The Double Tax Avoidance Regime as Institutional Foundation of Tax Competition*

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Introduction

The issue of international tax competition has attracted a lot of attention. The focus is on *effects*. How does tax competition affect economic efficiency and welfare (Wilson/Wildasin 2004)? How seriously does it constrain national policies (Swank 2002)? What incentives does it set for international cooperation (Dehejia/Genschel 1999, Rixen 2007)? Also, tax competition has become a central concern of policymakers. In all tax reforms in OECD countries over recent years the perceived need to stay competitive vis-à-vis other countries has played an important role.

The *causes* of tax competition, by contrast, have drawn much less interest. Tax competition is usually treated as a given in a globalized economy that does not merit further investigation. Of course, there is some truth to this view. Cross-border mobility is a necessary condition of tax competition. As long as taxpayers cannot move capital and other assets across borders, there is no incentive for governments to vie for these assets by tax policy means. However, cross-border mobility is not a sufficient condition. Tax competition also depends on the rules that define the tax consequences of particular cross-border moves and, hence, their usefulness for tax arbitrage and relevance for tax competition. Note that not all moves are relevant. Spending a night in Liechtenstein, for example, is not enough to terminate income tax liability in Germany. In order to understand the dynamics of tax competition it is insufficient, therefore, to focus on cross-border movements alone. It is also necessary to look at the tax rules applicable to these movements. These rules are codified in the international double tax avoidance (DTA) regime. In this paper I show, how these rules shape the strategic choices and opportunities of taxpayers and governments and thus the *structure* of tax competition. Tax com-

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petition is not exogenously given, but is to a significant extent an endogenous consequence of prior institutional choices by governments in the area of direct international taxation.

This has serious consequences for governments' tax policies. While the rules of international taxation are generally perceived to be weak and hardly constraining on governments, I maintain that this characterization underestimates their effect. The argument draws on the interplay of *de jure sovereignty*, by which I mean the legal authority to impose taxes, and *de facto sovereignty*, by which I mean the effectiveness of governments to achieve their policy goals. When it was created in the 1920s and 1930s the sole purpose of the tax treaty regime was to mitigate international double taxation so that governments could realize the benefits of international economic liberalization. As I will explain in more detail below, the specific approach that was chosen preserves de jure sovereignty. As an unintended consequence of this approach tax evasion, avoidance and competition were created. Precisely because the DTA regime provides the institutional foundation for harmful tax competition, governments can thus not effectively reach their policy goals of maintaining an efficient and equitable tax system any more. They cannot design their tax policies according to the preferences of their constituencies but have to adjust them to competitive pressures. Thus, while they dispose of de jure sovereignty, de facto sovereignty is undermined.

However, despite these negative side effects the tax treaty regime has only undergone gradual change. The DTA regime is characterized by a remarkable stability of the main principles on which it is based. At the same time, as I will describe below, we can observe several incremental changes of an implicit and indirect nature that are a response to the negative side effects of double tax avoidance. However, these responses are not a sufficient adaptation of the tax treaty regime to the challenge of under-taxation (summarizing the related problems of tax evasion, avoidance and competition).

The main objective of this paper is to make sense of this institutional trajectory that is characterized by the simultaneous occurrence of institutional stability in the core principles and 'subterranean' but significant incremental changes.[1] I provide a rationalist reconstruction – focusing on actors' preferences, the prevailing concerns at different times and the resultant strategic structures – of the institutional design and development of the DTA regime. I argue that the particular institutional trajectory can be understood by considering the collective action problems inherent in the two problems of double tax avoidance and under-taxation and

[1] The paper contributes to a research program that is interested in explaining the development of international institutions since World War II. See Zürn et. al. (2007).

the sequence in which they come up. On the one hand, the regime is subject to the endogenously produced undermining process in the form of under-taxation, which can be understood as an *asymmetric prisoner's dilemma*. However, these pressures do not lead to a full adaptation of the regime, for two reasons. For one, since double tax avoidance can be understood as a coordination game with a distributive conflict, there is a process of self-enforcement – actors do not want to endanger the coordinating function of the regime. Second, for several reasons governments are unable to resolve the prisoner's dilemma, and thus cannot come to a fully satisfactory solution to the problem of under-taxation. Accordingly, they can only realize incomplete and gradual reforms of the DTA regime.

This empirical analysis also has normative implications for the political debate on tax competition. It is intended to propagate cooperative international approaches and to help overcome the focus on ultimately self-defeating national responses to tax competition. As I will argue, real progress in the fight against under-taxation can only be achieved, if governments begin to share some of their de jure sovereignty and harmonize at least some aspects of their national tax systems. In particular, I argue that a system of unitary taxation with formula apportionment could be an important element of the regulation of harmful tax competition.

The rest of the paper is structured as follows. In the first part, I provide a baseline model of international tax cooperation and some definitions of tax sovereignty. Then I present a stylized historical narrative of international tax governance. In part three, I show how the DTA regime shapes the structure of tax competition and undermines governments' de facto sovereignty. Fourth, the institutional trajectory of the DTA regime is assessed in terms of the model. In the conclusion, I argue that the current institutional trajectory is unlikely to be stable in the long run. It should be replaced by a system of unitary taxation with formula apportionment.

1. Sovereignty and Collective Action in International Taxation

In this section, I introduce a very simple and basic model of institutional design and development of the tax treaty regime. Further, in order to adequately describe and categorize the observable changes within the regime I propose definitions for different dimensions of tax sovereignty.

A Simple Model of Institutional Design and Development

With respect to international direct taxation the collectively beneficial state of the world would be *single taxation*, which is given if international investment carries the same tax burden as purely national investments. Under single taxation the global welfare pie is maximized.

In order to achieve single taxation two problems have to be solved. First, international *double taxation* has to be avoided. Double taxation results from an overlap of jurisdiction to tax between a *residence state*, where the recipient of income lives, and a *source state*, where the income was generated. If both exert their power to tax to the full extent, the burden on trans-border economic activities is prohibitively high and international investment is hampered. Global welfare is not maximized. Second, international *under-taxation* (which is the category summarizing the phenomena of international tax avoidance, evasion and tax competition) must be prevented. Under-taxation would advantage foreign over domestic investment. Consequently, it would lead to an inefficient allocation of capital and undermine governments' tax revenues.

Only because single taxation is collectively beneficial does not mean that it is necessarily in a single country's interest to contribute towards realizing the avoidance of double taxation and under-taxation. In order to evaluate the problems of collective action and their implications for institutional design and development self-interested governments have to be assumed. The strategic structure of double tax avoidance can be understood as a *coordination game with a distributive conflict*.[2] In coordination games actors have no incentive to deviate from an equilibrium once they have settled on it. There should thus not be the need for an institution that monitors compliance and sanctions non-compliance. However, there could be a role for an institution that helps actors to select among the several possible equilibria. This will especially be the case if there is no salient point on which actors are likely to settle (focal point). Thus, in issue areas characterized by problems of coordination we expect to find institutions specialized on the generation and dissemination of information and (non-binding) recommendations in order to help actors settle on one of the available equilibria over which they have conflicting distributive interests (see e.g. Koremenos, et al. 2001, 787-788).

In contrast to that the problem of under-taxation is an *asymmetric prisoner's dilemma*, also known as a rambo game.[3] Given that over-taxation is avoided and international investment is

[2] For reasons of limited space I do not derive the strategic structure in this paper. This crucial step of the analysis is undertaken in Rixen (forthcoming, chapters 3 and 7). There I show that under reasonable theoretical assumptions of governments' preferences, they should be willing to relieve double taxation unilaterally. But given that unilateral relief is in place, they would be even better off if more of the right to tax were assigned to themselves. Empirically, this is evidenced by the fact that all governments provide unilateral tax relief on income that has already been taxed abroad. See also Dagan (2000) and Ring (2007, 129-139).

