Since then, about every two to three years consolidated updates of the 1992 MC have been published.[6] Most of the changes were intended to adapt the established institutional setup to new challenges arising from globalization, liberalization and technological innovation. Many of the changes had their origin in unilateral innovations, in particular from the United States.

I turn to the substantive issues underlying these incremental changes in the next chapter, but the important point to make here is that by introducing an ambulatory model, the CFA assumes the role of a collector and disseminator of relevant information on tax cooperation on a permanent basis. Through this it increases its influence on the development of international tax law, even though its work certainly remains non-binding. The OECD has secured its position as the most important multilateral forum in double tax avoidance.

Catering to the interests of capital importers: the United Nations model

While the institutional setup within the OECD became firmly established, the well known distributive conflict between residence and source interests became visible once again. Many developing countries considered the OECD MC to overemphasize the principle of residence taxation (see, for example, McIntyre 2002). Since they are usually importers of capital and thus exporters of the various kinds of income earned by that capital, the provisions of the model went against their revenue interests.

In reaction to this there had been a serious attempt to install a distinct alternative to the OECD model. In 1971, the governments of the Andean Pact (Bolivia, Chile, Colombia, Ecuador and Peru) agreed on a minilateral treaty that was based on exclusive source taxation (Loukota 1997, 87). While it is not surprising that many Latin American countries preferred the source principle to the residence principle (Figueroa 1990), the Andean treaty went further than that and was based on an outright rejection of any taxation in the residence country. In addition to the regional tax treaty, the group also developed a model treaty on the same terms for the conclusion of bilateral tax treaties with non-Andean countries. At about the same time, the Latin American Free Trade Association (LAFTA) developed a model convention that foresaw taxation on a source basis but allowed for some flexibility when negotiating

treaties with countries with a preference for residence taxation (Prang 1982, 192–7). However, neither the Andean model nor the somewhat more modest LAFTA model gained any influence on bilateral tax treaties, since developed countries refused to sign treaties on this basis (Vann 1998, 729). Over time, while they certainly still put emphasis on the source principle, their rejection of any taxation in the country of residence has receded (Vogel 1990, 125). Thus, the attempt to implement an entirely different solution from the established one had failed.

At about the same time, the Economic and Social Council (ECOSOC) of the United Nations took up the concerns of developing countries. The UN established an 'ad hoc group of experts' in 1967 to deal with issues of DTAs between developed and developing countries. The members of the group were nominated by their governments and usually were the same persons responsible for negotiating their countries' treaties (Surrey 1978, 5–6). Other governments, governmental organizations (IMF, OECD and UNCTAD) and private organizations, such as the ICC and the International Fiscal Association (IFA), representing tax academics, sent observers, who at times participated actively in the discussions (Phillips 1988, xvi). There were thus considerable overlaps in the membership of the UN ad hoc group and the OECD's CFA.

As a first step to ameliorate the position of developing countries, the group published 'Guidelines for Tax Treaties between Developed and Developing Countries' in 1977. In order to specify areas of potential conflict in bilateral treaty negotiations, the guidelines provided protocols for the discussions within the group of experts and indicated where controversies had come up. The intention was to provide information and guidance on tax treaties to negotiators from developing countries, who often did not have enough expertise and experience (Surrey 1978). The UN experts once again considered the question of a multilateral tax treaty. It was regarded as impractical for the same reasons that had come up within the OECD (Phillips 1988, xi).

In the discussions that ultimately led to the publication of a Model Convention (United Nations 1980), developing countries pushed to extend the scope of source taxation. While most of the developing countries accepted the general approach of the residence country providing relief from double taxation and the source country limiting its taxation in return, they wished to tip the balance further towards source taxation. For example, they perceived the OECD definition of a PE to be too narrow. A wider definition of the concept results in more kinds of activities being subsumed under source jurisdiction, thus resulting in a larger share of the tax base. Accordingly, the UN extended the definition. The time limit after which a construction site was considered a PE was lowered and certain activities that would not be considered a PE under the OECD MC were included in the PE definition of the UN MC (Owens 1996, 50–1). Developing countries also argued for higher withholding tax rates than those proposed in the OECD MC. Accordingly, the UN MC

does not contain suggestions on maximum withholding rates for dividends, interest and royalties (Owens 1996, 53).

The UN expert group also dealt with measures to encourage foreign investment. Developing countries were concerned that their unilateral measures intended to provide incentives for foreigners to invest in the country – for example, tax holidays, rapid write-offs of initial investment and exemption for reinvested earnings – would be neutralized through the use of the tax credit method in the residence country. If the residence country takes the tax effectively paid as the basis for calculating the remaining tax, then the tax burden for the investor is the same as if the source country had not implemented investment incentives. In order to counter this effect, the guidelines recommended the use of so-called 'tax sparing' methods, under which the residence country bases its tax assessment not on the tax actually paid but on the tax that would have been paid absent the particular tax incentive used by the source country (Musgrave 2002, 385–6). Most developed countries supported this solution, but a few, most notably the USA, objected, arguing that they would not like to get involved in other countries' tax incentive policies, instead preferring the source country to use direct grants. Additionally, they argued that the tax sparing credit would produce inequality among their own private investors (Surrey 1978, 46); that is, incur an inefficient capital allocation.

The text and structure of the UN model is very similar to the OECD MC. It reproduces many of the articles contained therein and overall the UN approach relies on the very same mechanics and principles as the OECD approach. It was instead through the accompanying commentary – being less detailed than the OECD commentary – and guidelines that the interests of developing countries were expressed.[7]

The UN model highlights the interests of developing countries and serves as a corrective to some of the provisions of the OECD MC. It is not a distinct alternative but a modest modification of it (Arnold and McIntyre 1995, 95). It pinpoints those provisions of the OECD MC that developing countries should strive to modify in bilateral negotiations with developed countries. Thus, the conflict of interest between developed and developing countries still has to be balanced on the bilateral level. Altogether, the influence of the UN Model Convention is limited but visible. Many developed countries subsequently granted higher withholding taxes on dividends, interests and royalties or allowed for a broader definition of PE in their bilateral treaties with developing countries. Later, many transition economies from the former Eastern Bloc tried to negotiate provisions of the UN model into their bilateral tax treaties (Kosters 2004, 4).

Unlike the OECD Model, the UN model has not been updated continuously. While the UN model became influential in bilateral negotiations between developed and developing countries, the UN as an organization could not challenge the OECD's standing as the most important organization

in the field of international taxation. 'The UN has not focused on, nor devoted resources to, tax matters. It has no steady body of acknowledged experts who make a consistent effort to effect a difference in the field of global coordination and cooperation in tax matters' (Brauner 2003, 318 n.225).

In reaction to the criticism voiced through the UN, the CFA began to invite developing country representatives to participate in its meetings (OECD 2005b, Introduction, para. 10). While this had been done since the late 1980s on an informal basis, some non-OECD members were invited to officially register their observations and reservations on the OECD MC from 1991 on (OECD 2005b, commentary, non-member country positions, para. 1).[8] Thus, many of the positions that were manifested in the UN model were subsequently also represented within the OECD and its model (see, for example, the positions on the PE definition: OECD 2005b, reservations, observations and non-member country positions on Art. 5).

New challenges to the institutional setup and old answers

In the 1990s and 2000s the basic institutional setup remained unchanged. Nevertheless, there have been some interesting developments. For one, there are discussions about how to deal with the challenges of e-commerce to the established rules of international taxation. Second, in recent years the CFA considered possibilities for improving the non-binding MAP and possibly replacing or complementing it with arbitration procedures.

E-commerce: raising familiar and new issues

With the advent of e-commerce in the 1990s, new ways of conducting economic transactions were developed and came to be widely used. E-commerce raises a number of problems for existing rules of international taxation. Is a website through which a foreign company sells goods to domestic consumers a PE of that country? What constitutes a PE in e-commerce (Doernberg 2000, 2419–20)? Is income from the sale of digital products classified as business profit or royalty? The answer to these questions determines which country has the right to tax the income. If the income is characterized as a royalty, then it is often taxable in the country of residence only, with the source country possibly applying a withholding tax. As business income, it is taxable in the country of source at the general rate of business taxation if the PE threshold is passed. If no PE is thought to exist, then the residence country taxes the business income (Li 2003, 421–45). To be sure, these problems of classification do not present qualitatively new issues. There has always been conflict about the question of whether some business entity really constitutes a PE or how some item of income is to be appropriately classified. However, due to the increased speed, mobility and interactivity that is enabled by e-commerce, these 'old problems' are magnified (see, for example, Horner and Owens 1996; Li 2003, 509–56).

In 1998 the OECD set up a 'Technical Advisory Group on Treaty Characterization Issues Arising from E-Commerce' (TAG) that suggested answers to these questions. First, the TAG came to the conclusion that a website cannot constitute a PE. Instead, the solution that was suggested is that for an e-commerce business to have a PE, it must control a server in a country where it engages in business and generates income (OECD 2005b, commentary on Art. 5, paras 42.1–42.10). Second, while the exact classification of income as royalty or business profit depends on the precise circumstances of the transaction that are described in some detail in the report and were incorporated into the commentary (OECD 2005b, commentary on Art. 12, paras 17.1–17.4), the basic result is that the income derived from the most common e-commerce transactions is classified as business income. In an exemplary investigation of 28 typical transactions, only three resulted in a characterization as a royalty (Li 2003, 444; OECD 2002d, Annex 2).

With these attempts at subsuming e-commerce under the current international tax rules, the CFA engaged in an effort of interpretive adaptation of the regime. While, as these answers show, it is possible to apply the traditional tax concepts to e-commerce transactions, the answers leave important questions unanswered. This is because e-commerce significantly increases the ability to generate income in a country without maintaining a physical presence there. It is generally not necessary to own a server in the country to which one wants to sell products. Apart from that, most businesses do not own or 'control' (as the legal PE definition requires) the servers on which they host their websites. Even if they do, and there is a PE attributable to them in some country, it is quite easy to move the server from time to time so that the PE threshold is not passed. Thus, if one follows the OECD's suggestions, this leads to the conclusion that PEs basically do not exist in the world of e-commerce (Li 2003, 472–3). Together with the conclusion that in most cases e-commerce income is business income and thus is not taxable at the source absent a PE, the OECD suggestions considerably limit the extent of taxation at source.[9]

The source states, or rather e-commerce-importing states, certainly dislike this outcome. Is it really fair that the source country, which offers a market place to e-commerce exporting states, does not share in the profits generated by these transactions? Should the source country not get any tax revenue from these transactions only because technological progress has enabled a process of 'disintermediation', whereby marketing goods in another country increasingly does not require establishing some 'fixed place of business' (as the OECD PE definition requires)? Thus, consideration of whether the established definition of PE will be viable in the future or whether alternative concepts will be needed to sustain a compromise on the distribution of taxing rights may indeed be warranted (OECD 2002b, paras 3–4).

So far, no international consensus has emerged on an adequate treatment of e-commerce (Doernberg 2000, 2422). For example, Spain, Mexico,

Slovakia, Greece and Korea wish to categorize more e-commerce transactions as royalties (OECD 2005b, commentary on Art. 12, paras 28–31.1). Likewise, Spain and Portugal have expressed some reservations about the PE definition in an e-commerce context (OECD 2005b, commentary on Art. 12, para. 45.6). However, outside the OECD the doubts concerning the proposed interpretations are even more significant. Brazil wants to be able to tax e-commerce transactions at source (OECD 2005b, non-member country positions on Art. 5, para. 23). Argentina, Morocco, Serbia and Montenegro and Tunisia would prefer to treat a greater part of e-commerce income as royalties and tax it at source (OECD 2005b, non-member country positions on Art. 12, paras 3 and 13). India has taxed e-commerce business income on a source basis, in some cases without a server being located in India (Doernberg 2000, 2419–20).

The suggested OECD interpretations that put a heavy emphasis on the residence principle are very similar to the US position, published in a Treasury White Paper (for a discussion see Avi-Yonah 1997, 523–31) before the TAG took up its work. The emphasis on the residence principle is certainly in line with US interests, since the country is the biggest exporter of e-commerce in the world.

Overall, the conflict about the proper treatment of e-commerce is interesting for two reasons. First, it reinforces the traditional conflict between the residence and source principles. It pits e-commerce exporting states against e-commerce importing states – a cleavage that is generally identical to that between capital importers and exporters. However, and this is the second observation, the conflicts go beyond the purely distributive issue between residence and source countries. Structural changes in the world economy, in this case technological change, put the adequacy of the established international tax concepts into question. It may quite simply not be appropriate to hang on to a concept like PE that relies on physical presence. Even if one uses a broad notion of PE and regards a website as a PE – a solution that would presumably be in line with the distributive interests of e-commerce importing states – then problems in administering this system arise. How does the tax authority in the source state collect all the necessary information about the potentially substantial number of PEs under its jurisdiction? While such fundamental questions on the appropriateness of the existing framework of international taxation do increasingly come up and are even acknowledged by the OECD, there is no apparent intention to initiate fundamental reform. Instead, the OECD takes the position that fundamental reform is not necessary at this point and should not be undertaken, since so far there has been no 'broad agreement that a particular alternative was clearly superior to the existing rules' (OECD 2005a, paras 350–1). Nevertheless, it recommended monitoring the development further. Potentially, change to existing tax principles would be necessary in the future (OECD 2005a, para. 354). So far, the approach has been one of 'creative

interpretation', whereby new challenges are subsumed under existing rules and concepts.

Mutual agreement or arbitration? Complements, not substitutes!

Due to the increase in international economic activities and further integration of global production chains, the MAP has been invoked very often since the 1990s. Most importantly, transfer pricing cases and the application of unilateral anti-avoidance laws – two issues that are discussed in detail in the next chapter – have often led to claims by taxpayers that they have been double taxed, and have been dealt with in the MAP. This has led to calls for a more efficient procedure. In particular, the business community disliked the fact that the MAP is not a binding process – the competent authorities are not obliged to come to an agreement. Even though they do usually reach agreement, this may take a long time. Many countries have accumulated large backlogs of cases (Aoyama 2004, 651). Accordingly, the OECD began to investigate how the effectiveness of the MAP could be improved. In particular, it wanted to investigate to what extent the introduction of arbitration might be able to mitigate the problems (OECD 2004b; Owens 2004).

For years, academics have been suggesting arbitration as a means to resolve tax treaty disputes (see, for example, Guttentag and Misback 1986). However, tax authorities, in contrast to businesses, are not necessarily in favour of arbitration. They state that the lack of a binding process does not matter in practice, since in nearly all cases agreement is ultimately reached. Instead, the widespread use of arbitration would hamper the mutual agreement procedure because it might lead the competent authorities to refuse to compromise (Sasseville 2002, 271–2). Furthermore, the MAP is also an important tool for treaty partners to interpret and further develop existing DTAs. In particular, countries with close economic ties are in frequent contact via the competent authority procedure. Accordingly, authorities were reluctant to hand over issues of interpretation and the further development of treaties to neutral third parties. They wished to retain control over treaty interpretations (Guttentag and Misback 1986, 354; Sasseville 1999, 51).

In Europe, the EC Treaty introduced the arbitration mechanism to international taxation in 1990. Since then, a few bilateral treaties have also introduced arbitration programmes. As of March 2002, there were about 50 bilateral treaties providing for arbitration (Aoyama 2004, 655 n. 26). However, these treaties did not replace the MAP with arbitration but introduced arbitration as a last resort if the competent authorities could not reach agreement within the regular MAP. Interestingly, with the introduction of that new mechanism, most cases have not actually gone to the stage of arbitration but have been settled within the framework of the traditional MAP structure (Aoyama 2004, 655). What appears to be needed is simply the *availability* of an arbitration procedure rather than arbitration itself. If the parties have at their disposal – or rather, if they are under the threat of – arbitration

outside the usual MAP, then tax administrators may be more keen to resolve the dispute on their own terms rather than submitting to an external body (Célestin 2000, 114).

Based on these experiences, the CFA suggested that arbitration should supplement rather than replace the MAP mechanism. Recently, it added an additional paragraph to Article 25 of the MC that foresees the submission to arbitration if the affected taxpayer so requests, and if the competent authorities do not reach agreement within two years (OECD 2007).

The empirical record of bilateral tax treaty making

How influential were all these activities on governments' bilateral tax treaty practices? How did the bilateral treaty network develop? As Figure 5.1 shows, the network of bilateral tax treaties has grown steadily since the 1920s.[10] Beginning in the 1960s, and particularly since the 1980s, capital controls were liberalized and the size of investment increased. Figure 5.1 shows the development of annual FDI flows and overall FDI stocks in relation to gross world product (GWP). This made issues of double taxation ever more important and the growth of the treaty network continued.

At the same time, the tax burden in developed countries continuously increased. While, as was detailed above, the problem was basically non-existent in the early years of the twentieth century because there was quite simply no income taxation, double taxation became an issue when many countries introduced income taxes around the time of the First World War. From then on the level of taxation, the so-called tax ratio (measured as tax revenue from a certain tax base as a percentage of GDP), steadily increased

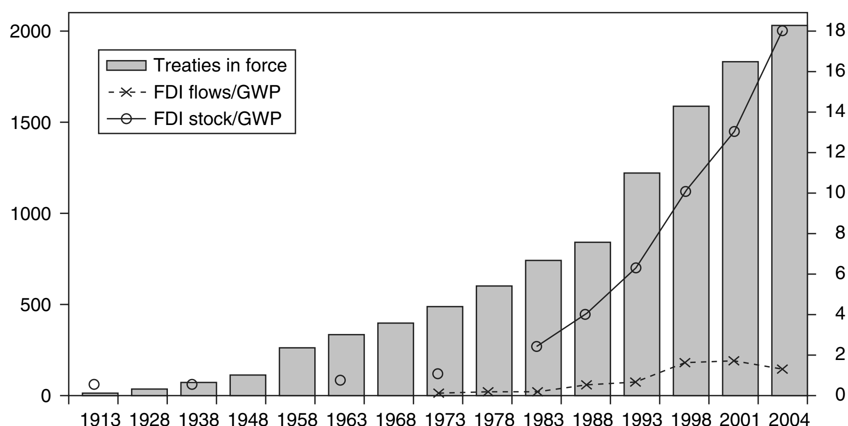

Figure 5.1 Number of treaties in force and international investment
(Data sources: see appendix)

until the mid-1980s. It appears that it reached a kind of plateau at that time. With increasing burdens of taxation, the DTA network grew and continues to grow, as tax burdens remain more or less constant on a high level, as Figure 5.2 shows.

Taking a closer look at the DTA network, it becomes apparent that in the 1920s and 1930s double tax treaties were almost entirely a regional phenomenon and most treaties were concluded between neighbouring countries (Debatin 1962, 5). Most often continental European countries concluded such agreements. The USA signed its first treaty in 1932 with France. While it did enter into double tax treaties, the UK was initially reluctant to provide more than a deduction of foreign source income in these treaties; it accepted neither an exemption nor a credit (Picciotto 1992, 14–16). Overall, the treaties concluded in the 1920s were quite diverse. They did not follow a uniform pattern (Spitaler 1936, 44–6). Despite the fact that in the 1920s there were efforts to re-establish the liberal economic order that had prevailed in the years prior to the First World War, between 1920 and 1929 only 37 treaties were signed. It should not be forgotten, however, that some countries already had unilateral measures in place that at least partially relieved double taxation. Treaty-making activity did not increase significantly in the 1930s, even though the limited number of double tax treaties of the 1930s had already become more homogeneous due to the influence of the first League of Nations models (Carroll 1939, 41–2). While the number of countries that were members of the network increased from 25 in 1928 to 36 in 1938, the number of treaties signed between 1930 and 1938 was only 47. Despite the activities within the League of Nations, double taxation was low on the political agenda because of the depression from 1930 to 1935.

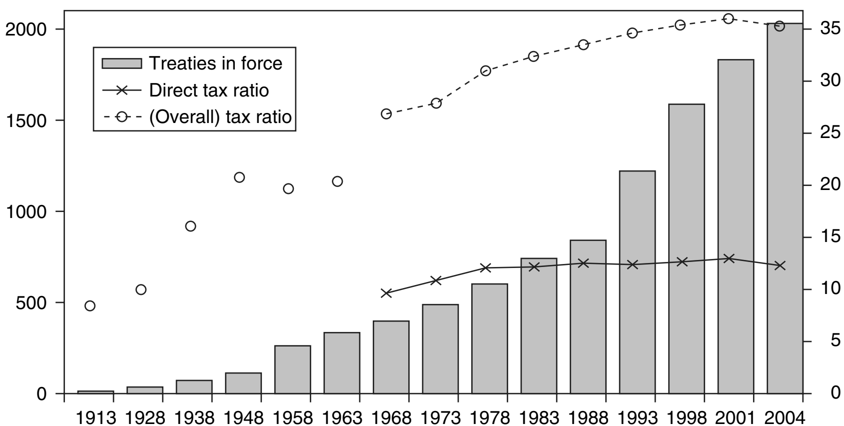

Figure 5.2 Number of treaties in force and tax ratios
(Data sources: see appendix)

Thus, while the basic principles were established by the League of Nations in the 1920s and 1930s, in terms of a material impact the regime remained largely dormant in that era.

After the Second World War, the tax treaty network began to grow significantly in terms of geographical scope and the number of treaties. The number of countries that are part of the treaty network grew to 95 in 1958 and 98 in 1963. In 1963, 333 DTAs are in force. Figure 5.3 shows the double tax treaty network in 1958.

Each vertex represents one country. The three-letter acronyms indicate its name (see the list in the appendix). The size of the vertices indicates the number of treaties – the bigger the circle the more treaties the country has

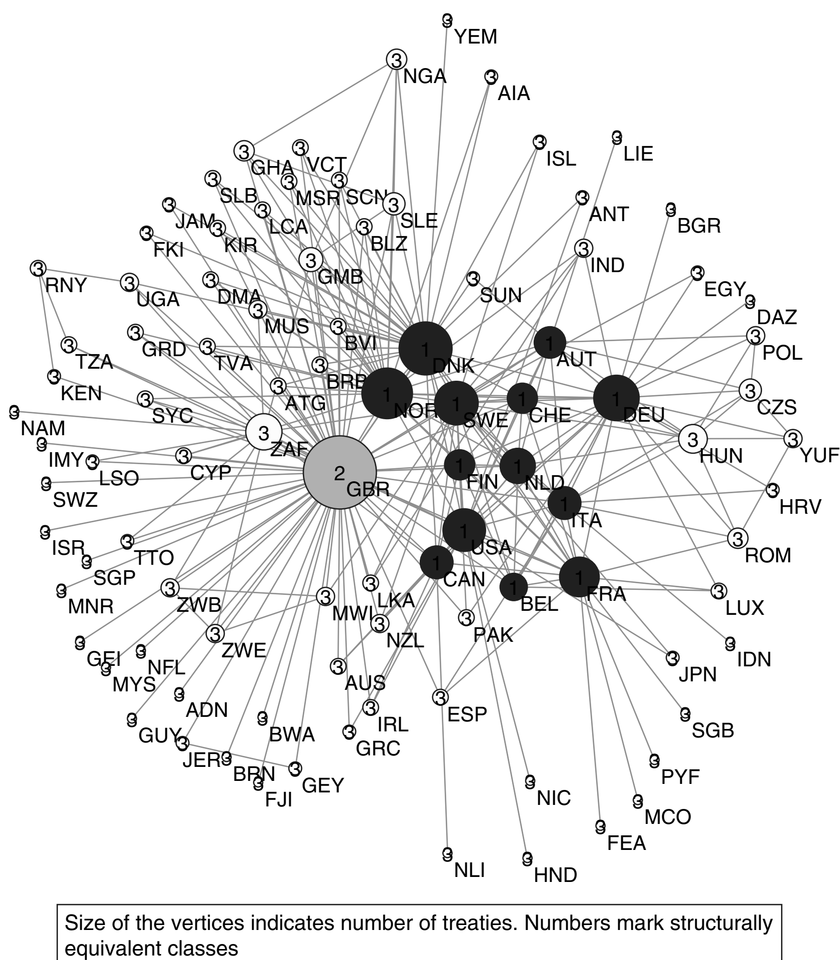

Figure 5.3 The tax treaty network in 1958

concluded. In Figure 5.3, three *structural equivalence* classes are imposed on the data.[11] The different colours and numbers mark the three different classes. It can be seen that industrialized, developed countries have been most active in treaty making. They have concluded most of the treaties between each other. Accordingly, they are generally in structurally equivalent classes. If the network were divided into two structural equivalence classes, one would see two different clusters that form a core–periphery relationship. However, with three structural equivalence classes instead, one industrialized country makes up a class of its own – the United Kingdom.[12] The reason for that lies in the fact that the UK, which is also the country with the most treaties (65), has concluded many treaties with countries with which the other countries did not contract – most importantly its dependent territories and colonies. Thus, classes 1 and 2, made up of 14 countries, form the core of the network. The network between the core countries is very dense. Eighty-five per cent of all possible connections between them exist. Eighty-one countries on the periphery surround the core and have signed only a few treaties.[13] Twenty-six of them – among them many colonies (or former colonies) of the UK and France – have only one treaty. Fifteen countries have two treaties.

With the increase in foreign investment activity, the practical significance of double taxation has increased substantially since the 1960s. Reflecting this increased importance, the number of bilateral tax treaties increased steadily from 397 in 1968 to 486 in 1973. The 1973 network connected 118 countries; it is depicted in Figure 5.4, for which two structurally equivalent classes are imposed on the data.

As can be seen, most of the OECD countries were in the same class and had generally concluded many treaties. The UK had concluded the most treaties (68), followed by Denmark and Sweden with 50 treaties each; France and Norway had 49. The USA had 30 treaties at the time, as did Japan. Only three non-members were within the core of this network: Pakistan, Israel and Zambia. Of OECD members, only New Zealand, Iceland, Australia, Portugal, Luxembourg and Greece were not in the core cluster, because they had not concluded many treaties at the time. For Australia and New Zealand, this is probably due to the fact that they only became members of the OECD in 1971 and 1973 respectively. Nevertheless, the network among OECD countries was dense. Sixty-two per cent of all possible treaties were concluded.[14] Thus, the network was dominated very much by the countries best integrated into the world economy; that is, mostly developed industrialized countries.[15] Only a few African countries, such as South Africa and Zambia, had concluded a significant number of treaties. The same is true for Asian countries. Only Japan and Singapore stand out. There was no relevant participation of South American countries. This may be due to their insistence on concluding tax treaties on the basis of the pure source principle.

This pattern began to change in the 1980s when Second and Third World countries joined the network in bigger numbers and concluded many treaties, as did the transformation economies of the former Soviet bloc in the 1990s

The circles indicate structurally equivalent classes. The size of the vertices marks the number of treaties. OECD members are black.

Figure 5.4 The tax treaty network in 1973

(United Nations 1998). By 1993, the number of participating countries had grown to 163. After that only a few countries joined the network. In 1998 it had 173 members and in 2004 there were 181. Although the number of new members only grew slightly, the number of treaties in force grew significantly from 741 in 1983, to 1219 in 1993, 1582 in 1998 and 2019 in 2004. Accordingly, the growth in the number of treaties comes from growth in the network's density – from 10.7 per cent in 1998 to 12.4 per cent in 2004.

Some examples illustrate the increased treaty-making activity of Second and Third World countries and transformation economies. For example, Poland had 32 treaties in 1993, 60 in 1998 and 70 in 2004. Likewise, the Czech Republic had 28 treaties in 1993 (most of which were concluded by the predecessor country Czechoslovakia), growing to 50 in 1998 and 65 in 2004.

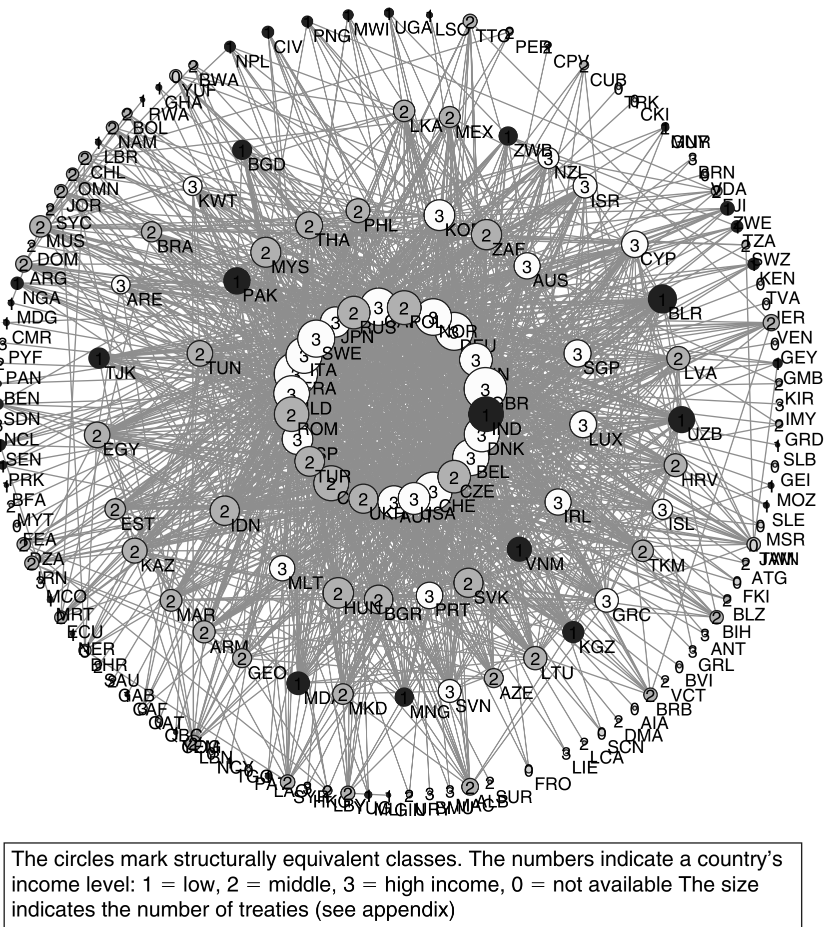

Figure 5.5 The tax treaty network in 2004 (income level and number of treaties)

India had 53 in 1993, 67 in 1998 and 73 in 2004. China's tax treaties increased in number from 34 in 1998 and 56 in 1998 to 75 in 2004. This development is also apparent in the fact that these newcomers are in the core of the network, even though they are poor. As can be seen in Figures 5.5 and 5.6, they are in the same structural equivalence class as the major developed countries. For this network I have chosen four structurally equivalent classes so that the picture is more legible. The classes reflect the core, semi-core, semi-periphery and periphery of the network.

As can be seen in Figure 5.5, the general pattern is that high-income countries are in the core and conclude most treaties. This is to be expected, since these countries are generally well integrated into the world economy.

But there are also a couple of middle-income countries that have concluded many treaties and are among the core or semi-core countries. Of low-income countries, India has a special role in that it is among the countries with the most tax treaties. Pakistan and Vietnam, both low-income countries, have also concluded quite a large number of treaties (42 and 35 respectively) and are in the semi-core of the network.[16] A possible explanation for this pattern is provided by Figure 5.6, which contains information about foreign direct investment going into and out of a country. The higher the FDI level the bigger the vertex. As is visible in the figure, the emerging economies, though they have low or only medium incomes, have quite a high level of

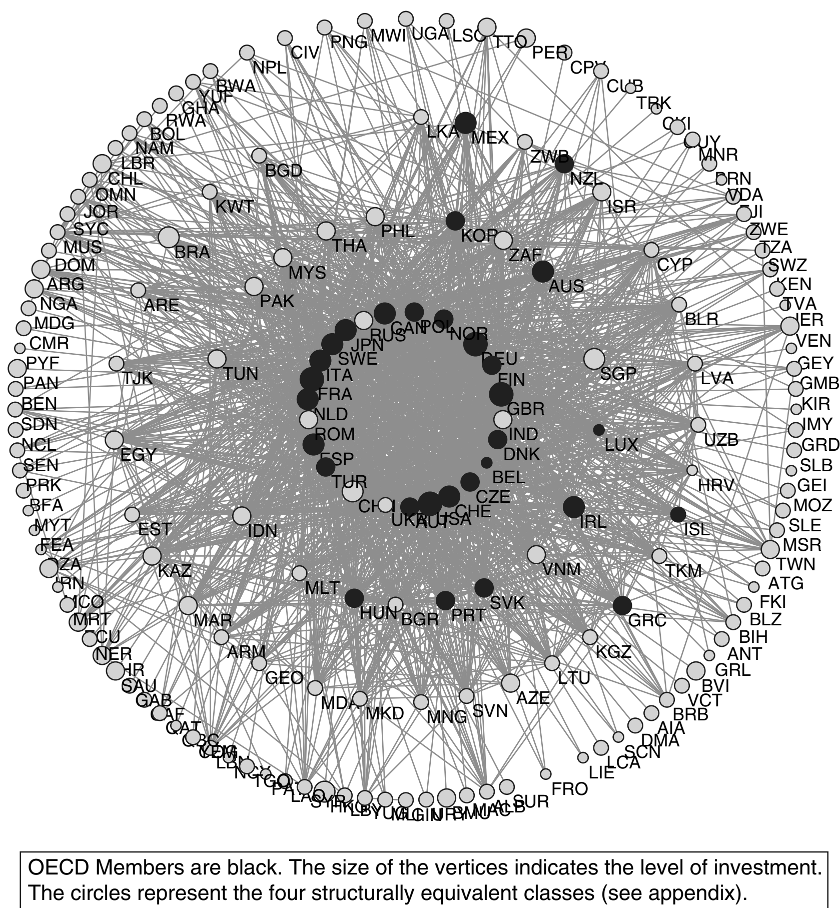

Figure 5.6 The tax treaty network in 2004 (OECD membership and investment levels)

FDI. As could be expected, the countries with higher FDI levels are generally in the core or closer to the core than those with lower FDI activity.

There is an important exception to this general rule. Some tax havens, such as the British Virgin Islands or Trinidad and Tobago, are on the periphery and do not have many treaties, but nevertheless rank high in terms of FDI. Thus, while many tax havens are on the periphery in terms of the number of treaties, they may in fact occupy quite a central position in terms of capital flows being passed through them. In this respect, although they are limited in number, their treaties may be quite central because they are used for purposes of treaty shopping. I return to this issue in Chapter 6.

Figure 5.6 also shows that most OECD countries are in the core of the network. Only a few OECD countries are in the semi-core or semi-periphery. As was the case in the 1990s, the network among OECD countries is very dense – in 2004, 90.6 per cent of all possible bilateral treaties among OECD members were in place.

Overall, the history of double tax avoidance can be summed up as follows. While the League of Nations did not achieve its initial goal of establishing a general multilateral agreement on the prevention of double taxation, the work within the League was important because it led to the establishment of basic principles and rules embodied in model conventions and thus laid the foundations for the international tax regime. By the mid-1930s, the core elements of the system were in place. The schedular structure based on the categorization of different kinds of income, roughly following the economic distinction between passive and active income and the fragile compromise between residence and source principles based on this schedular structure, was formulated. This solution struck a pragmatic balance between the principle of ability to pay and the benefit theory. It also represented the outcome of a compromise between the interests of capital importers and capital exporters. The compromise was put into practice by reference to a series of legal constructs such as definitions of residence, source, permanent establishment and the arm's length standard or separate entity accounting – all of which were conceived in this initial period. Overall, the entire setup represents a mixture of principled and theoretically derived concepts and pragmatic considerations. While not worked out in every detail, the solution proposed by the League of Nations was basically the same as the one that is still in place today. The mechanics, the categories in which the problem is framed and most provisions have remained unchanged (see, for example, Graetz and O'Hearh 1997, 1023–4; Avery Jones 1999, 12–13; Easson 2000, 619–20) – even in the face of new developments such as e-commerce.

