

# **SHIFTING MODES OF GOVERNANCE: THE CASE OF INTERNATIONAL DIRECT TAXATION**

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## **Shifting Modes of Governance: The Case of International Direct Taxation**

### **Abstract**

Although there is substantial academic interest in new modes of governance, the dichotomy ‘old-new governance’ is not really useful to understand the long-term evolution of governance in international and EU direct taxation. More fruitful insights come from focussing on shifting modes of governance as dependent variable, using a continuum from formal to informal modes. Drawing on this continuum, we make three claims.

First, informal governance is ‘old’ governance as far as direct taxation is concerned. Informal modes were institutionalized by the OECD with 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 social legitimacy of international tax governance has declined over the last 80 years or so. The wider the scope and the range of actors targeted by informal governance, the larger the contestation of OECD and EU policy. 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. We explain this paradox by arguing that the questions about social legitimacy should be posed in terms of switch of logics, from technocratic to political. Finally, we answer the questions ‘Why does the EU select more informal governance solutions at a time when the OECD looks into harder forms of governance?’ and ‘Why does governance switch from technocratic to political?’

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

## 1. INTRODUCTION

The analysis of modes of governance, their emergence, efficiency and their level of legitimacy, especially in the European Union is not a completely new approach, but with the growing complexity and interdependence of the EU this field of inquiry has gained importance and has become one of the most expanding and prominent areas in European Studies. Lawyers, sociologists, historians, economists and political scientists are engaged in the explanation of a multitude of aspects and consequences of modes of governance<sup>1</sup>. One of the frequently used dichotomies in this field is ‘old-new governance’ (Eberlein and Kerwer 2004; Heritier 2003). We will show in this paper that this dichotomy presents some problems and that it is more useful to focus on shifts in governance as the dependent variable.

Indeed, the recent literature shows that what really matters is not the supposed novelty of governance but its changing patterns. 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 of this attempt to come to terms with shifts 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.

A focus on changing patterns of governance (that is, shifts in modes of governance) as the dependent variable in the context of a continuum is useful for two reasons. First, the notion of modes of governance captures different policy tools in a meso-level concept. As such, it enables the researcher to sort out a high number of tools and individual initiatives and address the real issues about power – including classic questions like ‘who gets what from changing patterns of governance’. Second, modes of governance can be classified. Taxonomies can assist that type of conceptual work that is most indispensable to build explanations. There is a wider discussion on possible

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<sup>1</sup> For a detailed overview see for example Van Kersbergen and Van Waarden (2004)

taxonomies of governance. In a short report we prepared for a workshop (Radaelli and Kraemer 2005a) we reviewed some of the typologies and concluded that we should not see modes of governance in a dichotomised fashion but rather in terms of a continuum. Third, a continuum can be useful to grasp the interaction between the two properties that are measured at the two poles. This is important for taxation, because some modes of governance are nested into other modes, for example, non-binding codes are part of packages that include directives as well.

This is where the first problem of analysis kicks in. Having established that a continuum is more useful than a dichotomy, what do we put on the poles of the spectrum? Both policy makers and scholars investigating changing approaches to governance (be it alternatives to traditional regulation, the open method of coordination in the European Union, or policy tools in environmental policy, see Mandelkern 2001, Trubek and Mosher 2003, Zito, Radaelli and Jordan 2003) are fascinated by the novelty of governance arrangements. But solutions that are novel are not necessarily new. Most fundamentally, we run the risk of projecting a stereotypical account of the past onto our empirical evidence. Soft law has been around for many years. Clientelism shows that ‘alternatives to traditional social regulation’ have been known for quite a while in some countries. And soft policy diffusion, imitation, and emulation are at least as old as the history of US federalism.

A more promising idea is to look at informal and formal as possible poles of the continuum. Over the last few years considerable scholarly 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. 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 a political organization without opt-out options). Closest to the extreme pole of formal governance lie European Union legal measures such as directives and regulations, state aid rules and ECJ Case Law.

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 ‘a la carte’ options. Closest to this pole lie the tax communications of the Commission<sup>2</sup> and pilot projects on home state taxation. Along the continuum moving from informal to formal governance we situate policy tools like the Working Group on Common Consolidated Tax Base established in 2004, the Transfer Pricing Forum, the code of conduct on business taxation, the OECD campaigns against harmful tax practices, and the 1990 Arbitration Convention on transfer pricing<sup>3</sup>.

