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## GOVERNANCE ARENAS IN EU DIRECT TAX POLICY

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### ABSTRACT

*Conventional scholarship on international taxation tends to address competition. It focuses on governments, and does not integrate purposeful political strategy with the ideational dimension of policy change. In this article we examine cooperation, use a multi-actor perspective to explain the selection of modes of governance, and bridge the gap between the strategic and ideational components of policy change. We show how a political strategy pursued by the Commission has led to the emergence of two functionally differentiated governance arenas, dealing with different definitions of tax problems and operating with modes of governance that suit the internal logic of individual arenas. We then examine the limitations of political strategy, by showing how a third governance arena dominated by the European Court of Justice has become increasingly important, with little control exercised by the Commission and the Member States.*

Key-words: European Union, direct taxation, governance, ideational politics

# GOVERNANCE ARENAS IN EU DIRECT TAX POLICY

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## 1. Introduction: tax competition, tax cooperation, and modes of governance<sup>1</sup>

In this article we examine the emergence of cooperation and the selection of modes of governance in international direct taxation. By doing so, we deviate from the conventional approach in international tax scholarship, focused on tax competition (Devereux and Sørensen 2006; Zodrow 2003). Typically, competition is analyzed either as a dependent variable (i.e. why states compete, and how, see Tanzi 1995; Genschel and Pluemper 1997) or an independent variable (i.e. the impact of international tax competition on domestic policy autonomy, see Ganghof 2006; Swank 1998). Most economists tend to portray the problem as a classic prisoner's dilemma leading to a race towards the bottom (Tanzi 1995). Political scientists have argued that institutions determine the type of race taking place and its outcomes,<sup>2</sup> and have shown that domestic policy autonomy has been eroded but has not disappeared (Swank 1998).

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<sup>2</sup> Hallerberg (1996) shows how Stackelberg leaders provide a floor to tax competition. Basinger and Hallerberg (2004) substitute the race-to-the-bottom with a tournament model and find that governments consider their own political costs (of undertaking tax reforms) and the political cost of reform in competitor countries. Ideological distance, partisanship, and capital controls constrain the propensity to undertake tax reforms. Hays (2003) finds that competition affects more majoritarian democracies with liberal economies than corporatist countries, and the final outcome of the race is convergence near the centre of the distribution of capital tax rates (thus not convergence towards the bottom). Franzese and Hays (2005)

In the European Union (EU), cooperation in indirect taxation is facilitated by specific Treaty articles and by the commitment to create a single market. But there are no Treaty provisions for direct taxation. EU legislation in this area can be made following general single market provisions in which unanimity in the Council of Ministers applies. The contrast between winners and losers from tax competition (put differently, a stark contrast of Member States' preferences) makes unanimity a serious hurdle.

Yet multilateral tax cooperation exists, as shown for example by the OECD track record in transfer pricing and, over the last ten years, the campaigns for an international tax level-playing-field (OECD 1998, Webb 2004). The nature, forms, and specific modes of international tax cooperation are therefore emerging questions on the agenda of governance studies.

In this article, we address questions about the emergence, content, and institutionalization of tax coordination in EU direct taxation by introducing four conceptual innovations. Firstly, instead of looking at economic policy instruments such as tax rates or the tax base, we look at tax cooperation in terms of governance. This redirects the analysis from policy outcomes to policy-making processes, specifically the selection of governance instruments. Some forms of EU tax coordination are grounded in the classic Community method, whilst others make use of the so-called new modes of governance (Eberlein and Kerwer 2004; Heritier 2003; Rhodes and Citi 2007; Treib *et al.* 2007). Intriguingly, one of the most important tax achievements of the EU, the tax

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model spatial interdependence (by moving it from the stochastic component of regression models to the right-hand side of the equation and by using theoretically informed spatial weights) and the mechanisms it creates in the diffusion of tax reforms. Swank (2006; 2007) investigates the diffusion of tax reforms looking at the responsiveness to US tax changes.

package finalized in 2003, provides a combination of ‘new’ and traditional forms of governance.