Under the tutelage of the OECD, these basic principles and concepts were further elaborated and codified in model conventions. By accepting that the model conventions should be used not as a multilateral treaty but only as a model for the conclusion of bilateral treaties, the key mechanism for the coordination of states' jurisdiction to tax became entrenched in this period.

The multilateral model, which is now continuously modernized and updated, facilitates the conclusion and harmonization of bilateral treaties; and it made the application and interpretation of DTAs easier (Debatin 1962, 8; van den Tempel 1967, 13; Li 2003, 37–8). 'The OECD Model treaty is practically the infrastructure of the current bilateral treaty-based system' (Brauner 2003, 310). Accordingly, the bilateral treaty network grew and continues to grow in terms of geographical scope and the number of treaties.

At the same time, the MC leaves the parties to the treaties sufficient flexibility to accommodate their differing national tax systems and the distributive conflict over the allocation of the right to tax. In turn, experiences at the bilateral level were fed back into the multilateral deliberations on the further refinement of the model convention. In this way, the model and the activities of the CFA not only served to facilitate the conclusion of bilateral treaties but also made the experiences gained at the decentralized level available to all countries. The OECD became the central *forum* of international tax policy, where government representatives – who also negotiate bilateral treaties for their countries – met with representatives from the business community and academics. The OECD monitors the bilateral treaties and other tax developments.

The deliberations in and around this forum led to the formation of a 'community of international tax specialists'. In this community 'ideas and perspectives as well as economic advantage could be traded' (Picciotto 1992, 37). The OECD is engaged in international tax governance by means of a diffusion of principles and policy solutions – *governance by soft law*.

This setup, which can be labelled *bilateralism on the basis of multilateralism*, has made the conclusion of a truly multilateral treaty obsolete. There is a broad multilateral consensus on the idea that double taxation should be tackled on the basis of bilateral treaties. The bilateral nature of DTAs should not be misunderstood to indicate that multilateralism is ineffective. Quite to the contrary; the success of the non-binding model conventions is proof of the success of the multilateral initiatives. As Richard Vann (1991, 152) puts it:

> In a broader sense, the OECD Model (and the UN Model) can be regarded as having multilateral elements in substance which may be more important than the formal bilateral nature of the tax treaty network. The Models are sponsored by international organisations set up under multilateral treaties. Members are encouraged in as strong terms as feasible to use the Models (by and large they do so) and are expected to abide by the official Commentaries (tax administrations and courts regularly have recourse to the Commentaries). Hence a large degree of effective multilateralism has been achieved which indeed may be thought to have neutralised any sustained push for a general multilateral treaty.

6
The Struggle against Under-Taxation

The tax regime's growth and success also caused problems in the form of increased possibilities for tax avoidance and evasion. After a description of the development through which increased possibilities for tax avoidance and evasion were created, I outline how governments have reacted to this challenge by engaging in incremental reform since the 1960s. Then I turn to the more determined – and multilateral – efforts at curbing harmful tax competition that can be observed from the mid-1990s on. Finally, I describe the continuing efforts at incremental reform that are a reaction to the side effects of prior incremental reforms.

Economic liberalization and the problem of under-taxation

The effective removal of tax obstacles, together with other policies aimed at the liberalization of trade and investment, create an increased mobility of capital (see, for example, Quinn 1997). In the early 1950s, barriers to trade and investment were still very high. Then trade barriers were lowered significantly and international direct investment began to play a role, albeit still rather small, in the international economy from the 1960s on. For example, American companies began to locate manufacturing facilities abroad. However, investment in the financial and service sectors was not liberalized. Generally, there were restrictive policies against such flows, reflecting the general consensus of 'embedded liberalism' (Ruggie 1982): that international financial investment was less desirable than international trade and some forms of real direct investment (Helleiner 1994, 51–77).

From the 1980s on, this picture changed. Many countries implemented more liberal policies towards foreign direct investment (FDI) (United Nations 1998, xxvii). In the 1980s, the growth in world FDI flows was by far higher than the growth in trade. Increasingly, financial and service investments supplemented international investments in manufacturing (Kleinert 2001, 81). Much of this economic internationalization has taken place within the integrated business structures of multinational enterprises. In 1970, there were

about 7000 MNEs. By 1990, the number had increased to 35,000, with 142,200 subsidiaries (United Nations 1992, 12). An increasing part of international economic activity is thus taking place within firms. In 1998, one-third of overall world trade was estimated to be intrafirm trade (United Nations 1998, 213). One effect of the internationalization of the economy is that the tax base that is subjected to the rules of international taxation has grown. At the same time, the tax burden in industrialized developed countries has been increasing, as is evidenced by the increase in the average tax ratio in OECD countries from 21 per cent in 1963 to 35.7 per cent in 1993 (OECD 2006b; see Figure 5.2).

The successful liberalization, of which the avoidance of double taxation is one important aspect, together with increasing tax burdens, has two mutually enabling – and unintended – effects on international taxation. On the demand side, taxpayers in high-tax countries increasingly search for opportunities to take advantage of differing national tax laws in order to avoid or evade taxation. They demand international *tax planning* to minimize their tax payments. The various techniques for shifting profits and other assets to low tax countries in order to minimize tax payment have been sketched in Chapter 4. On the supply side, an incentive for states to change their tax laws to attract taxpayers' funds is created. While 'embryonic forms of offshore' had already emerged by the 1920s and 1930s (Palan 2003, 83–7, 112–17), the new opportunities given to mobile tax bases, together with increased levels of taxation and regulation, were intentionally used by some countries from the 1960s on (Hampton 1996, 9). In the liberalized economic environment, the *tax haven* strategy evolved from a 'marginal developmental strategy' to a widespread phenomenon of the internationalization of capital (Palan 2003, 127).

Apart from the general definition of tax havens as countries offering low or nominal tax rates or favourable tax regimes, 'there is no single, clear objective test, which permits the identification of a country as a tax haven' (Internal Revenue Service 1981, 21). This is so because from the 1980s, when the liberalization process really gained momentum, different tax havens started to specialize in various tax planning schemes demanded by customers and their tax advisors. They actively compete with each other for the attraction of business and thus search for and find different market niches.[1] Tax havens can be differentiated according to the features of their financial and tax systems. 'Headquarter havens' such as Belgium and Singapore offer incorporation in their territory regardless of where the shareholders reside. 'Sham havens' host financial intermediaries that are little more than an address for investment activity directed from elsewhere. Most of the tax havens in the Caribbean and Pacific fall into this category. 'Secrecy havens' specialize in allowing personal income tax evasion by reinvesting funds that have been provided without the knowledge of authorities at home. The classic example is, of

course, Switzerland. More recently, Luxembourg, Austria and some smaller jurisdictions have also pursued such a strategy (Kudrle and Eden 2003; Eden and Kudrle 2005, 101–2).[2]

Tax havens' two major groups of customers are MNEs and wealthy individuals (Hampton 1996, 17). Almost all tax havens are small states; often they are politically dependent territories that nonetheless enjoy the sovereignty to devise their own tax laws, such as the Channel Islands or the Netherlands Antilles (for a recent list of tax havens, see, for example, TJN 2007).

As this brief description of the economic and tax development indicates, the problems of tax evasion and avoidance emerged in the 1960s and have grown quantitatively more significant since the mid 1980s. High-tax countries played an ambivalent role in this development. On the one hand, they dislike tax avoidance and evasion as a general phenomenon. They do not intend to enable it through their double tax avoidance and other liberalizing policies. In the words of the OECD: 'Tax avoidance and evasion are of concern to governments because such practices are contrary to fiscal equity, have serious budgetary effects and distort international competition and capital flows' (OECD 1987, 11).

On the other hand, economic liberalization sets in motion a competitive dynamic *vis-à-vis* other countries. Thus, not only tax havens compete for mobile capital or 'paper profits', but so do high-tax countries. Since becoming fully blown tax havens with no or only nominal taxes is not a viable strategy for them, many offered preferential tax treatment to foreign investors, which is not available to domestic investors (OECD 1998a, paras 57–79). Examples of preferential tax regimes are Belgium's Coordination Centres, Ireland's 'Dublin Docks', special economic zones in China, enterprise zones in the United States and tax-favoured subnational regions, such as Eastern Germany, Southern Italy and Eastern Canada. Furthermore, they become vulnerable to pressures from their own business lobbies to maintain some regulatory laxity. Business generally argues that they need access to some offshore planning schemes in order to be able to compete on an equal footing with their foreign competitors whose governments are willing to grant more generous tax treatment to their MNEs. Governments are receptive to these pressures because they want to ensure that their own economies remain 'competitive'. In this respect, international tax policy is at times marked by the maxim voiced by Margaret Thatcher on the occasion of the establishment of International Banking Facilities in London: 'If you can't beat them, join them' (cited in Eden 1998, 659).

While governments in 'high-tax' countries generally wish to curb tax avoidance and evasion, they also experience pressures from business interests and have individual incentives not to act too vigorously. In the following account of the political struggle against tax evasion and avoidance, these conflicting interests play an important role.

Incremental reform in response to tax evasion and avoidance

In this section I first outline how countries only accorded secondary importance to the problem of under-taxation in the regime's founding period. This began to change in the 1960s. I describe the process of the introduction of unilateral anti-avoidance legislation and the reform of transfer pricing guidelines that serve as illustrations of how the existing institutional setup of international taxation was incrementally reformed.

International tax evasion and avoidance as secondary problems

In the period from the 1920s to the late 1950s, the issue of under-taxation was treated as secondary to the problem of over-taxation. Nevertheless, the issue of tax evasion and avoidance was present in the deliberations at the League of Nations. While the initial impetus for the activities of the League of Nations came from the ICC, which was only concerned with over-taxation, some governments had pushed to broaden the agenda. The addition was based on the concern that the coexistence of different national tax systems would increasingly enable capital flight. It is noteworthy, however, that the resolution to consider tax evasion and avoidance was only agreed upon after insertion of the statement that 'any proposal to interfere with the freedom of the market for exchange or to violate the secrecy of bankers' relations with their customers is to be condemned' (League of Nations 1925, 25).

Accordingly, the technical experts not only dealt with the problem of double taxation but also considered the issue of tax evasion and avoidance. They came to the conclusion that the proper way to proceed lay in providing for effective exchange of information between tax authorities. An adequate response to the problem of evasion and avoidance, according to the technical experts, must encompass all or at least most countries of the world, or there would be capital flight to those countries not part of the agreement (League of Nations 1925, 24–6). The technical experts therefore strongly urged governments to conclude a multilateral agreement on this issue (League of Nations 1925, 34).

However, most member states were not willing to subscribe to such a far-reaching solution. Besides the fact that some governments were not willing to engage in information exchange at all (see, for example, the Swiss position: League of Nations 1928, 14–15), they generally cautioned that the 'disadvantage of placing any obstacles in the way of the international circulation of capital, which is one of the conditions of public prosperity and world economic reconstruction', should be carefully weighed against the goal of fighting tax evasion (League of Nations 1927, 5). Many member states were of the opinion that measures against fiscal evasion should be preconditioned on effective double tax relief (see, for example, the position of Sweden: League of Nations 1928, 14). Accordingly, the technical experts ultimately proposed two draft conventions on 'administrative assistance in matters of taxation'

and 'judicial assistance in the collection of taxes' (League of Nations 1927, 22–30) to be templates for the conclusion of bilateral treaties. Under the information exchange clauses of these treaties, governments had to provide information only if the treaty partner was also willing to supply it. At the 1928 government meeting, these model conventions were adopted along with the three versions of the convention against double taxation.

In the 1930s the positions remained unchanged. The Fiscal Committee had drafted an updated convention on exchange of information that was supposed to be multilateral. The replies of almost all countries were negative. 'Governments showed reluctance to change their domestic legislation merely to meet the requirements of foreign administrations, and they were unwilling to ask their nationals to supply information not needed for domestic purposes' (Carroll 1939, 36).

Besides the bilateral clauses on information exchange and administrative assistance that were, and still are, generally quite limited in scope, some countries had adopted unilateral measures against tax evasion and avoidance. For example, in the UK, the Finance Acts of 1936 and 1938 introduced legislation that was intended to regulate the manipulation of residence status for tax purposes. The USA also enacted legislation against 'foreign personal holding companies' in tax havens, which were used by taxpayers to shelter their income from US tax authorities (Picciotto 1992, 97–109).[3] In an attempt to coordinate these unilateral actions, the Fiscal Committee reviewed the existing national provisions. The conclusions were discouraging. The report on the subject from October 1938 concluded:

> Divergent methods of control were employed in the various countries and the methods were for the most part the result of a slow adaptation of the laws and regulations to circumstances: gaps in the taxation system had been closed and the administrations had shown great ingenuity in combating evasion in every form. But the efforts of the various administrations were of so special a character that it appeared to be difficult to employ the methods used by one country in other countries, and it was clear that any proposal for a general scheme would have been received with serious hesitation. (Cited in Carroll 1939, 36–7)

Nevertheless, the report was made available to countries in the hope that they might learn from each other's experiences (Carroll 1939, 36–7). Provisions for the exchange of information and administrative assistance were also annexed to the Mexico and London models (League of Nations 1946).

Overall, while policymakers at the time did foresee that taxpayers could more easily engage in tax avoidance and evasion in an international economic environment, this problem was not given priority. On the contrary, it was feared that restrictive measures against evasion and avoidance would harm efforts at liberalizing trade and investment. Accordingly, they were not

willing to agree on comprehensive multilateral cooperation against undertaxation. Instead, the fight against evasion and avoidance was regarded as mainly the unilateral responsibility of national tax authorities. Reciprocal bilateral information exchange was considered acceptable on the condition that double tax relief was in place.

Unilateral action I: controlled foreign corporation legislation

The first country to introduce comprehensive unilateral anti-avoidance legislation was the USA. While up to the 1950s the political climate had very much favoured economic liberalization, under the impression of a slow-down in economic growth in the late 1950s and 1960s, foreign investment by US corporations came to be viewed more sceptically. In particular, the government was discontent with the erosion of its tax base owing to companies operating through foreign subsidiaries in tax havens that enjoyed the advantage of deferral. Besides the concern over the loss of tax revenue, the initial proposal for anti-avoidance legislation also stressed the violation of CEN due to this diversion of profits (Engel 2001, 1527). The administration's goal was to 'eliminate . . . the tax haven device anywhere in the world' (President Kennedy cited in Engel 2001, 1541). Therefore the administration proposed to end deferral. US corporations would have to include all current income of foreign subsidiaries in their US income (Rosenbloom 2000, 157).

The proposal submitted to the US Congress in 1961 was highly contested. It met with resistance from the business lobby and the Republican opposition in Congress. While it was conceded that most competitors of US enterprises were also from high-tax countries, it was argued that these companies could continue to divert profits to tax havens and thus reduce their global tax burden. Consequently, American corporations would have a competitive disadvantage *vis-à-vis* these foreign competitors. Ultimately, a compromise was reached by singling out certain kinds of 'tax haven income' of 'controlled foreign corporations' (CFCs). Instead of including all foreign subsidiary income in the current tax base, the rules implemented in 1962 singled out passive income that was attributable to foreign subsidiaries in tax havens that had at least 50 per cent American shareholders. Thus, the ultimate solution distinguished between 'good' active business income that should continue to enjoy deferral (under the assumption that there could generally be a real economic rationale for the relocation of active business functions), and 'bad' passive income that was merely shifted for tax purposes (Engel 2001, 1541–3). With this focus on passive income and requirements for the effective control over the foreign entity by Americans, the final legislation – 'Subpart F' of the American international tax code – was a compromise between concerns over international tax avoidance and business interests to preserve international competitiveness.

The experience that CFC legislation is opposed by business interests, often successfully lobbying for a more limited application of such rules, is

essentially the same in all countries that introduced legislation later (see OECD 1987, 43, with examples from the UK and Japan). This shows that there is a continuous tension between the goal of fighting tax avoidance and business pressures to maintain competitiveness. The compromise is quite unstable and the debate about the proper scope of anti-deferral persistently accompanies international tax policy; therefore the rules have been changed quite often (Graetz 2003, 225–6).

In the period up to the mid-1990s, while the basic content of CFC rules remained unchanged, the overall trend was to make the rules more comprehensive: they were gradually tightened. For example, in 1986 income from banking and financing businesses that had initially been outside the scope of the rules was included in the definition of Subpart F income; that is, income that is refused the benefit of deferral. Likewise, Congress enacted the Passive Foreign Investment Company (PFIC) regime and the CFC Excess Passive Asset rules, which ended deferral for US-owned stock of foreign corporations with excess passive assets (Engel 2001, 1549–50). These extensions – which were generally opposed by the business community (see, for example, National Foreign Trade Council 2001, Vol. II, 31–48) – were necessary to counteract new strategies developed by taxpayers to circumvent CFC rules (US Treasury 2000, Chapters 5 and 6).[4] One consequence of this 'proliferation spiral' between taxpayers and the authorities is that the anti-deferral regime is one of the most complicated parts of the American tax code (see, for example, Peroni *et al.* 1999, 458).

But the unilateral anti-avoidance rules were not only difficult to push through domestically. They also met with scepticism on the international level. Some countries opposed the measures, arguing that they would lead to double taxation because the residence state exerted a right to tax on income that is, according to tax treaties and the general principles of the tax regime, apportioned to the source state.[5] The CFC rules thus infringed on a government's right to determine the tax treatment of the relevant income at source and violated its internationally acknowledged tax sovereignty (OECD 2005b, history of commentary to Art. 1, paras 23 and 24). High-tax countries answered that the rules of international taxation clearly were not intended to facilitate tax avoidance, and therefore unilateral countermeasures should not be seen to be in conflict with international tax rules. Instead, since double tax conventions served the twin purposes of avoiding over- *and* under-taxation, they are in line with the spirit of double tax agreements (OECD 2005b, commentary to Art. 1, para. 7).

The most important argument as to why unilateral anti-avoidance rules do not constitute a treaty override used to be the concept of a 'deemed dividend'. According to this, CFC rules cannot be an infringement of the source country's sovereignty because they aim at taxing the shareholder rather than the base or conduit company. Since, according to the typical treaty rules, the source country's right to tax is limited to the company alone, there is, in

this interpretation, no infringement of its power to tax (OECD 2005b, Art. 10, para. 37). The CFC's profits are seen as 'deemed dividends' that can be attributed directly to the shareholder, and thus the anti-avoidance legislation is interpreted in such a way as to be in line with the general mechanics of double tax avoidance (Sandler 1994, 11–12). In this interpretation of CFCs' profits as dividends, there is no violation of the letter or the spirit of tax treaties, because in tax treaties the right to tax dividend income is attributed to the residence country.

The deemed dividend justification is, however, disputed. The conventional understanding in international taxation is that CFC legislation contradicts a fundamental building block of the institutional setup of international taxation: the separate entities approach. Instead it relies on consolidating the tax base of an entity in a foreign source country with that of a shareholder in the residence country (Vann 1991, 108). 'Such integrated treatment of CFCs and their domestic shareholders is an aberration, because the current international tax rules are built on legal "form" (rather than economic substance) and the separate-accounting approach (as opposed to unitary taxation)' (Li 2003, 105). Instead of accepting the legal form that is awarded to the CFC by the foreign source country, the residence country pierces the 'corporate veil' and thus undermines the fundamental notion of sovereignty-preserving tax cooperation. It is effectively an 'extra-territorial application of domestic tax law' (Sandler 1994, 113). The unilateral CFC rules undermine the approach of untangling national tax systems to the largest degree possible. While I mainly deal with CFC legislation here, this is also true for other unilateral anti-avoidance rules, such as general 'substance over form' clauses, foreign investment fund rules or anti-treaty shopping rules. All of these are a violation of the sovereignty-preserving approach of the tax treaty regime.

Because of this violation or at least stretching of one of the fundamental pillars of the tax treaty regime, the introduction of unilateral anti-avoidance rules initially spurred conflict. Most members of the CFA initially argued that countries have to explicitly preserve the application of unilateral anti-avoidance rules in their treaties, in order to prevent 'treaty override' (Ward 1993, 398–9, citing the 1977 OECD MC). However, a report from 1987 noted that countries were divided over the issue of how far unilateral rules would have to be safeguarded in bilateral treaties (OECD 1987, 101–2). Despite that, the 1989 report on treaty override still concluded that a swift renegotiation of treaties is the correct way to go in order to safeguard the unilateral rules (OECD 1989, para. 39). In 1992, the 'wide majority' of member states were arguing that anti-avoidance rules 'do not have to be confirmed in the text of the convention to be applicable' (1992 commentary to OECD MC, Art. 1, para. 24, cited by Ward 1993, 399). Today the commentary simply states that 'controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention' (OECD 2005b, commentary to Art. 1, para. 23).

Over time, with more and more countries adopting CFC rules, the subtle distinction between a 'deemed dividend' and a profit of a separate and independent entity became increasingly superfluous. An implicit consensus emerged that CFC rules are a legitimate instrument for 'pushing the boundaries' (Sandler 1994) of the territorial limits of residence taxation. This interpretation is clearly the dominant view today (Avi-Yonah 2006, 22–36). One important reason for today's acceptance of unilateral anti-avoidance rules is their promotion by the USA within the OECD. In 1987 the OECD suggested that all member countries should introduce unilateral anti-avoidance measures and support these by increased multilateral cooperation in order to make them more effective (see also OECD 1987; Eden and Kudrle 2005, 115–16). Most OECD members subsequently introduced measures tailored after the fashion of the US CFC legislation.

Importantly, though, the implicit consensus that unilateral anti-avoidance rules are acceptable and even desirable has not led to an explicit reformulation of the rules of double tax avoidance. Instead, the inherent tension between the unilateral anti-avoidance provisions and the existing rules of double tax avoidance was formally resolved by reinforcing the principle of de jure tax sovereignty. At least until the mid-1990s, the official position was that a country is generally free to offer tax shelters and neither the OECD nor other countries may pass judgement on that:

> True, taxpayers have the possibility, irrespective of double tax conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws; but it is for States concerned to adopt provisions in their domestic laws to counter such manoeuvres. (OECD 2005b, commentary to Art. 1, history para. 7)[6]

Thus, other countries were equally free to prevent their taxpayers from making use of these offers. They may treat such artificial transactions as what they are – instruments that have no real economic purpose but the avoidance of tax. The introduction of unilateral anti-avoidance rules was interpreted to be not an interference with a tax haven's policy but simply the legitimate exercise of the residence country's tax sovereignty. Unilateral anti-avoidance rules were seen to be legitimate, since they 'are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule . . . there will be no conflict' with DTAs (OECD 2005b, commentary to Art. 1, para. 22.1). Thus, the systematic aberration that unilateral anti-avoidance rules present in a system of territorial delimitation was 'resolved' by reinforcing the principle of legislative tax sovereignty. The principle of sovereignty-preserving cooperation was formally adhered to, while the actual nature of tax cooperation had been changed. Overall, the development is one of 'creative interpretation' of existing international tax

rules to permit the implementation of unilateral measures against double non-taxation (Vann 1991, 108; Green 1998, 135).[7]

Unilateral action II: regulating transfer prices

In the 1960s, it became apparent that US MNEs were shifting US taxable income to their foreign subsidiaries by manipulating intrafirm but cross-border transfer prices. Consequently, Congress directed the Treasury Department to issue new guidelines on transfer pricing that could better prevent such profit shifting. As a result, section 482 of the Internal Revenue Code was prepared and published in 1968. In this document the different methods for determining arm's length prices – the CUP, resale plus and cost-plus methods (see Chapter 4) – were codified for the first time. Subsequently, the USA engaged in an 'export campaign' to promote these rules internationally (Langbein 1986, 646–8). Ultimately, the OECD (1979) issued guidelines on transfer pricing for national tax administrations that were similar to the US rules and that quickly became the accepted standard.

The ALS has encountered many serious problems in practice. In order to see this, one has to briefly consider why MNEs exist in the first place. According to the dominant theory of the multinational enterprise, the main reason for its existence is the fact that it can internalize transactions that cannot adequately be performed through market mechanisms because they are too complex (Coase 1937). The complexity depends on the degree of asset specificity, uncertainty, opportunism and measurement problems involved in the transaction. The more complex a transaction is the more likely it is that it can more efficiently be carried out under 'hierarchy' than on the 'market' (Williamson 1996, 93–101).[8] The integration of business functions then serves to replace missing or defective external markets with the internal hierarchy of a multinational organization. The internalization of such functions allows the realization of economies of scale or scope respectively. For example, it may be advisable to have the production of a certain brand-name product under common control rather than to contract its production on the market and run the danger of being exploited by an opportunistic independent producer. Similarly, the production of R&D-intensive products is often undertaken under common control. Transaction cost reasoning of this kind can explain patterns of horizontal integration, where subsidiaries in different countries produce similar products, as well as vertical integration, where a subsidiary in one country produces outputs that serve as inputs for production in another country. The empirical pattern of the organization of MNEs is generally in line with these theoretical considerations (for an overview see Caves 1996, Chapter 1).

This means that the idea of transfer pricing by reference to comparable uncontrolled prices is conceptually inconsistent with the economic purpose of MNEs. The 'irony and the essential difficulty' is that MNEs exist because of the absence or imperfections of an arm's length market, yet the ALS is used to

determine transfer prices for tax purposes (Graetz 2003, 402). Arm's length transfer pricing is 'trying to separate the inseparable' (Eden 1998, 565). As the US Supreme Court has famously noted, dividing up income in an arm's length system is like 'slicing a shadow' (cited in Célestin 2000, 5). Critics consider the notion of arm's length pricing a 'fiscal myth' (Bird 1988, 299). With the continuously steep increase in FDI, the number of MNEs and intrafirm trade, the ALS has come under stress. The most significant problem is the increased importance of intangibles – trademarks, patents and other intellectual property – which are very hard to price correctly because there will often not be any comparable uncontrolled price. Estimates suggest that, overall, such payments quadrupled between 1986 and 1996 and that 80 per cent of all these payments take place within MNEs (United Nations 1998, 6).

In response to these problems, in the 1980s and early 1990s there were attempts to reform the internationally accepted standard of arm's length pricing. The originator of these efforts once again was the USA, which planned to change its national transfer pricing regulations. The motivation for this unilateral move was that the US government was concerned with two related problems at the time. First, there was concern about profit shifting. US MNEs were accused of underreporting prices charged for trademarks and other intellectual property to their overseas manufacturing subsidiaries. Foreign MNEs, in particular from Japan, were thought to overprice imports to their American subsidiaries in order to lower their American tax bill (see Green 1993, 18–19; Webb 2001, 136–8).

Second, the executive branch was under pressure from Congress. Many senators would have liked to see the USA push for fully fledged unitary taxation in order to prevent the erosion of the US tax base. The issue had become politicized during the dispute about California's system of worldwide unitary taxation. Due to California's unilateral resort to worldwide formula apportionment, which was incompatible with the arm's length standard in the rest of the world, the UK's Barclays Bank claimed to be overtaxed. The legal case had also led to political tensions, with the UK threatening to retaliate with unfavourable tax treatment to US companies in the UK if the unitary tax system was not repealed. But not only the UK complained. By 1989 the USA had received 'some thirty-five diplomatic notes from governments objecting to the worldwide unitary method' (Hocking 1993, 146). The Treasury had formed a working group on unitary taxation that strongly recommended the water's edge election criterion because it did not want to risk conflict with major trading partners (McIntyre 2004, 944). Because of these pressures, California introduced this criterion in 1986 and further liberalized it in 1993 (Hocking 1993, 135–51; Eden 1998, 568–74). Broadly speaking, the water's edge option allows MNEs to exclude their foreign income from the unitary tax base, thus enabling arm's length transfer pricing for their international dealings. In 1994 the Supreme Court upheld California's unitary tax system with the water's edge election criterion.

Stuck between these two demands – the need to tighten transfer pricing rules in order to combat tax avoidance and the desire to comply with the international standard of arm's length pricing that was upheld by the OECD and major American trading partners – the IRS proposed new guidelines in January 1992 that were to replace the 1968 regulations. For cases in which arm's length prices could not be determined for lack of comparables, it proposed the *comparable profits method* or the *profit-split method*. As described in Chapter 4, these methods are basically positioned between arm's length pricing and unitary taxation but are not covered by the traditional understanding of the ALS (Avi-Yonah 1995).[9] By using profit methods, the determination of transfer prices would acknowledge the fact that MNEs realize synergies, which – by their very nature – might not be reflected in traditional arm's length prices. Accordingly, these methods would make the manipulation of transfer prices more difficult.

In practice, tax administrators had relied on similar methods in the past. The 1968 US and 1979 OECD guidelines allowed flexibility by stating that unspecified 'other methods' were acceptable if arm's length prices could not be determined.[10] Webb (2001, 137) cites a report stating that in roughly half of the cases the IRS could not use any of the regulations specified in the 1979 OECD Guidelines or the 1968 US rules. Under the sheer pressure of economic reality, transfer pricing involved methods that in fact moved the system towards an implicit consolidation of the profits of related entities. Many commentators have argued that the 'true norm' of international transfer pricing has become a combination of determining comparable uncontrolled prices (CUP) and profit apportionment. Given the unavailability of CUPs, the reality of transfer pricing was closer to *ad hoc formula apportionment* on a case-by-case basis than the rhetorical emphasis on the ALS would have one believe (see, for example, Langbein 1986, 670; Eden 1998, 558). Given this reality of transfer pricing, the newly proposed regulations by the USA would to some extent merely have codified what had already been practised.

Nevertheless, the OECD opposed the proposed regulations, arguing that they were inconsistent with the traditional understanding of the ALS and would violate existing tax treaties (Avi-Yonah 1995, 138–40). Governments feared that the new methods would lead to an increase in the tax base assigned to the USA and consequently a loss of tax revenue for them. Some, including Japan, the UK and Germany, threatened to retaliate by subjecting US MNEs to stricter tax audits if the USA were to implement the proposed regulations. They emphasized that it was necessary for all countries to follow the same rules in determining transfer prices.

The CFA set up a Task Force to review the proposed US regulations and to formulate a joint response by developing new transfer pricing guidelines, and tried to accommodate the opposing views (Hay *et al.* 1994, 425). Since all sides were interested in coming to a common solution, the USA, the OECD and other governments crafted a compromise. Ultimately, the final US regulations

and the newly published OECD guidelines (OECD 1995) were made compatible (Radaelli 1998, 611–15). The USA reduced its emphasis on profit-based methods, in particular the profit-split method. In turn, the OECD subsumed profit-based methods under the arm's length principle, but required that they be used as a last resort if 'traditional transactional methods' do not yield appropriate results (OECD 1995, paras 3.49–3.50). Overall, the new guidelines bring the actual rules closer to how transfer pricing had already been done in practice, but take great care to formally reinforce the principle of separate entity accounting and very clearly reject the method of unitary taxation as a practicable alternative to the ALS (OECD 1995, paras 3.63–3.74). As the head of Fiscal Affairs at the OECD put it:

> The arm's length principle can encompass sophisticated and flexible profit split formulas tailored to the specific facts and circumstances, especially in cases where one is dealing with highly integrated operations (e.g., global trading). However, there is a difference between this approach and the mechanistically applied global unitary approach that, for example, had been used by California. Such a 'simplified formula' cannot recognize the facts and circumstances of each case and [is] therefore ill-adjusted to the complexities of modern MNEs. (Owens 1994, 878)

Overall, the arm's length principle has been reinterpreted so as to subsume methods that are not in line with the separate entity approach as originally understood. While similar methods had already been used in practice, they were now officially acceptable. Nevertheless, as the case of California shows, any attempt to install fully fledged unitary taxation meets with fierce opposition. 'The F Word . . . is blasphemy in transfer pricing circles' (Couzin 2005, 407). While the new methods move the system closer to a consolidated treatment of different parts of a business, the transfer prices are still determined on a case-by-case basis. Whereas a fully fledged unitary system with formula apportionment requires an international definition of a common tax base and formula, the new methods, even if they amount to ad hoc formulary apportionment, do not require a sharing of legislative sovereignty. The rules keep the appearance of not interfering with national tax laws, but still operating at their interfaces.

Two conclusions can be drawn from the episodes of the introduction of unilateral anti-avoidance legislation and reform of the transfer pricing guidelines. For one, countries did not address the problem of double non-taxation on the international level. At first, it was every country's own responsibility to tackle tax avoidance and evasion. Only subsequently were the international ramifications addressed. In both cases, the USA acted as a first mover and subsequently engaged in efforts to diffuse the innovations internationally (see also below).

Second, in order to do something about tax avoidance and evasion, governments were willing to implement rules that at least strain – if not violate – the

original understanding of the institutional setup of double tax avoidance. Nevertheless governments were unwilling to make an explicit change to the institutions of international taxation and opted for creative reinterpretation. In both cases, the principle of sovereignty-preserving cooperation is *formally* adhered to, while de facto the nature of cooperation changes. This shows that the rules of international taxation are malleable, but that it is hard to implement fundamental reform. Not even the USA could unilaterally redefine the rules as it wished to. On the contrary, as the case of the transfer pricing regulations shows, it had to accept that there is international consensus on the appropriateness of the ALS to which it had to adapt (see also Webb 2001; Graetz 2003, 406–7).

Efforts at internationalizing anti-avoidance policies

In the early 1980s, governments began to realize that their DTAs were increasingly subject to treaty shopping by citizens of third countries. The first country to engage in efforts to counter this was once again the USA. While many tax havens did not conclude DTAs themselves, they were covered under existing tax treaties. For example, the US treaties with the Netherlands and the UK extended to former overseas territories of both countries. In 1981, the Gordon Report on tax havens (Internal Revenue Service 1981) suggested unilaterally terminating such treaty extensions to counter tax treaty abuses. The USA sought to conclude agreements with these territories that were solely about effective information exchange and did not contain measures of double tax relief. Fourteen of these agreements with Caribbean tax havens entered into force in the 1980s and 1990s (Langer 2002, 1189). Likewise, the government began to include stricter anti-abuse rules in its tax treaties; for example, when it renegotiated its treaty with the Netherlands in 1992 (Radaelli 1997, 149–51).

However, the Gordon report also noted that a unilateral policy against harmful tax practices alone might be ineffective and potentially self-defeating because it endangered the competitiveness of US businesses (Internal Revenue Service 1981, 10). Accordingly, it became declared policy to achieve some minimum degree of internationalization of the fight against tax evasion and avoidance (Eden 1998, 99–100). The USA engaged in an effort to promote its activities within the OECD and to get other ‘high-tax countries’ to implement similar policies. The CFA drafted several reports dealing with issues pertinent to the problem of under-taxation (OECD 1986c; 1987). The objective of these reports was to further diffuse knowledge about countermeasures and thus to promote their use by as many countries as possible. If the OECD could not devise binding measures against double non-taxation, it should at least try to coordinate the decentralized reactions to tax evasion and avoidance in order to mitigate the negative effects of unilateral measures (Eden and Kudrle 2005, 115–16). However, while the report contained recommendations such as not concluding new tax treaties with tax havens and

insisting on effective exchange of information (OECD 1987, 46–7) or considering implementing unilateral anti-avoidance legislation, the proposals were quite moderate and unspecific (see, for example, OECD 1986c, 89–92; 1987, 83–4). This reflected the disagreement about unilateral anti-avoidance legislation discussed above. Nevertheless, many OECD countries have subsequently adopted unilateral anti-avoidance measures. Today, all major capital exporting nations have passed *CFC legislation*, *transfer pricing rules*, and *thin capitalization rules* (Arnold 2000, 17:6).