Van Tatenhove and Mak (2005) distinguish four strategic intends of actors to set up and participate structures that lie closer to the pole of informal governance: 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) the key actors are

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<sup>2</sup> In some of its tax communications, the Commission proposes templates for a coordinated adoption by member states, but the template is not binding. The template is suggested by the Commission as a rational response to the activity of the European Court of Justice in a specific policy sub-field. In a sense, this a response formulated in the shadow of ECJ hierarchy. A good example of this approach is the communication on dividend taxation, European Commission (2003).

<sup>3</sup> For the description of the individual instruments see [http://europa.eu.int/comm/taxation\\_customs/taxation/company\\_tax/gen\\_overview/index\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/company_tax/gen_overview/index_en.htm) and Picciotto (2003).

Finance Ministers and revenue authorities meeting in organizations like the EU and the OECD<sup>4</sup>. 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 institutionalization of governance. The ‘international tax order’ is a metaphor. There is nothing similar to a World Trade Organization for taxation and the tax competence of the EU and the OECD is not uncontested. Thus, we should perhaps say ‘embryonic tax governance’: there is more chaos than order in this notion.<sup>5</sup> Accordingly, we would expect policy tools with features of 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.

First, informal governance is ‘old’ governance as far as direct taxation is concerned. This is yet another reason to reject the old versus new governance approach to the design of a governance continuum. 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 features - was quite successful both in terms of diffusion and in

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<sup>4</sup> 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.

<sup>5</sup> So much so that the idea of a dedicated International Tax Organization has been discussed on several occasions. See Tanzi (1999) and Horner (2001).

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 towards informal governance. The trend is not linear. Since the second half of the 1990s, the Commission has been more interested in informal governance, first with the code of conduct in business taxation (1997), then with the 2001 Communication advocating for recommendations that would set the stage for a coordinated approach of the member states to the jurisprudence of the European Court of Justice in areas like pension taxation, exit taxation, dividends, and tax treaties (European Commission 2001a), and most recently with policy fora looking into EU-level corporate tax reforms with a high degree of flexibility and optional choices (European Commission 2001b). While the Commission has experimented with more informal governance in recent years, the OECD has somewhat ‘hardened’ its approach to modes of governance in three directions. First, the OECD has stepped up gear from bilateral solutions proposed by the Paris-based organization for adoption by member states (note that even the single articles of the tax treaty convention can be adopted with flexibility and the insertion of special clauses by governments) to multilateral initiatives in which the OECD provides a clear centre of political gravity. Second, the OECD has sought to produce policy change in offshore jurisdictions, thus effectively proposing a more formal definition of the OECD worldview of a ‘fair tax world’. Third, at least in some critical junctures, the OECD has made use of the shadow of sanctions to put pressure on recalcitrant jurisdictions. The implication is that bold statements about a generalised trend towards informality in governance are not corroborated by empirical evidence.

The third claim is about social legitimacy (as opposed to other notions of legitimacy such as normative legitimacy, see Follesdal 2005), that is, the perceptions of legitimacy dominant among international tax policy stakeholders. In the case of international taxation, social legitimacy involves both the content of policy, and the competence of organizations like the Commission and the OECD to coordinate tax policy.

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: 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 live, 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 discuss the apparent paradox of social legitimacy in international taxation. Empirically, over the long-term (say, from the 1930s to the present days), the contestation of international tax policy has increased. 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 governance mode on the informal side of the spectrum, the larger the contestation of OECD and EU initiatives. Apparently, this leads to the paradoxical conclusion that legitimacy has been higher under conditions of close, technocratic governance networks – a point hard to reconcile with democratic theory. In this paper, we discuss the paradox and conclude that the real issue is about 'legitimacy for whom?' We then re-interpret what at first glance looks like a decrease in social legitimacy as an increase in the political salience of international tax policy. In doing so,

we describe another important shift – one from a technocratic logic of international tax policy to a more political logic. This shift towards politicization has transformed opaque policy domains into arenas where public opinion, diffuse interests, parliamentary oversight, and political parties make tax problems more visible and the logic at work more political.

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 (Section 2). Then we analyze the case of international and European direct taxation in the context of the interplay of formal and informal governance and the consequences for legitimacy (Section 3). In Section 4 we try to explain shifting modes of governance by addressing the questions arising out of our claims. The last Section 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 20<sup>th</sup> century brought corporations into the scene. The League of Nations 1928 report on international taxation was a landmark in three respects (Picciotto 1992). First, 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 systematization of important definitions of tax policy problems, concepts, and solutions. Second, the process of institutionalization of principles was supported by the emergence of international consensus among tax experts (Picciotto 1992) – arguably an embryonic epistemic community. Third, the League of Nations report established a soft and very 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 mainly informal governance in international taxation was the Organization 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 pricing<sup>6</sup>.

