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GOVERNANCE'S LEGITIMACY:
THE CASE OF INTERNATIONAL DIRECT TAXATION**

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THE RISE AND FALL OF GOVERNANCE'S LEGITIMACY: THE CASE OF INTERNATIONAL DIRECT TAXATION

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Abstract

This paper covers the long-term development of governance in international and EU direct taxation. It makes three claims. Firstly, informal governance is 'old' governance as far as direct taxation is concerned. Evidence for this claim comes from the emergence of an epistemic community within the League of Nations before World War Two and the soft mechanisms used to diffuse principles of income taxation in the first part of the last century. Principles, rules, and instruments were then somewhat institutionalised by the OECD in the context of the model treaty convention and guidelines for transfer pricing between the 1960s and the 1980s. The OECD approach – based on informal governance – was quite successful both in terms of diffusion and in terms of legitimacy. During these years, the European Commission tried to promote formal governance of direct tax policy, with ambitious plans for directives, but the achievement was limited.

In the 1990s, the OECD launched more ambitious and multilateral plans aimed at cracking down harmful tax practices in member states and in non-OECD jurisdictions. At the EU level, the fight against harmful tax competition provided the opportunity to 'discover' informal governance with the code of conduct on business taxation. The code, however, was nested in a tax package containing a directive on savings – a classic example of formal governance.

This leads to the second claim. Overall there is no linear pattern of informal governance. The OECD-promoted international tax order is more formal than in the past, but in the EU there is more interest in informal governance than in the past.

The third claim is about legitimacy. The legitimacy of international tax governance has declined over the last 100 years or so. There are several reasons for that, most importantly the scope of governance and the range of actors involved therein. The wider the scope and the range of actors targeted by informal governance, the larger the loss in legitimacy. This seems to lead to the paradoxical conclusion that legitimacy has been higher under conditions of close, technocratic governance networks – a point hard to reconcile with democratic theory. The final part of the paper makes some steps towards reconciliation by looking at the issue of 'legitimacy for whom' and at politicisation as resource for developing the notion of public interest in international taxation.

Keywords: Governance, informal governance, international taxation, corporate taxation, European Union, OECD, legitimacy.

1. INTRODUCTION

The studying of new modes of governance, their emergence, efficiency and their level of legitimacy, especially in the European Union is not a completely new approach, but simultaneously to the growing complexity and interdependence of the EU it has gained importance and has become one of the most expanding and prominent areas in European Studies. Lawyers, sociologists, historians, economists and political scientists all deal with a multitude of aspects and consequences of new modes of governance¹: The concepts of global governance (Prakash and Hart 1999; Risse 2004), transnational governance (Zuern 2004), network governance (Rhodes 2000, Heritier 1999), multilevel governance (Kohler-Koch and Eising 2000; Van Tatenhove and Liefferink 2005) experimental governance (Zeitlin 2003) and informal governance (e.g. Christiansen, Follesdal and Piattoni 2003; Farrell and Heritier 2003; Wincott 2003; Van Tatenhove and Mak 2005) are examples for this attempt to come to terms with the shift in governance from nation states to inter- and supranational institutions on the one hand and to sub-national, regional and private ones on the other hand.

Over the last years much attention has been paid to the idea of informal governance, meaning “a society-centred way of ‘governing’ or ‘steering’, accentuating coordination and self-governance, manifested in different types of policy arrangements, which are an expression of an increasing encroachment of state, civil society and market, with rather vague demarcation lines” (Van Tatenhove 2003). Politics cannot longer be described solely as rule-directed institutions. It has moved “towards enabling institutions at several levels, based on the intermingling of rule-directed and rule-altering politics. [...] EU policy-making displays not only elements of intergovernmental bargaining, supranational problem solving and transnational negotiations, but policy-making in the EU is also the result of the interplay of formal and informal practices” (Van Tatenhove and Mak 2005: 2).

International direct taxation – the topic of our paper – is not an area where one would expect informal governance in the sense of society-centred self-governing networks dominated by private actors. Taxation is a fundamental function of government.

¹ For a detailed overview see for example Van Kersbergen and Van Waarden (2004)

In a sense, it defines the state - to such an extent that the proliferation of international tax policy issues has been considered an indicator of fragmentation of the state (Radaelli 1997: chapter 1). In the context of this paper, therefore, we define formal governance in international taxation as binding measures operating in the shadow of sanctions, with a high degree of rigidity (typically, they are applied to all members of an organisation like the European Union or the OECD without opt-out options). Formal governance includes European Union legal measures such as directives and regulations, and OECD initiatives based on multi-lateral actions and defensive measures (i.e., sanctions) against those who do not comply. By contrast, informal governance is non-binding, operates in the shadow of political determination to act (as opposed to sanctions), and it is often based on 'à la carte' options. To illustrate, informal governance in the EU covers recommendations of the Commission, codes of conduct agreed by Finance Ministers, soft law, and (for the OECD) model tax conventions, and guidelines on transfer pricing.