Countries have also reviewed their treaty policy *vis-à-vis* tax havens. A survey of existing tax treaties indicates that by the mid-1990s most tax havens had no or only very few DTAs. However, there are important exceptions to this rule. Countries like Switzerland, Luxembourg, the Netherlands and Singapore had many tax treaties (Eden 1998, 100, Table 2.7). While these countries may or may not be considered full-blown tax havens, their tax systems certainly have features that make them attractive for purposes of tax avoidance and evasion. One of the reasons for the variance in treaty policy towards tax havens may be the fact that many countries have important 'real' economic ties with the latter group of countries that make the avoidance of double taxation desirable.

The OECD has not only tried to coordinate the unilateral measures against evasion and avoidance, it has also attempted to supplement existing bilateral agreements on information exchange with a multilateral agreement of this nature. In 1988, it jointly drew up the Convention on Mutual Administrative Assistance in Tax Matters with the Council of Europe (2003a). The convention is a multilateral instrument that allows a broader exchange of information than the typical clause in a bilateral DTA. Multilateral information exchange and administrative assistance was considered desirable because many tax avoidance techniques involved more than two countries and thus bilateral measures were inherently limited in their effectiveness (Council of Europe and OECD 2003a, 20). The convention is open to member states of both organizations. One of its key features is that it allows simultaneous multilateral tax examinations (Council of Europe and OECD 2003a, Art. 1, para. 2). It proved difficult to gather support for the convention because governments came under pressure from the business lobby not to sign the convention. The German government did not sign the agreement for this reason. BIAC also initially objected (Picciotto 1992, 256). Thus, the Convention only entered into force on 1 April 1995 when the required minimum of five states – Denmark, Finland, Norway, Sweden and the USA – had signed it (Council of Europe and OECD 2003b).

Curbing harmful tax competition . . . with little success

In the 1990s and 2000s, the problem of tax evasion and avoidance grows even more important. Available data for the USA show that the reallocation

of profits to tax havens has increased substantially in recent years. In 1990, low-tax countries accounted for 20.7 per cent of foreign manufacturing profits of US multinationals, and that share rose to 46.8 per cent by 2000 (Desai 2005, 188). In 2002, the share of profits in tax havens reached 58 per cent.[11] Importantly, while the 'high-tax' countries Canada, France, Germany, Italy and the UK accounted for 44 per cent of foreign sales, plants and equipment, and 56 per cent of foreign employee compensation, they accounted for only 21 per cent of reported foreign profits of US corporations in 2002 (Sullivan 2004a). Furthermore, reported profitability in low-tax countries is significantly higher than in high-tax countries. This strongly suggests that companies are shifting their profits without relocating real economic activity (Sullivan 2004c).[12] Another illustrative piece of evidence is that India reports that 90 per cent of its inward investment flows into the country via Mauritius (Owens 2006, 869).[13] Likewise, the available estimates suggest that the problem of tax evasion on portfolio income is very significant. According to a 2001 estimate, financial assets of five million million US dollars are invested in tax havens (Levin 2001). Assuming an average rate of return of 5 per cent and a rather moderate average tax rate of 25 per cent, this would amount to US$62.5 thousand million of revenue forgone each year in residence countries. The Tax Justice Network, a non-governmental organization engaged in the fight against tax evasion and avoidance, estimates that US$11.5 million million are stashed away in tax havens (TJN 2005, 3).

In reaction to these developments, governments have made more determined attempts to fight under-taxation. The most significant of these attempts on a global scale is the OECD project against harmful tax competition, to which I now turn.

A break with traditions: the OECD project

As we have seen, the problem of international tax evasion and avoidance has been predominantly addressed on the unilateral level – with some coordination of these measures taking place on the multilateral level. In the mid-1990s, OECD governments began to realize that unilateral and bilateral reactions were insufficient to deal with the problem of under-taxation. First of all, the unilateral measures do not tackle the problem of tax evasion and avoidance at its root. They do not prohibit other countries from offering tax shelters; they simply make it less attractive for taxpayers resident in countries with anti-avoidance legislation to accept these offers. In addition, the anti-avoidance legislation is often quite complex and incurs high administrative costs (OECD 1998a, para. 87), which are likely to increase over time given the proliferation spiral between taxpayers and authorities. Finally, even the unilateral measures rely on some cooperation from other countries. In order to employ anti-avoidance measures, the tax authorities have to get information on the dealings of their residents abroad. Because of these problems, a multilateral approach was considered necessary (Owens 1998, 231).

In the early to mid-1990s, a few international initiatives to regulate offshore finance were launched.[14] In the context of this, at their 1996 summit in Lyon the finance ministers of the G-7 called upon the OECD to 'counter the effects of harmful tax competition', urging the OECD to 'vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively' to limit harmful tax practices (OECD 1998a, para. 2). Equipped with this mandate, the OECD came up with several suggestions that were published in a report entitled 'Harmful Tax Competition: An Emerging Global Issue' (OECD 1998a). Right from the start, the focus was limited to unfair competition for highly mobile activities such as financial service centres or portfolio investments. This was made explicit in that three types of tax competition according to the tax base that is to be attracted were distinguished:

1. Direct, 'real' investment in plant, building and equipment. Tax base: active capital income of enterprises.
2. Highly mobile direct investment, such as income attributable to service or profit centres of multinational enterprises, base companies etc. Tax base: active and (mostly) passive capital income of enterprises.
3. Savings and portfolio investment. Tax base: passive, mostly individual capital income (OECD 1998a, para. 6).

The OECD made it clear that the harmful tax competition project was not about type 1 tax competition on real direct investment (OECD 1998a, para. 6). Instead, it would only target tax competition of types 2 and 3.[15] And even with respect to passive investment and mobile financial services income, the focus was not on low tax levels as such. A country should generally remain free to design its own tax system as long as low rates are granted equally to everyone and the tax system is sufficiently transparent (OECD 1998a, paras 40–1). Instead, the project only targeted 'harmful' tax practices that were defined as attempts at 'poaching' the tax base of other countries. A country engages in a harmful tax practice if it intentionally designs its national tax system in such a way that the regular application of other countries' tax laws is frustrated; for example, if it offers itself to foreigners so that they can evade or avoid taxation in their country of residence. It intentionally attracts the tax base that 'rightly belongs' to other countries (OECD 1998a, para. 29).

The OECD differentiated between two kinds of harmful tax practices. First, *tax havens* have non-transparent tax systems; for example, they are unwilling to exchange information with other countries. Moreover, they do not require any substantive economic activity for a transaction to be booked within the country. The criterion of missing substantive activity targets transactions that may be booked in a country without adding any real economic value there. For example, it is fulfilled if a country allows the establishment of 'mailbox'

companies, which are merely booking centres for corporate profits that have been made elsewhere (OECD 1998a, paras 52–6).

The second kind of harmful tax practice is a so-called *preferential tax regime* (PTR), where a country offers foreign investors preferential tax treatment that is not available to domestic investors (OECD 1998a, paras 57–79). The decisive criterion in this case is positive discrimination in favour of foreigners. The OECD argued that such discrimination indicates an implicit admittance that the country does not wish such behaviour to be adopted by all countries. By 'ring fencing' the investment incentives from domestic taxpayers, it wishes to limit the tax revenue losses that would result if they made the lower tax burden accessible to all taxpayers (OECD 1998a, para. 62). Such PTRs are found in many OECD countries.

The differentiation between the two practices is motivated by the idea that the two types of countries should have different incentives concerning their willingness to cooperate against a potential 'race to the bottom' in revenues resulting from unfair tax practices. While countries with PTRs should be interested in ensuring that other countries do not poach their own regularly treated tax base, tax havens' incentives are not moderated by such concerns, since they generally do not have a significant tax base of their own to lose. Thus, the OECD reckons that obtaining cooperation from PTRs should be easier than from tax havens (OECD 1998a, paras 43–4).

The project was situated within the Forum on Harmful Tax Competition, a subsidiary body of the CFA (OECD 1998a, para. 142 and appendix 1). While the OECD cannot enforce any rules on countries, the idea is to build up 'peer pressure' (Webb 2004, 792) to get commitments from the jurisdictions concerned to abandon their harmful practices. In order to make this more credible, it used a 'naming and shaming' approach by publishing black lists of countries with harmful tax practices (Eden and Kudrle 2005, 122). At least with respect to tax havens, this soft power – and this is a second new feature – was backed up by threats to implement 'defensive measures' (OECD 1998a, para. 149).

Nineteen potential defensive measures on the unilateral, bilateral and multilateral levels were presented. Countries were advised to pass CFC, FIF and similar anti-avoidance legislation, such as stricter restrictions on the exemption of foreign source income from tax havens (OECD 1998a, paras 97–100). On the bilateral level, the OECD suggested terminating tax treaties with tax havens, insisting on more effective exchange of information and engaging in coordinated activities of tax enforcement, such as simultaneous audits (OECD 1998a, paras 113–37). On the multilateral level, member countries with political and economic links to tax havens were asked to ensure that these links did not contribute to harmful tax competition. Member countries should also try to engage non-member countries in an ongoing dialogue on the issue of harmful tax competition (OECD 1998a, paras 152–6). Hence, the threat is to intensify existing unilateral and bilateral policies and put them

on a broader, more coordinated – and thus effective – basis (OECD 1998a, para. 87). The defensive measures should be implemented by all countries to ensure that the fight against harmful tax practices will not harm those who are willing to implement unilateral and bilateral anti-avoidance policies (OECD 1998a, para. 138).

> Although one country's actions can be influential in curbing harmful tax practices, it is difficult for the actions of any single country to eliminate harmful tax practices. In fact, for many reasons, individual countries may not have a strong incentive to take action against harmful tax practices since by so doing they can worsen their position relative to where they would have been if they had not acted at all. For example, as a result of some of the defensive measures an individual country takes to counteract harmful tax practices, the targeted activity may simply move to another location that is not taking measures to combat such practices. Thus, individual actions do not completely solve the problem; they may merely displace it. For this reason, a multilateral approach is required and the OECD is the most appropriate forum to undertake this task. (OECD 1998a, para. 138)

This line of argumentation is apparent throughout the report and later publications on the issue (see, for example, OECD 1998a, paras 13 and 87; OECD 2004c, para. 28). Concerning PTRs, the 1998 report did not threaten any defensive measures.

All OECD members welcomed the 1998 report, except Switzerland and Luxembourg, which stated their disagreement but did not dare to vote against it. Both countries abstained and declared that they would not feel bound by the report. They criticized the exclusive focus on the financial sector instead of a consideration of all sectors of the economy. Furthermore, they disapproved of the implicit attack on bank secrecy laws inherent in the report (OECD 1998a, Annex II). Overall, the report did not raise much public interest at the time of publication (Ruchelman and Shapiro 2002, 411).

The project gains momentum . . . and is slowed down abruptly

In its 2000 progress report, the CFA published the blacklist of tax havens that were asked to formally commit to removing the harmful features from their tax systems. The list contained 35 countries and territories (OECD 2000, para. 17) that were asked to sign a Memorandum of Understanding (MOU) by 31 July 2001.[16] Through the MOU, tax havens should commit to removing the harmful features of their tax systems by the end of 2005 (Ruchelman and Shapiro 2002, 418). All countries refusing to enter into a MOU would be considered 'uncooperative jurisdictions' and would have to expect the implementation of coordinated 'defensive measures' (OECD 2000, 19–20).

Likewise, 47 PTRs in 21 of the then 29 OECD member countries were recommended for evaluation and removal in a process of peer reviews (OECD 2000, para. 11). Even though Switzerland and Luxembourg had abstained from the 1998 report, they were on the list and thus put under scrutiny.

After the publication of the 2000 progress report, political conflict over the project ensued. The listed tax havens objected to the policy pursued by the OECD, decrying it as an undue interference into their national tax sovereignty. Tax havens voiced their resistance via two channels. For one, they aimed at a better representation of their position within the OECD. The Commonwealth played an important role in this, criticizing the initiative as partial, coercive and an infringement of their tax sovereignty (Sharman 2006, 83–6). Together with OECD members Australia, Canada, New Zealand and the United Kingdom, they passed a resolution in September 2000 that decried the deadline proposed in the 2000 report as being counterproductive to establishing a constructive dialogue on harmful tax competition (Easson 2004, 1061–2).

In 2001 tax havens established their own lobby group, the International Trade and Investment Organization (ITIO), to coordinate their own investment and trade strategy. Three major criticisms were raised by the ITIO and tax havens. First, instead of their being involved in the design of the project, the criteria of harmful tax practices were externally imposed on them by the OECD. They considered this to be a fundamental infringement of their sovereignty and also to lack legitimacy (Zagaris 2005, 339). Second, they considered the project to be lopsided. While OECD members had not been confronted with any potential defensive measures if they failed to remove their PTRs, tax havens would have to face them if they failed to comply. Third, tax havens referred to the devastating effects of the project on their economies, which were highly dependent on the offshore sector (Hampton and Christensen 2003, 213). They argued that western industrialized countries had originally advised them, through institutions like the IMF and the World Bank, to specialize in financial services. Now that they had developed a strong financial sector, the very same countries were planning to take that away from them (Easson 2004, 1062–4).

In 2001, the United States joined the tax havens in some of their criticisms. The Clinton administration had been one of the initiators and most ambitious supporters of the OECD project (Kudrle 2003, 63), which had therefore initially been described as a ‘multilateralization’ of US international tax policies (Zagaris 1998, 1507–8). The Clinton administration had even planned to implement the OECD recommendations in national legislation. All payments going to any of the 35 listed tax havens would have had to be reported to US tax authorities. The government considered the termination of its regular policy of granting a foreign tax credit for any taxes paid at source in these countries. Any country on the list could have avoided these measures by making their tax systems more transparent or concluding a specific

information exchange agreement with the USA (Sheppard 2001, 2021). As described above, these positions were in line with the policies the USA had pursued over the previous decades. Nevertheless, the newly elected government of George W. Bush altered the policy. In May 2001, Finance Minister O'Neill (2001a) declared that

> in its current form, the project is too broad and it is not in line with this Administration's tax and economic priorities. . . . The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems. (O'Neill 2001a)

Thus, instead of trying to force tax havens to change their tax systems, the project should focus only on obtaining more effective exchange of information from tax havens.

Libertarian interest groups had played an important role in the government's policy change. Among them, the Center for Freedom and Prosperity, sponsored by the Heritage Foundation with the sole purpose of accompanying the OECD project, had been particularly active. This small 'think tank' succeeded in positioning its critique in the media (see, for example, Mitchell 2000) and lobbying American politicians. It raised public interest for the OECD's plans, portraying them as an undue interference with tax havens' fiscal sovereignty and an attempt by rich countries to build a cartel in order to squeeze taxpayers by taking away their financial privacy (bank secrecy).[17] Many US Congressmen wrote letters to Finance Minister O'Neill that were based on a template provided by Freedom and Prosperity (Sheppard 2001, 2018–19). Remarkably, the group warned Republicans that the OECD might push the USA to raise its taxes to the high levels prevalent in Europe, whereas Democrats were asked to consider the negative developmental consequences for Caribbean tax havens should the OECD be successful with its endeavour.[18]

After the US intervention, there were intensive discussions within the CFA on how to further pursue the project. In these discussions the USA effectively pushed the OECD to curtail the project (O'Neill 2001b; Scott 2001). However, even though many had feared otherwise, the project was not completely abandoned, nor did the USA withdraw its participation. Nevertheless, important changes were implemented. First, the criterion of missing substantive economic activity was removed from the definition of an unfair tax practice. This meant that the project was now restricted to the fight against harmful practices in the area of passive portfolio investments (tax competition of type 3) whereas mobile, financial direct investments (competition of type 2) were not considered any more. As O'Neill had requested, from now on the project only dealt with issues of transparency and establishing more effective information exchange (OECD 2001a, para. 27).[19]

Second, it was clarified that potential defensive measures would not be applied against tax havens only, but also against OECD members unwilling to abolish their PTRs. As long as OECD members operated PTRs and would not be subjected to defensive measures, uncooperative tax havens would not have to fear them either (OECD 2001a, para. 32). Considering the position of OECD countries like Switzerland and Luxembourg – which had been on the list of uncooperative tax havens but abstained from the 1998 report – this is a far-reaching concession that takes much of the bite out of the project. The OECD has been forced back to employing its traditional method of dialogue and persuasion (Sharman 2006, 86–100).

Furthermore, OECD members offered technical and administrative assistance to committed jurisdictions in reshaping their domestic tax systems. Likewise, assistance from the World Bank, other international organizations and single member states was offered but not specified further (OECD 2001a, paras 44–6).

'From Al Capone to Martin Luther King': the Global Forum on Taxation

Subsequently, the entire approach became less confrontational and more inclusive. On the initiative of the Commonwealth, the Global Forum on Taxation was set up in 2001 as a multilateral framework to bring together OECD economies and offshore financial centres to further develop the project (Samuels and Kolb 2001, 245–6). Given that their commitment was now conditional on all OECD countries also meeting the regulatory standards, most of the tax havens gave in to the demands of the OECD. A large majority declared that they would progressively allow exchange of information and get involved in the work of the Global Forum. In 2004, only five uncooperative tax havens remained: Andorra, Liechtenstein, Liberia, Monaco and the Marshall Islands (OECD 2004c, para. 27).[20]

The idea was to enter into an intensive dialogue with tax havens instead of forcing measures upon them. In the words of Jeffrey Owens, the OECD jettisoned the 'Al Capone approach and replaced it with the Martin Luther King approach' (cited by Easson 2004, 1066). This also became apparent in a semantic adjustment. Countries that had agreed to cooperate with the OECD were initially referred to as 'committed jurisdictions'. Now they were, together with OECD countries that were members of the Global Forum, referred to as 'participating partners' (OECD 2004c).

Thus, the approach not only became less confrontational and inclusive; by focusing on information exchange only, direct intervention into countries' tax systems was taken off the agenda. Therefore, the approach is far more indirect now, intervening in tax havens' sovereignty only with respect to their freedom to devise bank secrecy laws and other provisions intended to achieve non-transparency. As long as tax systems are transparent and allow for information exchange, a country is free to leave in place other features

that might have been considered harmful under the criterion of substantive economic activity. This means that many of the tax planning activities of multinational corporations have been removed from the project's scope (Webb 2004, 810–12).

The Global Forum engaged in developing criteria on transparency that could be used to evaluate countries' domestic legal systems. Governments should have the authority to access information on the ownership of companies, trusts and other business entities and the personal identity of account holders in their jurisdictions (OECD 2006c, paras 22–8). It also developed criteria on effective information exchange. In the course of this, the Global Forum developed a Model Agreement on Information Exchange (OECD 2002a) that is to serve as a template for bilateral tax information exchange agreements (TIEA) in those cases where governments do not wish to enter into full-scale double tax treaties. The agreements prevail over national bank secrecy provisions and information exchange is not restricted to a 'tax interest requirement', under which a state would only share information with another state if some of its own tax revenue was at stake (OECD 2002a, para. 43; OECD 2004c, para. 24). The Model Agreement contains a multilateral and a bilateral version. However, the multilateral version is not multilateral in the usual sense but an 'integrated bundle of bilateral treaties'. A party has to specify the partner(s) to which it is to be bound out of all those that accessed a potential multilateral convention. The work on the model agreement has also led to a revision of the relevant article in the OECD MC, which was vamped up accordingly (OECD 2004a).[21] However, information exchange is only on request and not automatic. This may restrict its effectiveness substantially, because information can only be requested in those cases where there is a suspicion of tax evasion (Sullivan 2007, 332–4).

The Forum reviewed countries' legal and administrative frameworks in order to assess progress achieved and determine areas for future activity. A report published in May 2006 compiled and presented detailed information on 82 countries (OECD 2006c). It was found that most countries reviewed, including offshore centres, have the authority to access banking and company ownership information at least for criminal matters. However, only 50 countries can exchange such information for civil tax matters (OECD 2006c, paras 164–5). Some TIEAs have already been concluded. For example, since 2000 the USA has signed TIEAs with Antigua and Barbuda, Aruba, the Bahamas, the British Virgin Islands, the Cayman Islands, Jersey, Guernsey, the Isle of Man and the Netherlands Antilles. Worldwide, 40 negotiations on such agreements are currently under way (Owens 2006, 873). This is of course insufficient to solve the problem of tax evasion and avoidance (Sullivan 2007, 332). However, it is also true that compared to the situation some years ago, when none of the offshore financial centres would exchange information and many OECD countries would only do so if there was a domestic tax interest, some progress has been achieved (Owens 2006, 877–8).

While the harmful tax practices project had been curtailed to deal only with information exchange and transparency in relation to tax haven jurisdictions, the substantive criterion that applied to PTRs in OECD countries – 'ring fencing' – was held up. In 2004, 45 of the 47 identified PTRs had been modified so that they were not considered harmful any more.[22] However, it is questionable whether countries have really abolished their PTRs, or have instead only rearranged them slightly in order to get OECD approval (Webb 2004, 815–16). The remaining two PTRs caused problems (OECD 2004c, para. 15). For one, Switzerland is unwilling to give up its '50/50 Holding Company Regime', even though it is prepared to introduce exchange of information with respect to this regime. The regime was subsequently removed from the blacklist. Second, Luxembourg has proposed modifications to its '1929 holdings', but is unwilling to implement information exchange with respect to this regime. Since the country is not willing to meet requirements, it should face defensive measures. But apparently the OECD is not willing to propose the implementation of such measures against its own members. Officially, the Luxembourg regime needs to be further investigated before its status can finally be determined (Easson 2004, 1074).[23] Thus, ultimately no defensive measures – neither against tax havens nor against OECD members – have been implemented.

An evaluation of the OECD project

Overall, the actual improvements achieved by the OECD project are very limited. Most importantly, since the criterion of substantive economic activity has been removed, tax havens remain free to offer schemes that are tailored to the needs of tax avoiders. While the fact that the respective jurisdictions increasingly have to exchange information with other countries may deter individual tax evaders and illicit activities by corporations, this strategy is far less promising with respect to 'regular' corporate tax planning activities. A multinational's tax optimization is not reliant on confidentiality in the haven country. On the contrary, they would probably rather demand transparency themselves in order to pre-empt potential suspicion that they were involved in any illegal transactions. Thus, an important goal that had initially been targeted was not reached and is not pursued any more.

The significance of the OECD project, I argue, lies not in the material progress achieved, which is indeed limited, but in the fact that the project represents a break with institutional traditions on international taxation. While the project did not attempt to reform the institutions of double tax avoidance themselves, it challenged two important assumptions on which these institutions are based. First, the project initially focused not on the interface between national tax systems but on their internal features. It was the first attempt to intervene in countries' legislative tax sovereignty on a multilateral basis. Even if the goal of restricting tax havens' freedom to offer tax shelters has not been achieved, the very fact that their sovereignty in this respect

was originally questioned is a major departure from the previous principle that governments do not pass judgement on each other's tax practices. Second, the OECD tried to formalize the obligations of tax havens by having them sign MOUs. It provided a monitoring system on progress achieved and suggested the imposition of countermeasures for non-complying countries. Thus, the project attempted to introduce an element of coercion into international tax policy. The large and powerful OECD countries attempted to regulate the tax policies of non-member tax havens by forcing them into compliance. With this, the OECD project was an attempt to create 'hard law'. This represents a major departure from the usual role the OECD plays as a provider of 'soft law' (Radaelli and Kraemer 2005; Zagaris 2005, 339).

Interestingly, the dynamic of the project did not stop there. While the empirical record shows that OECD countries can make use of power differentials to exert influence over tax haven policies, it suggests that in order to do so effectively they also have to accept for their own policies the very same restrictions they request from others. While tax havens were willing to cooperate with the OECD, they were also successful in getting the concession that they will not face any defensive measures until OECD members have removed their own PTRs or are at least willing to punish their members if they uphold them. Apparently, the reason the tax haven strategy worked is that it appealed to the legitimacy of the OECD's actions. Thus, in order to uphold demands on tax havens, OECD countries themselves have to be clean (Webb 2004, 806–10; Sharman 2006, 127–48). Since – in the long run – it should be in the interest of large and powerful states to impose restrictions on the tax sovereignty of low-tax countries, there is, if this line of argumentation is valid, reason to believe that the future will see a significant narrowing of the scope of national tax sovereignty everywhere. In this interpretation, the OECD project should turn out to be just the first of a series of attempts to impose international restrictions on national tax sovereignty.

Whether this is a correct prediction or not remains to be seen. For the time being, as has been shown, the attempt to intervene in countries' tax systems and force them to abolish certain tax practices has failed. Since there was too much resistance to putting the internal features of national tax systems under scrutiny, the project mutated into an effort to implement more effective exchange of information. Information exchange is an indirect tool in the fight against double non-taxation. Instead of prohibiting harmful tax regimes themselves, it merely helps the residence countries of investors to use their unilateral anti-avoidance measures more effectively. The efforts aimed at promoting information exchange are in line with the traditions of the tax regime. Thus, while the important point about the OECD project is that it did initially pose a challenge to the traditional institutional setup of international tax governance, it ultimately did not follow through on this. In its current form, the project does not pose a fundamental challenge to the established institutional setup. Instead, the increased multilateral administrative tax

cooperation resulting from the project can more appropriately be understood as a *support structure* for the existing institutions of double tax avoidance.

Related efforts to increase tax enforcement

Similar attempts to improve tax enforcement via information exchange and administrative assistance have taken place outside the OECD project. Some of these are briefly summarized here.

As has already been mentioned, Article 26 of the OECD MC was modified in the course of drafting the model agreement on information exchange. In addition to that, the OECD inserted a new Article 27 on 'assistance in the collection of taxes' to the MC in 2003. If one of the contracting states cannot recover a legitimate tax claim without help from the other state, it can request the other state to assist (OECD 2005b, commentary on Art. 27, para. 1). Prior to that, states had concluded separate agreements on administrative assistance if they wished to do so. The increased importance assigned to matters of international cooperation in tax enforcement is also evidenced by the fact that the membership of the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters has grown. In 2006, Italy became its twelfth member, joining Azerbaijan, Belgium, Denmark, Finland, France, Iceland, the Netherlands, Norway, Poland, Sweden and the USA (OECD 2006a). Arguably, though, this membership is still too small to make this a truly effective instrument (Davies 2004, 788).

In 2004, the USA, the UK, Australia and Canada created the Joint International Tax Shelter Information Center (JITSIC), an international task force to combat abusive tax-avoidance mechanisms. All four countries have become more restrictive in their international tax enforcement in recent years, trying to target the evasion of portfolio income taxes and aggressive tax planning schemes (Houlder 2006). With JITSIC, staffed jointly by the four countries, they try to pool their efforts and share the respective information. It monitors the tax industry and offshore developments in order to identify new tax planning schemes and abusive tax shelter mechanisms (Zagaris 2004, 764).

The Harmful Tax Practices project led to further efforts to promote stricter unilateral anti-avoidance legislation. The 1998 OECD report had asked the CFA to consider revising the MC and the commentary to incorporate better advice on provisions that countries could include in their bilateral tax treaties in order to restrict the abuse of tax treaties (OECD 1998a, paras 121–5). Accordingly, the respective sections of the commentary were ramped up (OECD 2002c).

All these activities are a sign that governments are willing to enforce their tax claims more determinedly. In doing so, they rely on their own administrative capabilities but are also increasingly willing to engage in administrative cooperation with other countries. These developments are a sign that the issue of tax evasion and avoidance is now awarded a higher priority than was

previously the case. Nevertheless, so far, the progress achieved is insufficient to solve the problem of under-taxation.

Dealing with complexity: the need for permanent incremental reform

Parallel to these developments, governments further pursued the incremental reform of international tax institutions. Interestingly, these reforms often became necessary because of deficiencies of prior incremental reforms.

Unilateral anti-avoidance revisited: the 'proliferation spiral'

In the 1990s and 2000s, governments continued to struggle with their unilateral anti-avoidance legislation. The development of CFC rules in the USA may again serve as an illustration. The US CFC rules were subject to almost permanent rewriting in response to ever more sophisticated techniques for getting around them. While, as mentioned above, the general trend during the 1970s and 1980s had been to make the rules more restrictive, the situation changed somewhat in the mid-1990s. One important battle concerns the use of 'hybrid entity structures'. Among other tax minimization that can be achieved with their help, they enable taxpayers to circumvent Subpart F regulations (US Treasury 2000, 68–70). In order to prevent this abuse of hybrid entity structures, the Internal Revenue Service (IRS) issued temporary 'antihybrid regulations' in 1998. In response to this, the business community lobbied Congress to terminate the regulations (Baker 1998). In order to prevent congressional action, the IRS decided to revise the proposed rules (Engel 2001, 1555–7). Additionally, further exceptions to the anti-deferral regime were introduced for financial services income in 1997 and 1998 (US Treasury 2000, 71–5). Critics argue that, as a result of this, 'highly complicated' rules have evolved that 'make deferral elective for the well-advised US taxpayer and create traps for the unwary' (Peroni *et al.* 1999, 508).

Another way to sidestep the anti-deferral rules is by undergoing a *corporate inversion*. The domestic company establishes a subsidiary – which may be little more than a mailbox – in a tax haven and subsequently inverts corporate ownership by turning the subsidiary into the parent company. A corporate inversion is simply a paper transaction – the real business activities and corporate functions do not relocate – that brings tax advantages to the corporation.[24] The parent company can supply intercompany (tax-deductible) debt to subsidiaries in high-tax countries, among them the former parent company, so that these are stripped of income (Thompson 2002, 1516). The most widely cited reason given by corporations for their decision to undergo a corporate inversion is that this allows them to circumvent CFC rules. Since the US rules of course do not apply to the parent company located in the tax haven, a corporate inversion is often simpler than other

techniques used to sidestep the CFC regime, such as hybrid entity structures (Desai and Hines 2002, 421).

Since the late 1990s, a number of well known American corporations, among them Ingersoll-Rand, Stanley Works, Fruit of the Loom, Tyco and Cooper Industries (see the list in Desai and Hines 2002, 418–20), have undergone or planned to undergo corporate inversions. A series of newspaper articles (see, for example, Johnston 2002; Surowiecki 2002) brought the issue into the broader political debate. Subsequently, Congress enacted new anti-avoidance legislation against such corporate inversion schemes as part of the Jobs and Growth Tax Reconciliation Act of 2003. The rules have the effect of including most of the income of inverted corporations in the domestic US tax base.[25] Some commentators believe that the legislation may have to be amended in the near future because it still leaves loopholes for companies wishing to expatriate for tax purposes (Thompson 2002, 1518–19).[26]

The conclusion to be drawn from this development is that the effectiveness of unilateral anti-avoidance rules is necessarily limited, because they can only target certain circumscribed avoidance schemes. Almost by necessity, the rules leave loopholes that can be exploited by taxpayers. CFC and similar anti-avoidance regulations therefore have to be patched up almost continuously, leading to an increasingly complex tax system. The dynamic is that of a 'proliferation spiral' between taxpayers and authorities, with authorities only being able to react to taxpayers' moves.

In addition, the ever-increasing effort and sophistication put into unilateral anti-avoidance measures strains the established institutional setup of double tax avoidance. This became apparent when the CFA, on the initiative of the USA, investigated the issue of hybrid entities (OECD 1999a). The discussions led to modifications of the OECD MC and commentary that were pushed in particular by the US. Provisions were introduced that preclude the accessing of treaty benefits by partnerships that were only created for tax reasons. However, France, Germany, the Netherlands, Portugal and Switzerland entered reservations and observations arguing that the modifications were not inherently consistent and did not adequately consider the various potentially legitimate uses of partnerships as foreseen in their domestic laws (OECD 1999a, Annex II). The issue is still controversial and many countries are not willing to enter into bilateral treaties with such provisions (Sheppard 2006).

In my interpretation, the fundamental problem behind such conflicts is the inherent incompatibility of unilateral anti-avoidance rules with a sovereignty-preserving approach to international taxation. Unilateral anti-avoidance measures necessarily interfere with other countries' de jure tax sovereignty. Since tax systems are determined on a purely national basis and this is the generally accepted standard, there is, strictly speaking, no basis on which one could consider international tax arbitrage to be objectionable (Rosenbloom 2000). However, as long as this interference only concerns aspects of the other countries' tax laws that are illegitimate according to an

implicit consensus – for example, the tax laws of tax havens – the inherent stress between the sovereignty-preserving international rules and unilateral anti-avoidance is not openly addressed. But with the ever-increasing sophistication of tax arbitrage behaviour, this implicit consensus may be challenged in the future.

Transfer pricing revisited: advance pricing agreements

The problems surrounding transfer pricing continued into the late 1990s. As opposed to the politically more charged developments of the early and mid-1990s, more recent developments took place on an administrative level. As taxpayers become more proficient at exploiting the leeway created by existing transfer pricing rules,[27] countries intensify their efforts at tax enforcement. More and more countries are introducing their own transfer pricing guidelines and very strict documentation requirements for the taxpayer. While in 1997 only six countries had documentation requirements, 32 had such provisions in 2005, with other countries expected to adopt them very soon (Ernst & Young 2005, 5–7). According to an Ernst & Young poll of 476 companies in 22 countries, nearly two-thirds of companies have been challenged over the tax treatment of internal transactions since 2001. At the same time, the difficulties in determining transfer prices correctly increased further due to the importance of intrafirm trade in intangibles and other hard-to-price items (see, for example, Célestin 2000, 90). Thus, it is not surprising that more than 40 per cent of the audits resulted in adjustments by tax authorities (Ernst & Young 2005, 8).

All this led to an increase in transfer pricing disputes between tax administrations and taxpayers. The IRS reported that in 1993/4 it spent more than one-third of its international tax examiner time on transfer pricing cases that were on appeal and litigated (Graetz 2003, 426). But not only tax administrations suffered under the difficulties of transfer pricing. Taxpayers, too, began to complain about the uncertainty involved in transfer pricing. Many feared the possibility of ex post tax increases and very long disputes in court (Vögele and Brem 2003, 367–8). Thus, there is discontent on all sides (Vincent 2005, 410).

But transfer pricing disputes occur not only between taxpayers and authorities in court: the uncertainty and contestation involved in transfer pricing also pits tax authorities against each other, since setting transfer prices also has revenue implications for the jurisdictions involved. 'Transfer pricing issues are probably the single most important source of conflicting claims to tax' (McLure 2001, 337). In particular, if countries' transfer pricing guidelines are not entirely compatible, there may be conflict over tax revenues between the jurisdictions that have to be settled via the MAP (OECD 2005b, commentary on Art. 25, para. 8). The increasing importance of transfer pricing thus also affected the established MAP under tax treaties. The workload that had to be handled within the MAP dramatically increased (Aoyama 2004, 654).