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 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***

The legal base for EU coordination on corporate taxes is thin: 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.

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

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<sup>6</sup> For a detailed explanation of these components see Picciotto (1992)

the European Court of Justice, who in fact turned out to be a major driving force in the area of 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 Treaty<sup>7</sup>.

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 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 harmonization. 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 harmonization 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

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<sup>7</sup> 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 or, more detailed, Gammie 2003).

problems. On the one hand, tax havens and tax avoidance had already caused some 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.

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, harmonization 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 extreme 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 harmonization 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 harmonization 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, harmonization, 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 centralization had a negative implication. Even incremental proposals (the 1969 draft directives, for instance) were damaged by this image of centralization 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 centralization 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. This table measures governance on the basis of the following dimensions:

- Cognitive base, that is, the set of principles providing the anchor of policy formulation
- Policy instruments, classified in terms of more formal or more informal governance tools

- How principles and instruments are diffused internationally (soft versus hard instruments)
- Impact on third countries
- Problem definition, that is, how policy defines the problems of international and EU taxation
- Institution-building, that is, presence-absence of specialised formal bodies in charge of tax coordination, for example special Council formations
- Role of formal governance (low or high)
- Actors involved
- Politicisation (low or high). Presence or absence of features such as attentive public opinion, diffuse interests, parliamentary debates, and political parties involvement
- Social legitimacy (low or high)
- Winners (preferences reflected in the development of tax policy)

The emphasis in Brussels was on governance modes close to the extreme pole of 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 harmonization and ambitious tax directives. So companies were not the real winners in terms of policy outcomes. In 1990 two directives against international double taxation of companies and one arbitration convention were approved<sup>8</sup>. However, they covered only minimal aspects. The idea of a convention rather than a directive was not inspired by considerations on the legitimacy of more informal governance. Instead, it was a way of escaping deadlock.

The OECD approach was in this period of time based on governance lying on the informal side of the spectrum. 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 social legitimacy. During these years, the European

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<sup>8</sup> 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).

Commission tried to promote very formal governance of direct tax policy, with ambitious plans for directives in the 1960s and 1970s, but no result was achieved.

**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. Ruding 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
Social legitimacy	High	No contestation of legitimacy, but no major achievement either
Role of formal governance features	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’ the informal side of the governance continuum 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 extreme 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 competition goes beyond the prescriptions of economics<sup>9</sup>. 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 organization 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.

But there was also contestation of the legitimacy of OECD positions. The debate especially in the US and the tax havens soon became political. When the Bush

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<sup>9</sup> For a review of international tax competition see Wilson and Wildasin (2003) and Zodrow (2003).

administration changed the US Treasury Secretary and Paul O'Neill took over from Larry Summers, the American support for the OECD campaign declined. In May 2001 O'Neill wrote an op-ed in the *Washington Times*<sup>10</sup> questioning the punitive intent of the OECD and the idea of 'stifling competition which forces governments, like businesses, to create efficiencies'. The op-ed was accompanied by a private letter to the OECD. This was the first time that the OECD project was discussed outside the technical framework of working groups of revenue authorities and specialists conferences. The tone of the article was aggressive and explicitly political. The reaction of offshore jurisdictions was also vocal and political. Most of the technical points made by the OECD report about the difference between desirable and harmful competition were ignored. So was the fact that the OECD report did not argue for any initiative on tax rate coordination. The public attack on the OECD revolved around the notion that the OECD was against low tax rates and that the Paris-based organization had no legitimacy to act as the 'tax policy of the world'.

Offshore jurisdictions and some parts of business soon found their advocates in the media and Congress. A right-wing lobbying organization, The Center for Freedom and Prosperity (CFP), was established with anonymous funding. Its members visited offshore jurisdictions and started lobbying against the OECD in Washington<sup>11</sup>. Some 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'<sup>12</sup>. 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

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<sup>10</sup> Paul O'Neill, *Confronting OECD's notions on taxation*, *Washington Times*, May 10, 2001.

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

<sup>12</sup> 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

calling into question<sup>13</sup>. None of this produced the withdrawal of US support to the OECD campaign, but it made it more qualified.