Van Tatenhove and Mak (2005) distinguish four strategic intends of actors to set up and participate in informal governance structures: informal practices as *lubricant* of policy-making in formal practices, as *experimental garden* for not yet fully developed ideas, as *whistle blower* to correct undesirable developments and as *adversary* against formal decisions. We will show in this paper that especially the first two strategies have been used by actors in the area of international and European direct taxation. But in all cases (formal as well as informal governance) governments participate in governance, typically via their Finance Ministers². There is no important aspect of tax policy that is entirely delegated to the self-regulation of social actors. Moreover, the notion of international tax governance does not imply high degrees of institutionalisation of governance. The 'international tax order' is a metaphor. There is nothing similar to a World Trade Organization for taxation. The tax competence of the EU and the OECD is often contested. Thus, we should perhaps say 'embryonic tax governance': there is more

² In the case of the European Joint Transfer Pricing Forum governments participate in the Forum together with representatives of the business community through experts who act for and report to their national governments.

chaos than order in this notion.³ Accordingly, we would expect informal governance to be the default mode in international tax policy.

This does not mean that governments are always the winners in tax governance. We argue that they will always participate, but winners and losers can change. Indeed, one theme in the long-term history of international direct taxation is that it started with business as the main beneficiary of informal governance, whereas recent patterns seem to benefit revenue authorities and government institutions in general more than business. The main winning preferences underlying the political economy of international tax policy have changed over time.

This paper covers the long-term development of informal governance in international and EU direct taxation. It presents three arguments.

Firstly, informal governance is ‘old’ governance as far as direct taxation is concerned. Evidence for this claim comes from the emergence of an epistemic community within the League of Nations before World War Two and the soft mechanisms used to diffuse principles of income taxation in the first part of the last century. Principles, rules, and instruments were then somewhat institutionalised by the OECD in the context of the model treaty convention and transfer pricing guidelines between the 1960s and the 1980s. The OECD approach – based on informal governance – was quite successful both in terms of diffusion and in terms of legitimacy. During these years, the European Commission tried to promote formal governance of direct tax policy. There was no interest in informal governance.

The second claim is about the long-term trend in informal governance. The trend is not linear. Since 1996-1998, the OECD has hardened its approach to governance, whereas the EU has somewhat softened it.

The third claim is about legitimacy. Governance beyond the nation state is a topic predestined to raise concerns about concepts like accountability, legitimacy, and participatory quality (Risse 2004). Without a world state in the international system there’s no monopoly force able to ensure these concepts – the international systems is ‘governance without government’ (Czempiel and Rosenau 1992). As Wincott (2003:

³ So much so that the idea of a dedicated International Tax Organisation has been discussed on several occasions. See Tanzi (1999) and Horner (2001).

238) explains, the logic of legitimacy on the European level worked for a long period by generating support indirectly through outputs while nation states legitimacy has been mainly rooted in majoritarian democracy and therefore issues of direct representation and participation. The performance of the international system, its capability to solve problems for the member states was the main basis for its legitimacy (Eriksen and Fossum 1998). Given the impact of the EU on its citizens and its rapid growth in all areas of daily life, the legitimacy problems seem to become more and more similar to the problems its member states have to deal with (Zuern 2004, Eriksen and Fossum 1998): indirect legitimacy might not be sufficient anymore.

The deepening of informal governance structures and relations provides both opportunities and problems. On the one hand it should be easier to get more actors from different levels on board to participate in information exchange, discussion, development of solutions for problems or ideas for improvement and to pursue common goals. On the other hand there is a danger that the lack of hierarchy and commanding control leads to unbalanced participation structures, be it out of opportunistic interests of strong actors or simply because relevant groups of actors were forgotten and therefore not involved in the process. That would create problems of legitimacy as well as of efficiency (Christiansen, Follesdal and Piattoni 2003: 10)

We argue that the legitimacy of international tax governance has declined over the last century. There are several reasons for that, most importantly the scope of governance and the range of actors involved therein. The wider the scope and the range of actors targeted by informal governance, the larger the loss in legitimacy. Apparently, this leads to the paradoxical conclusion that legitimacy has been higher under conditions of close, technocratic informal governance networks – a point hard to reconcile with democratic theory.