The point about governance arenas brings us to the second innovation. The international tax literature tends to privilege models based on strategic interaction between two or more governments operating under conditions of economic interdependence. However, we need to consider other actors to account for the emergence of tax coordination in a given institutional context. In the EU, the constellation of actors includes the European Commission, pressure groups, and communities of experts – as well as revenue authorities and finance ministers from the Member States.<sup>3</sup>

In this article we consider governments, EU institutions, and pressure groups. The European Court of Justice (ECJ) is another, increasingly important, element of the scenario. Legal scholars are debating whether the Court has indeed a political agenda towards tax harmonization (Graetz and Warren 2006) or is developing its jurisprudence around the interpretation of the Treaties – with no deliberate intention to create more or less harmonization (Gammie 2003). It is objectively difficult to look at the direct tax jurisprudence of the ECJ and expose its economic model (implicit or explicit; static or changing over the years) – not to mention a clear political orientation.<sup>4</sup> In line with the prevailing European legal scholarship on direct taxation, we do not consider the ECJ an

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<sup>3</sup> The European Parliament plays a limited role in direct taxation. Looking at classic modes of governance, direct tax proposals for directives are subject to the consultation procedure. The new modes of governance mentioned below do not envisage any specific role for the European Parliament. Civil society organizations concerned with taxation, such as the Tax Justice Network, have appeared on the stage in recent years but their influence is still limited.

<sup>4</sup> There seems to be a divide between American and European tax lawyers on this issue. While most European scholars consider recent Court decisions, however troublesome for national revenue authorities, arising out of the goal of a functioning single market, US-American scholars draw comparisons and parallels with the US Supreme Court and therefore, unsurprisingly, find that the ECJ has a political orientation in its tax jurisprudence.

actor with a specific political agenda for direct taxation, although we do show how the Court has effectively contributed to the emergence of a governance arena.

Thirdly, the conventional political science approach to strategic interaction in international taxation looks at the ‘race’ and its outcome (race-to-the-bottom or ‘tournament models’ are classic examples, see Hallerberg 1996; Basinger and Hallerberg 2004). This literature controls for a large number of variables, from openness to trade to institutional factors (Swank 2006, 2007). However, when cooperation is addressed (Persson and Tabellini 1995, 2000; Sørensen 2004), the literature does not say much on the policy-making process. By contrast, we focus on how governance arenas emerge – thus shifting the emphasis from outcomes to processes. We explain how arenas emerge as a result of material pressures, ideas championed by skillful actors, and preferences. Political strategy uses ideas as repertoires of concepts that can mobilize actors and make them think reflexively about their preferences. Theoretically, this third innovation is based on actor-centered analysis. We approach the analysis of strategic behavior within constellations of actors, problems, and solutions by considering both material and ideational factors. By doing so, we draw on previous research on how knowledge enters the policy process in combination with interests (Radaelli 1995) – a position recently dubbed strategic constructivism by Jabko (2006). An important clarification is in order, however.

Finally, we perform within-case analysis. This is motivated by the observation that modes of governance are not selected synoptically for the whole of direct taxation. The choice of modes takes place at the sub-systemic level, within functionally differentiated governance arenas. The role of the sub-systemic level has been recognized

by Sabatier (1993). More generally, the points we make about the autonomy of the sub-systemic level chime with Lowi's analysis of arenas of power and his underlying concept that 'policy determines politics' (Lowi 1972).

The organization of the article is as follows. We first sketch the preferences of the actors and the material-ideational context in which they operate (Section 2). In Section 3, we turn to the emergence of functionally differentiated governance arenas and the selection of modes of governance. The Commission has orchestrated the creation of two different governance arenas to balance the power relations between Brussels, the Member States, and the business community. We call one arena 'harmful tax competition' and the other 'corporate tax reform'. For Brussels it is vital to secure a process goal, that is, to make progress on EU direct tax policy. Revenue authorities are the dominant actor in the harmful tax competition arena, whilst the arena of corporate tax reform works on possible solutions to the tax problems of multi-nationals. In the first arena, modes of governance (such as negotiation, hierarchy, and facilitated coordination) are hybridized and are selected on the basis of political expediency. In the latter, facilitated coordination prevails – a consequence of the forward-looking and more experimental nature of governance in this arena. Neither the Commission nor the Member States have controlled the emergence of a third arena dominated by the European Court of Justice where the mode of governance is hierarchy. Section 4 presents our conclusions.

## **2. Pressures, ideas, and strategic interaction**

We now turn to our actors, their motivations and the context in which they operate. Their preferences can be sketched as follows. To begin with, for the Member States, represented by revenue authorities and finance ministers, the main goal is to guard the revenue base although they also want to attract foreign investment and mobile capital via a competitive tax environment (Sinn 2003). Countries with a high share in the financial sector and-or small size, such as Estonia, Ireland, Luxembourg, the UK and the Netherlands prefer tax competition to tax coordination. Countries with a large welfare state, such as France, Germany, and Italy, tend to prefer tax coordination. The conflict between winners and losers in the tax competition game is so stark that, as shown by Ruding (2005), even limited, pragmatic proposals for tax coordination may be antagonized by Member States that see them as the first step towards large-scale harmonization.