The OECD reacted by promoting more dialogue with offshore jurisdictions and by insisting on exchange of information as the final objective of the campaign, capitalizing on the issue linkage between tax transparency, money laundering, bank secrecy, and security which has characterized the post 9-11 environment. Now the OECD considers jurisdictions to be cooperative if they commit to the international standards of transparency and effective exchange of information upon request. The 2004 Progress Report provoked still hostile 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'<sup>14</sup>. However, the dialogue with offshore jurisdictions is a reality, under the aegis of the OECD Global Tax Forum. There has been a process of learning. On the one hand, the OECD has learned that blacklisting and sanctions are less important than establishing a process by which offshore jurisdictions take commitments to transparency and discuss the scope for exchange of information upon request. On the other, tax havens have discovered the advantages of transparent tax competition, with the exception of major financial centres like Hong-Kong and Singapore, which are still outside the framework of the Global Tax Forum.

The degree of politicization has increased for yet another reason, that is, the activity of NGOs on taxation. Charities such as War on Want<sup>15</sup> have campaigned on tax issues like the Tobin tax since 1998. The Tobin Tax Network<sup>16</sup> was set up in 2000, after ECOFIN voted against a European Tobin Tax. In 2000 the charity Oxfam published a report on tax havens, capital flights, and poverty (Oxfam 2000). The anti-globalization

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<sup>13</sup> S. Kirkell, 'OECD: 2002 Year in Review', Tax Notes International, 30 December 2002: 1316-1318

<sup>14</sup> D. Mitchell, 'The OECD's Dishonest Campaign Against Tax Competition: A Regress Report', [www.freedomandprosperity.org](http://www.freedomandprosperity.org)

<sup>15</sup> For more information about War on Want see [www.waronwant.org](http://www.waronwant.org)

<sup>16</sup> 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>

organization Attac<sup>17</sup> and the Tax Justice Network are fighting against tax havens. The advent of NGOs has raised new moral issues in the discussion of tax avoidance. Newspapers have been sent ‘tax stories’ about scandals, poverty and capital flight, major abuse of transfer pricing legislation, figures on the amount of tax revenue ‘lost’ in tax havens. Although Tax Justice Network is a small organization, its media campaigns have been carefully planned, with figures on tax avoidance released on Easter Sunday, when Bishops in the UK speak about global fairness.

The United Nations has revived its ad-hoc group of experts on international taxation and tax matters, now called the Committee of Experts on International Cooperation in Tax Matters, and NGOs have been invited to attend<sup>18</sup>.

To conclude, the OECD campaign shows some important changes in patterns of tax governance. First, there is a shift towards harder forms of governance. The new campaign has moved along the continuum towards harder forms: 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. Although the recent changes also show the importance of learning processes, there is no doubt that the mode of governance contains more formal features than in the past. The social legitimacy of OECD policy and, occasionally, of the OECD itself, has been contested by some actors and the discussion has become more political.

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 in 1996. The message was that harmful tax coordination can distort the balance between taxation of labour and taxation of capital, with some undesirable consequences on employment. Consequently, the political attention for tax coordination – this is an explicit impact sought by the Commission – must be raised to maximum levels.

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<sup>17</sup> For more information about Attac see [www.attac.org](http://www.attac.org)

<sup>18</sup> B. Zagaris, The United Nation’s role in international tax cooperation, *Tax Notes International*, April 25, 2005.

The emphasis on harmful tax competition magnifies the economic and political gains available to governments through European-level 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.

So the move 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 1997<sup>19</sup>. 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 more 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 more informal governance are nested into extreme formal governance. There is no switch from extreme formal to extreme informal. Rather, informal governance and formal governance have been bundled in a creative political technology – the tax package adopted by the Council.

Second, 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.

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<sup>19</sup> 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)

Very few documents and reports of the group are available through the ‘access to documents’ procedure of the EU.

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).<sup>20</sup>

The conclusion is that the code does not score well in terms of transparency, inclusion of social actors, and perhaps even social 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.

In order to address issues different from the ones concerning the member states, recent proposals of the Commission (2001b) target the tax problems of multinationals. Further to the elaboration of ideas supported by some areas of the business community and think tanks, the Commission initiated a formal debate on home state taxation, including a pilot project supported by systematic consultation. A non-paper was sent to the informal Ecofin Council (10-11 September 2004). Home state taxation would enable companies to extend the company tax rules of their residence state to subsidiaries and permanent establishments in other participating Member States – thus establishing a mutual recognition approach.