The remainder of this article is structured as follows: We first present the history of international direct taxation and the different developments on the OECD and the EU level. Then we analyze the case of direct taxation in the context of the interplay of formal and informal governance and the consequences for legitimacy. The last chapter contains the conclusion and some practical and theoretical recommendations.

2. CRAFTING INTERNATIONAL TAX GOVERNANCE

a) The Role of the OECD

At the outset, the most relevant problem of international direct taxation was the jurisdictional conflict about the taxation of diplomats. But soon the explosion of world trade in the first part of the 20th century brought corporations into the scene. The League of Nations 1928 report on international taxation was a landmark in three respects. Firstly, it defined a set of principles for international taxation. The principles were not invented by the League of Nations, but the latter provided a forum for discussion and systematisation of important definitions of tax policy problems, concepts, and solutions. Secondly, the process of institutionalisation of principles was supported by the emergence of international consensus among tax experts (Picciotto 1992) – arguably an embryonic epistemic community. Thirdly, the League of Nations report established a soft and informal method to deal with international tax governance – one based on the gradual diffusion of principles and policy solutions via consensus. Put differently, the role of international governance was to provide a catalogue of problems, a menu of solutions, and a forum for discussion. The diffusion of specific definitions of problems, solutions, and instruments was left to the propensity of individual governments to buy in into the framework.

After World War II, the major agent of diffusion of informal governance in international taxation was the Organisation for Economic Cooperation and Development (OECD), with primary emphasis on developed countries, although the United Nations, has also been active for the rest of the world. Broadly speaking, today the international tax system still follows the path-breaking suggestions of the League of Nations and the ‘codification’ efforts made by the OECD between the 1960s and the 1980s. The main components of this system are the classification of types of income, the residence principle, the treaty network and the arm’s length rules for transfer pricing⁴

For a long time, this approach was effective and considered legitimate by governments and the business community. In the 1990s, however, it became clear that the

⁴ For a detailed explanation of these components see Picciotto (1992)

micro-foundations of the approach (principles, instruments, and problems) were no longer up to the job. This triggered a re-orientation of the OECD activity. The approach based on bilateral action informed by OECD guidelines and model conventions was not rejected. Rather, it was supplemented by a shift of gear, from bilateralism to multilateralism, with political implications for non-OECD jurisdictions. Before we look at the 1990s, however, we need to contrast Paris with Brussels and have a look at the strategy of the Commission between the 1960s and the early 1990s.

b) The problematic development of a European strategy for tax governance

Legal resources for harmonising corporate taxes are scarce in the European Treaties: whilst the Treaty of Rome provides a relatively sound legal framework, direct taxation can draw only on single market provisions and the notion of using inter-governmental cooperation (but not Community action, the treaty refers to ‘negotiations’) for the abolition of double taxation within the Community (Art. 220).

However, important general principles such as free movement of people, freedom of establishment, free provision of services, and free movement of capital can be used by the European Court of Justice, who in fact turned out to be a major driving force in the area of harmonizing direct taxation since its landmark judgement in 1985. This judgement reaffirmed the principle that direct taxes should remain with the competence of the member states but this competence has to be consistent with the EC Treaty⁵.

This limited treaty base did not prevent the Commission from making proposals for direct tax policy co-ordination. The distortionary influence of domestic tax measures on the establishment and functioning of the common market was recognised soon after the conclusion of the European Economic Community Treaty (that is, the Treaty of Rome). On 5 April 1960 the Commission set up a Fiscal and Financial Committee chaired by Professor Fritz Neumark. The Committee delivered a report in July 1962. At that time the most important problem of the common market was the free movement of goods and the establishment of a customs union, and understandably most of the attention

⁵ Since then the ECJ has struck down national law in more than 50 cases, forcing national governments to redesign their tax systems in order to prevent further rules being struck down (for a brief overview see Evans and Roche 2004).

of European policy-makers was drawn to indirect taxation. However, one of the merits of the Neumark Committee was to highlight the crucial role of direct taxation: “it must be studied - the Neumark report started - if, how and to what extent the abolition of Customs frontiers could also lead to the abolition of ‘tax frontiers’ Another clear objective of integration is the avoidance of all taxation and other discrimination based on nationality or tax domicile”. (IBFD 1963:101).

The scene was set for the entry of formal governance in the European debate. But the Committee was also well aware of the political susceptibility arising from tax harmonisation. Accordingly, the Committee suggested a step-by-step approach. Tax co-ordination should start with turnover taxes and gradually extend to direct taxation and the European budget. Definitively, when compared with the OECD initiatives, the first moves made in Brussels were more ambitious. Not only was a degree of formal tax harmonisation requested, but taxation – Neumark added – would need a series of accompanying measures in other policy areas, such as the budget.