This, in turn, led to further taxpayer concerns that competent authorities are using the MAP for 'horse trading' that is based less on an exact evaluation of each single case than on a desire to come to an agreement that suits their revenue interests. The fact that the MAP procedure does not require authorities to reach agreement was a further source of discontent (Aoyama 2004, 658).

These concerns led to an administrative innovation, the introduction of so-called advance pricing agreements (APA). They were first introduced in Japan in 1987 (Aoyama 2004, 657) and in the USA in 1991. In contrast to the so-called 'adversarial process', in which taxpayers file a return and then face ex post assessment and possible adjustment, an APA is a cooperative mechanism. The multinational taxpayer and the taxing state(s) negotiate an APA, in which they agree ex ante – that is, before any transactions take place – on a detailed method of how the taxpayer will determine transfer prices (Vögele and Brem 2003, 363–5). This includes a detailed assessment of all the facts and circumstances of the case, such as the market conditions in the particular industry, the MNE's competitors and prior tax circumstances. The APA is binding on the taxpayer and the tax authority and is generally valid for several years (for example, three years in the USA). Thus, the APA is a 'model of advance dispute resolution for transfer pricing' (Ring 2000, 147).[28]

The advantage of an APA for the taxpayer is the certainty of tax assessment gained through the APA. On the downside, it has to reveal more information to authorities than under the usual methods. The advantage for tax administrations lies in avoiding burdensome ex post assessments and possible litigation. Furthermore, it obtains more information about MNEs' pricing practices and typical problems than it would have gained under the traditional method (Ring 2000, 148). On the cost-side for the administration is the fact that it gives up its position as the hierarchically superior regulator. Instead it becomes the bargaining partner of the taxpayer for a deal that results in non-standardized transfer pricing assessment (Vögele and Brem 2003).

In the meantime, many countries have begun to implement APA programmes. After Japan and the USA, other early adopters were Canada, the Netherlands, the UK and France. China, Germany, Korea and Mexico, among others, have followed (Brem 2005, 8). The number of APAs conducted worldwide is constantly growing. In its survey of over 400 multinationals, Ernst & Young found that 23 per cent of parent companies used an APA in 2005, as compared to 14 per cent in 2003. Companies have demanded APAs primarily in the USA (38 per cent of APAs), Australia, the UK (19 per cent each) and Canada (16 per cent). This means that APAs are far from universally used, but they are attractive for some MNEs to manage the uncertainties involved in transfer pricing (Ernst & Young 2005, 9).

The CFA promotes the use of APAs. It sees them as a mechanism that is 'intended to supplement, rather than replace, the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues'

(OECD 2001b, AN-22, para. 10). It also engaged in efforts to keep the APA programmes of different countries consistent with each other (OECD 2001b, 4.161).[29]

APAs are of particular importance because 'many competent authority settlements and advance pricing agreements (APAs) are based on profit splits, even though these were relegated to methods of last resort in the 1995 OECD transfer pricing guidelines' (Couzin 2005, 407). Some have argued that APAs are only a secret method of applying formulary apportionment on a business-by-business basis (US Senator Dorgan, cited in Célestin 2000, 130). The emergence of APAs is a further element of the picture that was already visible in the mid-1990s: the insistence on pure arm's length gets increasingly weaker, but the formal adherence to it remains. Tax authorities have established, at least in some cases, a system that their governments have officially and repeatedly shunned (Bird and Wilkie 2000, 92). While formally the ALS is still adhered to, it has been factually supplanted by formulary apportionment methods for a significant variety of cases (Couzin 2005, 407–8).[30]

However, while the transfer pricing methods used under the APA bring the system closer to formulary apportionment, there is still a difference from full formula apportionment, because APAs are bilateral or at best a series of bilateral agreements. Administrations do not apply the same formula for all agreements, but heavily rely on case-by-case evaluations. Each APA is an individual solution to the transfer pricing problem. Thus, the APA mechanism 'saves' the traditional concept of transactional, separate entity accounting. While it implies a somewhat more integrated tax treatment of different entities in single cases, it is not based on a general definition of a common tax base. APAs are a pragmatic answer to the problems of transfer pricing within the existing framework of international tax rules.

The comeback of the United Nations and some indications of politicization

With the OECD project against harmful tax practices, international tax policy has received more public attention and become more politicized in recent years. In this section, I briefly summarize some developments showing that international tax policy may indeed become more political in the future.

The United Nations revived its Ad Hoc Group of Experts. They reconvened in 1997 and began work on revising and updating the UN MC, which was published in 2001 (United Nations 2001a). The group intends to update the model more frequently from now on. As before, the UN MC suits the interests of developing countries. It extends the taxing rights of capital-importing source states (see, for example, Kosters 2004). In recent years, developing countries and transition economies have also voiced their interests within the OECD CFA more determinedly (see, for example, OECD 2005b, Non-member country positions on Art. 5, paras 7–14.4). These developments show that the distributive conflict between residence and source interests persists.

Furthermore, the UN has made far-reaching tax proposals as part of its Financing for Development initiative and suggested the creation of an International Tax Organization (ITO) (United Nations 2001b; 2002). The tasks of the ITO would be to monitor international tax developments, provide information and assistance to countries in matters of tax cooperation, install a multilateral mechanism on information exchange between countries and engage in efforts to curb harmful tax competition. In addition, the organization should seek 'international agreement on a formula for the unitary taxation of multinationals' (United Nations 2001b, 15). In brief, the tasks of such an institution would be basically identical to those of the OECD – apart from the support for formula apportionment. However, it would have the benefit of a more inclusive membership and thus grant developing countries real representation and influence (Horner 2001, 180–1). The proposal reflects a growing dissatisfaction with the importance of the OECD in tax matters. Due to its exclusive membership, the OECD lacks the legitimacy to implement far-reaching tax policy proposals (Horner 2001; Avi-Yonah 2004, 385–7; Zagaris 2005, 339).

While so far no action has been undertaken to put the proposal into practice, the UN continues to assert its ambition to become more influential in tax matters and further pursue the idea of an International Tax Organization (United Nations 2003a). In 2004, the Ad Hoc Group of Experts was renamed the Committee of Experts on International Cooperation in Tax Matters and put on a more permanent basis. It is supposed to work on the same issues as the OECD's CFA. Its main functions continue to be to try to influence international tax developments, with a particular focus on the interests of developing countries, and to provide a certain corrective to the activities of the 'rich countries' club', the OECD (United Nations 2005, 3). However, due to its limited resources, most observers agree that the UN Committee will not be able to challenge the leading role of the CFA (Zagaris 2005, 338).

Nevertheless, the OECD has apparently realized that there is a demand for its work to become more inclusive and transparent. Since 2002, it has sponsored the International Tax Dialogue, a joint initiative together with the World Bank, the IMF and the UN to facilitate debate on international tax issues among these institutions, tax experts and other interested parties. The idea is to collect and disseminate information on international tax issues by making available public documents and other data on international tax issues and listing the dates of upcoming meetings and conferences in one central location (see http://www.itdweb.org).

Recent years have also seen the emergence of NGOs on the scene. International tax issues are of course one of the main fields of activity of Attac, which was founded in 1998 and originally campaigned only for the introduction of a 'Tobin tax' on international financial transactions. Growing out of the international Attac movement, the Tax Justice Network (TJN) was established at the end of 2002. It involves activists and academics and campaigns

'for international tax co-operation and against tax evasion and tax competition' (TJN 2005). In the short time of its existence, it has already been quite successful in getting coverage on the business pages of major newspapers (see, for example, Houlder 2004). Further, charities such as War on Want and Oxfam have in recent years campaigned on international tax issues, focusing in particular on the adverse effects of tax competition and tax avoidance on developing countries (Oxfam 2000). According to the OECD's Jeffrey Owens, the emergence of NGOs campaigning on international taxation may be a sign of a higher priority for the issue in the future: 'Tax is where the environment was ten years ago' (cited in Houlder 2004).

While public interest in issues of international taxation is still rather limited compared with other policy areas, all this indicates that issues of international taxation – for a long time the domain of technical experts and bureaucrats – are increasingly coming under public scrutiny.

Summarizing the empirical record of international tax governance

The history of the global tax regime can be summed up as follows: At first, governments were concerned with liberalizing international trade and investment. The only international tax problem that was addressed was that of jurisdictional overlap leading to *double taxation*; the issue of *double non-taxation* was deliberately put aside and considered to be secondary. In order to resolve the problem of jurisdictional overlap, countries had to overcome a distributive conflict between residence and source taxation. None of the scholars who have discussed the issue of a desirable allocation of taxing rights have come out in favour of only the one or the other; instead, they have advocated various methods of sharing the tax base in the name of different theories of equity and neutrality. In the political debates of the 1920s and 1930s that were facilitated by the League of Nations, these theories were mingled with material conflicts of interest between capital importers and exporters. The latter favoured the residence principle and the former the source principle, since the respective solution would give each a bigger share of the international tax base. This distributive conflict between residence and source interests lies at the heart of double tax avoidance and is evidenced continuously throughout the entire history of international taxation. Although no general consensus on a single best principle could be achieved, a compromise solution emerged very early on, became firmly institutionalized after the Second World War and basically remains in place today.

The compromise solution is implemented in the form of *bilateralism on the basis of multilateralism*. Cooperation to avoid double taxation is built around the OECD as a multilateral forum of discussion that creates soft law. The OECD publishes and continuously updates a non-binding model convention that governments can use as a template for negotiating binding bilateral

double tax treaties. Thus, the basic text of the model can be adapted to the circumstances of each pair of countries. This setup ensures that bilateral tax treaties are similar in structure but at the same time allows countries sufficient flexibility to accommodate the differences of their tax systems and distributive interests. In turn, the experiences of bilateral tax treaty bargains are fed back into multilateral deliberations on further development of the model convention. In this way, the model and the activities of the OECD serve to facilitate the conclusion of bilateral treaties and also to disseminate the experiences and information created at the decentralized level to all countries. Measured by the continuing growth of the tax treaty network, this approach has been successful.

The entire conception of double tax avoidance is of a nature that does not interfere with national tax law definitions. The rules are sovereignty-preserving in so far as they accept different national tax systems as givens. The avoidance of double taxation is achieved by 'simply' disentangling overlapping tax jurisdictions. Tax treaties operate at the *interfaces* of national tax systems. The tax treaty regime does not aim at a harmonization of different tax systems, only at their *coordination*. This institutional setup could successfully handle the problem of double tax avoidance. However, it reinforced the problem of tax evasion and avoidance. Since governments retain their legislative tax sovereignty, they are also free to poach the tax base of other countries by offering favourable treatment to other countries' citizens. Thus, the institutional setup chosen to tackle the problem of double taxation becomes inadequate. Over time, due to capital account liberalization, financial sophistication and aggressive regulatory competition from tax haven governments, the salience of the problem of *double non-taxation* has increased significantly.

Beginning in the 1960s, this triggered reactions by states that led to changes in international tax governance. Until the mid-1990s the approach was indirect and incremental. Governments were unwilling to curb double non-taxation on the international level. They considered it to be mostly a national affair and passed unilateral anti-avoidance legislation. Nevertheless, the unilateral policies have international ramifications that lead to interpretive adaptations ('creative interpretation') of the rules of international taxation. In other words, the actors engage in efforts at *rule stretching*. The original meaning of the rules of international taxation has changed, but great care is taken to interpret defensive measures as being in line with the original setup – in particular the sovereignty-preserving character of international tax cooperation. Thus, while in fact international tax institutions change, this change is hidden by subsuming it under the established concepts of international taxation. Due to the 'invisibility' of the reforms, the two apparently contradictory processes of the maturation of the institutions of double tax avoidance and institutional change in response to the problem of under-taxation can take place simultaneously. The OECD even supports

these efforts at incremental reform by promoting and coordinating unilateral anti-avoidance measures and trying to supplant the bilateral tax treaty network with multilateral information exchange. In doing so, it relies on the same approach of soft law governance that is employed in the diffusion of policies of double tax avoidance. As has become apparent on several occasions, US hegemony was a decisive factor in crafting the OECD consensus (Bird and Mintz 2003, 426).

The second reaction of countries, which began in the mid-1990s, is more direct. With its project on harmful tax competition, for the first time in the history of international tax cooperation the OECD has attempted to create hard law. It defines criteria for harmful features and demands that countries remove them. Rather than relying on the regulation of interfaces between tax systems, it criticizes their internal features. However, most of the OECD's demands have not been upheld and the project has mutated into an effort to implement more effective exchange of information that is very much in line with the soft law traditions of the tax regime. The new rules do not replace the old institutional setup, but *supplement* them. They form a support structure for the tax treaty regime.

While all these efforts at reforming the tax regime are welcome from a pragmatic perspective of shoring up the existing system against overly aggressive tax avoidance, they also reveal the fundamental weakness of the underlying principles and concepts of international taxation. It becomes increasingly apparent that the efforts at curbing double non-taxation are incompatible with the traditional institutional setup. There is an inherent tension between the sovereignty-preserving character of the established institutions and the aim of curbing double non-taxation, which would require more hierarchical modes of governance to be adequately solved. In consequence, the political contestation in international tax policy has been increasing over time. Nevertheless, the institutions of tax governance, while undergoing almost permanent incremental reform, have proven remarkably resilient to change.

Part III

Explaining Institutional Choice and Development

7
Institutional Choice in the Avoidance of Double Taxation

In this chapter, I construct an explanation for the institutional form of double tax avoidance by reconsidering and refining the baseline model of Chapter 3. First, I summarize the basic features of the institutional setup as the empirical account has revealed them in the language of rational choice institutionalism. Then I argue that the baseline model fits the empirical record quite well and develop an in-depth theoretical account of the regime's design features on the basis of this model. Finally, the model's validity is explored by briefly contrasting it to an alternative explanation. While this chapter focuses on institutional *choice*, Chapter 8 turns to an explanation of the institutional *development* over time.

The stylized facts of the politics of double tax avoidance

International double tax avoidance takes place on three interrelated levels: unilateral, bilateral and multilateral. For one, all countries relieve double taxation in their national tax laws; that is, on the unilateral level. In effect, they entirely or partially give up their right to tax foreign source income in order to prevent interference with other tax systems. Second, in bilateral negotiations countries conclude double tax treaties, which mainly deal with the cooperative avoidance of double taxation and the division of taxing rights. Third, international tax policy takes place on the multilateral level. Technical experts, national tax administrators and scientific advisors cooperate in international organizations to develop model conventions, disseminate information on treaty practices, monitor the treaty network and standardize bilateral treaties. The resultant model conventions are legally non-binding, but are quite influential in practice. All existing double tax treaties are based on the MC.

In terms of the three stages of cooperation, this pattern can be described as follows. In double tax avoidance, *bargaining* takes place on the bilateral and multilateral levels. On the multilateral level, governments bargain about the non-binding MC. On the bilateral level, they bargain about binding double

Table 7.1 Empirical observations on the three stages of cooperation

Stage of cooperation	**Empirical observation**
Bargaining	1 *Bilateral* on (binding) tax treaties 2 *Multilateral* on (non-binding) model convention
(Binding) agreement	*Bilateral* on DTAs
Enforcement	1 No external enforcement, only *bilateral* MAP 2 Taxpayers have recourse to domestic courts

tax treaties and agree on the actual concessions they grant each other. In contrast, multilateral bargaining does not consist of making binding concessions. Nevertheless, multilateral bargaining has an influence on bilateral bargaining, as the MC is the starting point of bilateral bargains. Moreover, the commentary to the MC is sometimes changed in response to problems that were encountered in bilateral negotiations. Multilateral bargaining is *complementary* to bilateral bargaining. *Agreement* is bilateral in double tax avoidance. Only the bilateral treaties contain provisions that are binding on the states. The final stage of the cooperation process is *enforcement*. With respect to this, we can note that there is no external enforcement mechanism in double tax avoidance. Instead, disputes about the application of agreements are resolved through the bilateral MAP, which is more of a diplomatic than a judicial mechanism. Further, when a taxpayer claims to have been double taxed in violation of a convention, she may bring her case before a domestic court. Table 7.1 sums up these features.

Testing and refining the model

How can we make sense of this institutional arrangement? In order to answer this question, I first assess the baseline model against the empirical record of tax cooperation. The model is not only tested but also refined. On the basis of this more salient model, I then first consider the institutional form of *bargaining*. After that the weak institutions of *enforcement* are considered, before I explain why binding *agreement* was chosen to be bilateral.

Governments' preferences

According to the baseline model, the problem of avoiding over-taxation can be framed as a coordination game. More specifically, the residence country's decision to grant unilateral tax relief can be represented by an *assurance game*. In this game, strategic governments should be willing to use one of the methods of double tax relief, regardless of what other countries do. The model suggests that they should be willing to provide at least partial tax relief

(deduction), and according to newer theoretical contributions even full relief (credit or exemption). As has been detailed in the previous chapters, all countries do provide at least partial unilateral tax relief. Further, most countries go beyond a deduction and credit or exempt foreign source income; that is, they grant full double tax relief in their domestic law.

The fact that the deduction method is still in place in a few countries suggests that these adhere to the 'conventional wisdom' that partial double tax relief is in a nation's interest. However, over time, most countries have become more generous in their unilateral relief. While in the early years of tax cooperation the deduction method was not uncommon, it has clearly lost terrain. Today, only a few countries still employ it.[1] There are several possible explanations for this. First, it could be an indicator of the correctness of the newer theoretical contributions.

Irrespective of whether this is the case or not, an additional explanation for the preference of full unilateral relief can be found when we focus on the domestic politics of double tax relief. While unilateral tax relief can lead to decreasing tax revenues, which may have negative consequences for public spending, this negative effect is on the whole population of a country. Following Olson (1965), such a big group faces a substantial problem of collective action and cannot exert effective political influence. In contrast, the business lobby is a small group that can manage to make their interests heard. As we have seen in Part II, the business lobby requests such a treatment of foreign investment income and strictly opposes any restrictions on generous double tax relief. There is no other well organized domestic interest group that would oppose granting full unilateral tax relief, in the form of credit or exemption, to foreign investment.[2] Thus, even apart from the fact that providing full double tax relief may be adequate for the maximization of national income, there is an additional domestic political argument that makes such a strategy attractive for a government (see also Bird and Mintz 2003, 439).

Note that for a scholar subscribing to the 'conventional wisdom', the integration of domestic politics concerns would necessarily entail a change of the government's preference function. Following the conventional wisdom, granting credit or exemption would not maximize national income. Instead, the government would pursue its own egoistic goal of re-election or the acquisition of political rents at the expense of national income. In the perspective of newer economic contributions, yielding to particularistic domestic interests would at the same time maximize national income. Under these assumptions the observation that most governments allow full double tax relief unilaterally would not allow us to discriminate between the two possible specifications of the preference function. I have not undertaken a detailed investigation of the domestic politics in many countries that would allow me to discriminate between the two specifications of preference functions. The important point, however, is that under three of four possible combinations, the national interest as pursued by the government should lie

Table 7.2 Governments' preferences and expected unilateral relief policies

	Conventional wisdom	Newer contributions
Maximize national income	Deduction	Full relief
Maximize political rents	Full relief	Full relief

in granting full relief. There are two possible assumptions on national interest and on economic theory. The resulting 2×2 matrix with the expected unilateral relief policies is depicted in Table 7.2.

I contend that, in addition to the concern for national income, the preference function *also* contains a concern for domestic political support. The (rather low) variance in unilateral relief policies may be taken as evidence that the various concerns play out differently in different countries, but that the great majority of countries consider full relief to be in their national interest. Since individually rational governments have incentives to unilaterally provide double tax relief, and actually do so in practice, the model of a coordination game fits the empirical evidence. One very important conclusion is that there is *no enforcement problem* involved in double tax avoidance.[3] Then, however, the question arises, as to why governments should go through the hassle of negotiating and concluding DTAs at all. What are they bargaining about?

Why conclude tax treaties at all?

The answer is that the residence country still has an incentive to conclude a treaty in order to limit the source country's right to tax. There are two related reasons for this. First, a limit on source taxes reduces the tax burden of 'its' investors abroad. Second, if the source tax were lowered, countries using the credit (or deduction) method to avoid double taxation could collect the residual taxes on the foreign income. In other words, while the residence country is willing to grant unilateral tax relief no matter how much tax the source country collects, it would be even better off if at the same time source taxation was limited. In such a situation the level of foreign investment flows would be the same, but it could have a larger share of the tax revenue and its resident investors would face a better tax treatment abroad. Thus, under the unilateral relief interaction, the residence country only achieves its second-best outcome. It could improve upon this outcome if taxation at the source was limited. This is the major function of tax treaties (Dagan 2000, 982–3; Davies 2004, 779).

This still raises the question of why the source country should be willing to enter into a treaty that limits its right to tax, given that the residence country has given up its right to tax unilaterally and thus double taxation is already avoided. The answer to this question is that countries are generally residence and source countries at the same time. Residents of one state invest

in the other state and vice versa. Consequently, investment and the resulting income flow in both directions. Thus, as long as the condition of investment flowing in both directions holds, the interest in limiting other countries' taxation at source should hold irrespective of having given up residence taxation unilaterally.

The decisive point about this consideration is that governments, while they are able and willing to unilaterally forgo residence taxation, can only achieve a limit on source taxation in other countries if they cooperate with them. Due to the structural advantage of the source country through the right at 'first crack', a limit on source taxation needs a binding cooperative agreement. In other words, both countries hold a bargaining chip in that they can make concessions on the extent of source taxation. Tax treaties are a cooperative mechanism for the reciprocal lowering of source taxation.

In addition, there are further benefits in two aspects that are inherent in treaty formation. For one, tax treaties lower the administrative costs of taxation; for example, through information exchange. Another advantage is the increased legal certainty that is required by international investors. Rather than having to rely on potentially conflicting national rules, the taxation of international income falls under the rules of an international agreement. The conclusion of tax treaties has a signalling function to international investors that goes beyond that of favourable unilateral policies (Dagan 2002, 67). Again, by their very nature, these benefits can only be captured through cooperation with other states.[4]

So far, it has been established that countries are willing to provide tax relief unilaterally, but that they may additionally have a mutual interest in concluding tax treaties. This line of reasoning does not, however, make a case for a particular institutional form of double tax avoidance, it merely makes the case for *any* cooperative agreement. In order to explain the particular institutional form, the strategic structure has to be analysed in more detail.

Bilateral bargaining accommodates distributive concerns: the model

There is a distributive conflict built into double tax avoidance, which stems from the fact that investment flows between countries are often not symmetric. While countries are generally residence and source countries at the same time, they are so to different degrees. A country that is a net capital importer favours more extended source taxation; it has 'source interests'. A net capital exporter is in favour of residence taxation; it has 'residence interests' (Kingson 1981, 1158; Rigby 1991, 409–10). Governments often disagree about the extent of limitations on source taxation depending on whether they have residence or source interests. In a nutshell, this is the distributive conflict: who gets how much of the tax revenue and what is the tax burden for 'my' resident investors abroad? Overall, the structure of the double tax avoidance game is that of a battle of the sexes: adopting unilateral relief is always preferred to not relieving double taxation, but the distributive consequences of

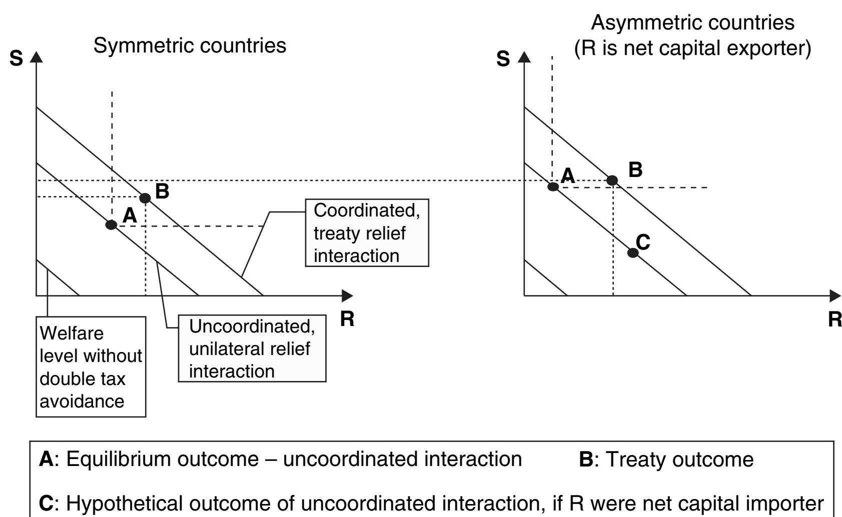

Figure 7.1 Tax treaty bargaining between symmetric and asymmetric countries

that strategy are more or less favourable to the country depending on whether they are net capital exporters or importers.

Now, being a net exporter or net importer is a relational attribute that can vary with respect to different countries. Country A could have source interests in relation to country B, if it is a net capital importer from B. At the same time, it might have residence interests in relation to country C, exporting capital to C. In relation to country D, there might not be any distributive conflict, if A and D are symmetric in capital flows. Hence, the nature and intensity of the distributive conflict depend on *dyadic* characteristics. Therefore, as I argue in the following, bilateral bargaining can accommodate countries' conflicting distributive interests. I first describe the mechanics of this bargaining game and then provide empirical evidence for my claim.

Figure 7.1 depicts the bargaining situation for the case of symmetric and asymmetric capital flows between potential treaty partners. The payoffs of country R are shown on the *x*-axis, those of country S on the *y*-axis. The diagrams show three different welfare levels and Pareto improvements. By moving from no tax relief to a situation of unilateral tax relief and then to coordinated relief under a treaty, both countries gain. In the case of symmetric capital flows, the unilateral relief interaction results in an equal distribution of the benefits. In the case of asymmetric capital flows the net capital importer gets a bigger share of the benefits. The difference in benefits stems from the difference in national income the countries receive from the foreign investment. The source country can exert some taxation at source without reducing the inflow of capital from the other country. Since double

tax relief is in place, source taxation, at least in the form of withholding taxes, does not drive away foreign investment and enables the source country to realize tax revenue at the expense of the residence country.[5] The residence country has an incentive to lower the withholding taxes at source because the withholding taxes directly diminish its national income in the form of either private income (in exemption countries) or tax revenue (in credit countries).

The starting point of treaty negotiations (point A in both graphs) lies in the middle of the welfare line for the unilateral relief interaction of symmetric countries, whereas in the case of asymmetric countries, it is tilted towards the net capital importer. Accordingly, the bargaining space, which is the room for Pareto improving negotiation outcomes and is demarcated by the dotted lines, is different in both cases. The extent of source taxation in the case of symmetric countries should not be controversial. They both benefit equally from a reduction of source taxes. Thus, the expectation is that source taxes are lower in the case of symmetric countries. In contrast, there should be conflict over this question in the case of asymmetric countries, with net capital exporters pushing for low and net capital importers for high source taxes. Since the bargaining space is tilted towards the net importer's interests, the outcome of this bargain should be higher source taxes than in the case of symmetric countries.[6] This is indicated in the diagram by the fine dotted lines that facilitate comparison of the outcomes of treaty negotiations between symmetric and asymmetric countries (point B in both graphs). Note that, in the extreme, this bargaining model predicts that there may not be any bargaining space at all if capital flows are extremely asymmetric. A net capital importer may simply not be able to benefit from a treaty under such circumstances.

If the preferred treaty rate depends on the symmetry or asymmetry of capital flows, this could be an argument for bilateral treaties, since capital flows are defined bilaterally. The qualitative evidence presented in Chapters 5 and 6 supports such an explanation. One of the reasons governments refused to conclude a multilateral treaty was the distributive conflict over the allocation of the tax base between countries with residence and source interests. In addition, as shown in Table 4.2, the withholding rates negotiated in bilateral treaties are considerably lower than the withholding rates that are contained in the domestic tax codes. This is further evidence that the function of tax treaties is to 'correct' the withholding rate that would result under the unilateral relief interaction. Governments are willing to provide unilateral tax relief, but often disagree about the distribution of the benefits inherent in double tax avoidance. The double tax avoidance game is a *coordination game with a distributive conflict*.

Quantitative evidence

In addition to the qualitative evidence some of the implications of the model can also be subjected to a quantitative test. The central provisions of the typical tax treaty concerning the extent of source taxation are the withholding

tax rates on passive investment income. An observable implication of the model is that these treaty rates should be higher the more asymmetric are the bilateral investment flows. In addition, the outcome of negotiations should also depend on the relative bargaining power of countries. A more powerful country should be able to press for its preferred treaty rate more successfully. To test these propositions, I set up a regression model and ran it for a set of 80 country pairs that have concluded DTAs (see Table A.2 in the Appendix).

The *negotiated withholding tax rate*, as the dependent variable, is taken from a set of 80 DTAs. A treaty contains four kinds of withholding taxes: on dividends, dividends between associated enterprises, interest and royalties (Articles 10 to 12 of the OECD MC); thus the number of observations on the dependent variable is 320. Since I am using all four kinds of treaty withholding rates simultaneously, the standard errors are adjusted for clustering. The coefficients can be interpreted as the relation between the respective independent variable and the average level of withholding taxes rather than a specific tax.

The dyadic *investment position*, i.e. the asymmetry of bilateral FDI stocks, is the first independent variable of interest. It is measured as the difference between the 'outward FDI stock', the stock that the first country holds in the second country, and the 'inward FDI stock', which is the stock of the second country in the first.[7] Since all country pairs have been arranged in such a way that the net capital exporter is in first position, this is always a positive number. The expectation is that the more unequal the investment position (that is, the higher the asymmetry of FDI stocks), the higher the negotiated rate. The coefficient should be positive.

As a proxy for *bargaining power*, the other independent variable, I use the concept and data of the Correlates of War (COW) project, which constructs its 'capability index' as a mix of military expenditure and personnel, energy consumption, iron and steel production, total and urban population (COW 2001).[8] I measure the bargaining power of the first country, i.e. the capital exporter, as the relative share of the sum of the bargaining power of both treaty partners. Since the capital exporter should favour lower over higher withholding rates, the variable should have a negative effect on the treaty rate. Since the outcome of negotiations should depend on the investment position and the bargaining power at the time of treaty conclusion, the data for all variables are those for the year in which the treaty was signed.

Additionally, I control for the wealth of treaty partners, measured as the *sum of per capita GDP*. It is conceivable that wealthier countries are less dependent on trying to tax the foreigner and thus the expectation is that the coefficient has a negative sign. In an analysis similar to mine, it has been found that this variable influenced the negotiated tax rate (Chisik and Davies 2004a, 1136).

Since the outcome of negotiations should depend on the investment position and the bargaining power at the time of treaty conclusion, the data

Table 7.3 Determinants of negotiated withholding taxes – linear regressions

	Model 1	**Model 2**
(Constant)	12.35***	18.41***
	(7.44)	(11.52)
Investment position (asymmetry in FDI stock)	0.0000553***	0.0000553***
	(3.63)	(3.62)
Bargaining power (share of capability index)	0.95	0.95
	(0.85)	(0.84)
Sum of per capita GDP	−0.000125***	−0.000125***
	(−3.59)	(−3.57)
Dividend tax dummy		N.A.
Associated dividend tax dummy		−8.325***
		(−17.05)
Interest tax dummy		−7.838***
		(−11.35)
Royalty tax dummy		−8.075***
		(−12.67)
Number of observations (*N*)	320	320
R^2	0.064	0.449

Note: Values in parentheses are *t*-values (robust standard errors).
***Significant at the 0.1 per cent level; **significant at the 1 per cent level; *significant at the 5 per cent level.

for all variables are those for the year in which the treaty was signed (see Appendix).[9] Column 2 of Table 7.3 shows the results of this first regression model.

Under this specification, the overall explanatory power of the model is low. Only 6.4 per cent of the variance of the dependent variable can be explained. A possible reason for the low R^2 could be that a particular withholding rate can best be explained by reference to the income on which it is levied. In order to test for this possibility, I include dummy variables for each kind of withholding rate. The dummy variable for, let us say, dividend taxes is 1 if the respective dependent variable is the dividend tax rate, and 0 if it is any of the other tax rates. Thus, the coefficients report the average tax rate for the respective type of income. The result of the second regression model is depicted in column 3 of Table 7.3. The inclusion of the control variables increases the overall explanatory power of the model. A total of 44.9 per cent of the overall variance can be explained.

The results confirm the idea that negotiated withholding rates vary systematically with respect to the *investment position*. The coefficient has the expected sign and is significant at the 0.1 per cent level. It suggests that an increase in the asymmetry of capital flows by one million dollars leads to an increase in the withholding tax of 0.0000553 percentage points. While this number may appear small, it can be shown to be highly plausible.

The estimation suggests that the average withholding rate in a treaty between the USA and Japan, where the asymmetry of investment stock in the year of signature was $102,458 million, should be 5.5 per cent higher than that between Australia and New Zealand (asymmetry of $2,430 million). In other words, since there are sizeable differences in countries' capital positions, the resultant differences in tax rates are also sizeable.[10]

The expectations concerning the influence of bargaining power do not hold. The coefficient has a positive sign and is insignificant. This result contradicts anecdotal evidence in the literature that more powerful nations try to pressure less powerful countries to agree on the tax rate as they see fit (see, for example, McIntyre 1993, 318).[11]

The dummy variables on the different tax rates are all highly significant. The coefficient of the constant, which is 18.41, can be interpreted as the effect of the *dividend tax dummy* on the withholding rate. The effect of the *associated dividend tax dummy* is 10.085 (−8.325 + 18.41), that of the *interest tax dummy* is 10.572 (−7.838 + 18.41) and that of the *royalty tax dummy* is 10.335 (−8.075 + 18.41). Together with the increase in R^2 this suggests that the tax dummies can explain the general level of the respective rates. This may be interpreted as evidence that there are focal points of generally accepted rates for different kinds of income and the variance around these rates can be explained by the asymmetry in the stocks of FDI.

Interestingly, the estimated effects of the *dividend tax dummy* and the *interest tax dummy* are quite close to the suggestions of the OECD MC (15 and 10 per cent respectively). However, the coefficients of the *associated dividend tax dummy* and the *royalty tax dummy* diverge considerably from the suggestions of the MC (5 and 0 per cent respectively). This implies that for the latter two kinds of income, the OECD MC is not as well accepted as a focal point as it is for interest and dividend income. This interpretation can be further substantiated by an analysis of the commentary to the OECD MC. Governments have entered far more reservations about and observations on the suggested rates for associated dividends and royalties than for dividend and interest payments (OECD 2005b, commentary, reservations and observations on Arts 10, 11 and 12).

Additionally, the negotiated rate is lower if treaty partners are wealthy. The coefficient of *sum of per capita GDP* is negative and significant. While there is no strong theoretical reason for why we would expect wealthier countries to agree on lower withholding rates, one possible explanation for this effect was developed by Chisik and Davies (2004b). They note that countries with a longstanding treaty relationship, which have renegotiated their treaties quite often, lower the negotiated tax rates over time. They explain this dynamic by the fact that over time countries attain a greater degree of economic integration. As the treaty is successful in liberalizing investment flows, and countries become more interdependent, they may be willing to agree on lower foreign

source rates. Since, in general, the countries that began making tax treaties earlier are also wealthier (see Chapter 5), the variable *sum of per capita GDP* may pick up this effect of the duration of treaty relationships.