Nevertheless, no Member State wants to see its tax revenue eroded by ECJ case law. And the idea of attracting capital from other European Member States has its limitations in that, in the long run at least, every country in the European Union depends on the others to achieve policy goals. Strategic games in the EU are never one-shot. Specifically, concessions to the goal of policy coordination can be made when negotiations take place at the highest political level and there is diffused political determination to crack down on 'clear and present' dangers (in the perception of Finance Ministers), a point illustrated by Radaelli (1999). Otherwise technical negotiations with the Member States' revenue authorities are always characterized by the preference for the

status quo. To conclude, Member States' goals can be specified in terms of outcome rather than process.

As for the Commission, Brussels has first and foremost a process goal, that is, to formulate policy and make sure that political discussion leads to an agreement.<sup>5</sup> But there are also goals in terms of outcome. The Commission has modified its strategy on several occasions since the early days of the Community. It changed from a single market and business-friendly strategy (typified by the proposals of Commissioner Scrivener in 1990 (European Commission 1990) and the idea to establish a committee of experts and business leaders chaired by Onno Ruding to formulate a template for action based on different EMU-like stages (see European Commission 1992) to Commissioner Monti's strategy for targeting harmful tax competition in the second half of the 1990s.

The business community, our third player, is not a unitary actor. The preferences for tax coordination may change depending on whether a company is exposed to international trade or not, the sector, and size, as shown by Bernauer and Styrski (2004). It is clearly more difficult for small- and middle-sized companies to deal with extensive transfer pricing documentation requirements, and afford lawyers that help to navigate through the jungle of various national tax systems, than for large multinational enterprises with their fleet of tax consultants.

However, as far as EU direct tax coordination is concerned, it is fair to say that the main goal of the business community has been to impose an agenda based on the

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<sup>5</sup> Note that when we say 'Commission' we largely talk about DG TAXUD. The Commission in itself is not always a unitary actor, as shown by Irish Commissioners McCreevy's reaction to the proposals of a common tax base by the end of 2008 (made by tax Commissioner László Kovács in 2005). He stated that tax harmonization was not and would not be on the Brussels agenda whether 'by the front door or the back' (www.FT.com, 10 November 2005). However, it is rather rare that commissioners publicly cast doubts over the policies of their colleagues and most of the time the Commission indeed has a common process goal.



elimination of the tax obstacles encountered by firms operating in the single market. This includes simplification of documentation requirements, reduction of compliance costs, and, thinking of most advanced solutions, the option of filing tax returns according to a single, EU-level consolidated definition of the tax base instead of coping with 27 different regimes. The role of the business community in terms of ideational politics has been to push for a redefinition of the EU tax policy agenda and to provide templates for possible solutions to the tax problems encountered by business in the single market.

Regarding strategic interaction, we consider the following two elements. Firstly, as mentioned the EU has pursued different goals across the year. The agenda has been redefined more than once. Secondly, it would be wrong to assume that an organization like the EU is a unitary actor. It is a political system in which ‘actor constellations<sup>6</sup>’ interact.

One has to provide a parsimonious description of strategic interaction to explain why the agenda is redefined, when, and with what choices in terms of modes of governance. Actors operate in an institutional context. We agree that the interaction of actors in the shadow of EU governance rules is fundamental, but we also consider material pressures and ideational dynamics. In doing so, we subscribe to Jabko’s theoretical position to keep material pressures, ideational forces and institutional rules distinct in the analysis of EU governance. Material pressures are filtered by ideas and institutions, but ideational frames and institutional rules are activated via political strategy (Radaelli 1995; Jabko 2006). Strategy is often the product of an entrepreneurial

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<sup>6</sup> According to Scharpf 1997:44 a constellation of actors ‘describes the players involved, their strategy options, the outcomes associated with strategy combinations, and the preferences of the players over these outcomes’.

actor, who brings ideas into the policy process in order to create consensus within a constellation.

Thus we draw on the following elements:

- i. Constellations of actors – namely three types of actors, EU institutions, governments, and pressure groups. Given the EU institutional context, we consider the preferences of actors in terms of process and outcome.
- ii. Interaction takes place in institutional settings that reduce empirical variance, and is also sensitive to material pressures and ideational dynamics. The material dimension includes both economic and legal pressures which demarcate the boundaries of what is politically possible. Of course, these pressures can be interpreted in different ways by the actors.
- iii. Turning to ideas then, they provide the definition of the EU tax policy problems (alternative problem definitions include harmful tax competition, corporate tax reform, tax discrimination and barriers to the single market) and discourses (in various guises, but often in the form of policy narratives). Ideas enable actors to articulate their interests and make them ‘actionable’ (Blyth 2002: 39). The ideational dimension does not determine policy outcomes in a crude cause-effect relationship; it rather enables some actors and constrains others. Ideational pressures are linked to the actors that push strategically for change and alternative definitions of tax policy problems. Thus, we go back to actors and the strategic dimension of policy making. We then end up in a position that is very close to Jabko’s strategic constructivism (Jabko 2006: 26-27; 39-41).
- iv. Strategic interaction within a material-ideational context leads to the choice of modes of governance. The most important modes are hierarchy (in two varieties, that is, directives and other EU-level rules establishing policy templates and market-making rules established by the Council, the Commission, and, most importantly in our case, the ECJ), negotiation, and learning-facilitated coordination (Bulmer and Radaelli 2005: 346).