The Commission, before launching specific proposals, set up working parties for the discussion of how taxation affected the competitive position of business (Farmer and Lyal 1994:19). It soon became clear that tax co-ordination had to solve two very different problems. On the one hand, tax havens and tax avoidance had already caused worries amongst European tax authorities, and the working parties analysed the phenomenon of revenue losses caused by damaging tax competition. On the other, the common market teemed with tax obstacles to cross-border mergers, withholding taxes on profits distributed abroad and domestic taxes on transactions between parents and subsidiaries of multi-national corporations, in a word, international double taxation.

It is important to observe that in 1967 the first two directives on value added tax were agreed by the Council. As for direct taxation, the Commission demanded a considerable amount of formal governance: approximation of tax rates, harmonisation of the tax base, and collaboration in tax collection amongst revenue authorities. In 1969 the Commission proposed two directives, later agreed upon by the Council in 1990, that is, after twenty-one years.

On balance, the Commission was poised to embrace grandiose ideas for formal governance in direct taxation, notwithstanding the treaty limitations. In fact, throughout

the 1970s the Commission pushed for major changes in European direct tax policy, hoping to exploit the momentum for EC action created by the Werner Report for monetary union. But these grandiose tax plans were frustrated.

In 1970 Professor van den Tempel analysed the different systems for the taxation of profits: the classical system, the imputation and the split-rate. In the same year, the Commission presented a proposal for a European Company Statute (OJ 1970, C124/1) which contained inter alia provisions on fiscal residence and its transfer from one country to another. This proposal has been revised and resubmitted a number of times (for example in 1975 and 1989) but it was not before October 2004 that the European Company Statute finally came into force.

1970 also was the year of the Werner report on the achievement of monetary union. The Commission expected concrete results on tax policy by exploiting the drive of the single currency. A Council resolution from 21 March 1972 provided ammunition in that it established that proposals for fiscal harmonisation would be given priority. Once placed on the agenda - the resolution stated - proposals from the Commission would receive a Council's ruling within six months. The Commission presented proposals for company taxation in 1975. But the dynamism of the Council on economic and monetary union was short-lived - by 1975 the promise to take action on direct tax policy was long forgotten.

In this period, European direct tax policy was always combined with a macro-objective of great relevance. Be it the single currency or the European capital market, in all cases the political difficulties of harmonising taxes were to be anaesthetised - according to the plans of the Commission - by inserting tax harmonisation into broader, shared goals. This is yet another indication of the scarce political support for formal tax governance per se.

However, and in blatant contradiction with the search for legitimacy, smooth policy-making and anaesthetic drives, the proposals of the Commission leant towards the choice of a final or "ideal" fiscal system based on robust doses of formal governance - such as directives, harmonisation, compulsory ranges of tax rates, and choice of a European system for the treatment of profits. Technocratic legitimacy went hand in hand with the effort to nest tax proposals inside broad, shared objectives, but collided with the

excessive ambition of the proposals. The Commission's bias for centralisation had a negative implication. Even incremental proposals (the 1969 draft directives, for instance) were damaged by this image of centralisation surrounding the proposals of the Commission. At the Council level there was strong opposition to the idea of granting the Commission even the mere general entitlement to regulate direct corporate taxation. Every specific tax concession would have been interpreted by member states as the beginning of a centralisation process.

c) Comparing international tax governance: The OECD and the EU until the mid-90s

The characteristics of governance on the OECD and the European level are illustrated in table 1. It is obvious that the emphasis in the EU was on formal governance and that the preferences underlying the development of policy proposals were those of the business community. Had the EU agreed on the proposals of the Commission for tax neutrality, governments would have suffered from revenue losses and firms would have gained from the mitigation of double taxation. However, this does not mean that the business community got what it wanted. Quite the opposite, policy was formulated in accordance with the preference of firms willing to strike down tax barriers, but member states were quite efficient in blocking most of the ideas for tax harmonisation and ambitious tax directives. So companies were not the real winners in terms of policy outcomes, with the partial exception of the limited 1990 measures.