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<sup>20</sup> Complaints have come as well from dependent territories like Jersey, Guernsey and the Isle of Man. Having no domestic domain in foreign affairs they were subject to the negotiations between the UK and the EU without being directly involved in a dialogue with or being once consulted by the EU. Note, that 20 of the 66 measures the code declares to be harmful are based in UK dependent territories and that the necessity to abolish them has considerable effects on their economies. None of the measures is situated in the UK.

In March 2002 the Commission set up the EU Joint Transfer Pricing Forum (JTTPF), 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 JTTPF 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 processes.

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 a majority of 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.

Finally, as mentioned, the European Court of Justice has intensified its jurisprudence on direct tax matters, so much so that, arguably, the Court represents the major source of pressure on domestic tax systems in the EU.

#### **4. EXPLAINING SHIFTING MODES**

The claims presented in the previous Sections have to be explained. Specifically, two questions arise from our discussion of shifting modes of governance:

1. Why does the EU select more informal governance solutions at a time when the OECD looks into harder forms of governance? How come that the two trajectories of modes of governance went in different directions in the 1990s?
2. Why does governance switch from technocratic to political?

We answer the questions in reverse order. The politicization of international tax policy is explained by the emergence of a new policy paradigm of taxation. Following Blyth (2002), Steinmo (2003), and drawing on our previous work on the role of knowledge in politics (Radaelli 1995), we acknowledge that ideas about taxation and interests (of revenue authorities and the business community) are interrelated<sup>21</sup>. Within this approach to ideational politics, Steinmo (2003) has discussed the evolution of ideas about taxation in the 20<sup>th</sup> century. His account of changing paradigms in tax policy terminates with the advent and institutionalization of the paradigm according to which tax policy should promote the efficient allocation of resources (as opposed to a paradigm oriented towards equity and ‘ability to pay’). This ideational turn was consistent with the interests of an increasingly mobile capital and the economics of open markets.

However, Steinmo’s account can be usefully completed with the changing economic ideas in the last decade of the 20<sup>th</sup> century. This is the period in which tax policy-makers became aware of some un-desirable consequences of unbridled competition in tax matters, especially in terms of the deterioration of tax systems and revenue losses. In a (evolutionary) sense, tax policy-makers were discovering the limits and international inefficiencies (in open economies and at the global level) of what looked sensible at the purely domestic level: to tweak tax systems in order to attract capital from abroad without losing the domestic revenue base.

These material preoccupations were reflected in the emerging narrative of harmful tax competition – ‘the’ emerging paradigm of international tax policy in the 1990s. As shown in another article (Radaelli 1999), this narrative is more than the reflection of the interest of revenue authorities. It is also the product of ideational entrepreneurs like the European Commission (and in the OECD the Committee for Fiscal Affairs). Faced with the substantial neglect of proposals for tax policy coordination, these entrepreneurs successfully promoted a more political discussion of international taxation by shedding light on the harmful consequences (not only for the revenue coffers, but for the welfare state and employment as well) of some wicked types of tax competition.

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<sup>21</sup> For an analysis of the problems that this interrelation creates see Hay (2004).

Rapidly, harmful tax competition became a dominant discourse in international tax policy circles. As mentioned, this discourse is more political than the discourse on tax efficiency. It brings in considerations of fairness in the tax world, moral considerations about tax justice and un-justice, norms of behavior according to which the actions of offshore jurisdictions should be assessed, North-South imbalances and distortions induced by tax-generated capital flights from Africa and Latin America. This more political discourse has gone further than re-kindling cooperation among revenue authorities at the OECD and in the EU. It has also wetted the political appetite of tax NGOs like Tax Justice Network, that see this as an opportunity to transform international taxation into the new environmental politics (in terms of political mobilization of citizens)<sup>22</sup>. Further, harmful tax competition has brought into the debate the thorny political question of the relationship between offshore jurisdictions and the OECD members, and, within the business community, the issue of the legitimate uses of tax havens for socially responsible corporations. The whole notion of the public interest in international taxation is gradually emerging in tax policy discussions, with potentially huge implications about the range of actors involved and the issues to be addressed. To conclude on this point, our answer to the second question is that the emergence and institutionalization (in the EU and the OECD) of the narrative of harmful tax competition (in turn linked to interest politics) has widened the range of actors and policy issues, and has made technocratic approaches obsolete, at least for the time being.