[3] In contrast to the strategic structure of double taxation, that of under-taxation respectively tax competition is well established in the literature (see e.g. Bucovetsky 1991, Dehejia/Genschel 1999, Holzinger 2005, Rixen 2007).

free to move across borders, countries can benefit individually from undercutting each other's tax levels. The prisoner's dilemma is asymmetric because this is especially true for small countries. Since these countries don't lose a lot of tax revenue from lowering their tax burden on the small domestic tax base, this can be easily compensated by the inflow of foreign tax base from other countries. Thus, they have deadlock preferences. They win in tax competition and will oppose the abolition of under-taxation. In effect, this means that big countries would either have to provide side payments to small countries, e.g. through issue-linkage with other policy areas, or force them into compliance with an agreement that leads to the collectively beneficial outcome of prohibiting under-taxation (see e.g. Zürn 1992, 209-218).

However, it is not clear that big countries are so clearly in favor of regulating international under-taxation. A country that is home to multinational companies as most big, developed nations are may have an incentive to help 'their' MNEs optimize their tax payments in order to maintain 'competitiveness' vis-à-vis other countries 'home' to multinationals (see e.g. Bucovetsky/Haufler 2005). In reaction to clocking up possibilities for simple paper profit shifting to tax havens, MNEs may dislocate 'real' production facilities and jobs. As a result, governments may be hesitant to vigorously push tax havens to abstain from under-taxation. The strategic structure of competition among big countries can be understood as a symmetric 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. On the other hand, it remains true that governments do not wish to loose tax revenue to tax havens poaching their tax bases. This should work against the fear of losing competitiveness. However, the benefits of higher tax revenues accrue to the entire population, which by its very nature is a big and diffuse group. Building on Olson's (1965) logic of collective action, it is conceivable that the business lobby as a comparatively small and well-organized group may be able to exert more influence on a government than the big group of the entire electorate can. From this, we can hypothesize that big countries may have ambivalent interests. On the one hand, they do not want to loose tax revenues to the tax havens; on the other, they may be responsive to the lobbying pressures from business interests and thus be hesitant to close all of the tax loopholes for "their" multinational companies.

The main issue in a prisoner's dilemma is the *enforcement* of an agreement. The institutional solution needed to address the problem must be equipped with the capacity to monitor and punish defectors. Also, it must encompass all countries so that no government can take a *free ride* and exploit those abstaining from under-taxation (see e.g. Holzinger 2005, 480). Due to the strong conflicts of interest among countries, especially between big and small ones, business the need for a broad encompassing solution, an asymmetric prisoner's dilemma is a very demanding strategic structure. These difficulties are further aggravated by the possibility of big countries' concern over their competitiveness. It is well conceivable that efforts of establishing a functional solution will not be successful.

From these standard predictions of rational institutional design, we can also derive some implications for the expected institutional development of the international tax regime over time. The first step in illuminating the process of institutional change is to realize that governments were not faced with the two problems of double taxation and under-taxation at the same time, but addressed them *sequentially*. Only after the problem of double taxation had been solved, could the problem of double non-taxation become relevant. This is so because only if double taxation is avoided, will it be worthwhile for individuals and enterprises to engage in trans-border investment. Avoiding double taxation is part of the liberalization of the international economy that is a necessary condition for the problem of international under-taxation to arise in the first place.

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. 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 change within the double tax regime.

However, there are theoretical reasons to believe that an institutional adaptation may not be instantaneous but that it will take quite some time and be contested. First, 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 e.g. Sugden 1989). Even if the institutional solution becomes sub-optimal, actors may not want to deviate from it. This can lead to a regime's inflexibility in responding to external shocks. In the extreme, a coordination regime may become 'dysfunctionally stable' (Snidal 1985, 939). This problem may be even more severe in cases where no natural focal point exists and actors had to construct one. Given the high bargaining costs that had to be incurred in creating the focal point, actors may shy away from engaging in disputes over which new convention to adopt. Due to these sunk costs, they may stick with a sub-optimal institution rather than risk being left with no coordinating agreement whatsoever (Pierson 2004, 143-4).

Second, since the problem of under-taxation is represented by an (asymmetric) prisoner's dilemma und thus subject to severely conflicting interests, it is far from certain that agreement on an adequate institutional response can be achieved. This aggravates the problem of rigidity. If there are conflicts of interest with respect to the institution that should replace the existing setup, the institution's chances of a longer survival increase.

In addition to the general prediction that institutional adaptation may be delayed and contested, it would be desirable to also derive theoretical predictions about the particular *path* of adaptation. Broadly speaking, the literature on institutional change has identified two different paths of reform (see e.g. Genschel 1997). The first one can be labeled creative destruction. In general, the literature on "new institutionalism" emphasizes 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 on them becomes very high, i.e. 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. 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.

Second, institutional change may also be incremental. Institutional designers need not necessarily engage in creative destruction. Rather, 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 is called 'layering' (Thelen 2003, 226-8). In this mode of institutional change, a new arrangement is layered on top of an existing one. Institutional entrepreneurs may lack the capabilities to reform an institution directly. 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). Rather, they bypass 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 the existing institution.

The second logic of incremental change is ‘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 fulfills other or additional functions rather than those to which it was initially assigned, while remaining unchanged in its basic setup.

However, as Pierson (2004, 139) has argued, so far, there is a lack of deductive theoretical knowledge that would allow me to discriminate between creative destruction and incremental change, or between conversion and layering. Also, it is not even certain that the two are mutually exclusive. It may well be possible that an institution undergoes a period of incremental change followed by a punctuated equilibrium change. Therefore, I leave this question open and approach it inductively. I will return to a characterization of the institutional trajectory on the basis of the qualitative empirical evidence to which I will turn in part two.

Dimensions of Sovereignty

A very common argument about international taxation is that its institutions are weakly internationalized because governments hang on to their sovereignty (see e.g. Li 2003, 31-2). According to this line of reasoning the costs of internationally sharing sovereignty are particularly high in taxation, because taxation is considered one of the core fields of sovereignty. If a state shares its tax sovereignty it is in danger of losing its ‘stateness’ (Schmölders 1961, 137). As has already become apparent in the previous subsection, 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. Rather, it is often simply assumed. 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 oversee the finer developments and less dramatic changes of how tax sovereignty is exercised by governments.

In order to adequately assess the transformation of tax sovereignty, it is helpful to differentiate between different dimensions of sovereignty. I proceed with the following definitions and distinctions: Sovereignty is a government's power to design and implement rules over its own territory or its own citizens. Tax sovereignty is thus about the power to tax its territory, citizens and residents. It can be differentiated into *de jure sovereignty* and *de facto sovereignty* (cf. Palan 1998, 628-9). De jure tax sovereignty is defined as the "legal freedom of action" (Keohane 1993, 91) to impose taxes. A government disposes of full de jure sovereignty if it can design all aspects of its tax system as it wishes, i.e. set the tax base, rate and system independently from other governments. De facto sovereignty is the ability to effectively achieve the desired goals of tax policy (see Keohane 1993, 93), such as efficiency or equity, or if we consider the possibility of governments being captured by interest groups, reelection through handing out rents.[4] De jure and de facto sovereignty may, but need not coincide. A government may have the legal 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.