The OECD approach was in the period time based on informal governance. The underlying preferences were as well close to the preferences of the business community but in contrast to the EU the OECD was quite successful in terms of diffusion and legitimacy. During these years, the European Commission tried to promote formal governance of direct tax policy, with ambitious plans for directives in the 1960s and 1970s, but no result was achieved. In 1990 two directives against international double taxation of companies and one arbitration convention were approved⁶. However, they covered only minimal aspects. The idea of a convention rather than a directive was not

⁶ These were the parent-subsidiary directive (90/435/EEC), the merger and acquisition directive (90/434/EEC) and the convention on transfer pricing arbitration (90/436/EEC).

inspired by considerations on the legitimacy of informal governance. Instead, it was a way of escaping deadlock.

Table 1 - Tax Governance: The OECD and EU approach until mid-1990s

	OECD	EU
Cognitive base	Principles and classifications for the allocation of income between competing jurisdictions	Tax neutrality in the single market
Policy Instruments	Guidelines (transfer pricing), model treaty convention	Directives, conventions and recommendations as second best
Type of diffusion	Bi-lateral, no multi-lateralism	Hierarchical, via directives and harmonization
Impact on jurisdictions outside the organization/ union	None	None
Problem definition	Elimination of double taxation and 'fair-share'	Mitigation of double taxation and tax distortions. Tax coordination linked to major political drives in European integration, like the Werner Plan for monetary union, capital market integration, and the completion of the single market
Institution-building	No dedicated 'world tax organization'	No dedicated Council formation or high-level groups. Policy proposals processed by ECOFIN, Ruling Committee composed of stakeholders, not by high-level tax policy-makers
Actors involved	Civil servants from revenue departments, economic diplomats, and international civil servants. Gradually, the business community acquired important consultation rights in the OECD process of policy formulation	Two coalitions of actors: a) Commission's staff, economists and tax experts, business community, limited involvement of the European Court of Justice b) member states' tax policy-makers (civil servants from revenue departments and Ministers of Finance)
Level of politicization	Low politicization	Low, tax policy coordination was framed as a technical exercise
Legitimacy	High	No contestation of legitimacy, but no major achievement either
Role of formal governance	Low	High
'Winners' (preferences reflected in the development of tax policy)	Business community	Policy formulation: business community Policy outcomes: revenue authorities

3. WIDENING THE SCOPE OF GOVERNANCE: MORE ACTORS, MORE AMBITIONS, AND LESS LEGITIMACY?

In the second half of the 1990s, the OECD launched more ambitious and multilateral plans aimed at cracking down harmful tax practices in member states and in non-OECD jurisdictions. At the EU level, the fight against harmful tax competition provided the opportunity to ‘discover’ informal governance with the code of conduct on business taxation. The code, however, was nested in a tax package containing a directive on savings – a classic example of formal governance: Informal governance mingled with formal governance.

At the OECD, the landmark report on harmful tax competition (OECD 1998) was a sea-change in terms of problem definition, instruments, and scope of tax governance. For the first time the major problem of international tax coordination was defined in terms of damaging or harmful tax competition. This was an exercise in political creativity rather than a case of usage of ideas developed by economists. True, economists are familiar with tax competition, and have discussed the conditions under which coordination improves collective welfare. But the identification of ‘harmful’ tax competition⁷ goes beyond the prescriptions of economics. Instead, in the 1998 report the OECD achieved consensus on a set of specific criteria to be used to test for the presence or absence of tax competition.

The Paris-based organisation defined classical tax havens, potentially harmful regimes, damaging tax competition, and other concepts. Tax policy coordination was thus provided with new concepts and new vocabulary. The scope of tax governance was also changed. The campaign against harmful tax competition enabled the OECD to engage with multilateral coordination. This was not the first attempt, as the OECD had already pushed for multilateral action in the cooperation of tax administrations. But it was the first time that multilateralism became so prominent. The scope of governance went further than the OECD itself, by affecting non-OECD members.

⁷ For a review of international tax competition see Wilson and Wildasin (2003) and Zodrow (2003).

But there was also contestation of the legitimacy of OECD positions. The debate especially in the US soon became political. A Washington-based lobbying organisation, The Center for Freedom and Prosperity (CFP), was established with anonymous funding. Its members visited offshore jurisdictions and started lobbying against the OECD in Washington⁸. Several US American politicians, for example the House majority leader Richard Armey in September 2000, US representative Sam Johnson in January 2001, or Democrat Delegate Donna M. Christensen in March 2001, criticised the OECD to focus on the wrong problem and to use instruments which may violate WTO obligations. The OECD was called ‘a global tax cartel for the benefit of a small handful of high-tax nations, [...] fatally flawed and contrary to America's interests’⁹. Others like tax attorney Marshall Langer criticised the OECD countries as a whole but especially the United States for having forced some of the tax havens to adopt tax practices that the OECD was now calling into question¹⁰. None of this produced the withdrawal of US support to the OECD campaign, but it made it more qualified.