Put differently, we have to account for material pressures, ideational pressures, and strategic behavior in governance arenas where multiple actors interact. Material pressures limit the range of options available to actors. Ideational changes make tax policy problems more or less visible and understandable to actors. Most importantly, ideas provide meaning to material pressures and contribute to the identification of interests so that actors can act upon them. Following Hay (2002, chapter 6) and Radaelli (1999), we consider the hypothesis that tax narratives and policy ideas can change the preferences of actors. Finally, once material and ideational factors have been identified, we have to show how actors use them strategically.

Material pressures on Member States arise out of economic integration in Europe and ‘globalization’. Without necessarily drawing bold inferences from functionalist explanations, there is no doubt that the single market has exposed the role of tax barriers and distortions and has made discussions on corporate tax reforms more urgent. At the same time, an integrating world economy has magnified the role of tax competition. In turn, this has contributed to the degradation of domestic tax systems (Tanzi 1995; Avy-Yonah 2000) and to the emergence of a discussion on harmful tax competition at the OECD and in the EU.

In terms of pressures within the EU, however, the single major factor is the jurisprudence of the ECJ. Although the Treaties do not envisage large-scale intervention of the Court in direct taxation, the ECJ has gradually increased its tax jurisprudence over the last 25 years. Tax regulations and entire tax laws have been struck down by the Court in more than one hundred cases. The ECJ has targeted both overt and covert

discrimination (between a resident and a non-resident company, provided that they are objectively comparable). It has also attacked the tax barriers to the exercise of freedoms in the single market. Derogations are possible only to protect the public interest. This has been conceptualized by the Court as the need to safeguard the cohesion of the tax system, to protect the efficiency of fiscal supervision, and to prevent tax evasion. However, Member States have to demonstrate that the tax measures used to protect the public interest are appropriate, necessary, least onerous, and proportionate (Gammie 2003: 93).

Corporations have found out that it is profitable to try to bring cases to the Court. To illustrate with an example, consider a company with profits in the Member State where it is resident. If this company cannot use losses in another Member State because of the resident country's tax rules, and there is no prospect of EU-level coordination on a solution to this problem, the best strategy is to try to get rid of domestic tax rules by getting the ECJ involved.<sup>7</sup>

The legal pressures of ECJ jurisprudence amount to revenue losses when domestic tax rules are struck down by the Court. They also create imbalances in the overall tax system. The ECJ decides that a rule is incompatible with the Treaties; it does not say how it should be substituted. As Member States have not agreed on a coordinated response to the ECJ and have not managed to rein in the Court via Treaty revisions, the overall impact (as seen from the point of view of domestic revenue authorities) is erratic.

As mentioned, material-legal pressures are interpreted via ideational filters (Blyth 2002; Hay 2002; Steinmo 2003). Two ideational factors have played a role. One is the

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<sup>7</sup> This has been successfully tried by Marks & Spencer. Marks & Spencer effectively won its claim but largely on the facts of its particular case. Whether other companies can take advantage of the judgment will very much depend upon how it is applied by the UK courts and on how UK law is amended to bring it into line with the judgment from 13 December 2005.

policy narrative of harmful tax competition (Radaelli 1999). Although both the European Commission and the OECD have engaged in the promotion of this narrative, it is at the EU level that explicit connections have been made between harmful tax competition, the degradation of tax systems, the imbalances between capital and labor taxation, and negative implications for the European ‘social model’. Ideas and interests are intimately connected: more often than not, new ideas enter the policy debate only if an actor or a coalition of actors ‘pushes’ them. Narratives such as harmful tax competition do not land on the policy stage as deus ex machina. They have been pushed by ideational entrepreneurs. The Commission has been an active ideational actor. The 1996 Commission’s paper to the informal ECOFIN meeting of Verona is considered the starting point of the political discussion on harmful tax competition in the EU (Commission 1996a, 1997b).