I assume that, while governments certainly prefer to dispose of full de jure sovereignty, this is not their ultimate goal. Rather, their ultimate goal is the effective implementation of policy preferences, i.e. the realization of de facto sovereignty. More specifically, under conditions of internationally integrated markets, it is quite likely that governments cannot effectively determine all aspects of tax policy on their own if they want to realize their policy goals. In order to deal with the problems resulting from interdependence, they create international institutions 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 institutionalism on the issue of sovereignty (see e.g. Keohane 1993). Since the ultimate goal of governments is to reach their policy goals, they may be willing to restrict or pool their de jure sovereignty so that they can regain de facto sovereignty over the problem at hand.

[4] 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).

Besides the differentiation between de jure and de facto sovereignty, it is useful to further differentiate de jure sovereignty into legislative and administrative sovereignty (see figure 1). *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: Cnossen 1996, 77). 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 and thus possess de jure legislative sovereignty. For example, they can choose the precise parameters of the tax system like 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. But a national government that has a monopoly on legislative sovereignty 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. Effectively enforcing this claim to tax may well require tax administrations to get information from other countries about bank accounts of their residents abroad. Likewise, determining transfer prices within multinational enterprises (MNE) und thus the national share of taxable income will often require the administrative assistance of other governments. In such a case, governments would pool a certain aspect of de jure sovereignty, i.e. administrative sovereignty, for the sake of de facto sovereignty, i.e. being able to more effectively achieve their policy goals, but they would not pool the other aspect of their de jure sovereignty, i.e. legislative sovereignty. Legislative and administrative sovereignty may thus be internationalized to different degrees.

2. The History of Tax Cooperation: From Avoiding Double Taxation to Creating "Double Non-Taxation"

In this section, I present the historical record of international tax cooperation.

The Founding Period: 1920 to 1945

The original and initially sole purpose of the global tax regime was to mitigate international double taxation in order to liberalize international trade and investment. In 1918 the USA had introduced the foreign tax credit that foresaw the unilateral tax relief on income earned abroad. Other countries followed in consecutive years.[5] In parallel to this development,

[5] Belgium had a system of partial deductions since 1906 and then a general deduction since 1919; the Netherlands had even introduced a credit prior to the US. Several Swiss Cantons operated deduction systems. Great Britain allows a deduction, but only for income earned in the dominions (League of

the League of Nations, as part of a larger strategy to cultivate peace by fostering international trade and investment after World War I, proposed a collective search to find a coordinative solution to the problem of overlapping tax jurisdictions. It appointed economists to address the issue and convened several conferences of technical experts and government officials (League of Nations 1923, Seligman 1928). Even though no general consensus on a single best principle, i.e. either only source or residence taxation, could be achieved, a compromise solution emerged in these discussions. It became apparent that both source and residence principles can be justified on certain grounds. All proposed solutions present different answers to the question what kind of nexus between a taxpayer and a state legitimates the state's right to tax him or her. Emphasizing individual fairness among taxpayers leads to the consideration that the residence principle should be accorded more weight, because it better allows to base taxes on the *ability to pay*. However, the consideration that the source country provides infrastructure that allows the generation of income in the first place leads to favoring source taxation. Under the so-called *benefit principle*, taxes are viewed as a 'price' for the public goods that help to produce private profit. Both of these arguments are simple and intuitive. None of the scholars that have discussed the issue of a desirable allocation of taxing rights have come out in favor of only the one or the other, but for some solution that accords different weights to these considerations.[6] In the political debates these theoretical issues of a legitimate link between a taxpayer and the country that wishes to exert its power to tax were mingled with material conflicts of interest between capital importers and exporters. The latter naturally favored the residence principle and the former the source principle, since the respective solution would give each a bigger share of the international tax base (see e.g. Dagan 2000, Kingson 1981).

To make a long story short, the solution that emerged represents a compromise between both principles on a case-by-case basis (Brauner 2003, 279): tax jurisdiction is assigned to either the source country or the residence country for different kinds of income. Broadly speaking, the primary (or exclusive) right to tax *active income* from business and labor is granted to the source country. The residence country, by contrast, has the primary (or exclusive) right to tax *passive income* (i.e. income from financial investment such as interest, divi-

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Nations 1925, 11, Dorn 1927, 232-36, Picciotto 1997, 1026). Australia, New South Wales and South Africa employed an exemption system (Graetz/O'Hearh 1997, 1046).

[6] The theoretical debate goes back to von Schanz (1892, 1923) who proposed the principle of "economic allegiance". A brief and accessible overview of the continuing debate is provided by Li (2003, 49-57).

dends or royalties).[7] The formula found widespread support in political and academic circles as a reasonable approximation of the economic nexus of different types of income to national territory (cf. among many Avi-Yonah 2004, Graetz 2001).

Sovereignty-Preserving Legal Constructs

In order to institutionalize the compromise solution, a series of non-binding and increasingly sophisticated and elaborate model conventions (MC) were drafted that could be used as a template for bilateral tax treaty negotiations. The MC refers to a series of legal constructs that establish the required nexus between the transnational tax base and a country. The constructs represent plausible assumptions, and make them legally tractable, about the correspondence between transactions across borders and the territorial base of the underlying economic activity that is the target of national taxation (Bird/Wilkie 2000, 91 ff.). For example, the concept of a permanent establishment (PE) codifies what is taxable as a separate entity in the country of source.

The important point about this and other constructs – which are in use until today – is that the rules defined internationally are kept at a minimum. The MC and thus the bilateral treaties based on it provide general definitions – which can nonetheless be quite complex, in order to ensure legal generality – about the nexus between a person or entity and the respective jurisdiction. Once jurisdiction to tax is established, the country is then basically free to use its own national tax law on the respective income. This includes the rules specifying the calculation of taxable income and the tax rates. Bilateral treaties do not contain comprehensive rules of taxation, but in essence achieve nothing more (and nothing less) than disentangling the transnational tax base and assigning it to different jurisdictions so that these can apply their own domestic rules to their share of the tax base. The approach is not aimed at harmonizing national tax laws. The internal qualities of national tax systems are not subject to the regime rules. The bilateral treaties merely help to "coordinate divergent national tax laws" (Li 2003, 33), they regulate the *interface* of autonomous national tax systems.

In this sense, the term 'international tax' "is a misnomer, since there is no overriding international law of taxation" (Li 2003, 31). The mechanics of double tax avoidance are such that jurisdiction to tax is *disentangled* to the highest degree possible. The legal constructs on which the tax treaty regime is based refuse to treat the transnational tax base as a global phe-

[7] It should be noted that there are exceptions to this division of the tax base. For example, bilateral tax treaties usually contain withholding taxes on dividends, royalties and interest in the country of source (OECD 2003, Art. 10-12).

nomenon, but rather force it into a framework of territorial delimitation. The advantage of this approach is that governments retain almost unlimited legal independence over the taxation of ‘their’ share of the transnational tax base. The tax treaty regime is built on *sovereignty-preserving* cooperation (Vann 1991, 102).[8]

Emblematic for this approach of territorial disentanglement of tax claims are the rules for allocating expenses and profits among different parts of multinational enterprises (MNE). According to the separate entity approach 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. A related embodiment of the sovereignty-preserving approach is the common use of *exemption* systems or credit systems with *deferral*. Either income that has been taxed at source is not subject to tax in the home country at all or it will only be taxed, granting a credit for the tax paid at source, upon actual repatriation into the country. Even if a foreign business is beneficially owned by a resident, e.g. subsidiaries of multinational enterprises, the country will not tax the current income of this entity unless it is repatriated. This illustrates the respect for the territorial integrity of differing national tax systems that is characteristic for the tax treaty regime (cf. Graetz 2003, 217).