These results are in line with the results of Chisik and Davies (2004a), who did a similar analysis with different data from those used here. Note, however, that my analysis does not provide a complete test. As has been explained, the model predicts that there may not be any treaty in the case of extremely asymmetric capital flows between countries. Using Heckman's two-step procedure, Chisik and Davies (2004a, 1140–2) show that it is indeed the case that the probability of concluding a treaty is lower the more asymmetric capital flows are.

It is not only negotiated withholding rates that vary with respect to the investment position. The same pattern can be observed for the definition of a PE under tax treaties. As described above, developing countries, which are generally capital importers, favour a broader definition of PE, so that the degree of taxation at the source is extended. A detailed analysis of 811 DTAs carried out under the auspices of the United Nations provides empirical support for this claim (Wijnen and Magenta 2001, 4–10). Rixen and Schwarz (2008) provide an empirical analysis showing that the variance of PE definitions in German tax treaties can be explained by the variance of bilateral investment positions: the minimum duration required for a construction site to be considered a PE is shorter if capital flows are more asymmetric. The basic pattern for PE definitions is thus the same as for treaty withholding rates.

Overall, these results provide quantitative support for the qualitative evidence presented in Chapter 5 that the politics of double tax avoidance are driven by the distributive conflict between residence and source states. The systematic variation of bilateral tax treaties according to bilaterally defined investment positions of countries provides a strong argument for bilateral bargaining. In dyadic bargaining, the terms of the tax treaty can be designed to accommodate countries' particular investment situation. Under multilateral bargaining, states would find it difficult or impossible to agree on one precise sharing rule that serves their revenue interests in relation to all others. In other words, multilateral bargaining would be very costly in terms of transaction costs. However, if states prefer bilateral bargains, this then raises the question of why there is also multilateral bargaining about model conventions.

A clarification: tax competition and the viability of source taxation

Before I address this question, two potential objections that could be raised against the model of double tax avoidance just developed must be addressed. The first objection concerns the issue of tax competition and the viability of source taxation. The second addresses the validity of the strategic structure and is dealt with in the next subsection.

The most important objection to the argument just developed is that under conditions of tax competition, it is implausible to assume that source countries wish to tax foreign capital at high rates. Shouldn't the incentives to attract foreign capital mitigate the desire to tax the foreigner? And if this were the case, wouldn't that make agreements that have as one of their main functions the limitation of source taxation largely superfluous?

First, it is generally correct to assume that a source country faces a trade-off between the desire to attract foreign capital and the wish to retain some tax revenue on inflowing foreign capital (see, for example, Avi-Yonah 2004, 379–80). But there are conditions under which taxation at source does not drive away foreign capital. The best known argument for why this may be the case is the so-called soak-up tax (Oldman 1966, 77–8), or 'treasury transfer' (Zodrow 2006, 272). Under the condition that the residence country grants a foreign tax credit, the source country should be able to tax foreign capital to the limit of this credit. In fact, such taxation falls not on the investor but on the treasury of his residence country. The foreign tax credit provides an umbrella for source taxation.[12]

However, there are objections to the treasury transfer argument. First, the argument should not hold in the case of exemption countries. Since investors from these countries do not face any taxation at the source irrespective of how much they paid abroad, they have an incentive to locate in countries with low tax rates. Second, even credit countries defer residence taxation, so that the current taxation of active business profits is not immediately borne by the treasury of the residence state. The treasury transfer conditions thus may not hold in many constellations in practice.

Another well known argument suggests that source taxation at rather high levels may be viable in cases where an investment is made in order to realize economic rents. Taxing such rents should not have a deterrent effect on FDI. However, here one must differentiate between location-specific and firm-specific rents. While the foreign investor is not able to shift location-specific rents on land and labour in the source country, firm-specific rents are more difficult to tax at source, because the investor may earn them in any location and can thus threaten to invest elsewhere (see, for example, Avi-Yonah 2004, 380–1). Although the argument only applies to location-specific rents, this leaves some scope for source taxation; for example, if an MNE wishes to extract natural resources.

Even if one grants the objections to both the treasury transfer argument and the viability of taxing economic rents, then tax competition still leaves some scope for certain ways of taxing foreign capital. For one, imposing withholding taxes may be possible. If one considers the investment options of a multinational company, this becomes apparent. According to Hartman (1985) and Sinn (1993), foreign operations of a multinational firm expand by investing their own profits rather than equity from their parent company. Retained earnings are a cheaper source of investment because they are

only subject to corporate taxation at source, whereas repatriated and then reinvested profits are subjected to a second layer of taxes in the form of withholding taxes. Therefore, withholding taxes have no influence on the size of mature foreign operations of a multinational firm. Foreign operations, and thus the stock of FDI in the host country, grow even if withholding taxes are high. Thus, multinationals do not repatriate any earnings as long as further investment in the host country is worthwhile, irrespective of whether the residence country operates a credit or an exemption system. In this calculation, the level of the withholding tax rate is irrelevant for the company, because it can avoid paying this tax at least as long as it is still growing by investing retained earnings. Thus, withholding taxes should not have a deterrent effect on FDI activity. In that sense, FDI levels are to a considerable degree exogenous to source withholding rates (Davies 2004, 785–7).

In other words, withholding taxes are not necessarily subject to a downward trend caused by tax competition for mobile capital. Even under conditions of fierce tax competition, a source country has significant leeway to implement withholding taxes. The fact that a foreign subsidiary may not repatriate income continuously but only when it reaches a mature size does not mean that the revenue from the withholding tax is lower. A one-time repatriation of high profits should lead to equal tax revenues as continuous revenue on smaller dividend payments.

As opposed to the withholding tax, the corporate tax on active business income is not irrelevant for FDI inflows. A high corporate tax can drive away foreign FDI because it determines how much after-tax profit the company can reinvest. These considerations suggest that a country wishing to balance its goals of attracting foreign investment and collecting some tax revenue on this investment should combine a low tax on active business profits – for example, the general corporate tax – with high withholding taxes on dividends, interests and royalties (Musgrave 2006, 173). Accordingly, it also makes sense for other countries to actively try to limit withholding taxes at source through the negotiation of a tax treaty, because the withholding tax directly diminishes their national income; consequently, if there are asymmetries of capital flows this leads to the distributive conflict that is at the heart of the proposed bargaining model.[13]

Apart from using withholding taxes to exert taxation at the source, it may also be viable to expand the tax base on which capital income is levied. Given that tax competition consists mostly in trying to attract mobile 'paper profits' and discrete investments of highly profitable firms that earn firm-specific rents (Devereux *et al.* 2002; 2004), one strategy for a source country is to lower its tax rates and at the same time broaden the tax base. Even under or rather because of conditions of tax competition, the source country tries to expand its tax base (see, for example, Ganghof 2006a; Rixen 2007). While it can do so independently if the foreign business operation is incorporated and thus subject to tax as a resident, the tax base definition may underlie

restrictions set in tax treaties, if the respective business activity is carried out in the form of a branch: it must pass the PE threshold. Accordingly, the source country prefers to define a PE as broadly as possible (set a low threshold for a PE), whereas the residence country would prefer a narrow definition. Once again, if capital flows are asymmetric, this causes distributive conflict.

As this discussion shows, my bargaining model still has relevance in today's age of tax competition. Although tax competition presents certain restrictions on countries' ability to tax (foreign) capital, there is still room for a distributive conflict over which country may retain the revenue from transnational investment. Since the data used to test the bargaining model are from the current period of tax competition, they may also provide indirect empirical support for the theoretical arguments discussed in this section.

A second clarification: minor enforcement problems in tax treaties

The second potential objection to the suggested explanation is in a way the opposite of the first. It accepts the idea that source countries wish to impose high taxes on foreign capital or broaden the PE definition. Precisely because of this, one could argue that the source country should always have an incentive to defect from any negotiated treaty (Green 1998, 115–18; Chisik and Davies 2004b). If this were so, one might think that the strategic structure is better represented by a prisoner's dilemma. Thus, the potential objection is that the strategic structure of double tax avoidance may not really be a coordination game.

While there is indeed an individual incentive to deviate from the terms of a tax treaty and to cheat on the other player, this incentive only arises because double tax relief is in place. The policy of unilateral relief creates an incentive for source countries to impose high taxation at source, creating a distributional disadvantage for residence countries. The fact that capital generally flows in both directions and treaties carry certain additional mutual benefits for treaty partners creates a bargaining space for mutually beneficial tax treaties that allow treaty partners to fine-tune the distribution of benefits. Due to the distributive conflict, which is more or less intense depending on the symmetry or asymmetry of capital flows, these treaties are subject to minor enforcement problems. But, if there were no relief from double taxation in the residence country, the source country would not get into the position of being able to profit from a defection.

Countries are willing to grant tax relief even in the face of the incentive for source countries to defect from the negotiated treaty rate. This shows that the coordination aspect of the double tax avoidance game is more fundamental than the potential incentive to deviate from the withholding rate agreed upon under the treaty. In fact, the incentive to deviate from withholding rates is simply an element of the distributive conflict that is at the heart of double tax avoidance. Every distributive conflict involves an incentive to deviate

slightly from the distribution of benefits on which parties have agreed. Every bargained outcome in such a situation involves a compromise: both parties have made certain concessions and thus would be better off if they could cheat; that is, withdraw their concessions with the other party's concessions still in place. Every coordination game with a distributive conflict involves an enforcement problem 'in the small' (Snidal 1985a, 933–4).[14]

Thus, it is correct to say that there is an enforcement problem in treaty making, but this enforcement problem is not an indicator for an entirely different problem structure of double tax avoidance. Instead, the enforcement problem is preceded by a willingness to avoid double taxation unilaterally. In other words, we need to distinguish between enforcement problems that come up in tax treaty making and the general strategic structure of double tax avoidance, within which treaty negotiations take place. The minor enforcement problem inherent in treaty bargaining is an artefact of the distributive conflict about the assignment of taxing rights *given that double tax relief is in place.*

The interaction of bilateralism and multilateralism: constructed focal points

After these two clarifications of the nature of the bargaining model and its theoretical underpinnings, I now return to the examination of the bargaining process and its institutional form. So far, I have argued that bilateral bargaining is preferred because concerns for distribution can be accommodated in dyadic bargaining. The question then is: if bilateral bargaining is appropriate for their distributive interests, why do governments engage in complementary multilateral cooperation on the development of the MC? In order to answer this question, one has to differentiate between the technical side of the problem of double tax avoidance and the problem of the distribution of benefits. Both issues have to be resolved through bargaining. On the technical side, the legal constructs to implement the avoidance of overtaxation have to be decided upon. This is represented by a pure coordination game. It may not matter so much which concepts are chosen; the important point is that agreement on any solution is attained. Since all governments were in favour of sovereignty-preserving solutions, there was no serious bargaining problem involved. On the other hand, the distributive conflict can be expected to be very tough. This is because there is no serious enforcement problem in double tax avoidance, while at the same time the distributive conflict is strong. Under this combination, governments have an incentive to 'hold out' for a long time to come to a favourable agreement, because they know it will stick for a long time (Fearon 1998, 270–1). Of course, holding out incurs costs for both countries, so that there is a mutual interest to moderate the intensity of bargaining to minimize transaction costs. The instrument chosen to achieve this is the multilateral model convention. In order to see this, I consider how bargaining problems are resolved.

Bargains very often find their solution in so-called *focal points*, which are the points of convergent expectations of actors with an overriding interest to agree on a coordinated outcome. Focal points are defined as social conventions that are not questioned but are followed 'automatically' because they have become self-evident: they are more obvious, conspicuous and prominent points of agreement than other possible solutions. Depending on the particular bargaining problem at hand, a focal point can have different sources. It may come from history, social norms and culture, or simply represent a status quo. If actors are in a bargaining situation where such a focal point exists, bargaining should not consume much time and effort because the solution gravitates towards the focal point (Schelling 1980, 57–80).

As discussed in previous chapters, there is no self-evident solution to the problem of double tax avoidance. The 'philosophical debate' about the proper allocation of jurisdiction to tax to the residence or source country has never been settled. In other words, a clear-cut, simple and discretely conspicuous focal point is not available. The creation of institutions 'can fill this void. By embodying, selecting, and publicizing particular paths on which all actors are able to coordinate, institutions may provide a *constructed focal point'* (Garrett and Weingast 1993, 176). Governments engage in the intentional creation of a focal point in the form of model tax conventions that limit the range of possible solutions.

Of course, when negotiations at the League of Nations began, the initial goal was not to construct a focal point for bilateral bargains but to come to a binding multilateral DTA. However, this proved to be elusive, so governments contented themselves with coming to an agreement on a model convention for bilateral bargains. The attempt to find a focal solution was subject to the very same bargaining problems as negotiations about binding agreement itself. Importantly, it proved to be comparably easy to come to agreement on the technical side of the problem, to agree on legal constructs that are (more or less) capable of achieving the coordination of different national tax laws. All actors agreed that the technical solution should be sovereignty preserving. While there were important technical problems to be resolved that required some ingenuity from tax experts, there was little conflict about these questions. However, the distributive conflict was more difficult to solve; the difficulties encountered in trying to forge agreement on the MC within international organizations are evidence of this.

The fact that the OECD MC is non-binding can explain why it was nonetheless possible to forge an agreement. Since states know ex ante that they are allowed to deviate from the convention in their bilateral agreements, they are more willing to subscribe to a model, even if it may not entirely accord to their distributive preferences. The flexibility inherent in soft law is one of the main reasons why it is chosen by states. Rather than

having to 'accommodate divergent national circumstances within a single text', it leaves 'flexibility in implementation' (Abbott and Snidal 2000, 445). The multilateral MC pre-structures the bilateral bargains but it does not predetermine them entirely. It is merely the starting point of bilateral negotiations, in which a binding solution to accommodate parties' distributive interests is achieved.

Importantly, the non-binding nature of the MC does not matter for its effectiveness with respect to the technical side of double tax avoidance. Since all countries have the desire to be coordinated, any workable solution that is found is accepted and there is no reason to deviate from this solution in bilateral bargains. In this sense, the OECD MC provides standards, which countries voluntarily adopt in their bilateral bargains. As is the case in most standard-setting regimes, while making the rules binding on states would not meet with resistance, there is no need to do so, because they wish to follow them in any case. The rules are self-enforcing. At the same time, since there are indeed various technical problems involved in developing these standards, there is a demand for pooling the expertise and information and making it available to other governments. A multilateral institution that specializes in collecting, creating and disseminating information can fulfil this task.

The fact that distributive problems and not technical issues are at the heart of difficulties in achieving agreement on a focal point is evident in historical developments. As shown, agreement on the technical side of the problem emerged rather early under the League of Nations. However, the League years ended with two technically identical conventions, the Mexico and London models, with different distributive implications – one emphasizing the source principle, the other the residence principle. Agreement on one model convention was elusive because of the heterogeneous group of countries in the League of Nations and later within the United Nations. During the OECD years, governments managed to agree on one model. This success was facilitated by the fact that the OECD is made up of a rather small group of countries with relatively symmetric capital flows between them. Therefore, the distributive conflict between these countries is weaker. Accordingly, in combination with the non-binding character of the model, agreement was easier. Importantly, though, the technical solutions that had been developed in the previous period were not challenged but merely further developed and refined.

The adoption of a model by a rather small and exclusive group of countries also has consequences for the countries remaining outside the agreement. Given the sophistication and resources devoted to double tax avoidance at the OECD, the MC became the technically best developed model. Due to the overall nature of double tax avoidance as a coordination game, states generally accept the OECD MC, since it provides such a technical standard. Even though it has been developed by an inclusive group of countries, the outsiders

voluntarily follow the standards adopted within the OECD. The OECD MC has eventually become entrenched as the 'natural' solution to the problem of avoiding double taxation.

This may have consequences for the question of the distribution of benefits. Since OECD countries were the 'first at the table', they could implement a system that favoured residence countries. The best the 'last at the table' developing countries could do was to follow them, even though the rules were less favourable to them than their preferred source principle (Horner 2001, 183–4). The first-mover advantage that is a feature of coordination games may account for the fact that, in general, the rules are of such a nature that they favour developed countries. Such an effect may exist, and the frequent complaints of developing countries about the bias inherent in the OECD MC are testament to this. At any rate, the disadvantaged countries have tried to change this situation and attempted to counterbalance the OECD MC through the UN MC. While the UN explicitly did not attempt to challenge the technical solutions, its MC aims to be a corrective to the distributive solution that emerged within the OECD. The OECD MC has quite clearly not achieved universal acceptance as a focal point with respect to the issue of the distribution of benefits. The empirical evidence presented above supports this view. The suggested rates for royalties and associated dividends are less well accepted than those for dividends and interest.

But even the coexistence of two distributively divergent model conventions facilitates bilateral bargaining. The fact that the disagreement about the distribution of benefits is embodied in multilateral model conventions sponsored by well respected international organizations legitimizes the distributive conflict. Discussions of these problems in multilateral forums allow treaty negotiators to anticipate the areas where conflict can be expected and thus may enable a quicker resolution of the distributive issues in the bilateral setting. Multilateral bargaining on focal solutions rationalizes the distributive conflict and thereby mitigates it to a certain extent.

In summary, multilateral bargaining is an important complement to bilateral bargaining. Since there is no natural solution for the avoidance of double taxation, countries have an interest in constructing a focal point for bilateral negotiations. Such a focal point limits the potentially endless solutions to the problem of double tax avoidance. While innovative technical solutions may be developed on the unilateral, bilateral or multilateral levels of the tax regime, countries have an individual incentive to diffuse them via a multilateral forum and thus facilitate coordination. In addition, although multilateral agreement on the distribution of the benefits of DTAs is elusive, multilateral bargaining about these issues rationalizes and thus speeds up distributive bilateral bargaining. With this, the OECD and its MC fulfil the typical functions of multilateral institutions in coordination regimes.

The enforcement phase and the mutual agreement procedure

Following discussion of the institutional design as it applies to the bargaining phase of international tax cooperation, I now turn to the enforcement phase. As argued above, there are only minor enforcement problems in DTAs. Turning to a closer investigation, I further substantiate this claim in the following.

First, one of the most important sources of enforcement problems is strongly mitigated in double tax avoidance: *monitoring* is not problematic at all in the case of tax treaties. Any violation of a treaty can be easily detected because there is a natural third party to the agreement taking care of this: the taxpayer. If one of the treaty partners violates a DTA, the taxpayer will notice this violation and notify the competent authorities of her home country. These then enter into a MAP in order to try to reach an agreement on the treaty violation.

As has been described above, the MAP is more political than judicial in nature and the treaty partners are not obliged to come to an agreement. However, the empirical record indicates that treaty partners generally resolve their conflicts through the MAP. This can be explained by reference to the coordination aspect of the double tax game. In general, parties do not have a sustained interest in cheating on each other. However, with respect to the distribution of tax revenues, the minor enforcement problem described above does exist. But this issue can be resolved by means of (implicit) threats to employ retaliatory strategies and does not require an external enforcement mechanism in order to successfully deal with it. In a bilateral setting, reciprocating to a defection by the treaty partner is not very costly. There is no danger of a retaliatory defection leading to a spreading of the defection to other countries. As opposed to a multilateral agreement, it is very likely that threats of reciprocal retaliation can achieve their intended goal of containing defection on the part of the other country (Oye 1985, 19–20).

The use of retaliatory strategies appears to be extremely rare in international taxation. As we have seen, the USA's trading partners, in particular the UK, threatened to retaliate against California's system of unitary taxation, which they considered a violation of existing tax treaties built on the ALS. But apart from this, few cases are known (Green 1998, 119–22). This does not, however, invalidate the possibility that enforcement by threat of retaliation may be the mechanism at work. Given that a taxpayer requests a remedy for double taxation, governments do not immediately retaliate but initialize a MAP in order to provide the remedy. It may well be that they exchange threats of retaliation within the MAP, which leads to a resolution of the dispute. Given that the MAP is not public, there is no evidence, so that it is difficult to judge the issue. One way or another, the conclusion remains the same: enforcement of agreements is unproblematic in double tax avoidance and this can explain the absence of external enforcement and mandatory dispute resolution.

The absence of an enforcement problem does not, however, mean that there are no conflicts in applying the provisions of the treaty. As shown, the MAP is employed quite often. However, rather than being conscious efforts to cheat on treaty partners, the disputes very often result from problems in interpreting the agreement correctly. Given the complicated domestic and international rules, avoiding double taxation can be understood as a complex transaction. The main feature of such complex transactions is that not all future contingencies can be dealt with at the time of concluding the contract.[15] For example, given the long life expectancy of a treaty, it is often necessary to adapt the treaty to changing domestic laws (Vann 1998, 725). Tax treaties are thus necessarily *incomplete contracts* that involve indeterminacy and will have to be amended to new circumstances ex post. Contract theory suggests that in such circumstances, treaty partners will not try to agree on what will be done in each contingency ex ante but will keep the treaty more general and instead agree on a procedure to be followed if a dispute arises about the application of the provisions.[16] The procedure chosen in tax treaties is the MAP. Its major function is that of a flexible mechanism of *ex post treaty negotiations*. It enables an 'ad hoc and ex-post agreement' between governments through which divergent treaty interpretations can be brought into line and 'temporary or unforeseen problems' can be addressed (Aoyama 2004, 653). The MAP is an 'ongoing treaty negotiation' (Lindencrona and Mattsson 1981, 24).

This can be substantiated by the kinds of cases that are brought before the MAP. A general feature of all disputes in tax treaty matters is that they result from divergent interpretations of domestic bodies (Züger 2001, 2). Many cases involve a lack of information of the authorities about the taxpayer's actual situation, especially concerning his residence or the existence of a PE (OECD 2005b, commentary on Art. 25, para. 8). As described in Chapter 6, many cases are disputes about the correct determination of transfer prices. As has been argued in Chapter 5, the decision in favour of the ALS as early as the 1930s involved the acceptance of the necessity to leave important aspects of treaty application to an ex post administrative process, through which transfer prices would ultimately be determined. Even today, this often involves a MAP.

Given that the ex post negotiation over the agreement is the major function of the MAP, it is understandable that governments did not choose an external enforcement mechanism and generally resisted the introduction of binding arbitration. They wish to determine the terms of agreement by themselves and to retain the flexibility to adapt the agreement to new circumstances rather than grant the power of treaty interpretation and ex post amendments to a third party (Green 1998, 129–37). In addition to its desirability, the absence of a major enforcement problem makes such a solution viable.[17]

If an external mechanism is not needed in the enforcement of tax treaties, why does the OECD suggest arbitration in tax treaty matters? The answer lies

in the difficulties of bargaining. The ex post negotiations under the MAP are subject to the same bargaining problems as the ex ante negotiations. Given the distributive conflict, there is the danger of negotiations taking a very long time because negotiators have an incentive to hold out. This is not only undesirable from the perspective of taxpayers who remain in a situation of uncertainty regarding their tax payments; it is also undesirable for negotiators who have a mutual interest in speeding up the MAP. The development described in Chapter 6 – the adoption of several treaties with arbitration *complementary* to the MAP and the OECD promoting a solution under which arbitration ensues if the dispute cannot be resolved within two years – is evidence for this. If spelled out as complementary to the MAP, arbitration is a mechanism of self-binding. It provides an incentive for negotiators to speed up the procedure. A provision for arbitration makes this commitment credible. '[T]he entire mechanism is designed to help the MAP work more effectively' (Aoyama 2004, 663). The fact that very few cases have actually moved to the stage of arbitration is evidence that complementary arbitration is indeed successful in achieving this goal. Second, it reinforces the case that there is no major enforcement problem in tax treaty making that would require arbitration or another mechanism of third party enforcement.

Bilateral agreement and the absence of free-rider problems

So far, it has been argued that bilateral bargaining is well suited to accommodate governments' distributive concerns. In addition, there is no major enforcement problem that would require third party enforcement. But this does not explain why binding agreement is bilateral in tax treaty making. As we have seen, there is an important role for complementary multilateral bargaining in order to provide focal points for bilateral bargains. This raises the possibility that countries could also come to a binding multilateral agreement. In fact, it is easy to draft a multilateral tax treaty that contains the same provisions as the OECD MC (Lang 1997; Lang *et al.* 1997). Governments could, in principle, agree on a multilateral tax treaty that would leave them distributional flexibility; for example, by agreeing on different withholding rates for different pairs of countries. The distributively sensitive aspects could still be determined in bilateral bargains and subsequently all countries involved could agree on one multilateral document that included a series of bilaterally varying provisions. In fact, the one instance of multilateralism (or, in fact, minilateralism) – the Scandinavian tax treaty – is of this kind (Vann 1991, 151). Why, then, is agreement not multilateral in double tax avoidance?

The answer to this question is that there is no need for such a binding multilateral framework in double tax avoidance because there is no free-rider problem. This point can be worked out by contrasting the cases of the international trade and tax regime (for a more detailed account, see Rixen and Rohlfing 2007). In international trade liberalization, which has for a

long time been achieved through bilateral agreement, countries have to balance the interests of 'their' import-competers and export-competers. They generally do not engage in unilateral trade liberalization and can best achieve this balance in bilateral agreements. However, once they have struck a deal, the balance achieved in relation to one country may be upset by a subsequent trade agreement between their treaty partner and a third country. If that agreement is more favourable to the third country, the exporters of the first country may suffer. In order to prevent this, governments introduced Most Favoured Nation (MFN) clauses into their bilateral agreements, so that their exporters would always be given the best treatment that their treaty partners grant to any country. Thus, MFN treatment, which became mandatory under the GATT, is intended to ensure that the domestic balance between import- and export-competers is not disturbed. However, once a series of bilateral agreements with MFN treatment is in place, a positive externality for other countries is produced. Governments have an incentive to lean back and wait for other countries to conclude agreements, which they are able to access without granting any concessions themselves. In this situation, *multilateral agreement* is an institutional safeguard by which such free riding can be prevented. After all concessions have been exchanged, each member country can consider the bargains in conjunction. If one country believes that another one intends to take a free ride on its concession-making, it can withhold some of the concessions previously granted and insist on concessions by the potential free-rider.

In international taxation the situation is different. A third country effect of the kind that led to the introduction of MFN treatment in international trade does not exist. In a first take, it is conceivable that a government would like to ensure that no third country gets a better deal from one of its treaty partners. One motive might be concerns for competitiveness. A country might want to make sure that its own investors get at least the same concessions as investors from other countries. Accordingly, it could insert an MFN clause into its treaties to ensure that if its treaty partners agree on more favourable terms with other countries, these will also be extended to its own investors. The fact that MFN clauses are sometimes found in tax treaties is evidence that such considerations may play a role in tax treaty making. However, MFN treatment is more the exception than the rule in tax treaties. In fact, the empirical results in this chapter suggest that the kind of third country effects that would make MFN treatment desirable in many cases are not very strong. Otherwise, the correlation between withholding tax rates and bilateral investment positions should not be as strong, because an MFN clause clearly upsets the distributional balance that is the main reason for reciprocal concession-making in bilateral bargains. And it can be shown that the way MFN clauses are used in tax treaties has more to do with the desire to balance bilateral, reciprocal deals, than with the desire to grant benefits to third countries (Lennard 2005, 99–100).[18]

The decisive difference between taxation and trade is that in the trade regime, the MFN treatment has become mandatory to solve an enforcement problem. If there is no mandatory MFN treatment, the fear is that an unravelling of all bilateral bargains occurs due to the third country effect. This fear is clearly not present in the case of the tax treaty regime. If a government dislikes the fact that a third country has been granted more favourable tax treatment by one of its treaty partners, this does not induce the government to defect from the treaty. In trade, the domestic import- and export-competers' balance that has been disturbed by the third country effect provides an incentive to defect from the prior treaty. In international taxation, since a comparable politically salient conflict does not exist, a country would not defect from prior agreements, even if one made the questionable assumption of a strong third country effect. This explains why there is no mandatory MFN treatment in double tax avoidance and why it is rarely used in practice. Consequently, the ability to free ride on the concessions other countries have made is not a relevant factor, and thus there is no need for a binding multilateral agreement.

Contrasting the cases of international trade and taxation suggests that the absence of a free-rider problem explains why we find bilateral agreement in the international tax regime. Whereas bilateral agreements in international trade create externalities that countries wish to internalize by means of binding multilateral agreement, externalities of this kind do not exist in double tax avoidance. Governments do not come to a binding multilateral agreement because there is no need for it. This reasoning suggests that in principle it would be possible to conclude a multilateral DTA that leaves countries the desired distributional flexibility. But since – if one focuses on the problem of double tax avoidance alone, as I have done here – there was no need for multilateralism in agreement and enforcement, governments did not engage in serious efforts to establish such multilateral institutions.

The fact that the tax regime has a strong bilateral element, and a switch to a multilateral tax treaty did not occur, contradicts the claim that 'solving coordination problems is institutionally neither complex nor particularly demanding, and it was the domain in which multilateralism ... flourished in the nineteenth century' (Ruggie 1993a, 22). My argument turns Ruggie's logic around. Precisely because the underlying strategic structure does not necessarily require multilateral agreement, binding agreement could remain bilateral. The multilateral institutions of double tax avoidance 'only' have a facilitating role in resolving *bargaining* problems – a task that they accomplish successfully, as the continuing growth and substantial degree of homogenization of the treaty network shows.

However, with the problems of tax evasion and avoidance becoming more serious over time, this may change. These problems do of course entail significant externalities. Thus, potentially the issue of double non-taxation could make multilateral double tax treaties necessary. I consider this question in

the next chapter, when I turn to the institutional development of the tax regime.

Probing the explanation

The account just offered needs to be checked for its plausibility. Only to the extent that the mechanisms identified can also explain other cases and fare better than other potential explanations can we put some trust in their validity (see, for example, George and Bennett 2005, 117–19). I first demonstrate that the same mechanisms employed here can also account for the development of the international trade regime. Then, I consider a potentially competing explanation for the institutional setup of double tax avoidance, namely that governments' desire to preserve their tax sovereignty makes them unwilling to enter into a multilateral agreement.

Contrasting cases: international trade

In deriving the conclusion that binding multilateral agreement would in principle be possible in double tax avoidance but that it is not adopted because it is not necessary due to the absence of free-rider problems, I have already contrasted the institutions of double tax avoidance with those of international trade liberalization. This comparison is also helpful when considering the institutional choices in the bargaining stage of cooperation. The following picture emerges (for a more comprehensive treatment, see Rixen and Rohlfing 2007). While the dichotomous characterization of the double tax regime as bilateral and the trade regime as multilateral is correct with respect to the agreement stage, it misses important similarities between the two regimes. The similarities are most pronounced in the bargaining phase. In trade, as in taxation, bilateral bargaining is vital for countries to realize their concerns for the distribution of benefits. In both regimes multilateral bargaining complements bilateral bargaining. In trade, due to the complexities arising from MFN treatment, multilateral bargaining replaced bilateral bargaining where possible in order to economize on transaction costs. Since MFN treatment of the kind used in international trade does not exist in double tax avoidance, bilateral and multilateral bargaining could remain complementary. As we have seen above, the regimes are quite different with respect to enforcement problems, which accounts for differences in the agreement and enforcement stages.

Both regimes exhibit a mix of bilateral and multilateral elements and the observed similarities and differences between them can be accounted for by the explanatory framework used here.

Competing explanation: bilateralism preserves sovereignty

It is quite common to 'explain' the bilateral nature of double tax agreements by a very broad and often unspecified reference to the desire of countries to

maintain their tax sovereignty (see, for example, Abbott and Snidal 2000, 441; Arnold 2000, 17:22–3). While this claim is hardly ever spelled out in a fully developed account of the institutional design of international tax governance, it could be understood as a competitor to my explanation.

First, it is true that governments want to preserve their legislative tax sovereignty. The institutional setup is constructed in a sovereignty-preserving way, so that double taxation can be avoided by interface regulation and national decision-makers retain their legislative sovereignty to the largest degree possible. Governments cherish the flexibility of this setup to design their domestic tax laws independently of other countries. However, this fact by itself is not a sufficient condition for the bilateral nature of tax treaties. It must be complemented to form a complete explanation. For one, it would be conceivable to conclude a multilateral tax treaty based on the very same legal constructs and technical solutions currently used in bilateral tax treaties. Such a treaty would be as sovereignty-preserving as a bilateral treaty. This shows that multilateralism does not restrict sovereignty per se. Likewise, the bilateral form as such need not necessarily be more sovereignty-preserving than multilateralism. Instead, it depends on the substantive provisions contained in a treaty as to whether it preserves legislative sovereignty or not. For example, bilateral tax treaties that were not based on separate accounting but instead used unitary taxation with formulary apportionment would require the definition of a common tax base. This would restrict a single government's legislative sovereignty more than a multilateral treaty based on the ALS.

A more complete explanation of the bilateral nature of tax treaties is the one that I have developed above. The characteristics of the strategic structure underlying the problem of double tax avoidance make bilateral bargaining attractive, and there are no overriding enforcement problems that would necessitate multilateral agreement or interference in national tax sovereignty. While the desire to preserve national sovereignty makes this particular setup attractive, the fact that such a solution was viable cannot be explained by reference to this desire. The viability of the sovereignty-preserving and bilateral approach to double tax avoidance hinges on the underlying strategic structure.

This will become obvious when I turn to the fight against under-taxation. As shown in the next chapter, governments are willing to compromise some of their administrative tax sovereignty in the fight against tax evasion and avoidance. This is a reaction to the functional requirements of the problem of double non-taxation. While I in no way question the notion that governments are keen to preserve their legislative sovereignty and that this desire is visible in their cooperative ventures, sovereignty is not the immovable mover that some analysts see. Instead, governments are willing to share some of their sovereignty if necessary to realize their policy goals – in other words, if the underlying problem structure requires it.

In this chapter, I have constructed an explanation of the design features of international tax governance. I have developed a model of tax treaty making in which bilateral bargaining is preferred over multilateral bargaining, because the asymmetry of investment flows can be better accommodated in bilateral bargains. Despite this preference for bilateral bargains, governments have an interest in developing model conventions and a multilateral forum for discussion serving as constructed focal points. Concerning the ex post phase of cooperation, it was shown that there is no need for external enforcement mechanisms. The MAP procedure is sufficient to deal with the minor enforcement problems of tax treaty making and is best understood as a device of ex post treaty modifications. Concerns for third country benefits – that is, externalities of bilateral agreements – are not relevant, so that there is no free-rider problem and thus no need for multilateral agreement.

This account shows that the problems of cooperation in double tax avoidance lie mainly within the sphere of bargaining. Cooperation is made difficult not by the fact that enforcement is problematic but by struggling over the terms of the agreement. Since the question of 'who gets what?' is quite hard to resolve, most of the governance design elements – for example, constructed focal points and the MAP – concern the facilitation of successful bargaining between countries. This finding lends support to the argument that consideration of bargaining and distribution problems is as important as enforcement – the problem much of cooperation theory has focused on in the past – and should receive more attention from international relations scholars (Fearon 1998, 297–9; Koremenos *et al.* 2001, 765; Simmons and Martin 2002, 204). However, as shown, this does not mean that the enforcement phase can be ignored. To the contrary, it is crucial to understand that the (relative) absence of enforcement problems amplifies the intensity of bargaining problems and accounts for the fact that multilateral agreement is not necessary. This reinforces the need to understand both the bargaining and enforcement phases and their interaction in order to make sense of institutional design (see, for example, Drezner 2000; Barkin 2004).