Over the years the OECD has changed its policy as to whether a jurisdiction is classified as an uncooperative tax haven or not – the OECD now does not consider jurisdictions to be uncooperative if they commit to the international standards of transparency and effective exchange of information. But the 2004 Progress Report provoked still similar reactions from organizations like CFP: ‘The OECD made two commitments to low-tax jurisdictions. First, it promised that it would achieve a "level playing field." This promise has been broken. Second, it committed to the even-handed application of sanctions against nations and territories with free market tax policy. This "uniform consequences" promise also has been broken. Low tax jurisdictions should be outraged by the OECD's deceitful actions’¹¹.

In 2002 the OECD released its findings on the Tobin Tax¹², one of the very few topics in the area of taxation that brings radical political movements and non-

⁸ R. Goulder, 'New coalition strikes back at OECD tax haven campaign' Tax Notes International, 11 December 2000: 2650-2654.

⁹ C. Scott, 'House Majority Leader, Congressional black caucus member join growing list of US lawmakers opposed to OECD tax haven campaign', Tax Notes International, 26 March 2001: 1479-1480

¹⁰ S. Kirkell, 'OECD: 2002 Year in Review', Tax Notes International, 30 December 2002: 1316-1318

¹¹ D. Mitchell, 'The OECD's Dishonest Campaign Against Tax Competition: A Regress Report', www.freedomandprosperity.org

¹² The idea of a Currency Transaction Tax was first suggested by Nobel prize-winning economist James Tobin

governmental groups on the stage. The idea is to have a very low rate Currency Transaction Tax that operates in normal market conditions. Each trade would be taxed for example at 0.1 to 0.25 percent. This would discourage speculative, short-term currency trades but leave long-term productive investments undistorted. Billions in revenue would be generated each year that could be used to meet urgent global priorities such as for example preventing global warming, disease, and poverty. The charity War on Want¹³ has campaigned on this issue since 1998 and set up the Tobin Tax Network¹⁴ in 2000, after ECOFIN voted against a European Tobin Tax. The anti-globalization organisation Attac¹⁵ is fighting for the Tobin Tax ever since its existence. The OECD, however, reported in June 2002 that a Tobin Tax would not have the desired effects and may even deter investment and cause the tax base to shrink instead of reducing market volatility¹⁶. The campaign has not been completely unsuccessful though: In July 2004 the Belgian Parliament approved as the first country a law introducing a Currency Transaction Tax. Note, however, that Belgium decided to implement the tax only if all the other EU member states will do the same.

To conclude, the OECD campaign shows some important changes in patterns of tax governance. Firstly, there is a shift towards harder forms of governance. In the past, the OECD has pushed for a la carte forms of governance, such as guidelines on transfer pricing and model treaty conventions. Member states were free to adopt or not to adopt the OECD guidelines and model conventions. Their diffusion was based on the intrinsic quality of the models proposed by the organisations. The new campaign against tax competition is harder: it contains defensive measures, it is explicitly multi-lateral, and covers jurisdictions outside the OECD. The diffusion process is not based on the adoption of instruments that suit a government's preference, nor is it based on the intrinsic efficiency of the model. Instead, it is based on a mechanism of sanctions and a certain degree of coercion. Consequently, the legitimacy of OECD policy has been more contested than in the past and the discussion more political.

¹³ For more information about War on Want see www.waronwant.org

¹⁴ For a position paper by the Tobin Tax Network on the International Financial Facility see <http://www.globalpolicy.org/soecon/develop/oda/2003/09iff.htm>

¹⁵ For more information about Attac see www.attac.org

¹⁶ OECD (2002) Exchange Market Volatility and Securities Transaction Taxes, in: OECD Economic Outlook 71, Chapter VIII

In Brussels, the Commission made a successful attempt to re-shuffle ideas and policy instruments by launching – more or less simultaneously to the OECD – its own campaign against tax competition. The political message is that tax coordination is a fundamental bulwark of EU public policy. Without it, the edifice of the single market, the welfare state and employment policy will soon cave in. The political attention for tax coordination – this is an explicit impact sought by the discourse on tax competition – must be raised to maximum levels.