Political Choices – the Alternatives were on the Table

However, it was not self-evident that governments would choose the sovereignty-preserving method for avoiding double taxation. Rather, this decision was subject to debate. In principle, there are three possible methods for approaching the problem of double taxation. First, transnational economic activity could be taxed internationally, i.e. governments would agree on a common tax base, a common tax rate and a common system of tax administration. Such an *international business tax* would imply the delegation of the power to tax international income to an international authority. The proceeds of this tax would then be distributed to the respective countries. One example of such a solution would be the system of business taxation on the federal state levels in Germany. A second option would be the one that has actually emerged. As has just been described it lies at the other end of the spectrum in terms of the need to share sovereignty. Third, there is also an intermediate option. Multinational enterprises could be subjected to *unitary taxation with formula apportionment*. The MNE's

[8] What I refer to in shorthand as the sovereignty-preserving approach to international taxation must in the light of the distinctions introduced in section 1 be understood as the preservation of de jure sovereignty, and more particularly, as will turn out, as the preservation of de jure legislative sovereignty.

profit is determined by a combined report and then allocated to each part of the enterprise on the basis of a predetermined formula. The formula should reflect the economic contributions of each party to the production of the profits, e.g. by referring to factors such as property, sales and payroll. Governments would then remain free to apply their own preferred tax rate to their share of the overall profit. Such a system would require governments to share their de jure sovereignty with respect to the definition of the tax base but it would leave them free to apply their own preferred tax rate.

The first option has never seriously been contemplated and is generally believed to be utopian. Even within the European Union, there are no indications that there is a serious political will to go into that direction. In contrast, the intermediate option of unitary taxation with formula apportionment has received serious consideration in the development of the international tax regime. In the 1930s the Fiscal Committee of the League of Nations investigated the question of whether the apportionment of the transnational tax base should be based on separate entity accounting or unitary taxation with formula apportionment. The Committee tackled the question very thoroughly and conducted an ambitious study of the tax systems of 35 countries, financed with a grant by the Rockefeller Foundation (League of Nations 1933). The multi-volume study that had been conducted under the supervision of Mitchell B. Carroll led to the "1935 allocation convention" suggesting the separate accounting method based on the arm's length standard (ALS). The provisions of the 1935 draft, while they have in the meantime been developed further, are still the essence of today's transfer pricing rules (Langbein 1986, 633-4).[9]

The Carroll Report marked a change in the direction of the law of double tax avoidance. While the 1928 model had ultimately left open the question on which allocation method is preferable, one can find a slight preference for formula 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. In addition, while it has been accused of understating the extent to which formula apportionment methods were actually in use – e.g. in Spain, Switzerland and some US states, the Carroll report itself shows quite clearly that both formula apportionment and separate accounting were in use at the time.[10] Accordingly, the report's conclusion that sepa-

[9] The allocation convention was not awarded the status of an official model convention itself, but was later incorporated into the London and Mexico Model Conventions (League of Nations 1946).

[10] Further, even the USA, at the time the most important proponent of separate accounting, had only adopted the ALS in 1934. Prior to that, it had also relied on apportionment. The Leagues' alloca-

rate accounting was the more common method is questionable. It has led to the claim that Carroll has created the "myth of arm's length" as the "accepted international norm", while in reality both formula apportionment and separate accounting were in use (Langbein 1986). Irrespective of this, the decisive point is that both formula apportionment and separate accounting were seriously considered as potential solutions at the time (Picciotto 1992, 65 f.).

Ultimately, however, governments were unwilling to agree on formula apportionment because it would have required agreement on a common business tax base, and agreement on a formula for apportioning this tax base to countries. In contrast to that, the arm's length principle does not require actors to openly address the distributive conflict. It is perceived as a 'natural' solution capable of de-politicizing the distributive conflict inherent in the avoidance of double taxation (see Picciotto 1992, 172). Nevertheless, even at the time it was already recognized that the determination of arm's length prices for purposes of tax assessment might cause problems since comparable uncontrolled prices, i.e. those prices that market participants transacting at arm's length would agree on, are often hard to find. This would in turn create leeway for tax minimization by taxpayers.[11] Accordingly, the allocation convention allowed tax authorities to use "empirical methods" and, as a last resort, "fractional methods", i.e. formulary apportionment, for those cases where an arm's length price could not be determined (Wang 1945, 77-81).[12] This meant that while it was considered to not be possible to come to agreement on a general formula, the problem was to be tackled on a case-by-case basis by the administration whenever the problem arrived (Picciotto 1992, 35). The flipside of maintaining legislative sovereignty over the definition of tax bases at the national level is intensified administrative cooperation between revenue authorities (see also UNCTAD 2000, 13), i.e. sharing administrative sovereignty.

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tion convention basically copied the new US rules. This was the first instance where US leadership in international tax issues became visible.

[11] The "irony and the essential difficulty" is that MNEs exist because of the absence or imperfections of an arm's length market, yet an arm's length standard 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). This problem is particularly severe for the case of intangibles, such as know-how and R&D.

[12] Empirical methods were defined as an "attempt to estimate an income by comparing the given enterprise with similar enterprises, or taking into account turnover, assets or other readily ascertainable factors", whereas "fractional apportionment" is the "determination of the income of one establishment of an enterprise by dividing total net income in the ratio of certain factors – for example, assets, turnover, payroll, or a fixed percentage" (Carroll report cited after Langbein 1986, 632).

International Tax Evasion and Avoidance as Secondary Problems

In addition to over-taxation, the League of Nations also addressed the issue of tax evasion and avoidance. The addition was based on the concern that the co-existence of different national tax systems would increasingly enable capital flight. It is noteworthy, however, that support for the resolution to also consider tax evasion and avoidance could only be organized on the condition of inserting 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" (cited after League of Nations 1925, 25) into the resolution. Nonetheless, the issue of tax evasion and avoidance has been present in the deliberations of the League of Nations right from the start.

A group of experts commissioned by the League argued that a functionally adequate response to the problem of evasion and avoidance must be multilateral, because otherwise there would be capital flight to those countries not member to the agreement (League of Nations 1925, 24-6). But most member states were not willing to subscribe to such a far-reaching solution. Besides the fact that some states were not willing to engage in information exchange at all (cf. e.g. the Swiss position: League of Nations 1928, 14-5), 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). They were of the opinion that measures against fiscal evasion should be preconditioned on effective double tax relief (cf. e.g. the position of Sweden: League of Nations 1928, 14).[13] In the 1930s the issue came up again and a draft multilateral agreement on the exchange of information was produced. But "[g]overnments 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". Also, they were unwilling to help other countries "enforce their respective tax laws unless they first agree to remove the inequitable burden that results from double taxation". Thus, the conclusion was that the appropriate way to deal with evasion and avoidance was to include provisions on the exchange of information in bilateral double tax treaties. Besides these clauses that were, and still are, generally quite limited in scope, the fight against evasion and avoidance

[13] It is noteworthy that in its 1925 report the technical experts had developed a counterargument to the reasoning of many member states. Rather than seeing effective prevention of double taxation as a precondition for fighting evasion, the experts argued that effectively curbing international tax evasion would recover many tax revenues now forgone and consequently put states into a position where they could more willingly provide double tax relief to honest taxpayers (League of Nations 1925, 28).

was regarded to be the responsibility of national tax authorities with little hope of being able to agree on common approaches (Carroll 1939, 36 f.). Thus, 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 a high priority. To the contrary, it was feared that restrictive measures against evasion and avoidance would harm efforts at liberalizing trade and investment that was their main objective.