The other ideational factor has been generated by the business community and EU-level think tanks. In the 1990s, a small team of tax experts (sometimes referred to as the Stockholm group<sup>8</sup>) elaborated ideas for EU corporate taxation, which, instead of starting with harmful tax competition as the main problem, focused on the presence of the then 15 different tax rules and obligations for companies. The Group met in October 1998 and January 1999 and drafted early ideas that could form the basis for further consideration of a proposal for home state taxation in Europe. The idea of home state taxation (see Lodin and Gammie 2001) developed from the research by Malcolm

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<sup>8</sup> The Stockholm Group comprised the following individuals: Sven-Olof Lodin, Albert Rädler, Robert Baconnier, Ad der Kinderen, Malcolm Gammie, Jim Hausman, Hugh Ault, and David Tillinghast. The Group met regularly from 1993 on to discuss the development of the corporate tax systems in their respective countries and the development of corporate tax systems within Europe and internationally.

Gammie during his 1998 Unilever Chair in International Business Law at Leiden University.

Proposals for corporate tax reforms, including common base taxation and home state taxation, were then comprehensively assessed in two task forces established by the think tank Centre for European Policy Studies (CEPS 2000, 2001). The CEPS task forces included some 30 members of the business community. They provided a forum for a closer dialogue between business, the Commission, and the Council's top officers.

### **3. The emergence of functionally differentiated governance arenas**

The legacy of the past has provided an important learning point for the Commission. The tax strategies pursued in the 1990s by the Commission were characteristically unbalanced in terms of power relations. Scrivener's approach based on tax neutrality in the single market was biased towards the interests of multinational firms. Monti's strategy was more sophisticated. It revolved around a two-step approach, based on the elimination of beggar-thy-neighbor, harmful tax practices in the first stage, and then on the completion of a single market without tax barriers. Chronologically, however, it was step 1 that dominated the scene between 1996 and 2000. The problem was one of power relations, this time too close to the goal of the tax authorities to guard the revenue base.

This is a classic catch-22 situation. Each time the Commission got one actor on board (be it governments or corporations), it lost the support of the other one. This is how

a goal in terms of outcome emerged within the tax directorate of the Commission (DGTAXUD). It can be described as the goal of balancing power relations.

One obvious way to balance power relations is synoptic coordination at the policy level. Practically, this can be achieved by a high-level body (say, a tax committee within ECOFIN, alongside the existing Economic Policy Committee and Economic & Financial Committee) in which the preferences of the governments and the business community can be accommodated. Systemic action in one single, high-level governance arena is possible only if there are shared beliefs on the final goal of tax coordination. Preference heterogeneity would not prevent the emergence of systemic-level cooperation if the final benefits of coordination were clearly specified and agreed, but this is not the case. Hence, it is impossible to balance power synoptically at the macro-systemic level, that is, a level where all major tax issues, including harmful tax regimes, corporate tax reform, and the implications of the tax decisions of the ECJ, can be comprehensively assessed. Member States such as the UK would interpret synoptic-level coordination as a first step towards large-scale harmonization – a position that would not be defensible in the domestic debate on Europe. There is no agreement on what the final goal of synoptic-level coordination should be – a point made clear by the two CEPS reports that have looked into the possible future of direct tax policy in the EU (CEPS 2000, 2001).

This has led the Commission to the development of a political strategy based on functionally differentiated tax-governance arenas. Preferences are accommodated, and the capture problem of the Commission is eased, but only across arenas, not within one single arena. Governance arenas in direct taxation have the following properties. Firstly, they provide distinct rules for the selection of participants, modes of interaction and

decision-making rule. Secondly, arenas evolve around different ideas. The precise meaning of tax coordination (that is, what tax coordination is supposed to fix) varies across arenas, due to the ‘skillful playing’ (in the sense of Jabko 2006: 37) of ideas by strategic actors. Thirdly, tax arenas have emerged diachronically, not simultaneously, as a result of a political strategy in which some goals had to be achieved by one constellation of actors before another constellation could move on to another goal. Finally, arenas empower actors differently (in order to balance power relations across arenas some actors can be pivotal in some arenas but not in others) and enable actors to choose their own policy instruments. The choice of a mode of governance instrument takes place at this (sub-systemic) level.

Over the last ten to fifteen years, two main governance arenas instigated by the Commission have emerged, that is, the arena of harmful tax competition and the arena of corporate tax reform. However, a third emerging arena dominated by the ECJ is becoming increasingly relevant.

#### *The harmful tax competition (HTC) arena*

This arena developed in the second part of the 1990s, further to the 1996 Verona paper of the Commission and the 1997 ECOFIN agreement on the main components of a tax package to handle harmful tax competition. The major innovation has been the identification of a policy problem, i.e. harmful tax competition, combined with solutions that, taken together, could turn individual negative-sum games among the revenue authorities into a larger positive-sum game.