The emphasis on harmful tax competition has also an important political property. It talks directly to member states by magnifying the economic and political gains available to governments through European cooperation. By contrast, the pro-business discourse of efficiency and tax neutrality adopted by the Commission in the past - based on the selective elimination of domestic taxes hampering the growth of genuine multinational companies in Europe - highlighted gains to be reaped by companies and costs to be borne by states. In a sense, one element of success of the tax competition strategy is its appeal in terms of member states' priorities. It should be observed that, at least in the long term, both tax neutrality and the new strategy of tax competition are ways of securing collective gains. But in the short term the immediate impact of the fair tax competition strategy is the closure of tax havens and special tax concessions (a gain for member states in terms of revenue stabilization, but a loss for companies benefiting from special tax rules). By contrast, the immediate impact of the technocratic strategy pursued up until the early 1990s would have been a gain for companies and a cost for revenue authorities, compelled to give up withholding taxes. Webb makes a similar point when he observes that the activity of the EU in corporate taxation up to the early 1990s was “overwhelmingly oriented towards eliminating double taxation, not to increasing the ability of governments to raise revenues from corporate taxation” (Webb 1996:24).

So the switch to harmful tax competition is not just a re-shuffle of ideas, it is also a re-shuffle of winners and losers. It also triggered a change of policy instruments. In order to examine potentially harmful tax regimes, make sure that new damaging tax provisions are not introduced by member states, and roll-back existing harmful tax schemes, the Council adopted a code of conduct for business taxation on 1 December

1997¹⁷. The code is a non-binding instrument. It is managed by a high-level group of tax policy-makers. It is based on peer review of potentially harmful tax regimes and specific guidelines provided by the group itself. The definition of harmful tax competition is contained in the 1997 ECOFIN agreement.

This is a switch to informal governance, but with some important qualifications. The most important of which is that agreement on the code was reached in a context of tax policy package, which includes also a directive on the taxation of savings and a directive on cross-border payments of interests and royalties. Structures of new informal governance are nested into traditional formal governance. There is no switch from formal to informal. Rather, informal governance and formal governance have been bundles in a creative political technology – the tax package adopted by the Council.

Secondly, the business community has been excluded by the deliberations of the Group in charge of the code. There have been several complaints from employers' confederations and think tanks. The code was managed in secret, without involving social actors and firms. Neither were national parliaments involved. In 1999, some parliaments debated the issue of harmful tax competition (French Senate, 1999; House of Commons Hansard Debates, 5 July 1999) without having access to the results of the Council group. In London, at the House of Commons, two MPs expressed their disappointment with the following words:

‘Is it not an insult to democracy and to all that we are meant to stand for that the government are agreeing to measures in so-called tax loopholes without the House of Commons or the people being told?’ (Sir Teddy Taylor)

‘The House deserves to know what tax measures are being discussed elsewhere, as it practically came into existence to take the means of taxation away from the Crown or the Executive and put it in the hands of those who are answerable to the electorate’ (Mr. Heatcoat-Amory). [Source: House of Commons Hansard Debates, 5 July 1999]

According to some MPs, secrecy has made the code ‘nothing but a PR disaster’ (Lord Desai, see House of Lords, 1999: 163). The conclusion is that the code does not score

¹⁷ ECOFIN Council (1998) Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, in: Official Journal of the European Communities (98/C 2/01)

well in terms of transparency, inclusion of social actors, and perhaps even legitimacy – three key aims of informal governance. The code is more the response to the problem of calming political apprehension over EU tax coordination than a way to bring the society back in the EU policy process. The political cost of preserving consensus among member states may have been high in terms of legitimacy.

Recent proposals of the Commission (2001) target the tax problems of multinationals: this may be a political counterbalance to the emphasis on the problems of governments that has characterised the code. In March 2002 the Commission set up the EU Joint Transfer Pricing Forum (JTPF), with the approval of the Council, consisting of an expert of each member state and 10 experts from business. Representatives from applicant countries and the OECD were invited to take part as observers. The task of this forum is to elaborate on the basis of consensus pragmatic, non-legislative solutions to practical transfer pricing problems in the European Union, within the framework of the OECD guidelines - this is to consider ways of reducing the high compliance costs and eliminating the double taxation that might arise in the case of cross border intercompany transactions. The JFTP therefore focuses particularly on the reduction of the compliance burden due to documentation requirements, the promotion of greater certainty and the exploration of speedier dispute resolution processes¹⁸.

Apart from this exception, the tendency not to include the business community has not disappeared. In September 2004 ECOFIN decided to set up a working group on a possible consolidated EU tax base - a measure supported by the business community. However, the idea of involving the business community in one form or another has been rejected. Paradoxically, the more the Commission moves towards informal governance, the less inclusive governance becomes.

4. CONCLUSIONS

¹⁸ The final report of the Transfer Pricing Forum's first two-year period of work is not yet published, but former reports and our interviews suggest that the practical influence of this forum and the political impact of the business experts therein may be limited.