Regime Maturation: 1960s

In the founding period, the practical relevance of the DTA regime had been very limited. While the 1920s saw a very brief revival of open international capital markets (Helleiner 1994, 26 f.), which of course ended with the Great Depression, the level of trans-border investment and MNE activities remained low/limited well into the 1960s (Bordo, et al. 1999, 11 and 62). In addition, direct taxes had only been introduced after World War I and tax burdens were still rather modest (see e.g. Webber/Wildavsky 1986, 436-45). Transnational tax revenues at stake were quite low. Thus, while the basic principles were established by the League of Nations in the 1920s and early 1930s, the regime remained largely dormant. In the 1920s only a few European States signed bilateral double tax agreements (DTA) mostly with neighboring countries. In 1928, 35 DTAs were in force.[14] In the 1950s and early 1960s, the regime was still of limited practical significance. While the bilateral treaty network grew (from 108 in 1948 over 263 in 1958 and 333 in 1963), the number of DTAs in force was still rather low.

After World War II, the OECD took over the position of the League of Nations, and briefly the United Nations, as the main multilateral policy forum for discussions of international tax issues. From 1956 to the early 1960's the OECD's Committee on Fiscal Affairs (CFA), which is made up of government officials and tax experts, integrated and consolidated the prior versions of the MC (OECD 1963), which firmly institutionalizes the arrangement of a non-binding convention as a basis for bilateral treaty negotiations. The principles and norms of the tax treaty regime had come to full fruition.

Since the 1960s the network of DTAs has grown continuously. Today more than 2000 bilateral tax treaties that connect about 180 countries are in force.[15] During that time and in par-

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[14] The numbers of DTAs used throughout this paper come from a self-compiled database. For data sources see Rixen (forthcoming, appendix).

[15] The growth of the network went on in three waves: industrialized countries were the first to conclude treaties amongst them. Then second world and third world countries joined the network, as did the transformation economies of the former soviet block in the 1990's.

ticular since the mid-1980's international investment flows increase steeply (United Nations 2004, 39). Much of this economic internationalization has taken place within integrated business structures of multinational enterprises. In 1970, there were about 7000 MNEs. In 1990, the number had already increased to 35,000 with 142,200 subsidiaries (United Nations 1992, 12). One effect of the internationalization of the economy is that the overall tax base subjected to the rules of the DTA regime 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, measuring the tax burden as a percentage of GDP, of 21 % in 1963 to 35.7 % in 1993. Since then it has remained rather stable, with 36.3 % in 2003 (OECD 2006). Therefore the DTA regime gains in practical significance.

Reflecting this increased importance, the cooperation within the OECD was intensified. The CFA is permanently engaged in technical elaborations and adaptations of the model. Nowadays, the Model Convention is published in an ambulatory format, with consolidated versions every two to three years (OECD 2003, Introduction, para. 11). Basically all bilateral treaties are based on the model, which is quite successful in homogenizing them. It can safely be stated that "[t]he OECD Model treaty is practically the infrastructure of the current bilateral treaty-based system" (Brauner 2003, 310). It embodies the general consensus about the rules of international taxation. As such, the principles, norms and rules of the OECD Model convention also effectively set limits on the policies that countries can pursue in their unilateral foreign tax policies (Avi-Yonah 2004). However, while the rules get more sophisticated and complex over time, the basic principles, norms and "mechanics" of the sovereignty-preserving approach that emerged in the 1920's remain unchanged (cf. e.g. Graetz 2001, 262 f.).

Unintended Consequence: Harmful Tax Competition and Loss of De Facto Sovereignty

But the regime's growth and success cause problems. The effective removal of tax obstacles and other liberalizing policies induce an increased mobility of capital. Since the 1960s taxpayers have increasingly taken advantage of the differing national tax laws by making sure that their income is taxable in low tax countries. Importantly, such *tax planning* activities do not necessarily involve the relocation of economic hardware like direct investments or jobs, but can be achieved by taking advantage of the sovereignty-preserving approach of the regime rules.

A common method of tax planning is to set intra-company but cross-border transfer prices in such a way that income is shifted to a low tax country and expenses to a high tax country.

The diversion of profits to low tax countries is often used in connection with controlled foreign corporations (CFC), i.e. corporations that are owned fully or to a large extent by non-residents of the low tax country. Income can be retained in these entities, in order to make use of deferral and thus realize a tax advantage. Setting up such companies, which are commonly known as mailbox-companies, is attractive because they enable the taxpayer to establish tax residence in a country and thus make sure that income is taxable in the respective low-tax country. CFC's can also play a role in so-called treaty shopping. As opposed to retaining income in a base company, the CFC is used as a pass-through entity in order to access the benefits of a DTA to which one would not have access otherwise. Further the scheduler structure of the DTA rules enables companies to reclassify financial flows in a way that optimizes their tax payments, e.g. by substituting equity for debt (for an overview of these and other techniques, see Arnold/McIntyre 1995, 8-17). These and other tax planning schemes divert income into jurisdictions with only an artificial connection to the real economic activity that should be the correct target for taxation. They are most pronounced with respect to passive investment income, which can easily be diverted to and accumulated in a tax haven.

Note that all these arbitrage activities between differing national tax laws are only possible because countries rely on a sovereignty-preserving approach to international taxation. Only because every country is free to design its own rules of national taxation can some mailbox company in a tax haven be treated as an independent entity, and thus profits diverted to it be subject to the national tax rate of zero. Similarly, 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 created by that. While the rules deny the "unity of the subject" (Palan 2003, 105 ff.), 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 fundamental problem with the sovereignty-preserving approach is that transnational tax bases are not givens that sit still and wait to be carved up between national tax authorities but are endogenous to the rules themselves. Taxpayers, individual and corporate, can structure their cross-border activities such that – given the regime's sharing rules – most taxable profits fall to low tax jurisdictions and most deductable expenses to high tax jurisdictions. Due to the sovereignty-preserving setup the size of the national share of the transnational tax base becomes a choice variable of taxpayers.

There are two interrelated policy responses to this challenge, which reveal that the sovereignty-preserving character of cooperation undermines de facto sovereignty. First, the opportunities given to mobile tax bases also present opportunities to states. A new type of state –

the tax haven – emerges. Tax havens are countries offering favorable tax regimes to companies and wealthy individuals. They are generally small countries, which have little domestic tax base to lose but a lot of foreign tax base to gain. The very notion of being a tax haven implies that such a country is willing to create a tax system that is geared towards the needs of foreign taxpayers. Tax havens use their legal sovereignty not to impose taxes on their legitimate share of the transnational tax base, but rather to "poach" the tax bases of other countries. They make a living off the "commercialization" of their tax sovereignty (Palan 2002). Thus, these countries intentionally – while certainly retaining legal sovereignty – give up their de facto sovereignty.

This becomes most evident when one considers that tax havens are actually in competition with each other for the transnational tax base. While there is empirical evidence that their operations are profitable (Hines 2004), this competition does nonetheless restrict them in their actual freedom to design their tax systems. Tax havens actively search for market niches and try to specialize for different tax planning activities.[16] While this restriction of de facto sovereignty certainly differs among different kinds of tax havens[17], there are quite a few small and poor havens, whose economies have specialized completely on offshore activities. They have intentionally become tax havens as an economic development strategy and can be seen to be in a situation of "provocative dependence" (Hampton/Christensen 2003). They need the offshore sector for their economic survival, but at the same time they are viewed as "renegade states" (Eden/Kudrle 2005) by high tax nations.