The main actors in this arena are the Member States and the Commission. Following Bulmer and Radaelli's classification, the modes of governance are negotiation at the level of policy formulation, and hybrids of hierarchy and facilitated coordination at the level of specific policy choices. The savings directive and the use of state aids to crack down on fiscal regimes are the best examples of hierarchy used to create market-correcting policies and EU-level policy templates (in the sense of Bulmer and Radaelli 2005: 344-345). There are also cases in which hierarchy is used to produce market-making rules - a directive on interest and royalties was added to this arena, although, as shown by Radaelli (2003), it was not an instrument to tackle undesirable tax competition. A code of conduct on business taxation has been in use since 1997. The code is based on facilitated coordination, arguably a case in which the policy-makers make use of the open method of coordination without using this label explicitly (thus one can dub this mode 'open coordination in disguise', Radaelli 2003 or 'forum politics', Radaelli 1999: 672). The material context is characterized by globalization and deep economic integration in the single market. The ideational variables operate via the mobilizing aspects of the narrative of harmful tax competition.

How are modes of governance selected in this arena? Is the arena stable, or contested? What do modes of governance 'produce', what is their impact? The selection of modes of governance is politically contingent. Within this arena there is no clear preference for one mode of governance or another. What matters is the political result of combining different instruments and modes of governance in order to increase pressure on the negotiating partners. The Commission packs together different proposals with the

aim of transforming individual zero-sum games (and consequently deadlocks) into a collective positive-sum game in which there is compensation across dossiers.

The notion that the most important goal of EU-level cooperation should be to reduce harmful tax competition has been opposed by multi-national business. Echoing these concerns, finance ministers and delegates from Estonia, Luxembourg, the Netherlands, Poland, and the UK have made the point that it is sensible to protect the revenue base across Europe, but without damaging the competitiveness of the tax systems or damage the financial industry. Yet these concerns have not led to the destabilization of this arena. Instead, they have contained the scope of the arena (there is no intention to use the code of conduct or state aids to go beyond the most glaring cases on beggar-thy-neighbor tax policies). For its part, the Commission has accommodated these requests by orchestrating the emergence of a second arena dealing with corporate tax reform.

Turning to what has been ‘produced’ by the modes of governance, negotiation in this arena was quite longsome. Although some of the most controversial measures gained extensions, the code of conduct has produced some changes. It is not easy to pin down the notion of ‘impact’, but there has been an effect in terms of socialization processes within the code of conduct group. Member States have accepted the principle of peer review of harmful tax regimes. It has to be observed, however, that socialization has been limited to the Member States. All meetings and documents have been protected by strict confidentiality. Parliaments, civil society organizations, and business have been kept out of the code. There has been an impact on specific regimes in the Member States and their dependent territories - most measures are being rolled back, although some dependent territories are thinking of moving from selective tax concessions to across-the-board tax

competition.<sup>9</sup> The latter, although acceptable under the specifications of the code, can trigger races towards the bottom (Keen 1999).

The overall business climate has also changed. In our interviews with accounting firms, the opinion was expressed that ‘the code has had an effect. It absolutely changed the way people do their tax planning. And it also changed the strategies of governments’, although the statement was clarified, ‘Some countries still play the game. Maybe the effect is not permanent after all’ (Interview at a top-5 consultancy firm, 23 May 2005). On balance, there is evidence of embryonic institutionalization of a mode of governance based on peer review, soft pressure, and commitment to roll-back harmful measures.

The directive on savings only entered into force on 1 July 2005. Switzerland and other European third parties (such as Andorra, San Marino, Liechtenstein, and Monaco) were supposed to adopt equivalent measures to the Member States for the directive to be agreed by the Council. After years of negotiation, the EU and Switzerland finally agreed in October 2004. However, banks and financial advisors in Switzerland and elsewhere have already introduced financial products that are not affected by the directive. Additionally, the directive does not tackle trusts. The idea of automatic exchange of information has been dented by extensions granted to Austria, Belgium, and Luxembourg. The three Member States will collect withholding taxes instead for a long transitional period, until 2015. The *Financial Times* called the compromise ‘unacceptable’ and demanded a ‘solution that does not destroy the credibility and

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<sup>9</sup> The Isle of Man has introduced a zero-ten corporate tax rate from 2006 onwards (Treasury Department, Income Tax Division (2002) Modifications to Taxation Strategy). This means a corporate tax rate of zero percent for most businesses, except defined regulated businesses that are taxed on a ten percent rate. Specified financial services companies include *inter alia* banks, trust companies, collective investment fund functionaries (but not funds or fund managers), investment managers and brokers. Jersey is following a

effectiveness of information exchange'.<sup>10</sup> Even the OECD criticized the agreement, fearing that the global effort on cracking down on tax havens would be undermined by EU plans that allow some of their jurisdictions to maintain bank secrecy (Gnaedinger and Radziejewska 2003).<sup>11</sup>

Finally, the procedures against tax aids (i.e. state aids with a tax component) have been used successfully to put pressure on Member States in the context of the negotiation of savings and the roll-back process of the code. In July 2001, the Commission launched the state aid procedure against no less than 15 tax regimes. The idea was to increase pressure on Finance Ministers by using the state aid procedure. The Commission noted in its 2004 report on state aids relating to business taxation that: 'The Commission's state aid work, carried out in parallel with the code of conduct work, has facilitated the conclusion of an agreement on the code of conduct' (Commission 2004: 19).