8
Institutional Development in the Avoidance of Double Non-Taxation

In the previous chapter, institutional choice in double tax avoidance was analysed. In this chapter, I broaden the perspective to include double non-taxation. I first briefly summarize the major developments in the fight against double non-taxation and show that they can be characterized as indirect and implicit changes in the international tax regime. Then I show that the observed reforms are a response to the functional requirements of an asymmetric prisoner's dilemma. Then I try to make sense of the particular institutional trajectory by exploring the linkage and the temporal sequence between the problems of double taxation and double non-taxation. I argue that the tax regime is subject to reinforcing and undermining processes that can explain the particular mode of institutional change.

The stylized facts of the fight against under-taxation

Until the 1960s, the issue of international tax avoidance was secondary to the avoidance of double taxation, but it has gradually increased in importance since then. Since the 1990s, it has been of major importance for tax policymakers. Efforts to curb under-taxation – with a generally limited impact – can be categorized into three groups. First, many countries have introduced unilateral anti-avoidance legislation. Since such legislation contradicts the sovereignty-preserving character of double tax avoidance, actors simultaneously engaged in a *reinterpretation* of existing institutions. The OECD engaged in efforts to coordinate and promote implementation in as many countries as possible. A similar process occurred with respect to transfer pricing, which is indirectly moving towards consolidated treatment of multinationals.

Second, various efforts at *supplanting* the institutions of double tax avoidance can be observed. Actors strengthen administrative cooperation and information exchange. The multilateral convention of the OECD and the Council of Europe, the introduction of APA programmes and very recently the establishment of the JITSIC are examples of such efforts. These measures

do not directly intervene in the institutions of double tax avoidance but provide a support structure for the bilateral DTA network against problems of under-taxation.

Finally, within the OECD project against harmful tax practices there have been efforts to directly intervene in countries' national tax systems. The OECD project was an attempt to pressure tax havens to abolish their harmful practices and to make OECD countries eliminate their preferential regimes. While the project did not try to change the institutions of double tax avoidance themselves, it broke with an important principle of international taxation: the preservation of national legislative sovereignty. Ultimately, these efforts were mostly unsuccessful, but the project continues, with a focus on improving supplanting measures like information exchange and administrative assistance.

The interesting aspect of all these institutional reactions to the problem of under-taxation is that they are *indirect* solutions. They do not aim at a direct reform of the institutions of double tax avoidance. The original institutions, and countries' legislative tax sovereignty, are left intact to the largest degree possible. In their reform efforts, actors take great care to leave fundamental legal constructs, on which the regime rules are based, at least notionally intact. Likewise, implementing more effective information exchange supplements these institutions with a support structure, instead of changing them directly. In this sense, given the mounting challenge of double non-taxation, there is a remarkable measure of institutional resilience. Nevertheless, the indirect reforms represent important incremental changes in the overall governance structure of international taxation. In other words, what can be observed is institutional rigidity and change at the same time. Overall, the reform process has clearly taken the road of incremental reform and not that of creative destruction. This particular mode of institutional development is in need of an explanation. In the next two sections I try to provide one.

Comparative statics: fighting double non-taxation as an asymmetric dilemma

In this section, I consider to what extent the observed reactions to the problem of double non-taxation are in line with the hypotheses of the asymmetric prisoner's dilemma model.

The decisive aspect of a prisoner's dilemma is that there is an enforcement problem. Because of this, the prospect of being able to enforce any agreement on abstaining from harmful tax practices is not bright. In addition, it is very difficult to come to an agreement in the first place, because of conflicting interests between big (high-tax) and small (low-tax) countries. Accordingly, (high-tax) states at first only implemented unilateral measures. But by doing so, a state becomes vulnerable to exploitation. If all other states

allow their own corporations to engage in international tax optimization by using tax havens, a single state closing such loopholes is in a disadvantaged competitive position, and countries are therefore hesitant to tax 'their' multinational companies. This behaviour by rich OECD countries, 'home' to many multinational companies, shows that there is indeed home–home tax competition. In order to overcome the symmetric prisoner's dilemma inherent in this competition, governments have pursued a double-edged strategy. On the one hand, they have restricted the application of their anti-avoidance measures to cases of obvious abuse and have not tried to rigorously close all possible loopholes in order to remain competitive.[1] On the other hand, they have increasingly tried to coordinate their countermeasures on a *multilateral* basis (Picciotto 1992, 309–10). At first, they tried to ameliorate the free-rider problem by promoting the diffusion of these unilateral measures. If all, or at least many, countries adopt such legislation, no one would be exploited. The 1988 multilateral convention on exchange of information is another effort at multilateral cooperation that can be accounted for by the realization that the free-rider problem inherent in the dilemma structure requires multilateral cooperation.

The very same dynamic is observed within the OECD project against harmful tax practices. Governments take great care to ensure that there are no outsiders to cooperation. But since it pays to defect – that is, to stay outside any agreement – and this incentive actually increases the bigger the group of cooperators is, this is very difficult to achieve. In particular, small countries, which have a lot of tax base to gain and little to lose by undercutting other countries' tax rates, have an interest to defect. Accordingly, the model can also account for the particular cleavage between large and small states observed within the OECD project. The interests of tax havens, all of which are small countries, are pitted against those of the big countries. We can also observe strategies of *reciprocity* in these efforts to come to an agreement. Big states threaten defensive measures if small tax havens do not behave. Further, by naming and shaming them they exert pressure. Being put on a blacklist is potentially damaging to their business reputation and thus their economic welfare (Sharman 2006, 104–25). Likewise, tax havens manage to extract concessions from the big states (Rixen 2007).

The OECD project also shows that governments came to realize that a satisfactory solution to the problem of double taxation must be based on 'hard law' and that the traditional OECD 'soft law' approach is insufficient (Zagaris 2005, 339). Since the asymmetric prisoner's dilemma entails an enforcement problem, agreements are not self-enforcing. Accordingly, a more hierarchical mode of governance is required, under which agreements can be enforced. Such governance is necessarily more invasive of national de jure sovereignty than cooperation to avoid double taxation.[2] At first, governments had been hesitant to implement such rules, but they nevertheless tried to react to the problems by means of unilateral anti-avoidance legislation. While in the

process of creative reinterpretation these rules were brought into line with the sovereignty-preserving setup of the double tax regime, this remains an implicit interference in another country's de jure sovereignty. The implicit challenge to tax sovereignty turned into an open one with the OECD project. There is a shift in the modes of governance, from non-binding standards and decentralized agreements to more coercive and hierarchical forms (Radaelli and Kraemer 2005). Such an overt attempt at interference in tax sovereignty was unprecedented. While the project has ultimately not achieved it, this shows that governments react to the functional requirements of the problem of double non-taxation by trying to implement hard law modes of governance.

An objection could be raised that direct interference in tax systems has been taken off the agenda, and that cooperation in administrative matters and information exchange, on which the project now focuses, has always been necessary to sustain the tax regime; for example, in the area of transfer pricing. Thus, in a way the increase in such measures of administrative cooperation could be interpreted as simply more of the same. However, this objection is unconvincing because effective exchange of information also necessitates a restraint of unlimited tax sovereignty. A country is no longer free to refuse exchange of information, and is thus forced to help other countries to enforce their tax laws. Prior to the OECD project, save for a few bilateral information exchange agreements, information exchange was entirely voluntary. Thus, while the resort to information exchange means that the direct interference in a country's legislative sovereignty is off the agenda, the OECD project shows that countries' desire to maintain their sovereignty is not an absolute goal. Governments are willing to compromise their administrative tax sovereignty and try to meet the functional requirements inherent in the underlying problem structure of an asymmetric dilemma.

Overall, the establishment of cooperation against under-taxation encounters serious obstacles and fails if measured against what would be required for an effective solution. However, the cooperative efforts are based on strategies of reciprocity, becoming gradually more hierarchical and developing multilateral elements. In this sense, the hypotheses derived from the baseline model of an asymmetric dilemma can be corroborated.

From comparative statics to process: from over- to under-taxation

Focusing on the functional requirements of an asymmetric dilemma is insufficient to discriminate between paths of reform that may be functional equivalents. While the account so far has been static, it is necessary to focus on process if we want to get an understanding of the institutional trajectory. As explained in Chapter 3, this discussion proceeds inductively.

The argument to be presented can be summarized as follows: the institutional development of the international tax regime can be analytically differentiated into two simultaneous processes. On the one hand, there is a process of *positive reinforcement* that can explain the institutional rigidity concerning the core of the institutions of double tax avoidance. On the other hand, there is a process of *undermining* that forces the actors to engage in institutional redesign. They have to find solutions to the functional requirements of an asymmetric dilemma. However, there are different viable paths of reform that could be taken. One would be a direct reform of the existing institutions; the other would be an indirect one. Due to the process of positive reinforcement, the mounting challenge of under-taxation is answered by indirect and incremental reforms. The sequence and interaction of the undermining and reinforcement processes can account for the particular institutional trajectory that is characterized by the simultaneous occurrence of inertia and change.

I first provide an account of the undermining processes that are the drivers of institutional change. Then I describe the reinforcement mechanisms that can explain institutional resilience. Finally, I focus on the institutional trajectory resulting from the parallel occurrence of these processes.

The undermining process as an endogenous effect of double tax avoidance

The source of the under-taxation problem challenging the institutional setup of the tax regime is to a considerable extent *endogenous* to this very setup. First, it is endogenous in a historical sense, in that the problem of under-taxation is a consequence of the previous liberalization of trade and capital flows, of which double tax avoidance is an important element. However, there is also a more direct link through which the institutions of double tax avoidance create the problem of under-taxation. The most clear-cut cases of endogenous creation of the problem of under-taxation are the techniques of treaty shopping and transfer pricing manipulations, in which the rules of double tax avoidance themselves are the instruments of tax avoidance. Similarly, the differentiation of income into active and passive income and its allocation to the source and residence state respectively make it worthwhile for taxpayers to establish fictional residence in a tax haven country.

These and all other techniques of tax avoidance depend on the sovereignty-preserving approach of international double tax avoidance. The rules of international taxation provide an opportunity structure for taxpayers to minimize their tax payments. International tax arbitrage is possible because the tax laws of different countries are independent of each other, allowing taxpayers to exploit these differences to minimize their overall tax payment. The fundamental problem of the sovereignty-preserving approach is that transnational tax bases are not givens that sit still and wait to be allocated to different

national tax authorities. Instead, they are endogenous to the rules of international taxation themselves. Because of the sovereignty-preserving setup, the size of each national share of the transnational tax base becomes a choice variable of taxpayers.

In reaction to this, governments engage in tax competition. Thus, as opposed to how it is conceptualized in the literature, tax competition is not exogenously given, but endogenously constituted and shaped by the rules of international taxation.[3] Accordingly, any change in the institutional setup is *endogenous institutional change*. Endogenous change is given if the processes of an institution lead to an undermining of the institution itself (Greif and Laitin 2004, 634). But in a wider sense, endogenous change is also given if an institution endogenously creates a problem, the intentional solution of which leads to changes in the institutional setup.[4]

Of course, the inventors of the double tax regime did not intend to facilitate double non-taxation. Instead, they simply wanted to realize the potential benefits of liberalization. Nevertheless, even in the regime's founding period actors already considered the problem of tax evasion and avoidance. While they could not foresee the magnitude of the problem caused by the development of global markets, technological progress and the multinationalization of firms, they were generally aware of the fact that the internationalization of economic activity would lead to increased possibilities for tax avoidance. In other words, while the creation of the problem of under-taxation was surely not intended, the actors anticipated the problem. Double non-taxation is an *unintended consequence* but not an unanticipated consequence.[5]

If actors at least partly anticipated the problems of double non-taxation, why did they not choose an institutional setup that was capable of dealing with the problem right from the start? The empirical record suggests that actors did not want to overburden the negotiations about double tax avoidance. As shown, solving this latter problem proved to be difficult enough. With respect to the problem of double non-taxation, the conflicts of interest would have grown considerably. One reason for this is that avoiding under-taxation requires considerable interference with national tax sovereignty. Even helping other countries to enforce their tax law was considered appropriate only in very narrowly prescribed circumstances. In the founding period of the tax regime, the international pooling of sovereignty to enforce national tax laws was unthinkable. Since some tax avoidance seemed to be a rather modest price in comparison to retaining their tax sovereignty – in particular if one considers that the actors did not foresee the quantitative dimensions the problem would take later on – they chose to deliberately put the issue of under-taxation aside. It played at best a secondary role and was made conditional on a satisfactory solution to the problem of double taxation. This behaviour is in line with *incomplete contract* theorizing. Even though the actors foresee that the particular solution creates problems later on, they do not tend to these problems. Given the conflicts of interest, it would

have been too costly to develop solutions. Instead, they leave the issues open and try to tackle them when they actually arise.

At the inception of the international tax regime, the main objective was to avoid double taxation. Achieving this goal was compatible with a coordinative approach and did not require interference in national tax systems because the strategic structure did not exhibit an enforcement problem. From a procedural perspective, this may have important ramifications for the viability of the institution. As has just been described, this very setup unintentionally creates and reinforces tax evasion and avoidance. The under-taxation problem challenging the institutional setup of the tax regime is an unintended consequence of its own success. The international tax regime has had the seeds of its own undermining implanted right from the start. Absent any countermeasures, it is very likely that the regime would produce its own demise.

Mechanisms of inertia: path dependence of a coordination regime

Having considered the undermining process, I now turn to an explication of the positive feedback to which the regime is subjected and which creates institutional rigidity. The task for this subsection is to spell out the positive feedback loops that can be found in the institutions of double tax avoidance.

The most important reason why the tax treaty regime is subjected to positive feedback is that it is the solution to a coordination problem. In this situation, the overriding preference is to be coordinated, so that any convention is better than none. Changing to another convention is difficult under these conditions for several reasons.

First, the convention that emerged was very difficult to find. A natural focal solution had not been available, so that actors had to engage in a lengthy and difficult bargaining process over an extended period of time to establish a solution. The crafting of the institutional setup occurred in a series of bilateral and multilateral negotiations that built upon each other. Given these sunk costs, the actors had invested in the institution. Once the focal point is constructed, actors are reluctant to put this solution at risk. Constructed focal point solutions are subject to strong path dependence (see Martin and Simmons 1998, 746). This is particularly true with respect to legal constructs such as separate accounting or PE. These concepts were capable of facilitating a fragile compromise on the difficult question of the allocation of taxing rights that is sufficiently flexible to be adapted to varying distributive positions and divergent national tax laws. Since actors are primarily interested in being coordinated, they are unwilling to change the legal constructs that are the basis of the particular coordinative solution. Not even the United States was able to abolish separate accounting and implement unitary taxation because other governments feared the resulting entropy in the international tax system and strongly objected to such a move. More precisely, even the

US government – in particular the administrators working in international taxation on a daily basis and therefore acutely aware of the vulnerability of the existing focal solution – shied away from pushing hard for institutional change. The efforts to present unilateral anti-avoidance legislation as being in line with the traditional approach are another example of this institutional rigidity.

The administrative opposition to California's unitary tax system illustrates a second related mechanism. As has become obvious, the solution now in place is very complex and technically demanding. Operating the system requires an immense amount of knowledge, experience and expertise. Thus, tax treaty negotiators and administrators have an interest in staying with the current system because they made very high asset-specific investments in terms of education, personal relationships and experience. They have adapted to the institution and know how to live with and operate it (Doernberg 2000, 2423). For example, tax administrators are used to bilateral negotiations and might thus object to a multilateral tax treaty (Davies 2004, 795). Asset specificity should lead to increasing positive feedback over time (Pierson 2004, 151). The longer the system operates, the higher the investments of actors become as they gain experience.

A third source of positive feedback can be seen in the fact that the double tax regime is not aimed at a harmonization of tax systems. Governments' freedom to design national tax systems tends 'to reinforce the preoccupation with national interests' (Picciotto 1992, 36). There are cases in which countries have introduced certain tax rules in their domestic legislation simply as bargaining chips for treaty negotiations (see, for example, Vann 1991, 110; Avery Jones 1999, 3–6). This describes a positive feedback mechanism: the entire conception of the double tax regime not only passively allows divergent tax systems, but actively sets up an incentive to introduce unusual rules into domestic tax systems. As a result of this incentive, the divergences between tax systems grow, and the implementation of international tax rules that are based on widely shared principles and certain restrictions of national legislative tax sovereignty becomes more difficult. To some extent, the argument against another system that would aim at more harmonization and would thus be better able to prevent under-taxation is a self-fulfilling prophecy (Vann 1991, 158). Likewise, the bilateral nature of tax treaties may account for some rigidity. It has been argued that it is more difficult to exert radical change on a series of bilateral treaties than on one multilateral document. The bilateral treaties could only be changed in a series of renegotiations. This problem is aggravated by the fact that the network of bilateral treaties is constantly growing (Vann 1991, 100).

These positive feedback loops may be the reason for sticking with the particular institutional setup even though its shortcomings are widely recognized and have been criticized extensively (see, among many, Arnold and McIntyre 1995, 96; Graetz 2001). The following two quotations nicely capture the basic

ideas of the reinforcement mechanisms just outlined and link them to the widespread discontent with the status quo:

> Even those who uphold the existing system most strenuously, on the understandable ground that it has taken so much time and argument to get to where we are that we should stick with it lest worse disagreement and fiscal chaos ensue, seem uncomfortable with the present system. (Bird and Wilkie 2000, 99)
>
> One might describe the current international tax system as the second worst imaginable – the worst system being whatever would replace the current system. Inertia has its advantages. (Doernberg 2000, 2423)

Making sense of the institutional trajectory

The processes of undermining and reinforcement together make up the 'mechanisms of reproduction' (Thelen 1999, 397) that can explain the particular mode of institutional change in the international tax regime. By considering the timing and interaction of the two processes of reinforcement and undermining, we can make sense of the observed indirect and incremental institutional change.[6] The institutional trajectory can be explained by the fact that the undermining process became virulent much later than the reinforcement process. At the time of the regime's inception, the problem of under-taxation was largely disregarded. After the institutional setup was in place, the positive feedback led to its gradual entrenchment. Over time, the undermining process set in and changed the problem context in which states operated. In this situation there is a choice between abandoning the original setup and replacing it with an entirely new under-taxation proof institution – that is, *creative destruction* – or attempting to save the existing setup by means of *incremental reform*. Since the route of direct reform was more costly, if not blocked, by the institutional rigidity spelled out in the previous subsection, the path of incremental reform was chosen. Importantly, this choice has not been a simple discrete choice at one critical juncture, but – since the undermining process had slowly matured over time – the picture of the institutional trajectory that can be described as indirect and incremental reform also emerged only gradually over time.

We can indeed observe the two modes of incremental reform introduced in Chapter 3. The first, *layering*, consists of efforts to work around an existing institution in order to support or subvert it. The institutional arrangement that is layered upon (or under) the existing structure is distinct from it. The efforts to implement more effective information exchange in bilateral agreements and the multilateral OECD and Council of Europe agreement are examples of layering.

Likewise, the OECD project against harmful tax practices is an attempt at layering. While being carried out by the same organization that sponsors the MC, the project is distinct from the bilateral treaty network and the activities

to avoid double taxation. The relation of the OECD project to the tax treaty regime is ambivalent. On the one hand, this parallel institution supports the existing setup. But at the same time it may also undermine it, because it foresaw a direct intervention in the legislative tax sovereignty of countries, which runs counter to traditional regime principles. The ambivalence is actually one of the advantages of the strategy of layering. There is no prerequisite to be consistent with an existing institution. The very fact that the new structure is external to the old structure relieves actors of the burden of clarifying how the two institutions relate to each other. This can make institutional layering an effective tool of institutional change. Something that would not have been possible within an existing institution can be undertaken when it is formally distinct from the existing arrangement. Over time, the new institution may lead to change in the old institution. Thus, while the OECD project provides a support structure for the existing institutions in the short run, it could well have turned out to exert change in the tax treaty regime in the long run. However, direct interference in a country's tax system has been put off the agenda in favour of the pursuit of administrative assistance and information exchange – instruments that are quite clearly meant to provide a support structure for the existing institutions and not a challenge to them.

The efforts to incorporate anti-avoidance and anti-abuse provisions in bilateral tax treaties are a *functional conversion* of these treaties. An institution is functionally converted if it is assigned additional functions or functions other than those originally intended.[7] While tax treaties were initially designed only to deal with the problem of over-taxation, they now also serve as instruments of curbing under-taxation. However, it is doubtful that these attempts will be successful. Since the problem of under-taxation requires a multilateral response, it can at best deliver partial improvements.

More interesting instances of attempts at functional conversion are the two cases of reinterpretation of fundamental building blocks of the double tax treaty regime. As we have seen, the introduction of CFC rules in many countries and the attempts to reform the ALS had the goal of moving closer to taxing multinational companies on the basis of consolidated accounts rather than the traditional method of separate accounting. The conflicts of interest about these initiatives and the way they were ultimately resolved are quite telling about the institutional resilience of the international tax regime. In both cases we ended up with incremental changes to the original understanding of the concepts but, importantly, actors took great care to subsume this new understanding under the traditional concepts because the entire coordinative setup is based on them. In other words, what we observe is *rule stretching*. The actors want to react to the undermining processes and try to shore up the institution, but at the same time they do not wish to endanger the coordinative setup for fear of not being able to agree on an adequate replacement (the reinforcement process). The technical solutions on which

the regime is based and that have become widely accepted as workable solutions stay in place, while their meaning undergoes an implicit change. Such gradual change is very much in line with what we expect to find in a coordination regime. Its advantage is that it does not endanger the benefits of the coordinative solution but at the same time represents an answer – albeit only partially effective – to the undermining process.

In such processes of gradual change, even the influence of powerful actors is limited. While it is true that powerful actors may be the only ones trying to push for change at all, their overriding interest in being coordinated with other countries makes them act cautiously. This fits with the empirical evidence on the reform of transfer pricing guidelines. The USA was not able and not willing to entirely overturn the standard but contented itself with the implicit changes. One interesting point about this is that the rules of the double tax regime successfully govern actors' behaviour even though they only constitute non-binding soft law. Because states depend on this institution in order to be coordinated at all, they put forward voluntary compliance or act very cautiously if they desire rule changes. Thus, the consensus embodied in the model convention and other guidelines does in fact exert a substantial influence over governments and can constrain their choice of domestic rules for the taxation of international income. Not even powerful actors can simply overturn a standard that has become locked-in, even though it is formally non-binding. The coordination aspect not only produces positive feedback and thus institutional rigidity, it also makes the institution effective in achieving compliance. It may be a good explanation for instances of the seemingly paradoxical 'strength of soft law' that could also be at work in other areas of international relations.[8]

Competing explanation: sovereignty-preserving reform path

The account just offered for the institutional trajectory of the tax regime builds upon the characteristics of a coordination regime. It is plausible in itself, but in order to ascribe causality to this story, it has to be contrasted with competing explanations. One competing explanation could be built upon the notion of sovereignty-preserving cooperation.

Governments want to maintain their tax sovereignty to the largest extent possible. This is visible in the particular setup of the tax treaty regime, which is based on a series of legal constructs that leave governments the freedom to design their tax laws independently. This setup comes under increasing pressure due to the mounting challenge of under-taxation. In this situation governments react to the challenge and try to shore up the institutions of double tax avoidance. As before, they do this in a way that preserves as much sovereignty as possible. In short, rather than ascribing causality to the mechanisms of reproduction, the particular mode of reform can simply be explained by the desire of countries to maintain their national tax sovereignty

to the largest extent possible. Even if there had not been a coordination regime in place before the issue of under-taxation came on the agenda, the reform path would have been exactly the same.

This account is quite plausible. It is true that the argument of national tax sovereignty has played an important role, particularly in the case of the OECD project against harmful tax practices. It is also true that all the observed reforms try to preserve national tax sovereignty if possible. But there are also plausible arguments against this account. In the process of reform, governments have in fact lost some of their national tax sovereignty. As has been shown, the reinterpretations of the ALS and the use of unilateral anti-avoidance legislation move the system closer to consolidated accounts. Thus, there is in fact some parametric tax coordination going on, albeit on a case-by-case rather than on a principled and entirely transparent basis, which means that the restriction on legislative sovereignty is quite small. The same can be said about information exchange. While information exchange may be less of an infringement of tax sovereignty than 'parametric tax coordination' (Keen and Ligthart 2006, 81–2) because it concerns administrative rather than legislative sovereignty, it restricts national tax sovereignty nonetheless. It obliges a country to help another country in the enforcement of its tax laws.[9] Making information exchange more effective was a restriction on sovereignty that was unthinkable during long periods in the history of international taxation. Thus, the actors react to the functional requirements inherent in the asymmetric dilemma and are willing to openly give up administrative sovereignty and, at least implicitly and only grudgingly, also share some legislative sovereignty because the fight against under-taxation requires it.

Ultimately, I cannot discriminate between the two explanations for the reform path with certainty. It remains possible that we would have observed the same reform path whether the coordination regime existed or not. Whereas in Chapter 7 it was possible to show that the desire to maintain sovereignty is not a sufficient condition for the particular institutional form, such an argument cannot be made in this case. Since the institutions of double tax avoidance are organized in a sovereignty-preserving way, the predicted outcome under both accounts is the same, so that I have little explanatory leverage to discriminate between them. While it can be shown that governments give up some sovereignty in order to meet the functional requirements of the under-taxation game, it remains true that they still try to find ways to keep as much of their legislative sovereignty as possible. The path of reform ultimately taken is a smaller restriction of states' sovereignty than a more direct reform of the institutions of double tax avoidance would have been.

It is also true that governments were eager to stay coordinated. This motivation was very apparent, especially in the case of the conflict about transfer pricing methods. On the basis of the available empirical record, the conclusion to be drawn is that both concerns – the desire to remain coordinated

with others and to preserve legislative sovereignty – have played a role. Therefore, I take the two accounts to be more complementary than competing explanations.

A corollary: no multilateral double tax agreement

The problem of double non-taxation creates an externality that needs a multilateral response. I hypothesized that this externality could force governments to conclude a binding multilateral double tax treaty. One direct consequence of the indirect reform path is that such a switch did not occur. Instead, the challenge was answered by rule stretching and layering. While these institutional responses do increasingly contain multilateral elements, double tax treaties, which fulfil the core function of allocating the tax base among countries, remain bilateral. Instead of trying to multilateralize tax treaties themselves, the challenge of under-taxation was answered by constructing a multilateral support structure for them. This is in principle a functionally adequate response to the externality produced by double non-taxation and tax competition.

An implication of this is that there is no direct relationship between effectively preventing under-taxation and a multilateral tax treaty. For one, constructing multilateral institutions that are formally distinct from bilateral treaties can, in principle, prevent under-taxation – though one may have doubts about the long-run effectiveness of such an approach, as I will argue below. Second, not every form of a multilateral tax treaty would necessarily be able to prevent double non-taxation. As has been argued in Chapter 7, it would be possible to get multilateral agreement on a tax treaty built upon the legal constructs and rules currently in use in bilateral treaties, if such a treaty provided for sufficient distributional flexibility to accommodate dyadic investment positions. However, such a treaty would still not prevent under-taxation.

While a direct response to the problem of under-taxation is probably the best answer, the extent to which this immediately leads to a replacement of existing bilateral treaties with a multilateral treaty is not obvious. For example, a switch to a system of formula apportionment, if it is to effectively prevent tax evasion and avoidance, requires multilateral agreement on the definition of the tax base. However, it is possible to combine such a multilateral definition of the tax base with a system of bilateral tax treaties (Vann 1991, 106). Yet, if such a switch were to occur, it would certainly require a degree of multilateral agreement and multilateral pooling of legislative tax sovereignty that has so far been missing in international taxation. The conclusion of a multilateral tax treaty would then arguably be only a formality, not, importantly, a necessity.

How likely is such fundamental change? This is the question to be addressed in the next section.

Will incrementalism prevail over creative destruction in the future?

In this section, I speculate on whether the international tax regime may be subjected to fundamental reform in the future. As discussed in Chapter 3, the two options of incremental reform and creative destruction need not be mutually exclusive. It is conceivable that a process of incremental reform will not be successful in remedying the problems at hand. In that case, it may be followed by more fundamental reform.

This becomes apparent when we consider that there are also costs attached to the path of incremental reform. Thus, in the case of the tax regime the benefits of legislative independence and of staying coordinated on the basis of the traditional solution have to be balanced against the costs of incremental reform. If the costs outweigh the benefits, we would expect fundamental reform. It is difficult to accurately assess the benefits and costs inherent in this choice, and it becomes even more difficult if this is to be done for future developments. Bird and Mintz (2003, 425) argue that we do not know enough about the relevant benefits and costs to make a reasonable judgement. I agree and restrict myself to what I hope are reasonable speculations. I argue that there are reasons to believe that the path of incremental reform will not be viable in the long run because it produces internal contradictions that grow over time.

The costs of incremental reform consist of two aspects. For one, layering and functional conversion may be less effective in curbing tax competition than more fundamental reforms such as forcing other countries to adopt minimum tax rates or introducing formula apportionment. According to Tanzi,

> it seems naïve to assume . . . that enhanced exchange of information among countries independent in their tax affairs is the instrument that will allow countries to cope with the exponential growth of foreign source income that accompanies the increasingly deeper integration of the world's economies. (Tanzi 1995, 89)

One problem with administrative cooperation and information exchange is that it leaves room for manipulations. Many low tax countries have an incentive to install only lax administrative control if they are forced to exchange information with other countries (McLure 1997, para. 62). Furthermore, if the reform path taken is to be successful, then it will incur substantial costs. The construction and effective operation of multilateral information exchange and administrative assistance requires time, money and manpower. In addition to increased expenses for tax administration, incremental reform involves a loss of administrative sovereignty. While it leaves legislative sovereignty to governments, they become more dependent

on other countries in the day-to-day operations of their tax systems. There is a trade-off between legislative sovereignty and administrative sovereignty. Apparently, the trend is contrary to what Cnossen (1996, 11) would consider a healthy development: 'tax sovereignty has to be ceded in establishing the tax entitlement rules so that tax independence can be exercised more fully in administering these rules'. Countries are less willing to give up legislative sovereignty, and are willing to pay the price in terms of administrative sovereignty. However, this need not stay like this as administrative cooperation becomes increasingly costly, and if it should indeed turn out to be less effective in the fight against under-taxation. Apart from that, as I will argue in the following, it is far from clear that enhanced administrative cooperation will leave national legislative sovereignty intact.

The case of administering the transfer pricing regulations shows that actors do indeed consider the costs of incremental reform. However, this has not led them to pool, let alone delegate, some of their legislative sovereignty. Instead, they reacted by devising creative methods of administrative cooperation in the form of APA programmes. APA programmes can be understood as a 'hybrid governance' mechanism that is chosen because the governments are unwilling or unable to implement pure 'hierarchical governance' that implements a solution to the question of the allocation of the tax base (Brem 2005). While this development can be interpreted as evidence that incrementalism will prevail because governments are apparently able to find substitutes for fundamental reform, another interpretation is also plausible.

There are reasons to think that in the long run such hybrid governance solutions may also become ineffective. As has been described in Chapter 6, there is a clear trend towards an implicit consolidation of accounts in the taxation of multinational companies. While administrators formally adhere to the ALS, the reality of transfer pricing is better described as ad hoc formulary apportionment. APAs in particular are often based on such apportionment. Thus, while governments have not agreed ex ante on a definition of a common tax base, such consolidation does de facto take place ex post – on the administrative level. Forced by the sheer pressure of the economic reality of internationally integrated firms, administrations are forced to implicitly define international tax bases. Thus, while governments do not deliberately give up their legislative sovereignty, there is a clear undercurrent to the new forms of hybrid governance that – albeit not openly but only implicitly – puts legislative sovereignty into question. This suggests that there is a limit to the extent to which one can trade off the maintenance of legislative sovereignty against sharing administrative sovereignty. Even if cooperation is 'officially' restricted to sharing administrative sovereignty, this may eventually lead to an undermining of national legislative sovereignty. Forced by the necessity to come up with adequate solutions to transfer pricing problems, administrators (implicitly) consolidate the international tax base, a prerogative that should actually be that of legislators. Thus, while formally there is no

infringement of legislative sovereignty, there is a de facto internationalization of legislative sovereignty through the administrative back door. With further international economic integration the legislative sovereignty that governments officially hold on to will become more and more fictitious.[10]

Sophisticated methods of tax arbitrage such as hybrid entities and corporate inversions are examples of the increasing internal tension within an international tax system built on the notion of sovereignty-preserving cooperation. These cannot be tackled effectively with unilateral anti-avoidance measures for two reasons. First, the application of such measures inevitably results in a proliferation spiral in which governments can only react to ever more sophisticated techniques of avoidance and evasion. The taxpayer will always be one step ahead. Second, and more importantly, it will ultimately lead to conflict among governments. The respective legislation is in contradiction to the sovereignty-preserving approach of double tax avoidance. As long as national governments alone design their tax systems, it is, strictly speaking, not possible to consider tax arbitrage as something illegal (Rosenbloom 2000). This incoherence of the international tax system has only been stabilized because of an implicit consensus among 'high-tax' OECD nations that these violations serve the legitimate goal of avoiding undue double non-taxation. However, as has been worked out, recent developments put this consensus into question. What one OECD country considers undue double non-taxation another considers the desired outcome of its policies. If conflicts of this kind increase in number and intensity, the implicit consensus may break down. If they should in the future be forced to craft an explicit consensus, governments would have to address the current incoherence of the international tax regime head on. Either they drop the ambition to counteract 'tax arbitrage' and continue to have purely national tax systems or they come to harmonize at least certain features of their tax systems – that is, share legislative sovereignty with others – in order to be able to define and counteract 'tax arbitrage'.

Both examples show that staying on the current institutional trajectory of incremental reform is costly. These costs are likely to increase further in the future. It is unlikely, though by no means impossible, that the tax regime will survive these internal contradictions of its setup without undergoing fundamental change. Instead, it seems plausible that governments will at some point wake up to the realization that what they hold on to – that is, legislative sovereignty over designing their tax systems – has become useless. They may then become willing to share their legislative sovereignty with other governments in order to regain de facto sovereignty.

Looking at the historical development of the international tax regime in a long-term perspective, tax sovereignty has seen considerable restrictions, as is evidenced by the implicit trend towards consolidation or the OECD project. The norm of untrammeled national tax sovereignty is no longer taken for granted but is increasingly seen as pathology in need of a (multilateral) fix.

This trend – and this is the thrust of my admittedly bold projection – will not stop short of legislative sovereignty but will in the long run take hold of it. This does not mean that attempts at curbing harmful tax competition will not meet with opposition. On the contrary, transnational businesses and their lobbies will continue to decry attempts to enforce effective regulations on tax competition. This and the specific problem structure inherent in tax competition are important, but in the long run not insurmountable, obstacles to effective collective action by governments.