Second, non-haven countries are put under the pressure of tax competition. The ever-present threat of the erosion of their tax bases that is caused by the particular institutional structure of the international tax regime has to be taken into consideration in the design of their national tax systems. The general trend of corporate taxation in 'high-tax countries' in reaction to tax competition can be summarized under the heading "tax cut cum base-broadening". While this response has been successful insofar as on average there are hardly

[16] Tax havens have been subdivided into "production havens", "headquarter havens" (offer the 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) and "secrecy havens" (specialize in allowing personal income tax evasion by reinvesting funds that have been provided without the knowledge of authorities at home) depending on the particular features of their financial and tax systems. Most real world tax havens provide some mix of these functions (Eden/Kudrle 2005).

[17] For rich and longstanding tax havens such as Switzerland or Liechtenstein the dependence upon offering tax shelters is probably smaller than for poor micro states with new haven operations. But, considering their resistance to refrain from offering tax shelters, even these countries appear to be restricted in their de facto sovereignty.

any revenue drops, this policy negatively impacts on the *structure* of national tax systems. Big and highly profitable multinational enterprises enjoy tax relieves, while small and medium sized companies are taxed more heavily. Tax burdens are shifted from capital income to labor income and towards consumption. In addition, the lowering of nominal corporate tax rates can undermine the progressivity of the personal income tax, because the corporation tax serves as a backstop function for personal income tax (Ganghof 2006, Rixen 2007). Examples of policies that are a reaction to tax competition and are unlikely to have been introduced otherwise are the introduction of dual income taxation systems, which put a lower burden on mobile capital income than on labor, unilateral rules against tax flight (see below) and the introduction of so-called preferential tax regimes, which provide more favorable tax treatment to foreign than to domestic investors. The negative consequences of tax competition are even worse for developing countries, which could not even stabilize their corporate tax revenues (see e.g. Keen/Simone 2004).[18] In other words, tax competition restricts governments' de facto sovereignty to design their tax systems as they and their constituents wish (Rixen/Uhl 2007).

Both high-tax and low-tax countries lose de facto sovereignty. Precisely because the tax treaty regime intentionally preserves legal sovereignty, it actually shapes and constrains de facto sovereignty of all countries. Hence, the sovereignty-preserving character of the regime is more apparent than real.

3. Institutional Reaction to the Problem of Under-Taxation

This effect of the DTA regime was clearly not intended by governments – even though, as I have shown in part 2, they were not unanticipated. In reaction to this, since the 1960s, we can observe efforts at incremental reform of the DTA regime. Since the 1990s, with the problem of capital flight further growing in significance we can also observe somewhat more determined efforts at reform.

The 'Subterranean' Transformation of the DTA Regime

Driven by the desire to prevent these negative effects, countries started to design unilateral anti-avoidance measures that were subsequently diffused internationally via the OECD.[19]

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[18] Christian Aid (2008) estimates the annual revenue loss of developing countries from the two avoidance techniques of transfer mispricing and false invoicing (under- or overvaluing the actual price of a commodity in official documentation to strip a company off profits) to be US$ 160 billion.

[19] First attempts at unilaterally curbing tax flight were introduced in the 1930's already. In Great Britain, the "Finance Acts" of 1936 and 1938 introduced legislation that was intended to regulate the manipulation of residence status for tax purposes. The US also enacted legislation against foreign personal holding companies in tax havens, which were used by wealthy individuals to shelter their

While there are many different unilateral anti-avoidance measures, like thin capitalization rules and anti-treaty shopping provisions, two very prominent ones are the introduction of so-called controlled foreign corporation legislation and the reform of transfer pricing guidelines.[20]

In the 1960's, the USA are the first country to introduce comprehensive unilateral anti-avoidance rules, the so called *controlled foreign corporation (CFC)* legislation. CFC rules are directly aimed at the use of foreign subsidiaries as base or conduit companies in tax haven countries which serve no substantive economic purpose but the tax privileged holding of assets for the multinational enterprise. The rules pierce the 'corporate veil' of the tax haven entity. The proposal was quite contested domestically and met with resistance. Business and the opposition in Congress argued that American multinational corporations would have a competitive disadvantage vis-à-vis their foreign competitors who could continue to shelter their income from taxation. As a compromise solution the rules that were finally implemented singled out certain kinds of income, which could most easily be diverted to tax havens, i.e. passive income (Engel 2001, 1527 f.). The USA also promoted such legislation within the OECD. In 1987 the OECD suggested for all member countries to introduce unilateral anti-avoidance measures and to support these by increased multilateral information exchange in order to make them more effective (Eden/Kudrle 2005, 115 ff.). Today, basically all major capital exporting nations have passed similar legislation (Avi-Yonah 2004, 488).

Initially, tax havens opposed these measures arguing that CFC rules infringed on their right to determine the tax treatment of the relevant income at source. In principle, the anti-avoidance measures could lead to double taxation, since both residence and source state claim the right to tax the same income[21] and thus violated tax treaties and the general principles of the tax regime. The formal answer of the OECD and high-tax countries relied on the construction of the deemed dividend. Instead of viewing the holdings of a CFC in a tax haven as a profit, it should more correctly be viewed as the income of the shareholder (i.e. the country resident in the high-tax country). Thus, the argument goes on, the CFC rules do not interfere with tax haven's sovereignty nor do they constitute double taxation because the income in question rightfully belongs to the residence country. This interpretation clearly has become

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income from US tax authorities in the 1930's. However, these rules were less comprehensive then the measures that were introduced in the 1960's (Picciotto 1992, 97 ff.).

[20] For more details on the processes of incremental reform in these two cases, see Rixen (forthcoming, chapter 6).

[21] Of course, in practice a tax haven would impose no or only nominal taxes.

the dominant one (Avi-Yonah 2004, 488-9). Today there is an implicit consensus that CFC rules are a legitimate instrument of “pushing the boundaries” of the territorial limits on residence taxation (Sandler 1994).

Another area, where incremental reform can be observed is transfer pricing. As described above, there are two basic approaches to taxing companies that are dispersed in several countries. For one, under unitary taxation with formulary apportionment, the MNE is treated as a single economic unit. Instead, as described above, countries deliberately opted for the sovereignty-preserving approach of separate entity accounting. Each subsidiary is treated as an independent entity dealing at arm’s length with other parts of the same enterprise. For allocating the tax base to the countries involved, taxpayers have to price all their internal but cross-border dealings as if they were transacting on a regular market. The arm’s length principle is implemented by reference to different national transfer pricing guidelines that closely follow OECD guidelines.[22]

With the multinationalization of production and the rising importance of intangibles – trademarks, patents and other intellectual property – the ALS comes under pressure. In practice, tax administrators therefore often relied on a combination of determining comparable uncontrolled prices and profit apportionment. Thus, the reality of transfer pricing is much closer to unitary taxation than the rhetorical emphasis on arm’s length would have one believe (Langbein 1986, Bird/Wilkie 2000, 92, Picciotto 1992, 172 ff.). In the 1980s, the USA planned to change their national transfer pricing regulations so that the comparison of profits would explicitly be recommended (Webb 2001, 137 ff.). The motivation for this unilateral move was that the US government was concerned with two related problems at the time. For one, there was concern that US MNEs were shifting profits abroad by underreporting prices charged for trademarks and other intellectual property to their overseas manufacturing subsidiaries. Second, foreign MNEs, in particular from Japan, were accused of overpricing imports to their American subsidiaries in order to lower their American tax bill (Webb 2001, 136 f.).[23]

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[22] The OECD guidelines in turn were very similar to regulations the USA had issued in 1968, which was the first country to introduce such rules.

[23] The executive also was generally under pressure from Congress. Many senators would have liked to see the US push for full-fledged unitary taxation. However, at least since the confrontation between the UK and the US over California’s system of formula apportionment, it was thought to be impossible to achieve consensus on this internationally. The IRS therefore rejected the demand (Radaelli 1998).