Back to the first question, how does one explain the different selection of modes of governance at the EU level and in the OECD arena? For the EU, the answer is deeply rooted in the politics of this organization. The code of conduct in business taxation was chosen as a solution to bargaining problems. It was a political expedient that made the tax policy package proposed by the Commission effectively negotiable. There was no idea of looking at the informal side of the governance spectrum because of its quality in terms of participation, learning, alternatives to rigid regulation etc. Instead, the code was chosen to create a package deal in which the divergent interests of member states could be accommodated. To illustrate, Belgium accepted the code (although reluctantly) because the tax package included also a directive on savings. Shortly, there was no grandiose

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<sup>22</sup> Houlder, V. The tax avoidance story as a morality tale, [Financial Times](#), 22 November 2004.

political strategy about new modes of governance in this choice, but a classic problem of negotiation to be solved by a package deal. Turning to the recent more informal instruments selected by the EU to discuss corporate tax reform, their existence is motivated by the need of the Commission to balance relations of power across tax governance arenas. As shown in another paper (Radaelli and Kraemer 2005b), the transfer pricing forum, the working group on common consolidated base taxation, and the projects under way in the area of home state taxation are solutions to the problem of the Commission to avoid being captured by either the business community or the member states. To conclude, power politics explains a good deal of the EU choices.

What about the OECD then? Three mutually reinforcing factors were at work. First, the narrative of harmful tax competition was grounded in real preoccupations of the revenue authorities, increasingly frustrated by the difficulty to tax their own residents via traditional instruments. It should be considered that the Committee for Fiscal Affairs of the OECD is eminently a committee of revenue authorities. Second, and in connection with the previous point, due to technological innovation and financial sophistication, the marginal returns of uni-lateral (i.e., controlled foreign company legislation) and bi-lateral solutions to tax avoidance and tax evasion decreased quickly between 1980 and the 1990s – a point illustrated by Hugh Ault (2002). The OECD multi-lateral action should not be seen as an alternative to uni-lateral and bi-lateral initiatives, but as a much needed complement to increasingly limited instruments (OECD 1998: 42). In consequence, the choice of the OECD was one of widening the menu of instruments available rather than drastic re-direction. Third, in the late 1980s and the 1990s tax policy problems showed their connection with another bundle of policy problems, emanating from money laundering, security, political corruption, and lack of transparency in international economic transactions. The bundling of taxation with other and more political salient problems made the harder and more ambitious approach suggested by the OECD possible.

## 5. CONCLUSIONS

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 on business taxation, the Joint Transfer Pricing Forum or the working group on a common consolidated tax base.

Our first claim was that informal governance is ‘old’ governance as far as direct taxation is concerned. Informal modes were already used by the League of Nations and then institutionalized by the OECD with the model treaty convention and guidelines for transfer pricing between the 1960s and the 1980s. The European Union started to experiment with more informal modes in the 1990s mainly to escape deadlock. Informal governance is neither a very new phenomenon nor is it one limited to recent developments in the EU.

Our second claim was that 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 initiatives like the transfer pricing forum or the tax base working group have yet to be proofed. 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, Attac or Oxfam have limited influence on the development of international direct taxation. However, the foundation of the Tax Justice Network in 2001, its increasing media presence especially in the UK and Switzerland and its efforts to influence national and international agenda-setting by turning public attention towards the area of international taxation can be seen as an indicator that the debate has not only become politicized but also ‘moralized’.

**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	Global Tax Forum for dialogue and negotiation with tax havens.	High-level group within the Council on the code of conduct on business taxation
Actors involved	Revenue authorities Offshore jurisdictions involved in the Global Tax Forum	Revenue authorities Business and revenue authorities jointly participate in the Transfer Pricing Forum European Court of Justice
Level of politicization	High	High
Social legitimacy	Contestation of legitimacy	Contestation of legitimacy
Role of formal governance features	Higher than in the past	More exploration of informal governance
'Winners'	Revenue authorities	Revenue authorities, although under increasing pressure from the European Court of Justice

Our last claim was concerned with the striking point that the legitimacy of international tax governance is more contested now than 80 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 promoting a 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. Corporations question the legitimacy of secret discussions on tax regimes where there is a lot of corporate money invested. 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. NGO’s and radical political organisations from the left and the right try to influence the agenda-setting of EU and OECD – so far maybe with limited success but they have entered the stage and they have access to the media.

Overall, the process is not one of lower degrees of legitimacy over the long run, but one of politicization 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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