Fundamental change is unlikely to consist in the creation of a World Tax Organization in the first step. Instead, a reform that would qualify as going beyond incremental change could be the replacement of separate entity accounting with a system of formulary apportionment. Since the ALS is subjected to increasing pressure, many observers believe that transfer pricing is the area in which fundamental change can be expected to occur first (see, for example, Vann 1991, 99). The operation of formulary apportionment would require international agreement on the definition of the tax base and thus a sharing of legislative sovereignty with other countries. But in return, governments would gain de facto control over their tax revenues. Formula apportionment would make the legal constructs of residence and source, which are currently open to various manipulations by taxpayers, superfluous. It uses an entirely different definition of the nexus between the transnational tax base and a country – one that is ideally based on economic substance and not on legal form (see, for example, McIntyre 2004, 924–7). Further, formula apportionment can only be effective in mastering the challenges of double non-taxation if it is based on multilateral agreement (see, for example, Li 2003, 617–18; Couzin 2005, 407). In effect, it would not only be a repair of the current approach but would ultimately lead to entirely different mechanics of double tax avoidance. This is, of course, also the decisive reason why there is so much resistance to it. Nevertheless, I do not believe this resistance to be insurmountable in the future because the costs of the existing solution continue to grow. At least within the European Union, which is economically more integrated than the rest of the world, the creation of a unitary tax base is seriously considered and discussed (Rixen and Uhl 2007).

9
Conclusion: Which Future for International Tax Governance?

In this book, I have explored the governance structure of international income taxation. The causal reconstruction has shown that the underlying strategic structure of double tax avoidance – historically states' only concern – is a coordination game with a distributive conflict. Distinguishing between different stages of the cooperation process – bargaining, agreement and enforcement – I show that bilateral agreements sponsored by a multilateral organization disseminating information and shared practices that all have an interest to follow can best accommodate countries' distributive concerns, which are shaped by the asymmetry of bilateral investment flows. Despite this preference for bilateral agreement, governments have an interest in developing a Model Convention and a multilateral forum for discussion, serving as a focal point. Thus, bargaining is both multilateral and bilateral.

Concerning the ex post phase of cooperation, there is no need for strong enforcement capabilities. Therefore, diplomatic procedures for the resolution of disputes – that is, the Mutual Agreement Procedure – are sufficient to deal with the minor enforcement problems of tax treaty making. The MAP is best understood as a device to speed up ex post amendments to necessarily incomplete tax treaties. Finally, concerns for third country benefits – that is, externalities of bilateral agreements – are not relevant. Consequently, there is no free-rider problem and thus no need for multilateral agreement. Both agreement and enforcement are bilateral.

In a second step, I have tried to make sense of the institutional development of international taxation over time. While the nature of the double tax problem is such that it does not necessitate the interference with countries' tax systems but can be handled through sovereignty-preserving interface regulation, this very setup endogenously creates the problem of double non-taxation, as the economy becomes more global. Double non-taxation exhibits the institutionally more demanding strategic structure of an asymmetric prisoner's dilemma. The cooperative solution to such a dilemma

requires the establishment of multilateral institutions capable of effectively ensuring that countries follow the rules.

These functional requirements of the fundamentally transformed tax game drive institutional change. But full adaptation to them is difficult to achieve because institutional rigidities inherent in the pre-existing setup shape and constrain the ongoing efforts to reform the international tax regime. The core building blocks of the institutions of double tax avoidance are subject to a path-dependent development because of the sunk costs invested in finding the coordinative solution to the fundamental distributive problem. Likewise, the sovereignty-preserving setup provides countries with incentives to create divergent national tax rules, which then make fundamental reform of the regime itself less likely.

Nevertheless, we can observe incremental institutional change, which takes two forms. First, actors construct support structures that are distinct from the core institutions of double tax avoidance (i.e. they engage in layering). This support structure – consisting of administrative cooperation and information exchange – is becoming increasingly multilateral and tries to employ more hierarchical modes of governance. Second, there are gradual changes even of the fundamental constructs of the tax regime, such as the reinterpretation of the separate entity approach through the coordinated introduction of unilateral anti-avoidance legislation and the reformulation of the ALS (i.e. rule stretching). However, these de facto changes are subsumed under the established concepts of international taxation so that the original operability of the system is not endangered. Instead of sharing legislative sovereignty, they respond by merely sharing administrative sovereignty. The goal is to make the bilateral treaty network avoidance-proof without changing the original solution. The durability of the international tax institutions is an instance of the strength of soft law that is reformed only in an incremental fashion.

Finally, I went on to speculate about the long-run viability of the tax regime and the mode of incremental change. While it is conceivable that actors will content themselves with incremental reforms, I argued that the internal tensions inherent in the current trajectory may in the long run lead to fundamental institutional change.

These findings are relevant for research in international political economy in several respects. First, they exemplify that a straightforward and dichotomous classification of international cooperation into bilateral or multilateral cooperation is often not helpful. Instead, it is quite likely that different policy fields will exhibit different mixes of bilateralism and multilateralism at different stages of the cooperation process.

Second, established mechanisms of rational choice institutionalism can help us make sense of the choice between bilateral and multilateral forms of cooperation. However, the account offered here is contingent on a particular configuration and interaction of distribution and enforcement problems.

Other issue areas may exhibit different configurations so that my findings may not be easily transferable to other cases. However, since the explanation developed here is couched in theoretically relevant terms, it should be useful for the development of systematic knowledge about the choice between bilateralism and multilateralism. One conclusion to be drawn from my findings for such future efforts at theory development is that they should pay close attention to issues of bargaining and distribution and their interaction with enforcement problems. As my account has shown, problems of cooperation in double tax avoidance lie mainly within the sphere of bargaining. Since cooperation is made difficult not by the fact that enforcement is problematic but by struggling over the terms of the agreement, most of the governance design elements concern the facilitation of successful bargaining between countries. However, this does not mean that the enforcement phase can be ignored. On the contrary, it is crucial to understand that the (relative) absence of enforcement problems amplifies the intensity of bargaining problems and accounts for the fact that multilateral agreement is not necessary. This finding reinforces the need to understand both the bargaining and enforcement phase and their interaction in order to make sense of institutional design (see also Fearon 1998; Drezner 2000; Koremenos *et al.* 2001; Simmons and Martin 2002; Barkin 2004).

A third implication relates to research on institutional change. Quite surprisingly, the non-binding principles of international taxation embodied in the OECD and UN MC do effectively constrain states' policy choices. The relative resilience of the institutional setup is an instance of the strength of soft law. While the question of why states choose soft law instead of hard law has received some attention in the international relations literature (Abbott and Snidal 2000; Guzman 2005), the unintended effects of soft law have received hardly any attention. My findings on the international tax regime suggest that this could be a fertile area for further research. In a related and more general vein, this study suggests that it is worthwhile for IR scholars to pay close attention to issues of institutional development. At least in the tradition of rational choice scholarship, issues of endogenous change and path dependence have so far received too little attention in the study of international institutions.

Sovereignty and the future of international tax governance

While the original problem of international taxation – double taxation – was primarily about finding a solution to the distributive problem of sharing the international tax base, nowadays the decisive issue is that of finding a satisfactory solution to the enforcement problem inherent in double non-taxation. Only if actors succeed with this will any answer to the question of how to share the transnational tax base be sustainable. Unfortunately, the principles on which the traditional answer is built are precisely the reason

why the current solution is unenforceable. The concepts of residence, source, arm's length or PE are fictions that taxpayers can manipulate quite easily (see, for example, Prebble 1997; Sheppard 2005b). They 'were formulated for a world that no longer exists' (McLure 2001, 333) and 'decreasingly serve to carve up the international tax base in a reasonable and sustainable way' (Bird and Wilkie 2000, 90). Instead, they facilitate the disappearance of the tax base. Because of this causal link between the established institutions of double tax avoidance and double non-taxation, I predict that the international tax regime will be inherently unstable as long as it stays on the current trajectory of indirect and incremental reform.

While it is possible that the system will remain in this state of instability, such an outcome would certainly be normatively undesirable. Unilateral anti-avoidance legislation is a systematic aberration in a system based on sovereignty-preserving cooperation that purposefully violates the protection against double taxation for certain transactions (see, for example, Vann 1991, 108). Similar arguments can be made with respect to current transfer pricing rules (see, for example, Vincent 2005). While in my view this is justified by the goal of preventing undesirable double non-taxation, it is nonetheless evidence for the incoherence of the current international tax system. Furthermore, it is unlikely that increased administrative cooperation and information exchange will suffice to cope effectively with the problem of evasion and avoidance, as long as countries are independent in their tax affairs. The ultimate outcome of all these efforts at incremental adaptation is 'international tax entropy' (Radaelli 1997, 148). To be sure, it is entropy of a special kind: rather than a lack of rules, it consists of a tremendous pile of very complex, and often inherently contradictory, rules.

The problem, however, is that the rules cannot adequately deal with real problems. 'The growing dichotomy between economic reality and the assumptions underlying the existing international tax system need to be bridged' (Bird and Mintz 2003, 419). A solution is needed that addresses *both* the enforcement problem of avoiding double non-taxation and the distribution problem of double tax avoidance in an integrated fashion. One system that would, in principle, address both problems directly is unitary taxation combined with formula apportionment. Governments would have to define a common tax base and agree on a formula that apportions this base to the respective countries. Each country could then apply its own tax rate to its share of the base. With such a system, double taxation is avoided and double non-taxation is also addressed. Such a system would not only be a cure for one element of the old approach but would ultimately lead to an entirely different mechanic of double tax avoidance. The very concepts currently used to allocate the tax base would become superfluous. Instead, the allocation of the tax base would be determined by the formula that would be based on a combination of different factors that better represent economic reality than the old constructs can.

As I have shown, there is strong opposition to unitary taxation and formula apportionment. Many consider it to be arbitrary, and find it unacceptable that the allocation of the tax base will become subject to political negotiations. However, in the absence of uncontrolled comparables – a condition that is the norm rather than the exception – there quite simply is no apolitical criterion to apportion the profits and tax bases to different countries. Thus, the correct question is not whether arbitrariness is acceptable, but whether the arbitrariness of a predetermined formula is less acceptable than a post facto determination of arm's length transfer prices by tax authorities (Vincent 2005, 415). In my view, the answer is clearly no, because a predetermined formula is more transparent and consistent than the ad hoc decisions of tax administrations.

Admittedly, the desirable transparency of unitary taxation and formula apportionment may diminish the chances for realization. Governments may have great difficulties coming to an agreement on a formula because they can easily predict the consequences in terms of the distribution of the tax base. They would have to address the distributive issue head on instead of leaving it to the implicit and seemingly neutral solution of arm's length transfer pricing. However, as has just been argued, in reality the presumed political neutrality of the ALS is illusive anyway.

Additionally, agreement on the definition of a common tax base is difficult to achieve. Defining a tax base narrowly or broadly has different economic consequences (Ganghof 2006a, 25–42; Zodrow 2006, 276–80) and thus governments have different interests on this question depending on the different policy objectives they pursue. The introduction of unitary taxation and formula apportionment would force them to address such issues head on and would require them to share a significant part of their legislative tax sovereignty with others. Most observers believe that in the near future such far-reaching multilateral agreement on a common tax base will remain elusive on a global scale, but may have better chances of realization within regional trade blocs (see, for example, Vann 1991, 154–62). In the EU, the European Commission is currently developing proposals for the introduction of a common consolidated corporate tax base (CCCTB). One reason why there appears to be a higher willingness among at least some governments in the EU to seriously consider the introduction of some form of unitary taxation could be that many of the unilateral anti-avoidance rules have been ruled by the European Court of Justice (ECJ) to be in contradiction to EU law and will thus have to be abolished or modified. Thus, European governments may be forced to acknowledge the incoherence of unilateral anti-avoidance with sovereignty-preserving cooperation. At any rate, the pressure on governments' capacity to raise revenue will increase (Rixen and Uhl 2007). However, even within the EU there are technical obstacles and considerable political opposition that still make the realization of unitary taxation seem quite unlikely.

In order to correctly assess the consequences of unitary taxation and formula apportionment in comparison to separate accounting and arm's length pricing, one important question is to what extent formula apportionment would lead to an undesirable intensification of the competition for real investment. Under formula apportionment, companies could no longer optimize their tax payments through simple profit shifting.[1] They might then react to tax rate differentials by relocating economic 'hardware'. Additionally, due to the harmonized tax base, this competition would also be more transparent and potentially more vigorous. 'Financial' tax competition might be turned into 'real' tax competition with potentially negative welfare effects (for a discussion of the pros and cons of unitary taxation, see McLure and Weiner 2000; Sørensen 2004). Thus, it would be advisable to complement unitary taxation and formula apportionment with a minimum tax rate (Rixen and Uhl 2007, 16).

Unitary taxation and formula apportionment must be considered difficult to implement on a global scale. Therefore, it has been suggested by some scholars that a first pragmatic move to curb double non-taxation may be the introduction of a simple withholding tax at source on non-residents' income (see, for example, Avi-Yonah 2000; Li 2003, 592–6). As we have seen, most techniques of tax evasion and avoidance rely on the manipulation of passive income flows. If such income were subjected to a withholding tax at source, the incentive to engage in evasion or avoidance would be significantly reduced. Given the tremendous administrative difficulties in enforcing residence taxation of such income, many have argued that, if the countries of the world are going to tax income from capital – and such taxation is essential to the survival of income tax as a coherent policy tool (see, for example, Ganghof 2006b) – they must impose some of that tax at the source. Taxpayers seeking to confuse the tax collector by 'funneling capital income through a maze of corporate shells should be subject to cascading withholding taxes at each juncture in the maze' (McIntyre 1993, 317).

While it would not involve a fundamental reform of the foundations of international tax governance, the problem with this proposal is that it would only be feasible if countries multilaterally committed themselves to a minimum withholding rate – and renegotiated their bilateral tax treaties accordingly (Li 2003, 595–6).[2] Thus, even the commitment to a uniform withholding tax, which does not provide an integrated solution to the over- and under-taxation problems, involves the sharing of countries' legislative tax sovereignty.

This illustrates the point made above: the functional requirements of avoiding double non-taxation can only be met if international tax governance moves beyond interface regulation. Only if governments come to share their legislative tax sovereignty, which is becoming ever more fictitious, will they regain de facto sovereignty over their tax systems. Only collectively can they recapture what they have lost individually.

Appendix

Tax treaty database (TTD)

Table A.1 Country acronyms used in the network diagrams

ABW	Aruba	ADN	Aden	AFG	Afghanistan
AGO	Angola	AHU	Austria-Hungary	AIA	Anguilla
ALB	Albania	ALR	Alsace Lorraine	AND	Andorra
ANT	Netherlands Antilles	ARE	United Arab Emirates	ARG	Argentina
ARM	Armenia	ASM	American Samoa	ATG	Antigua and Barbuda
AUS	Australia	AUT	Austria	AZE	Azerbaijan
BDI	Burundi	BEL	Belgium	BEN	Benin
BFA	Burkina Faso	BGD	Bangladesh	BGR	Bulgaria
BHR	Bahrain	BHS	Bahamas	BIH	Bosnia and Herzegovina
BLR	Belarus	BLZ	Belize	BMU	Bermuda
BOL	Bolivia	BRA	Brazil	BRB	Barbados
BRN	Brunei	BTN	Bhutan	BTW	Bophuthatswana
BVI	British Virgin Islands	BWA	Botswana	CAF	Central African Republic
CAN	Canada	CHE	Switzerland	CHL	Chile
CHN	China	CIV	Cote d'Ivoire	CKI	Ciskei
CMR	Cameroon	COG	Congo	COK	Cook Islands
COL	Colombia	COM	Comoros		
CPV	Cape Verde	CRI	Costa Rica		
CUB	Cuba	CYM	Cayman Islands	CYP	Cyprus
CZE	Czech Republic	CZS	Czechoslovakia	DAZ	Danzig
DEU	Germany	DJI	Djibouti	DMA	Dominica
DNK	Denmark	DOM	Dominican Republic	DZA	Algeria
ECU	Ecuador	EGY	Egypt	ERI	Eritrea
ESP	Spain	EST	Estonia	ETH	Ethiopia
FEA	French Equatorial Africa	FIN	Finland	FJI	Fiji
FKI	Falkland Islands	FRO	Faroe Islands	FRA	France
FSM	Federated States of Micronesia	GAB	Gabon	GBR	United Kingdom
GDR	German Democratic Republic	GEI	Gilbert Ellice Islands	GEO	Georgia
GEY	Guernsey	GHA	Ghana	GIB	Gibraltar
GIN	Guinea	GLP	Guadeloupe	GMB	Gambia
GNB	Guinea-Bissau	GNQ	Equatorial Guinea	GRC	Greece

(*Continued*)

Table A.1 (Continued)

GRD	Grenada	GRL	Greenland	GTM	Guatemala
GUM	Guam	GUY	Guyana	HKG	Hong Kong
HND	Honduras	HRV	Croatia	HTI	Haiti
HUN	Hungary	IDN	Indonesia	IMY	Isle of Man
IND	India	IRL	Ireland	IRN	Iran
IRQ	Iraq	ISL	Iceland	ISR	Israel
ITA	Italy	JAM	Jamaica	JER	Jersey
JOR	Jordan	JPN	Japan	KAZ	Kazakhstan
KEN	Kenya	KGZ	Kyrgyzstan	KHM	Cambodia
KIR	Kiribati	KNA	St Kitts and Nevis	KOR	Republic of Korea
KWT	Kuwait	LAO	Laos	LBN	Lebanon
LBR	Liberia	LBY	Libya	LCA	Saint Lucia
LIE	Liechtenstein	LKA	Sri Lanka	LSO	Lesotho
LTU	Lithuania	LUX	Luxembourg	LVA	Latvia
MAC	Macau	MAR	Morocco	MCO	Monaco
MDA	Moldova	MDG	Madagascar	MDV	Maldives
MEX	Mexico	MHL	Marshall Islands	MKD	Macedonia (Former Yugoslav Republic)
MLI	Mali	MLT	Malta	MNG	Mongolia
MNP	Northern Mariana Islands	MNR	Myanmar	MOZ	Mozambique
MRT	Mauritania	MSR	Montserrat	MTQ	Martinique
MUS	Mauritius	MWI	Malawi	MYS	Malaysia
MYT	Mayotte	NAU	Nauru	NAM	Namibia
NCL	New Caledonia	NCY	Northern Cyprus	NER	Niger
NFL	Newfoundland	NGA	Nigeria	NIC	Nicaragua
NIU	Niue	NLD	Netherlands	NLI	Netherlands Indies
NOR	Norway	NPL	Nepal	NZL	New Zealand
OMN	Oman	PAK	Pakistan	PAN	Panama
PAT	Palestinian Autonomous	PER	Peru	PHL	Philippines
PLW	Palau	PNG	Papua New Guinea	POL	Poland
PRI	Puerto Rico	PRK	Democratic People's Republic of Korea	PRS	Prussia
PRT	Portugal	PRY	Paraguay	PYF	French Polynesia
QAT	Qatar	QBC	Quebec	REU	Reunion
RNY	Rhodesia Nyasaland	ROM	Romania	RUS	Russia
RWA	Rwanda	SAU	Saudi Arabia	SBS	Swiss Canton Basel-Stadt
SCA	Swiss Canton St Gallen	SCB	Swiss Canton Basel-Land	SCG	Swiss Canton Graubünden
SCN	St Christopher Nevis	SCS	Swiss Canton Solothurn	SDN	Sudan

(*Continued*)

Table A.1 (Continued)

SEN	Senegal	SGB	Saargebiet	SGP	Singapore
SLB	Solomon Islands	SLE	Sierra Leone	SLV	El Salvador
SMR	San Marino	SOM	Somalia	SPM	St Pierre Miquelon
STP	São Tome and Principe	SUN	Soviet Union	SUR	Suriname
SVK	Slovakia	SVN	Slovenia	SWE	Sweden
SWZ	Swaziland	SYC	Seychelles	SYR	Syria
TCA	Turks and Caicos Islands	TCD	Chad	TGO	Togo
THA	Thailand	TJK	Tajikistan	TKM	Turkmenistan
TON	Tonga	TRK	Transkei	TTO	Trinidad and Tobago
TUN	Tunisia	TUR	Turkey	TVA	Tuvalu
TWN	Taiwan	TZA	Tanzania	UGA	Uganda
UKR	Ukraine	URY	Uruguay	USA	United States of America
UVI	US Virgin Islands	UZB	Uzbekistan	VCT	St Vincent and Grenadines
VDA	Venda	VEN	Venezuela	VNM	Vietnam
VUT	Vanuatu	WSM	Samoa	YEM	Yemen
YUF	Yugoslavia (former)	YUG	Serbia and Montenegro (Yugoslavia)	ZAF	South Africa
ZAR	Democratic Republic of Congo	ZWB	Zambia	ZWE	Zimbabwe

Data sources for tax treaties

The self-compiled database was taken from Tax Analysts (1997; 2004) and IBFD (2005). The compilation was completed on 18 January 2005.

There is no comprehensive listing available for the time before the First World War. I have included the treaties listed in Spitaler (1936), Carroll (1939) and Rosendorff and Henggeler (1936–43).

Data sources for other information used in the network diagrams

OECD Membership is from http://www.oecd.org.

Income is the World Bank Classification (as of July 2004), available at http://www.worldbank.org. The categories are: 1, low income; 2, middle income; 3, high income; 0, no data available.

Level of FDI is from the UNCTAD Handbook of Statistics (http://stats.unctad.org/handbook, accessed 23 June 2006). The numbers used are those from 2003.

Data sources for other descriptive data used

Tax ratios from 1968 onwards are from OECD (2006b). The data point for 2004 is that of 2003.

Tax ratios for the years 1913 to 1963 are from Mitchell (2003). They were constructed by averaging the tax ratios of Japan, Australia, the USA, Canada, Austria, the UK, France, Denmark, Italy, Germany, Norway, Sweden and Switzerland.

FDI in relation to gross world product comes from UNCTAD (2006).

Data for the years 1913, 1938, 1963 and 1973 are from Dunning and Archer (1993, 64), and Maddison (1996). They consider the estimated stock of accumulated FDI in developed countries, instead of the entire world. The entry for 1913 is that for 1914 in the source; the entry for 1963 is that for 1960 in the source; the entry for 1973 is that for 1971 in the source.

The regression analysis

Due to restricted data availability, I could include only 80 treaties in the analysis (see Table A.2). Most importantly, for many other pairs of countries, especially outside the OECD, FDI data are not publicly available.

Table A.2 Treaties included in the regression analysis

Country A	Country B	Year signed
Australia	New Zealand	1995
Australia	South Africa	1999
Australia	United Kingdom	2003
Austria	France	1993
Austria	Germany	2000
Austria	Russia	2000
Austria	Singapore	2001
Austria	Slovenia	1997
Austria	South Africa	1996
Austria	United States	1996
Canada	Denmark	1997
Canada	Germany	2001
Canada	Japan	1986
Canada	Mexico	1991
Canada	Netherlands	1986
Canada	Norway	2002
Canada	Sweden	1996
Canada	Switzerland	1997
Czech Republic	Canada	2001
Denmark	Italy	1999
Denmark	Poland	2001
Denmark	Portugal	2000
Denmark	Singapore	2000

(*Continued*)

Table A.2 (Continued)

Country A	Country B	Year signed
Finland	Austria	2000
Finland	Netherlands	1995
Finland	Russia	1996
France	Japan	1995
France	Mexico	1991
France	Russia	1996
France	Spain	1995
France	Sweden	1990
Germany	Denmark	1995
Germany	India	1995
Germany	Indonesia	1990
Germany	Italy	1989
Germany	Republic of Korea	2000
Germany	Mexico	1993
Germany	Norway	1991
Germany	Russia	1996
Germany	Sweden	1992
Germany	Turkey	1985
Germany	USA	1989
Italy	France	1989
Italy	Netherlands	1990
Italy	Turkey	1990
Italy	UK	1988
Japan	Republic of Korea	1998
Japan	Malaysia	1999
Japan	Norway	1992
Japan	Turkey	1993
Japan	USA	2003
Netherlands	Denmark	1996
Netherlands	Indonesia	2002
Netherlands	Portugal	1999
Netherlands	USA	1992
Norway	Austria	1995
Norway	Ireland	2000
Norway	Netherlands	1990
Norway	UK	2000
Poland	Germany	2003
Poland	Netherlands	2002
Portugal	Brazil	2000
Slovakia	Czech Republic	2002
Sweden	USA	1994
Switzerland	USA	1996
UK	India	1993
UK	Republic of Korea	1996
UK	Malaysia	1996
UK	Singapore	1997

(*Continued*)

Table A.2 (Continued)

Country A	Country B	Year signed
UK	South Africa	2002
UK	USA	2001
USA	Denmark	1999
USA	France	1994
USA	Indonesia	1988
USA	Ireland	1997
USA	Italy	1984
USA	Mexico	1992
USA	South Africa	1997
USA	Spain	1990
USA	Venezuela	1999

Table A.3 Descriptive statistics of variables used in the regression analysis

Variable	Mean	Standard deviation	Minimum	Maximum	*N*
Withholding tax (all)	8.278	5.657	0	20	320
On dividends	14.338	2.316	0	20	80
On associated dividends	6.013	4.074	0	15	80
On interest	6.5	5.704	0	15	80
On royalties	6.263	5.004	0	15	80
Investment position (asymmetry in FDI stock)	4,290.89	11,936.86	42.8	102,458.8	80
Outward FDI stock (stock of country A in B)	9,510.006	28,395.55	117.4	208,534.2	80
Inward FDI stock (stock of country B in A)	5,219.116	22,973.96	−349.8	198,656.9	80
Bargaining power (A's relative share)	0.550	0.315	0.0100	0.995	80
Capability of A	0.031	0.041	0.001	0.15	80
Capability of B	0.026	0.043	0.0004	0.15	80
Sum of per capita GDP	38,766.31	11,263.62	15,612	62,839.74	80
Per capita GDP of A	21,524.24	5,981.888	6,988.11	33,529.68	80
Per capita GDP of B	17,242.07	8,704.813	1,740.73	37,313.33	80

Data sources

Source withholding rates are from Tax Analysts (2004).

Bilateral investment positions (inward stock and outward stock) are from the OECD's International Direct Investment Statistics Yearbook, available at http://www.sourceoecd.org.

GDP per capita data are from the Penn World Tables, available at http://pwt.econ.upenn.edu.

Additional material

Table A.4 Unilateral and treaty relief methods of OECD countries in 2001

	Unilateral relief		Treaty relief	
	Dividends	**Interest**	**Dividends**	**Interest**
Australia	Credit	Credit	Exemption	Credit
Austria	Exemption	Credit	Exemption	Credit
Belgium	Exemption of 95%	Credit	Exemption of 95%	Credit
Canada	Credit	Credit	Exemption	Credit
Czech Republic	Deduction	Deduction	Credit	Credit
Denmark	Exemption	Credit	Exemption	Credit
Finland	Exemption	Credit	Exemption	Credit
France	Exemption of 95%	Credit	Exemption of 95%	Credit
Germany	Exemption of 95%	Credit	Exemption of 95%	Credit
Greece	Credit	Credit	Credit	Credit
Hungary	Exemption	Credit	Exemption	Credit
Iceland	Credit	Credit	Credit	Credit
Ireland	Deduction	Deduction	Credit	Credit
Italy	Exemption of 60%	Credit	Exemption of 95% (for EU countries only)	Credit
Japan	Credit	Credit	Credit	Credit
Korea	Credit	Credit	Credit	Credit
Luxembourg	Exemption	Credit	Exemption	Credit
Mexico	Credit	Credit	Credit	Credit
Netherlands	Exemption	Credit	Exemption	Credit
New Zealand	Credit	Credit	Credit	Credit
Norway	Credit	Credit	Credit	Credit
Poland	Credit	Credit	Credit	Credit
Portugal	Credit	Credit	Exemption (for EU countries only)	Credit
Slovakia	Deduction	Deduction	Credit	Credit
Spain	Exemption	Credit	Exemption	Credit
Sweden	Exemption	Credit	Exemption	Credit
Switzerland	Exemption	Deduction	Exemption	Credit
Turkey	Credit	Credit	Credit	Credit
UK	Credit	Credit	Credit	Credit
USA	Credit	Credit	Credit	Credit

Source: Information from Yoo (2003).

Notes

Chapter 1

1. The issue scope of international taxation is 'anything involving cross-border transactions' that is subject to *direct* national taxation (Eden 1998, 72). Indirect taxes, most importantly consumption taxes and other value added taxes, are not dealt with in the international tax regime. To the extent that there are international implications, they fall under the international trade regime (Daly 2006, 527–8) and are thus not considered in this study.
2. Tax competition refers to a situation in which governments compete to attract tax base. International tax evasion and avoidance refer to attempts by taxpayers to escape fiscal authorities. The difference between evasion and avoidance is that the first is illegal, whereas the latter is not. In the famous words of former British Chancellor Denis Healey, this difference is the 'thickness of a prison wall' (cited by the *Economist* 2000).
3. States are not obliged to deposit their treaties with the United Nations, so the numbers should be a lower bound estimate. The search was restricted to 'original agreements' and therefore subsequent amendments to a treaty are not included. A treaty is classified in the database as multilateral if it has at least three participants.
4. A particularly ironic critique in this respect can be directed towards early game-theory regime research that used two-person games to analyse multilateral cooperation. Even though the bilateral form of the games would suggest otherwise, there is little explicit discussion of bilateralism in this work. While these scholars correctly stated that two-person games can be used for the analysis of *N*-person situations, they hardly ever considered truly bilateral interactions. Some of the rare exceptions in the earlier literature, where bilateralism plays a role, are Oye (1985), Snidal (1985a) and Pahre (1994).

Chapter 2

1. The analytic narrative approach is similar to Scharpf's (1997). 'actor-centred institutionalism' and the 'strategic choice approach' in international relations (Lake and Powell 1999).
2. The contributors to the analytic narratives volume start their investigations in the inductive mode by first presenting the empirical material. In contrast I start the investigation with a theoretical model. While the researchers in the analytic narrative volume do not make such a step explicitly, it can be argued that they must have used an implicit model. Otherwise, how would they be able to discriminate between relevant and irrelevant aspects of the story? On the other hand, it could be argued that constructing a model always entails knowing something about the empirical material. In a sense, then, whether to start inductively or deductively is just a matter of deciding where to explicitly begin the inescapable and infinite regress of deductive and inductive reasoning.
3. Some argue that testing a model that is derived from a single case against evidence from that case cannot confirm the model. However, this problem can be addressed by testing against evidence that has not been used to construct the model. Thus, it

is important to use *other* evidence for the test than that used for the construction of the model (George and Bennett 2005, 109–10).

4. At the same time, societal interest constellations may also be influenced by developments on the international level. There is 'mutual causation' (Frieden and Martin 2002, 120–6).
5. Similar conceptualizations are put forward by Martin (1993), Aggarwal (1997) and Drezner (2000).
6. Cooperation in the real world has bargaining and enforcement phases. Even if there is no explicit analytical enforcement problem, the agreement has to be enforced. Such enforcement is then institutionally less demanding. There might still be some interesting institutional features to be observed, depending, for example, on the degree of uncertainty involved in cooperation. But in order to see that, one has to consider the enforcement phase as a distinct phase. Likewise, if there is no serious conflict about the distribution of benefits, bargaining might not be very tough and probably does not take very long. Again, in order to see that, one has to conceptually consider the bargaining phase.
7. Efforts to protect the ozone layer might serve as an example. In this instance, there is a problem of enforcing an agreement because due to the nature of the object of cooperation, states have the opportunity to free-ride. While everybody would benefit from the reduction of emissions, a single state would be even better off if everybody else abstained from emitting and it did not. In this way, depletion of the ozone layer would be prevented, but they could still emit CO_2. We would thus expect efforts to establish broad multilateral cooperation and effective enforcement mechanisms so that free riding is prevented. Given that the large industrialized countries are responsible for much larger CO_2 emissions, there are also distributional issues involved. Who bears which parts of the costs of reducing emissions? Thus, one might expect tough bargaining on the distribution of the costs if an efficient enforcement mechanism is in place, but at the same time, states only agree to efficient enforcement if they are sufficiently content with the distribution of the benefits they agreed upon.
8. Even if contingencies could be known, the transaction costs of agreeing ex ante on contractual provisions for highly unlikely cases might be too high to incur. However, subject to this constraint, parties to an agreement try to make their contracts as precise as possible ex ante. Thus, the expectation would be that (different) treaties on the same or similar kind of transactions become more detailed over time, as negotiators learn about potential contingencies.
9. North (1995, 24) has observed that the very existence of institutions contradicts the notion of perfect rationality. If all actors knew everything and had perfect foresight all the time, institutions as devices that reduce information costs and implement credible commitments would not be needed. Therefore, the assumption of limited rationality is a precondition for rational choice *institutionalism*.
10. What I refer to as de jure sovereignty is labelled 'operational sovereignty' by Keohane (1993), who referes to de facto sovereignty as 'effectiveness'. In addition to that, Keohane also introduces a third category, 'formal sovereignty', which is a necessary attribute of any state that is a member of the international system. '[F]ormal sovereignty is threatened neither by international interdependence nor by international agreements ..., indeed it is the property of a sovereign state that it has the authority to enter into agreements' (Keohane 1993, 93). Thus, a formally sovereign state is free to agree to limits on its de jure sovereignty, e.g. by agreeing on a common tax base with other countries. One possible motivation to accept a sharing of de jure sovereignty could be the insight that it is

necessary to do so under conditions of interdependence or globalization (Keohane 1993, 93–4).

Chapter 3

1. These are the standard assumptions of welfare economics. For a precise statement of this condition, see, for example, Atkinson and Stiglitz (1980, Lecture 11) and Musgrave and Musgrave (1989, Chapter 5).
2. The assumption that governments' main concern is the maximization of their citizens' welfare is subject to debate in the public finance literature (Buchanan and Musgrave 1999). Other possible assumptions are that they are interested in maximizing tax revenue (Brennan and Buchanan 1980), political rents or a mixture of these (Edwards and Keen 1996; Persson and Tabellini 2000). The assumption chosen here is in line with the standard assumption in welfare economics and selected for matters of convenience. In line with the deductive–inductive–deductive sequence pursued in this book, it is scrutinized in Part III.
3. However, it might also lead to a reduction in the rate of return on investment in B, since capital is more plentiful. Overall, it can be assumed that national welfare in B would nonetheless increase.
4. The interaction between the countries is referred to as 'competition' in this literature, because the countries pursue their own national self-interest and interact purely strategically (for overviews of this literature, see Gresik 2001, 814–27; Davies 2004). Thus, the assumptions are the same as in my derivation of the strategic structure. In general, while economists have analysed the welfare implications of residence or source taxation and the methods of double tax relief in great detail, they have not paid very much attention to the strategic interaction of countries in this area. Thus, they implicitly assume that the residence or source principle is implemented exogenously (see, for example, Cappelen 1999, 440–1). But note that a few lawyers have considered the strategic interaction among governments. For example, Dagan also describes double tax avoidance as a coordination game. However, she derives this game structure on the basis of somewhat different assumptions from those I use here. Green (1998), without labelling the strategic structure in a particular way, comes very close to the game that is presented here (see my brief discussion in Chapter 7). Shaviro (2002, 318–19) describes the situation as a prisoner's dilemma without rigorously deriving the strategic structure.
5. A good diagrammatic exposition of how a country can individually profit from a policy of deduction at the expense of world welfare is provided by Caves (1996, 189–200). It should be noted that the model of Bond and Samuelson (1989) is different from those of Hamada (1966) and Musgrave (1963; 1969) in that it makes the choice of tax rates endogenous. A country can simultaneously choose both the method of double tax relief and the tax rate.
6. However, the deduction method still plays a prominent role in this model, because it remains the dominant strategy in many, though not all, specifications of the situation (Davies 2003, 745).
7. In the case of a credit system, this is only true because I still assume that the tax rate is the same in both countries.
8. Because of the declining rate of return, its tax revenues from home investment might also go down. This effect would probably be (over-) compensated by an increase in tax revenue from other tax bases that become more profitable due to

increased investment from abroad; for example, the income of labour employed by foreign capital.