However, the OECD and foreign governments initially opposed these rules, arguing that they were inconsistent with the arm's length standard and would violate existing tax treaties. Subsequently, in a process of mutual adjustment both sides came to a compromise. The United States reduced its emphasis on profit methods, agreeing to so-called "transactional profit methods" (OECD 1995, para. 3.1), which relies on *transaction-based* rather than *overall* profit indicators. The OECD interpreted these methods as being in line with the traditional arm's length principle (cf. Radaelli 1998, Webb 2001, with further details on the political process). Overall, the new guidelines move 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. With the introduction of advanced pricing agreements (APAs) in many countries and their promotion by the OECD (OECD 2001a, AN-22, para. 10), this trend has become even more pronounced.[24] Some have argued that APAs are only a secret method of applying formulary apportionment on a business-by-business basis (US Senator Dorgan, cited after Célestin 2000, 130).

Both the introduction of CFC legislation and the development of transfer pricing regulation show that governments do not share or delegate their legislative sovereignty. Instead, they act unilaterally, with some tacit coordination organized by the OECD, to meet the growing challenges of international double non-taxation. Ultimately, any disputes or incoherences arising from the unilateral rule changes will then have to be settled at the administrative level.

The OECD Project on Harmful Tax Competition: A More Radical Approach?

The unilateral anti-avoidance rules are very complex but not very effective (Bird 1988, 297). What can be observed in practice is a proliferation spiral. States almost continuously have to amend their unilateral rules to react to new tax planning schemes devised by taxpayers – or rather their advisors.[25] Recognizing that unilateral anti-avoidance rules were insufficient to tackle the problems of tax evasion and avoidance effectively, the G-7 Finance Ministers mandated the OECD in 1996 to launch a project against "harmful tax competition" (OECD

[24] APAs are mechanisms under which MNEs and tax administrations can bargain over the appropriate method of arriving at reasonable transfer prices and thus basically commit to certain prices before the transactions actually take place.

[25] As anecdotal evidence, consider some of the legislative measures the USA have introduced over the years that go by names like the "branch profits tax" in 1986, the "earnings stripping rule" that belongs to the class of thin capitalization rules, the "multiparty financing rules" of 1995 (belonging to the class anti-treaty shopping provisions) or the "reverse hybrid rules" of 1997. The list is far from exhaustive.

1998).[26] The original purpose of the project was to bring tax havens to abolish their harmful tax practices. In particular, they should change their national tax laws so that it was not possible anymore to merely book some economic activity in the respective country without relocating the underlying 'real' economic activity. In addition to that, the project also aimed at so-called preferential tax regimes in 'high-tax countries' i.e. national tax regimes that tried to attract foreign capital by offering better treatment than was available to domestic investors.

Tax havens questioned the legitimacy of these requests by dismissing them as an undue interference with their national tax sovereignty (Sharman 2006, 83-86). In 2001, after fierce lobbying by business interests (see Ring 2008, 24-32 for an account of the lobbying activities), the new administration of George W. Bush declared that "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 2001), the project changed its objectives. While the project had originally been a challenge for the notion of national legislative sovereignty – governments were asked to change their national tax systems – it now merely pushes for better administrative cooperation between haven and non-haven countries (OECD 2001b; 2004). To this end, the OECD began a process of evaluating the transparency of 82 financial centers. Tax havens are asked to meet certain requirements of transparency in their financial and tax systems and conclude bilateral information exchange agreements with other countries (e.g. OECD 2007) on the basis of a non-binding model convention that was developed as part of the process (OECD 2002). So far, about 68 of such agreements have been concluded.[27] With this reformulation of the project, it fits quite well into the pattern of older initiatives to ameliorate international tax enforcement, e.g. the multilateral "Convention on Mutual Administrative Assistance in Tax Matters" (Council of Europe/OECD 2003), which has been ratified by thirteen countries so far (OECD 2008).

4. Assessing the Institutional Trajectory

So what can we make of this empirical record? I will characterize the observed changes in terms of the model of institutional change and the dimensions of sovereignty introduced in section 2.

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[26] For a more comprehensive account of the OECD project, see Rixen (forthcoming, chapter 6) and Sharman (2006).

[27] See OECD (2007, 9) and the updates under http://www.oecd.org/document/7/0,3343,en_2649_37427_38312839_1_1_1_37427,00.html (accessed 4 June 2008).

Making Sense of the Institutional Development

As the empirical record has shown, the problem of under-taxation can be understood as undermining the established institutions of double tax avoidance. Importantly, the resultant institutional change can be understood as a combination of an endogenous process and an external shock. First, as explained above, the particular construction of the institutions of double tax avoidance creates certain possibilities for tax evasion and avoidance that would not exist had another setup been chosen. The under-taxation problem is an unintended consequence of its own success. In that sense, any observed institutional change would be *endogenous change*. Second, however, the problem of under-taxation is not only endogenous, but is also caused by other developments and decisions. Many of the decisions to abandon capital controls, lower trade barriers and other policies of liberalization that enhance the international mobility of tax bases and thus have ramifications for the system of international taxation, were taken outside the tax treaty regime. While the institutions of double tax avoidance are one element of the overall trend towards liberalization, they are certainly not the only one. In this respect, institutional change is due to an *external shock*.

The specific institutional trajectory of the DTA regime is characterized by institutional stability in the core principles and "subterranean" (Thelen 2003, 233) but significant incremental changes. We did not observe fundamental change or a complete dismantling of the existing institutional setup (punctuated equlibrium). More particularly, we can observe both conversion and layering. The introduction of CFC rules in many countries and the attempts to reform the ALS are instances of attempts at functional *conversion*. As we have seen, the two cases of reinterpretation of fundamental building blocks of the double tax treaty regime had the goal of moving closer to taxing different entities of a multinational group in a more consolidated fashion than was acceptable under the traditional understanding of separate accounting. The conflicts of interest about these initiatives and the way they were ultimately resolved is 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. In other words, what we observe is *rule stretching*.

The OECD project against harmful tax practices can be interpreted as an effort at *layering*. While the OECD project was eventually not very successful, it is remarkable in that, for the first time in the history of international taxation it openly questioned the principle of national tax sovereignty. Interestingly, however, the OECD project was not intended to change the institutions of double tax avoidance themselves. It was established apart from the DTA regime and the connection between the two was deliberately left open. This is one of the advantages of the strategy of layering. Since two formally separated institutions are concerned, the original and the layered rules do not necessarily have to be consistent. Other efforts, like the introduction of multilateral and more effective exchange of information, or the implementation of APA programs can also be interpreted as layering.

This institutional development can be understood on the basis of distinguishing between self-enforcing and self-*re*inforcing respectively (self-)undermining institutions. An institution is self-enforcing if no one has an incentive to deviate from the behavior associated with the institution for the specific transaction under consideration. "An institution is reinforcing when the behavior and processes it entails, (…), increase the range of (…) 'situations' in which the institution is self-enforcing" (Greif/Laitin 2004, 634).[28] The institutional setup of double tax avoidance is, I argue, self-enforcing, but not self-reinforcing. Rather it is subject to undermining pressures. The self-enforcing character can be attributed to the character of double tax avoidance as coordination game, and the undermining process can be attributed to the partially exogenous, partially endogenous problem of under-taxation, represented by an asymmetric prisoner's dilemma. In addition, the fact that big countries are responsive to lobbying interests by business and care for their 'competitiveness' makes them ambivalent in the interests they pursue. This clearly dampens the effects of the undermining process. The effects of the combination and interaction of these different forces shape the institutional trajectory of the DTA regime.