Overall, different modes of governance have been used strategically to reinforce each other in the same governance arena. Some Member States have not liked it, and argued that the Commission could not demand agreement on a soft learning process within the code, and at the same time dangle the Damocles' sword of the Treaty-based state aid procedure on the recalcitrant governments. But this is precisely what the Commission's political strategy was trying to achieve.

### *The corporate tax reform (CTR) arena*

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zero-ten tax strategy, too (States of Jersey, Finance and Economics Committee (2005) Fiscal Strategy, p. 44, 8 March).

<sup>10</sup> *Financial Times* Editorial 'Reject the squalid tax compromise' 17 January 2003, p. 10.

<sup>11</sup> Switzerland raised only 69m GBP in the first six months of the new law's operation, while Jersey with 9m GBP and Guernsey with 3m GBP stayed well behind the EU expectations.

The main actors in this arena are the business community, the Commission (sometimes with a key role played by individual Commissioners), and, often reluctantly, the Member States. The material pressure is provided by the fact that economic integration in Europe exposes the tax obstacles to genuine cross-border and multinational economic activity in several areas, such as transfer pricing, tax treaties, dividend taxation, exit taxation, and so on. The major ideational variables are competitiveness and the abolition of tax barriers to economic activity in the EU. The Lisbon agenda, with its insistence on competitiveness, is often mentioned by actors involved in CTR (Commission 2005), although the discourse on corporate tax reform predates Lisbon as it was shaped by the Stockholm group. The prevailing mode of governance is facilitated coordination.

The change of Commissioners obviously mattered when looking at the development of a corporate tax reform agenda (see Smith 2003 on the role of Commissioners in EU politics). Commissioner Bolkestein was less interested in playing in an arena characterized by a package that was linked to Mario Monti and dubbed ‘Monti package’ by the press. A former high-level Commission official stated in an interview for this project (12 May 2005):

The code of conduct and the whole tax package was based on the direct involvement of the Commissioner. Monti chaired practically all meetings. He insisted with the governments to get the best people in the Tax Policy Group and the Primarolo Group. [...] When Bolkestein arrived, he was not so interested in chairing these meetings. [...] Bolkestein had a set of priorities, they were well known, and it is a fact that taxation was not one of his priorities.

Commissioner Bolkestein put more emphasis on corporate tax reform than on the fight against harmful tax competition. As mentioned, it has always been an issue for the Commission to balance power relations. As soon as Brussels felt that some progress was being made in the HTC arena, it released a communication with the following plan of action: “Now that the work on the tax package seems to be progressing satisfactorily, increased attention must be paid to the removal of these obstacles. It is high time to put much more emphasis on the concerns of the EU taxpayers” (Commission 2001a: 20). The point was reiterated in a 2005 document, arguing that the elimination of harmful tax regimes was meant to re-establish the integrity of the tax base in the interest of the fiscal authorities. Having eliminated the main elements of fiscal degradation – the document goes on - the EU should eliminate the main fiscal obstacles to economic cross-national activity and turn to the preoccupations of European taxpayers (Aujean et al. 2005: 12-13).

This is an important element of political strategy: the two arenas developed diachronically because the Commission had a clear priority of goals in mind and wanted to achieve goals in the HTC first. But the ideas, in this case, were provided eminently by the business community.

Following the proposals of think tanks and the Stockholm group for more action directed towards the tax problems of multi-national, and in order to show to some Member States such as the UK and the Netherlands that harmful tax competition was not the only preoccupation in Brussels, the Commission embarked on a large study on company taxation, following a request made by ECOFIN to produce an analytical document on this topic. In October 2001 the Commission published the results of the

study in the communication ‘Towards an Internal Market without tax obstacles’ (Commission 2001b). The study included an economic analysis of taxation and the results of a panel of business experts on the key tax obstacles to the single market.