9. For overviews of the literature, see Oates (1999), Wilson (1999), Wilson and Wildasin (2004) and Rixen (2007).
10. There is a quite recent theoretical and empirical literature on the welfare effects of allowing or closing tax 'loopholes' for multinationals (see, for example, Janeba and Smart 2003; Bucovetsky and Haufler 2005; Desai *et al.* 2006). This literature has drawn some counterintuitive conclusions. In arguing that the game can be represented as a prisoner's dilemma, I adopt what could be labelled the conventional wisdom on this question that has recently been revived by Slemrod and Wilson (2006).
11. Since the payoffs are ordinal, the numbers were adjusted accordingly. Here I do not depict the situation for asymmetric country sizes, but for simplicity show only the regular prisoner's dilemma.
12. While the enforcement problem is more fundamental, it does not have to be solved first in a temporal sense. Instead, it is enough that actors expect to be able to find a solution to the enforcement problem. In real-world bargaining situations, actors may be forced to switch back and forth between bargaining and enforcement problems (see Heckathorn and Maser 1987, 154–7). They have to decide not only *how* to enforce an agreement, but also *what* agreement to enforce (see Garrett and Weingast 1993, 179–81). This may complicate the discovery of adequate institutional solutions.
13. Therefore, one could say that the notion of punctuated equilibria is similar to the account of institutional adaptability in a model of perfect rational choice. In both accounts, institutions are adapted if they become inefficient. Immediately after the redesign, they will be perfectly efficient. The difference is that the level of inefficiency required for change to occur is much higher in a punctuated equilibrium conception, whereas under the assumption of perfect rationality the institutions adapt immediately.
14. This shows that incremental reform may aim only at a 'meliorative, rather conservative mode of response to any dysfunctional aspects' of the existing institutions (David 1992, 18). As has been argued above, the effective solution to the undertaxation problem requires multilateral cooperation. Introducing more effective bilateral information exchange is still inefficient but less so than ineffective or no information exchange.

Chapter 4

1. In the words of the OECD: 'Double taxation's harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries' (OECD 2005b, Introduction, para. 1).
2. To see this, one can distinguish between *economic double taxation* and *juridical double taxation* (Vogel 1991, m.no 5; Arnold and McIntyre 1995, 31–3). Economic double taxation occurs whenever there is multiple taxation of the same item of income. International double tax avoidance is generally only concerned with juridical double taxation, which is defined as 'the imposition of comparable income taxes by two or more sovereign countries on the same item of income

(including capital gains) of the same taxable person for the same taxable period' (Arnold and McIntyre 1995, 31).

3. T. S. Adams, one of the leading figures in the development of the US system of international taxation and the international tax regime, once stated: 'A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment' (cited by McLure 2000, 6:4).
4. This is possibly the main reason why it has proven to be so much more difficult to find a solution to the problem of allocating taxing rights in the field of direct taxation than in the field of indirect taxation. Since the objective of indirect taxation is to tax consumption, it was relatively easy to agree on a general principle: to allocate the tax jurisdiction to the destination country, where consumption takes place (Seligman 1928, 11–12). Such a straightforward and self-evident focal point does not exist in direct taxation.
5. Neutrality in this sense is only identical to economic efficiency under the assumption of perfectly competitive markets. In the case of market imperfections, a tax might even help to achieve economic efficiency.
6. This is true except for a lump-sum tax that would take a fixed amount from everybody. Such a tax is generally regarded as inconceivable under present conditions. The issue of trying to design a 'second-best' tax system that causes the least distortion in economic decisions is the domain of the theory of 'optimal taxation' (see, for example, Atkinson and Stiglitz 1980, Lectures 13 and 14; Slemrod 1990a).
7. To achieve this fully, the residence country would have to pay a negative tax to the taxpayer in a case of excess credit, where the tax paid abroad is higher than the tax due at home. In reality the tax credit is usually limited to the domestic tax rate, so that there is no refund for taxes paid abroad. This is so because removing the limitation on the tax credit would provide source country governments with an incentive to tax foreign investments excessively (Frisch 1990, 583).
8. Underlying these assumptions are the claims that the intertemporal substitution of consumption is low, indicating a low interest elasticity of savings, and that the international substitutability of capital is high, indicating a high elasticity of investment. Whether this assumption is correct or not is actually an empirical issue. The majority of economists agree with the assumption (OECD 1991, 40–2).
9. Thus, DTAs do not intervene with the definitions of the tax bases. The national tax base definitions are accepted, even though there may be quite significant differences between them; for example, different standards of accounting (Brauner 2003, 271–3). This shows that the treaties target juridical and not economic double taxation.
10. The difference between a branch and a subsidiary is that the first is a dependent agency of the parent company. In contrast to that, the subsidiary is legally independent from the parent company, which owns shares of the subsidiary and thus exerts economic control.
11. Note that a subsidiary is of course also liable to tax in the country where it operates; that is, at the source. However, this tax liability is not created by virtue of being a PE but because it is a legally independent resident of that country. Because of this status, one might expect that the home country would not credit or exempt the corporation profit tax against taxation at home. In reality, however, many countries, such as the USA, the UK and Japan, do provide a so-called 'indirect tax credit'. Thus, if a subsidiary chooses to remit after-tax profits to its parent company in the form of dividends, the home country not only credits the withholding tax

on the dividend payment but in addition also credits the corporate tax paid at source (see, for example, Vann 1998, 770–4).

12. In fact, with respect to the parent–subsidiary relationship the ALS must not be violated at all, whereas for the case of a PE branch, formula apportionment may be used if the result is in accordance with the ALS (OECD 2005b, Art. 7, para. 4). However, recently, the OECD has been considering whether to exclude paragraph 4 from this article (Li 2003, 609–10; Vincent 2005).
13. With respect to the dividend withholding tax, one of the topics that has received considerable attention is the question of the degree to which countries using an integrated system of business taxation, in which the tax paid at the corporate level is in one way or another credited towards personal income taxation, have to grant this treatment to foreign shareholders as well. In general, this is not the case, but some countries did so through their tax treaties (see, for example, Ault 1992; Vann 1998, 767–70). However, in recent years there has been a general trend away from integration systems in most countries (see, for example, Weichenrieder 2005, 9–10).
14. This special rule for income from public service is probably due to the consideration that historically it was seen as inappropriate for a state to tax another state. Today such an understanding seems outdated; one should instead differentiate between the office a public servant holds and the private income she receives for it. The rule is nevertheless still valid.
15. Countries with 'indirect foreign tax credits' are even more generous. Not only do they allow the company to defer taxation in the country of residence, but in addition, if dividend income is repatriated, they also credit the corporation tax paid at source through the indirect tax credit (Vann 1998, 770). Such a policy is actually inconsistent with the presumed rationale of deferral, which is to accept the foreign subsidiary as an independent legal entity (see, for example, Musgrave and Musgrave 1972, 76; Green 1993, 25).
16. However, national treatment is only approximated, since the dividends and interest of foreign investors are taxed on a gross basis. In contrast, home investors are assessed on a net basis. The reduced treaty rate on gross income usually cannot guarantee equal treatment but only represents a rough approximation of non-discrimination. Apart from that, tax treaties leave room for discrimination in residence taxation. A country is free to favour international investment by its residents over their home investment; for example, by granting an exemption rather than a credit for foreign investment income. But since this is a matter of discriminating among *its own* residents, it is not subject to tax treaty constraints.
17. This classification has different tax consequences. Such classifications can be particularly controversial in the context of 'thin capitalization rules' that are intended to counter tax avoidance (Arnold and McIntyre 1995, 72–6).
18. There are important exceptions to this. Switzerland, for example, generally only includes the narrow clause in its treaties (OECD 2005b, commentary on Art. 26, para. 24).
19. The willingness of residence countries to grant double tax relief unilaterally is another indicator of the acceptance of the idea of first crack (Arnold and McIntyre 1995, 31–2).
20. The actual rules contained in the national tax codes can be quite complex. As far as possible, this table represents the stylized facts of a more or less complicated tax code for two important categories of transborder income flows (for further details see Yoo 2003).

21. As explained above, extended deferral is equivalent to an exemption of foreign source income. However, the incentive effect of deferral is different because it actively discourages repatriation. Deferral may thus make it even less likely than exemption that the country of residence benefits from investment abroad (Bird 1988, 295; see also Hartman 1985).
22. In this case, the loophole was intentionally created by the USA: 'During the early 1960s, the US government, in an effort to prevent a devaluation of the dollar in a time of fixed exchange rates, decided that providing such access would be in the best interests of the nation's economy' (Papke 2000, 299). The US Deficit Reduction Act of 1984 repealed the unilateral withholding tax. There is empirical evidence that before 1984 borrowing from abroad was conducted through the Antilles, whereas afterwards corporations did it directly (Papke 2000, 308).
23. While it may appear as if CFC rules were only relevant for countries employing the credit method of double tax avoidance, they are also relevant for exemption countries. The latter need these rules to be able to employ the exemption with progression method.
24. Assuming a country runs an imputation or shareholder credit system in its corporate tax system and both the investor and the corporation are domestic, the advantage on the side of the investor would vanish. But often there is no imputation credit for shareholders of foreign corporations (Ault 1992, 578–80). Thus, in countries operating an imputation credit system, thin capitalization becomes more attractive internationally than it is in a purely domestic context.
25. In addition to these measures, those countries generally opting for the exemption of foreign source income sometimes insert so-called 'switch-over clauses' into their tax treaties, under which they can switch from exemption to credit in reaction to a change of the other country's national tax law (Krabbe 2000, 473).
26. Admittedly, the gap between the legal construction of a tax base and its real economic substance may not be closed entirely. At the most fundamental level, it is a result of the 'logical separation between the world of physical facts and the world of abstract concepts' (Prebble 1997, 387). We necessarily need abstract concepts to make the world of real facts (legally) tractable, and thus there is necessarily a gap between economic substance and legal form. However, the gap may be bigger or smaller.
27. Others also doubt whether the established concepts of neutrality are a sensible guideline for developing an international tax policy that is in line with national interest. For example, according to McIntyre (1993, 320), CIN is only in the interest of big business and thus 'a lobbying position, not a coherent tax policy goal', whereas CEN enhances worldwide welfare and not necessarily national welfare. The fact that normative arguments are employed in policy discussions is not proof that governments are inherently interested in these goals. For example, Bird and Wilkie (2000, 90–1) state that 'international tax rules are essentially an attempt to work out a division of economic income between two political jurisdictions: they are inherently pragmatic and they are purpose-driven. ... Normative rationalizations of particular sets of operational rules may come along later and become widely accepted.' Whether the rules actually precede the normative rationalizations in a strict sense or, as I have argued here, neutrality and equity may, in certain respects, be intermediary goals in the pursuit of national interests, is difficult to judge and can be left open.

Chapter 5

1. Examples include such well known tax experts as T. S. Adams, who, as well as being a member of the ICC's committee on double taxation (Graetz and O'Hearh 1997, 1066), was also US representative in the Group of Technical Experts and a Professor at Columbia University, and Professor Bruins, one of the League's four economists (Spitaler 1936, 14).
2. It is quite surprising that the ICC considered solving the problem of assigning the right to tax to be unproblematic. In fact, there was opposition to the pure residence principle even within its own ranks. The ICC had actually reversed its own preference from the source to the residence principle between 1921 and 1923 (Wang 1945, 97–9).
3. The four economists had already noted this fact of real life: 'A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner' (League of Nations 1923, 39).
4. For example, in the USA it was argued that 'our people get the worst of it, and they ought to, if they go to another country to invest. Let them invest in their own country' (Kansas Senator Curtis in 1921, cited by Graetz and O'Hearh 1997). One reason that had been given in the USA for the introduction of a unilateral tax credit was that without it many US citizens working abroad – for example, in Canada – would be induced to give up their US citizenship (Picciotto 1997, 1026 n22).
5. In the early League of Nations activities, the UK rigorously advocated the strict residence principle. As long as source states were not willing to relieve double taxation, the UK as a residence state was not willing to forgo tax (Blackett 1921). However, in line with the stance of pure residence taxation, the British had not taxed foreigners at source. Furthermore, in relation to its overseas dominions, the UK did relieve double taxation as a residence state. They began to change their position in the late 1920s, but it was not until the 1940s that Britain signed a comprehensive double tax treaty that acknowledged the right to tax foreign income at source (Graetz and O'Hearh 1997, 1071–2).
6. Consolidated Model Conventions were published in 1994, 1995, 1997, 2000, 2003 and 2005.
7. Some observers have criticized the UN for not marking its intentions more explicitly in the text of the model itself (Dagan 2000, 992).
8. The represented non-member countries are: Albania, Bulgaria, China, Croatia, Estonia, Gabon, Israel, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, the Philippines, Romania, Russia, Serbia and Montenegro, Slovenia, South Africa, Thailand, Tunisia, Ukraine and Vietnam.
9. Further, given the possibilities of manipulating residence status, it may even be doubtful whether there is residence taxation in its stead. Thus, e-commerce also raises problems of double non-taxation.
10. All the information and descriptive statistics in this section are from the TTD (see the Appendix).
11. Structural equivalence is a concept from social network analysis. 'Two vertices are structurally equivalent if they have identical ties with themselves, each other and all other vertices' (de Nooy *et al.* 2005, 266). Of course, not all countries in the same class are structurally equivalent in the strict sense. They are considered to be structurally equivalent only if they are sufficiently similar with respect to their ties (treaties) with other countries (Scott 1991,128). The researcher chooses the number of structurally equivalent classes. The partition is determined through

a procedure called 'blockmodelling' (Scott 1991, 134–48; de Nooy *et al.* 2005, 274–88).

12. Cluster one has a higher degree of structural equivalence than cluster two, which in turn has a higher degree of structural equivalence than class three. By grouping the countries into three structural equivalence clusters, I have put some stress on the data. The overall error that is placed on the data by imposing the three classes is detailed in the Appendix.
13. My use of 'core' and 'periphery' of the double tax treaty network refers to the fact that the countries in the core exhibit a higher level of structural equivalence and are thus well connected with each other and have similar ties to the periphery, which exhibits a lower degree of structural equivalence (de Nooy *et al.* 2005, 274–9). Thus, it should not be confused with the concepts of a 'k core' and an 'm core', which are established concepts of network analysis (Scott 1991, 113–17).
14. The density would be higher if one left out the newer members with very few treaties.
15. An interesting aspect is that the UK and France still have many treaties with their former colonies. As in 1958, these colonies generally only have this one treaty. As was the case for the 1958 network, if one imposed three or four structurally equivalent clusters, then the UK and France would not be in the same one. In contrast to 1958, the UK would not be alone in its cluster but would form a cluster together with Norway, Sweden, Denmark and Switzerland.
16. Vietnam had four treaties in 1993 and 27 in 1998. Pakistan had 30 in 1993 and 38 in 1998.

Chapter 6

1. The available economic indicators suggest that the business of offering tax shelters is profitable (Hines 2004). Notwithstanding this fact, specializing in 'offshore' activities can have negative long-run economic and social consequences for a country if the entire economy becomes dependent on the offshore sector (see, for example, Hampton and Christensen 2003).
2. In addition there are 'production havens', which not only attract 'paper profits', but are also attractive locations for real production (Eden and Kudrle 2005, 101). Ireland may be an example.
3. The US rules were aimed at the use of foreign subsidiaries as incorporated pocketbooks, which serve no substantive economic purpose other than the tax privileged holding of liquid assets for a corporation (US Treasury 2000, 5–10, 106–25). They were the forerunners of CFC legislation, but were far less comprehensive.
4. However, while the general anti-deferral regime was tightened, Congress at the same time believed that reduced US tax for exports was necessary to encourage trade. Therefore, it enacted the Domestic International Sales Corporation (DISC) regime, which explicitly allowed the deferral of taxes on income for US-owned foreign companies exporting goods to other countries. The DISC regime later had to be repealed as an illegitimate export subsidy under GATT rules. Its successors, the Foreign Sales Corporation (FSC) and Extraterritorial Income (ETI) rules, suffered the same fate (Daly 2006, 537–41).
5. Of course the suggestion that CFC legislation could lead to double taxation is only hypothetical, since, in practice, a tax haven would impose no or only nominal taxes.

6. In 2002 the text was changed slightly, indicating the somewhat harsher attitude to tax avoidance that has been characteristic of the recent decade. 'Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned' (OECD 2005b, commentary on Art. 1, para. 7.1).
7. Green (1998, 135–6) describes how the tension between unilateral thin capitalization rules and the non-discrimination provisions of tax treaties (Art. 24 of OECD MC) is reconciled through creative interpretation.
8. Of course, hierarchy incurs certain costs, too. In order to make an efficient choice between market and hierarchy an entrepreneur has to consider the costs of markets and hierarchies. Between these two extremes, mechanisms of 'hybrid' governance exist (Williamson 1996, Chapter 4).
9. As Avi-Yonah (1995) shows, the methods for apportioning international income can be lined up on a continuum, where the ALS lies at the one extreme and unitary taxation at the other. The profit-based methods (in particular profit-split) are near the unitary taxation end. In fact, strictly speaking, the CUP method is the only one in line with the ALS. The cost-plus and resale-price methods, even though they are included in the traditional ALS, represent one step away from pure separate entity treatment, since they also implicitly consider the profits of the group. Therefore, the common practice of treating the ALS and formula apportionment as dichotomous is actually an oversimplification (see also Owens 1994, 878).
10. It is noteworthy that the 1968 US regulations had been somewhat cautious in their advocacy of the ALS, leaving open the way in which appropriate transfer prices could be determined in the case of services and contemplating the problem of finding comparables in the case of intangibles (Avi-Yonah 1995, 107–9). In contrast, the 1979 OECD regulations were explicitly hostile to profit-split methods (Langbein 1986, 651–2).
11. From 1999 to 2002, US corporations increased their overall reported profits in 18 tax haven countries from $88 thousand million to $149 thousand million in 2002. This is an increase of 68 per cent, which is about three times as much as the increase in total foreign profits (Sullivan 2004a).
12. If there was no profit shifting, reported profitability should be roughly the same in high- and low-tax countries. Actually, rates of return should be higher in high-tax than in low-tax countries in order to compensate investors for the taxes.
13. For further references to the empirical work on tax avoidance and income shifting see Zodrow (2006, 274–5).
14. The G-7's Financial Stability Forum (FSF) and the IMF monitor developments in offshore financial centres. The OECD's Financial Action Task Force (FATF), established in 1989, deals with international money laundering (for a very brief overview see Hampton and Christensen 2003, 195–7). The EU launched an initiative against harmful tax competition that sought to develop a code of conduct of business taxation. Its criteria for harmful tax practices are similar to those developed by the OECD (Kudrle and Eden 2003, 46–7).
15. Concerning savings income, the report is difficult to interpret. On the one hand, it explicitly states that such income is not being dealt with at this time (OECD 1998a, para. 12). On the other hand, it does refer to tax regimes that are specifically tailored to such incomes (OECD 1998a, para. 29). Besides that, the entire issue of tax havens and information exchange, which makes up the biggest part of the

report, is very relevant for interest income. Accordingly, the general opinion is that the report does in fact also consider savings income (Easson 2004, 1038). More importantly, the project subsequently did include it on its agenda.

16. Forty-seven countries were initially targeted. However, 12 jurisdictions made advance commitments to the OECD so that they were not on the list (Easson 2004, 1042). The 35 listed jurisdictions were Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey (including Alderney and Sark), Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Samoa, Seychelles, Tonga, Turks and Caicos, US Virgin Islands and Vanuatu.
17. These views were often expressed in drastic terms: 'In a display of imperialism not seen since the collapse of the Soviet empire, the OECD is demanding that these low-tax regimes surrender their sovereignty and agree to help the high-tax nations collect taxes . . . by what right can a bunch of Paris-based bureaucrats dictate tax policy to sovereign nations that are not even members of the OECD? . . . The OECD wants its member nations to subject low-tax regimes to financial protectionism. . . . In a truly Orwellian touch, the OECD even has the gall to refer to these threatened actions as "defensive measures" – sort of like Hitler's defensive attack on Poland' (Mitchell 2000).
18. The letters can be viewed at http://freedomandprosperity.org/congress/congress.shtml (accessed 13 June 2008).
19. The transparency requirement is met if countries have access to relevant financial information about their own citizens; for example, access to their domestic bank accounts. Effective exchange of information requires that authorities may also legally exchange such information with other countries. Thus, while domestic transparency is a necessary condition for information exchange, it is not sufficient.
20. This short list is remarkable in so far as in October 2003, Antigua and another unnamed country, probably St Vincent and the Grenadines, withdrew their prior commitment to cooperate (Scott 2003).
21. Switzerland, Belgium, Luxembourg and Austria entered reservations (OECD 2004a).
22. Eighteen PTRs were abolished, 14 were changed so that they are now considered acceptable, and in the case of 13 regimes the conclusion was that they were not harmful after all (OECD 2004c, para. 12).
23. The European Commission has recently opened an investigation into the 1929 holding company regime because it may contravene the EC Treaty State Aid rules (Owens 2006, 870).
24. There are different ways of achieving an inversion, and all of them trigger some taxation in the USA. Nonetheless, overall, the scheme is apparently still profitable for many companies (Desai and Hines 2002).
25. However, the reform package also contained a tax holiday that allowed companies to repatriate retained earnings they had sheltered abroad at a reduced tax rate of just 5.25 per cent. This offer is only valid for one year and is expected to lead to a repatriation of as much as $350 thousand million in profits (Alden 2005).
26. In reaction to the corporate inversions an ongoing academic and political debate over the general appropriateness of the US system of international taxation ensued. This debate is framed in the categories of CEN and CIN. One camp, in favour

of CIN, argues that the US system has degenerated into 'self-help territoriality' through the understandable efforts of US MNEs to remain competitive *vis-à-vis* firms from countries with territorial tax systems. Consequently, the appropriate answer for the USA should be to move to a consistently territorial system of exempting foreign source income (see also National Foreign Trade Council 2001; US Treasury 2002, 27–30). The other side argued that the best answer was to rebuild and significantly strengthen the US CFC regime in order to re-establish CEN. Otherwise MNEs would be advantaged over firms that only operate nationally and cannot shelter their income from taxation through an inversion. They consider this unequal treatment of domestic and internationally active businesses to be the real competitiveness issue to be addressed (Thompson and Clary 2004). The issue also figured in the 2004 election campaign. While John Kerry favoured the CEN position, George W. Bush argued in terms of CIN. Indeed, the re-elected Bush administration has considered such a reform as part of a planned federal tax reform (Sheppard 2005a, 675–6). Such a change of policy in the world's most important economy would certainly be a very significant event for the international tax system (Mullins 2006).

27. Sixty-eight per cent of companies worldwide and four out of five US companies now involve the tax function in the 'concept or initiation phase', compared with 43 and 40 per cent respectively five years ago. 'Transfer pricing is increasingly perceived as less of a compliance issue and more of a planning issue that contributes value' (Ernst & Young 2005, 15).
28. An APA can be 'unilateral' or 'bilateral/multilateral'. A unilateral APA simply consists of an agreement between the MNE and one tax authority. Accordingly, a unilateral APA may still be subject to ex post corresponding adjustments between competent authorities under the regular MAP. A multilateral APA also includes other relevant tax administrations that are affected by the transfer prices to be determined in the agreement (OECD 2001b, para. 4.131). It is generally conducted under the MAP provision of tax treaties and thus sometimes referred to as 'MAP APA'. A 'multilateral APA' is not really multilateral but consists of a series of APAs, each of which is concluded between the taxpayer and two countries (OECD 1999b, para. 21). Therefore, it is sometimes also referred to as a bilateral APA. Since such arrangements are generally not prone to an ex post adjustment of the transfer prices, the OECD recommends that countries try to conclude bilateral/multilateral APAs (OECD 2001b, para. 4.163).
29. The OECD also stressed some of the problems of APAs. One concern is that they may lead to an uneven application of tax laws. While some taxpayers, most often large MNEs, are able to negotiate their tax treatment with administrations, others do not get such treatment. Quite often, only large MNEs, which would probably be audited anyway, apply for APAs. Thus, instead of being audited every year, they are only audited every three years, since an APA is generally valid for this period. Likewise, the OECD warned that the administration of APA programmes diverts personnel capacity from auditing non-compliant taxpayers not applying for an APA (OECD 2001b, paras 4.153–4.159).
30. Further examples of such a development are so-called cost contribution agreements, often used to price R&D expenses and other intangibles (OECD 2001b, paras 8.1–8.43), and Global Trading of Financial Instruments (OECD 1998b). In these cases, even the OECD, the staunch defender of the ALS, has accepted the use of profit split methods to determine an arm's length price (see also Li 2003, 608).

Chapter 7

1. As early as 1918, the USA provided a credit instead of a deduction. It has been speculated that the pioneering role of the USA may have persuaded other countries to follow (McIntyre 1993, 318). If other countries voluntarily followed the USA, then that would cast doubt on the possibility that the decision between full and partial tax relief is represented by a prisoner's dilemma as the conventional wisdom suggests. Within the past two decades or so, tax treatment has become even more generous, with countries switching from credit to exemption. Compare Table 4.2 with Table A.4 in the Appendix.
2. Dagan (2002, 59) reports that trade unions in the USA generally oppose the exemption method but not the foreign tax credit. I am not concerned with the choice between credit and exemption in this section. Both methods are considered to be full double tax relief. Under the assumption that the foreign tax rate is below the domestic rate, the exemption (and credit with deferral) method even favours foreign investment over domestic investment, which may not be in a country's national interest. Many economists, while being in favour of the tax credit (without deferral), are puzzled by the 'continuing strength of the modern mercantilist doctrine that it is . . . better to export capital than to use it at home' (Bird 1988, 295), which is embodied in the use of the exemption method. The domestic politics extension of the model showing that business interests have a strong influence on government policies may be an explanation for such preferential treatment of foreign investment.
3. The existence of a few countries using the deduction method in their domestic legislation casts a grain of doubt on this conclusion. Recalling the discussion in Chapter 3, this would imply a prisoner's dilemma structure, and thus an enforcement problem, for the move from deduction to full double tax relief. However, keeping in mind that a deduction is a partial tax relief, any enforcement problem in those few cases should be small.
4. To the extent that some countries are unwilling to unilaterally grant credit or exemption instead of a deduction, treaties may additionally help to overcome the enforcement problem that lies in precluding the use of the deduction method. And indeed, as shown, treaties do prescribe either credit or exemption. By assuring each other that they will not employ deduction, for these governments a tax treaty also overcomes an enforcement problem. Hamada (1966) and Musgrave (2001, 1346–7; 2006, 177). argue that this is one of the major functions of tax treaties. However, given the prevalence of credit and exemption methods in domestic laws, this is not corroborated by the empirical evidence.
5. The most obvious case is that of the residence country granting a foreign tax credit. However, even under different constellations the imposition of source taxes does not drive away foreign investment. These issues are discussed in more detail below.
6. It has been suggested that net capital exporters could ameliorate their bargaining position if they adopted a deduction in their domestic tax laws. If the 'conventional wisdom' were correct, this would increase their bargaining leverage as opposed to the situation of credit or exemption in their unilateral laws. Given that most countries do not use the deduction method in their unilateral legislation, this does not seem to be relevant empirically. But even then, net capital exporters could threaten to revert to the deduction method if the other country does not limit source taxes to the degree desired (Gresik 2001, 822). This threat point would lie closer to the middle of the diagram, and on a lower welfare level.

If this were a correct description of the bargaining process, we would not necessarily expect source taxation to be higher in the case of asymmetric capital flows. However, it is not entirely clear how credible such a threat point is, given that it entails a change of domestic law, which is not done easily.

7. There are two kinds of FDI data. There is the FDI flow in a given year, measuring the new investment flowing into and out of a country, and the FDI stock accumulated over time in a country. This latter measure should be expected to be relevant for tax treaty negotiations, since it is the income generated from the stock of foreign investment that is to be subjected to taxation. Before the background of this technical terminology, the preceding discussion of the effect of 'capital flows' might appear incorrect. However, it can be justified because the stock measure represents the long-term capital flows between two countries more accurately than the annual measures of capital flows, which fluctuate significantly. In addition, using the stock data instead of the flow data can ameliorate potential endogeneity problems – if one thinks that the flow of FDI will depend on the negotiated withholding rate rather than the other way around. On this issue see the discussion in the next subsection.
8. In regressions not reported here, I have also experimented with other possible specifications of bargaining power. Using the relative share of GDP or the relative share of military expenditure yields similar results to those reported below.
9. Running the regressions with the respective data for the year prior to the signature of the treaty basically yields similar results as reported below.
10. Note that the dataset is actually biased against my prediction. Due to problems of FDI data availability, it mostly contains OECD countries with generally more symmetric capital flows between them.
11. This interpretation presumes that the capability index is an adequate proxy for bargaining power. As is well recognized in the political science literature, it is notoriously difficult to measure power (Baldwin 2002).
12. This consideration should hold at least for withholding taxes on capital income to be remitted back home. As long as the residence country also operates an indirect foreign tax credit – as important capital-exporting countries such as the USA, the UK and Japan do – this argument should also hold for the taxation of active corporate income.
13. Note that if withholding taxes are exogenous to FDI, this means that lowering the withholding tax through a treaty will not lead to additional FDI. This expectation is corroborated in empirical investigations, suggesting that DTAs do not increase FDI activity between countries but instead lower it (Blonigen and Davies 2004).
14. The enforcement problem is small in another respect, too. Since countries are willing to grant tax relief unilaterally, a defection from the treaty and its potential abandonment by the other treaty partner – that is, mutual defection – would not lead to a situation of full double taxation, but only to an equilibrium that both parties consider second-best when compared to the treaty outcome.
15. To be more precise: some contingencies might even be known, but the transaction costs of agreeing on contractual provisions for them would be too high.
16. Parties to an agreement will nonetheless try to make their contracts as precise as possible ex ante. Thus, the expectation is that treaties become more and more complex over time, since negotiators learn about potential contingencies that have arisen in other treaties. Sasseville (1999, 54) demonstrates the growing complexity of treaties using the example of Austrian DTAs concluded since 1950. While the average number of words in treaties concluded before 1950 was 2,764 and between

1950 and 1960 it was 5,034, it grew to 5,599 (1960–70), 6,444 (1970–80), 6,787 (1980–90) and 9,189 (since 1990).

17. The fact that the MAP enables the ad hoc and ex post adaptation of tax treaties to new circumstances may also be a good explanation for the fact that on average treaties between OECD countries are changed formally only every 14 years (Sasseville 1999, 56). Given the flexibility of the MAP, formal treaty renegotiations may not be considered necessary.
18. The treaty between Norway and Australia may serve as an example. Norway was not able to push through its desired low withholding rates. In order to at least 'win' something in the negotiations, it managed to introduce an MFN clause that foresees the renegotiation of the treaty, should Australia grant lower withholding taxes in the future (Lennard 2005, 99). In most tax treaties, MFN treatment is not granted automatically, but only consists of a commitment to renegotiate (Hofbauer 2005).

Chapter 8

1. As shown, there was domestic conflict on this issue. The situation is comparable to that of double tax avoidance. A small and effective pressure group (the business lobby) is against closing loopholes, whereas a large and unorganized interest group (the entire population) desires effective measures to prevent under-taxation.
2. Thus, in contrast to Radaelli and Kraemer (2005), who attribute the shift in the modes of governance to discursive practices and the success of the 'policy narrative' of 'harmful tax competition', I would maintain that the attempts to shift to harder modes of governance are more adequately understood by the functional requirements that the problems of double non-taxation and tax competition exert.
3. It should be noted that this is not necessarily a critique of this literature. As long as the focus is on *effects* of tax competition, it is acceptable to analyse it under the assumption that it is given. However, in order to develop proposals for reform of international tax rules, it is very useful to understand how the existing set of rules *causes* tax competition.
4. However, it would be an overstatement to suggest that the problem of double tax avoidance is caused *only* by endogenous factors. The liberalization of goods and factor markets and technological progress are, of course, broader developments that have also played an important role in the creation of the problem of under-taxation. Institutional change has been driven by a combination of exogenous shocks and endogenous processes. However, since the rules of double tax avoidance were in place when the exogenous forces just mentioned entered the scene, the rules of double tax avoidance provided the structure within which the exogenous forces played themselves out. In that sense they are more fundamental than the exogenous factors.
5. On the need to distinguish between unintended and unanticipated consequences, see Martin and Simmons (1998, 750).
6. Note that the distinction between undermining and reinforcement processes is an analytical one. Empirically, the choices and events that make up these processes are often identical. As has been argued above, institutional change and stability are to a large extent endogenous. Institutions unleash processes of stability and change simultaneously. Thus, the analytical distinction between undermining and reinforcement does not contradict but is very much in line with Thelen's (1999,

396–9) insistence that the mechanisms of reproduction should be able to explain both stability and change (Greif and Laitin 2004, 635–6).

7. These provisions can be considered as instances of functional conversion, because they actually work by refusing double tax relief in certain cases of abuse of treaties. In contrast, information exchange is a tool to help in the enforcement of domestic and treaty rules. It leaves the function of double tax relief untouched and is thus better understood as layering.
8. Of course, whether the strength of soft law is to be welcomed or not from a normative perspective depends on how functional the standard is. As should have become clear by now, the OECD solution is arguably 'dysfunctionally stable' so that a weakness of soft law might be more welcome.
9. 'Parametric tax coordination' refers to the full or partial harmonization of tax bases or rates. Keen and Ligthart (2006, 82) observe that such harmonization 'has got nowhere: the implied restriction on national tax sovereignty seems, for many countries, to be simply too much to swallow, both for themselves and also, in some prominent cases, as a matter of principle in terms of what they believe they can properly ask of others. In simply passing information to other countries, however – the argument goes – countries are not giving up any of their national sovereignty in terms of taxing their own residents, but are simply helping others to exercise their sovereignty in taxing their citizens (and receiving a reciprocal benefit).' However, as Keen and Ligthart (2006, 106) themselves acknowledge, one could make the counter-argument that information exchange is in fact more invasive of a country's sovereignty than parametric tax coordination. This understanding of sovereignty would entail that 'no country should be asked to deal with the problems caused by the dishonesty of residents of other countries'.
10. Apart from the ineffectiveness of this approach, which I focus on here, the administrative approach is rightfully criticized for its lack of legitimacy, which may be a further factor in its non-viability in the long run (Picciotto 1992, 305–6).

Chapter 9

1. However, even under a system of formula apportionment, there may be ways of shifting profits by manipulating the factors used in the formula.
2. Avi-Yonah (2005, 125) has suggested that such a move might even be successful if only the OECD countries introduced it, since most of the capital is ultimately used in these countries in order to earn an adequate return. Thus, they might have sufficient 'market power' to make such a policy sustainable.

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