The discussion of recent changes in governance patterns is summarized in Table 2. The set of principles underlying policy development revolves around the notion of harmful tax competition. Diffusion is based on harder pressures than in the past at the OECD, but the EU has made more exploration into soft forms of diffusion, notably in the context of the code of conduct and the Joint Transfer Pricing Forum.

The trajectory of informal governance is not linear. OECD-promoted governance is less informal than in the past, but the opposite happens in the EU – although the robustness of the code of conduct hinges on the success of formal governance and the efficiency of the Transfer Pricing Forum seems to be limited. The impact of tax policy formulated within the OECD and the EU has reached out to third countries and tax havens. The business community has less impact than in the past on policy formulation. Non-governmental groups and radical political movements such as War on Want or Attac have very limited influence on the development of international direct taxation. With the exception of the debate about the Tobin Tax they don't appear on the stage at all and they are neither on the OECD nor on the EU level involved in the agenda-setting and decision-making process in the area of international direct taxation.

Table 2 – International tax governance today

	OECD	EU
Cognitive base	Harmful tax competition	Harmful tax competition
Policy Instruments	memorandum of understanding, defensive measures, peer review of harmful tax regimes of OECD members	code of conduct, bundled with directives
Type of diffusion	Coercive pressure on harmful tax schemes and classical tax havens	roll-back managed consensually within the Council's group in charge of the code of conduct
Impact on jurisdictions outside the EU	Yes	Yes (agreement on the savings directive was achieved only on the basis that Switzerland, Liechtenstein, Monaco, Andorra, and San Marino implement equivalent measures)
Problem definition	Tax competition is good, but beggar-thy-neighbor tax competition should not be accepted. It triggers a prisoner's dilemma where all countries are worse off	Tax competition is good, but beggar-thy-neighbor tax competition should not be accepted. It triggers a prisoner's dilemma where all countries are worse off
Institution-building	Special forum for dialogue	High-level group at the Council

	and negotiation with tax havens.	
Actors involved	Revenue authorities	Revenue authorities
Level of politicization	High	High
Legitimacy	Contestation of legitimacy	Contestation of legitimacy
Role of formal governance	Higher than in the past	More exploration of informal governance
‘Winners’	Revenue authorities	Revenue authorities

One striking point is that the legitimacy of international tax governance is more contested now than 100 years ago. This has something to do with the scope of governance and the range of actors involved therein. The wider the scope and the range of actors targeted by informal governance, the larger the loss in legitimacy. Does this lead to the paradoxical conclusion that legitimacy is higher under conditions of close, technocratic governance networks dominated by bureaucrats and major corporations– a point hard to reconcile with democratic theory? We need to look into the issue of ‘legitimacy for whom’ in order to answer this question. The old world of international taxation was dealing with low political salience issues. It was limited in scope. The OECD operated like a forum for the elaboration of instruments to be voluntarily adopted by the members. International tax governance was eminently bilateral. There was almost no EU component in international tax policy. Legitimacy was not contested because that world was somewhat insulated from wider political debates and the scope of governance limited. There was legitimacy within networks of specialists and revenue officers.

By contrast, the new world is one where tax debates are more political than in the past. The scope of governance has widened, with the OECD engaged in multilateral policy, and both the EU and the OECD engaged in the promotion of tax order outside their jurisdictions. The emphasis on harmful tax competition made tax issues more prominent in the political agenda, but has also raised the political awareness of a multitude of actors. It has placed revenue authorities in the driver’s seat, and understandably corporations question the legitimacy of secret discussions on tax regimes where there is a lot of corporate money invested. Similarly, national parliaments and the European Parliament do not provide any major input in the discussion about the roll-back of tax schemes targeted by the EU code of conduct. Effectively, national parliaments are relinquishing sovereignty – they no longer legislate on some areas of tax policy. The EP cannot intervene in a non-binding instrument operating outside the framework of EU

legislation. The contestation to the OECD legitimacy is more questionable. It comes mainly from aggressive tax jurisdictions who have successfully commercialised their sovereignty in the past (Palan 2002) and from US-based think tanks with anonymous funding.

Overall, the process is not one of lower degrees of legitimacy over the long run, but one of politicisation of the debate. Politics has brought more fundamental discussions about the legitimacy of actors into the previously insulated world on international taxation. Hot discussions about legitimacy – we submit – are an indicator of the maturation of the debate. Perhaps a more political discussion of international taxation is the best way to forge the notion of public interest in this policy area – a notion that so far has been hinted only in textbooks of public economics but has not been taken seriously by tax policy-makers.

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