Actors do not want to endanger the coordinating function of the established regime principles for fear of not being able to agree on an adequate replacement (the process of self-enforcement) and for fear of endangering the competitiveness of their MNEs. At the same time actors react to the undermining processes and selectively shore up the regime – albeit only partially effective – against the most obvious cases of abuse by stretching the rules and layering additional institutions on top of the existing one.[29] While the regime nominally ad-

[28] Greif and Laitin develop this distinction, in order to explain endogenous institutional change in a game-theoretic framework of institutions-as-equilibria. Their idea is that "some aspects of the situation should be considered as parametric [which are fixed, TR] in studying self-enforceability, but as variables [which are subject to change] in studying institutional dynamics". They call these aspects quasi-parameters, which are basically fixed in the short run, but variable in the long run and are thus the drivers of endogenous institutional change. In so far as the undermining process to which I refer is endogenous, my account is in line with their conception.

[29] One very obvious example is the behavior of the USA in the reform of transfer pricing guidelines. While it pushed for change it did not want to dismantle the ALS entirely. This shows that 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

heres to the sovereignty-preserving cooperation it embodies, its actual nature is transformed. In effect, this means that the DTA regime not only contributes to the constitution of tax competition but it also pre-structures the institutional reactions to tax competition.

The Transformation of Tax Sovereignty

In terms of the different dimensions of sovereignty that were introduced in section 2, the transformation of tax sovereignty can described in the following way: Governments deliberately opted for an approach that left their de jure legislative sovereignty over their national tax systems intact. A system of unitary taxation with formula apportionment, while it was seen as a potential alternative, was put aside. However, in the process of a further liberalization of the economy, the preservation of de jure sovereignty undermines government's de facto sovereignty. In reaction to this, they do not respond by harmonizing their tax systems or at least parts of their tax systems, which would imply a sharing of legislative sovereignty. Rather, governments attempt to regain de facto sovereignty by sharing administrative sovereignty. They increasingly pool their administrative sovereignty in order to ensure the enforcement of nationally diverging tax laws. As Keen and Ligthart (2006) observed, policymakers seem to see the future of international tax cooperation in better information exchange and administrative cooperation, while efforts at "parametric tax coordination", which would involve the sharing of legislative sovereignty, are on the retreat. While legislative sovereignty remains an entirely national affair, administrative sovereignty is increasingly internationalized.

Conclusion

Instead of summarizing this already very long paper, I would like to conclude by arguing that the current institutional trajectory of the tax regime is unstable and that a system of unitary taxation with formula apportionment could be an effective and more legitimate solution.

Rule stretching and layering do not explicitly challenge the sovereignty-preserving setup of double tax avoidance. Governments still remain largely free to devise their national tax laws as they wish, and the unintended consequences of this setup in the form of tax evasion, avoidance, or competition are only addressed through increased administrative cooperation. The problem with this approach – apart from the fact that there are still gaping holes in the system – is that it can only provide an *ex post* remedy to unwanted tax arbitrage. Administrative co-

act cautiously. One interesting point about this is that the rules of the double tax regime successfully govern actors' behavior even though they only constitute non-binding soft law. The coordination aspect may be a good explanation for instances of a seemingly paradoxical 'strength of soft law' that could also be at work in other areas of international relations.

operation can only intervene after the deed, i.e. after taxpayers have already tried to avoid or evade taxes. While it is necessary and worthwhile to push for better information exchange and administrative cooperation in order to make international tax enforcement better, it is questionable, whether such an approach will be cost-effective in the long run (Clausing/Avi-Yonah 2007, 15-6).[30] As long as national tax systems retain so many differences, they present opportunities for international tax arbitrage and thus the costs of ex post administrative enforcement will continuously increase. As Vito Tanzi (1995, 89) observes "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".

The case of transfer pricing shows that considerations of the costs of administration have already become relevant. Governments are indeed concerned with the continuously increasing costs necessary to keep the system running. 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, such as the introduction of APA programs. APA programs can be understood as a "hybrid governance" mechanism that is chosen because the governments are unwilling or unable to implement more "hierarchical governance" to allocate the tax base among them (see Brem 2005). There are reasons to think that in the long run such hybrid governance solutions may also become ineffective. The case of transfer pricing is actually quite instructive to show what I have in mind. As has been described, there is a clear trend towards an implicit consolidation of accounts in the taxation of multinational companies. While administrators formally adhere to the arm's length standard, the reality of transfer pricing is better described as ad hoc formulary apportionment. Particularly APAs are often based on such apportionment. Thus, while governments did not agree ex ante on a definition of a common tax base, such consolidation does de facto take place ex post – case-by-case 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 administrative practices that – albeit not openly but only implicitly –

[30] While an intensification of administrative cooperation may be sufficient to tackle the problem of tax evasion by (mostly wealthy) private individuals, it will hardly affect the tax planning strategies of big MNEs. Notwithstanding Tyco and other recent scandals, it is quite likely that MNEs will restrict themselves to the legal possibilities of tax arbitrage, because of their fear of losing reputation.

puts legislative sovereignty into question. 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 of coming up with adequate solutions to transfer pricing problems administrators (implicitly) consolidate the international tax base, a prerogative that would actually be that of legislators. Thus, there is a de facto internationalization of legislative sovereignty through the administrative 'backdoor'. Under the assumption that international economic integration will advance, the legislative sovereignty that governments 'officially' hold on to will become more and more fictitious. This suggests that there is a limit to the extent by which one can trade off the maintenance of legislative sovereignty against sharing administrative sovereignty.

What is needed in the medium to long term is more *ex ante* cooperation, i.e., governments have to be willing to harmonize at least certain parts of their national tax codes. Instead of letting the rules of international taxation drift unconsciously towards implicit consolidation of accounts, governments should officially push for a system of unitary taxation with formula apportionment. A system of formula apportionment would require elected governments to consciously take decisions on an appropriate definition of the common tax base and the apportionment formula. Not only in terms of administrative costs but also in terms of democratic legitimacy and transparency this would certainly be preferable (see also Picciotto 1992, 305-6).

Formula apportionment would ideally be based on factors like sales, payroll, or capital invested, to ensure that economic activity is taxed where it actually takes place. Under these circumstances, the typical letterbox company in a tax haven would only be assigned a very small or no part of the enterprise's profit, because hardly any real economic activity, as measured by these factors, is undertaken there. However, a system of unitary taxation would not be without problems. With a common consolidated tax base plus formula apportionment, tax competition would no longer be mostly about just shifting "paper profits." Instead, companies and countries would structure tax competition on those factors which are part of the apportionment formula.[31] To what extent this would be possible or actually have harmful effects will depend on the particular formula chosen. In addition, it may be necessary to agree on a

[31] Clausing and Avi-Yonah (2007) argue for a formula that uses only sales on a destination basis in order to dampen unwanted competition on labor costs or investments. This consideration shows that the choice of a reasonable formula is essential and difficult (see also Rixen/Uhl 2007, 14-5). For good overviews of this and many other issues concerning the choice between unitary taxation and separate accounting, see Sørensen (2004) and McLure/Weiner (2000).

binding minimum tax rate (Rixen/Uhl 2007). Given that it is appropriately designed, such a system would be an improvement over the current state of affairs.

Currently, the political prospects for establishing such a system are bad. Even in the European Union – where the Commission planned to propose a directive on a common consolidated tax base this year – the resistance against such a move is strong and the chances of achieving real change in the near future are low. Apparently, governments have still not yet come to realize that, under conditions of globalization, it is necessary to share legislative tax sovereignty with others, if they want to be able to regulate international tax competition effectively in the future. Only collectively can governments recapture what they have lost individually.

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