Since then, the Commission has launched several initiatives for corporate tax reform (on transfer pricing, home state taxation, and a common consolidated tax base). They fall outside the classic Community method. This suits the political logic of the CTR arena rather well, given its long-term nature, the problem-solving attitudes of bodies like the Transfer Pricing Forum and, most importantly, the effort to tone down the political implications of tax base coordination. The Commission has insisted on the technical nature of the exercise, knowing that revenue authorities in countries such as the UK and Estonia fear that soft governance will lead to draft directives on the harmonization of the tax base and to the consideration of minimum rates for corporate taxation (Ruding 2005; interviews with DGTAXUD and revenue authorities in Estonia, Finland, Germany, and the UK, 2005).

On the one hand, this arena scores well on transparency and participation, at least with reference to the Transfer Pricing Forum and the consultation process for the pilot project on home state taxation. On the other hand, the Common Consolidated Tax Base Working Group refused to have permanent non-governmental experts participating, although they agreed on building an expert group that can be consulted on request. Some members of the Group even wanted to keep meeting records unpublished until informed by Commission services that there was an obligation imposed by the Council and the European Parliament to disclose working documents, the same as for the meetings of the

Joint Transfer Pricing Forum (CCCTB WG 2004:5). The business community does not like the fact that the group is not permanently open to them:

Having established that we have a favorable opinion of the CCCTB Working Group, we have put forward a number of reservations. [...] UNICE would have preferred a working group of the Council, modeled on the successful experience of the transfer pricing forum. The CCCTB Working Group is not permanently open to companies; it is essentially a group of member states' delegates. We are consulted, but who knows what's going to happen in the future?

(Interview with a representative of a national federation of industry, 6 May 2005).

It is difficult to evaluate this arena. Some of the exercises are highly ambitious and technically complex. A common consolidated tax base, for example, requires a detailed analysis of accounting standards and their relation with the tax concepts. The pilot project on home state taxation for small- and medium-sized enterprises went through an extensive consultation process and has entered a five year trial period. The Transfer Pricing Forum has produced a code of conduct for the effective implementation of the Arbitration Convention (Council 2005) but it deals with a wide range of issues - from practical functioning of the Arbitration Convention to documentation requirements and the suspension of tax collection, interest, and penalties. On some issues, specifically documentation requirements, business and Member States have different positions. The Commission extended the Forum's mandate for another two years in 2004, acknowledging that progress has to be made slowly.



More crucially, one major problem is the declining political attention to EU taxation. Some governments think the tax package has delivered what it could, and there are no other urgent issues to address at the moment: ‘There is no political explosiveness behind it anymore and the things we deal with are purely technical’ (Interview with a member of the Code of Conduct Group, 19 May 2005).

The arena of corporate tax reform is dominated by experiments in facilitated coordination, dealing with technically complicated forward-looking issues. If political determination across arenas is decreasing, it will be difficult to find the resources necessary to agree on these far reaching matters and achieve concrete results in corporate tax reform once the exploratory mission is terminated.

#### *The emerging arena of judicial tax policy*

For the domestic tax policy makers interviewed for this project, the major source of pressure is neither globalization (via races-to-the-bottom) nor the code of conduct. Instead, it comes from the Court in Luxembourg. Companies and banks discuss the decisions of the ECJ more often than any other EU tax topic. Both companies and policy-makers are performing a number of risk-assessment exercises to see whether tax rules will stand up to future judgments of the Court.

The Commission has sought to use the ECJ decisions strategically, arguing that the ECJ policy impact is asymmetrical: ‘even when a ruling forces a number of Member States to introduce new tax rules, they often do so in vastly different ways’ (Commission 2001a: 22). In its 2003 Communication, the Commission proposed the adoption of informal governance, especially recommendations (prepared by non-papers, working

papers, and informal discussions) to provide guidance and ‘pro-active coordination of those features of Member States’ tax systems that are or are likely to be in conflict with EU law’ (Commission 2003: 7). Accordingly, Brussels issued Communications on the tax treatment of occupational pensions (2001), investment funds (2000), dividend taxation (2003), exit taxation and cross-border loss relief (2006). Edward Troup, an expert who has worked both for the private sector and Treasury in the UK, has argued that too many pieces of the tax systems are being carved off by the ECJ. He has also noted that:

‘Herein lies the rub: the only corporation tax system truly compatible with those freedoms is a fully harmonized one [...] As long as harmonization is off the agenda, EU governments should establish new parameters for the application of the single market rules to taxation, before they find they have no corporation tax revenues left to defend.’ (‘Europe is losing control of company taxation’, [www.FT.com](http://www.FT.com), 4 February 2003)

The reaction of Member States to the Commission’s Communications has been lukewarm. In June 2005, the UK decided to launch an inter-governmental initiative for the reduction of the ECJ powers in tax legislation in the context of the British Presidency of the EU. The German finance Minister Hans Eichel asked at the June 2005 ECOFIN Council to set up a reflection group to consider the implications of ECJ tax decisions.<sup>12</sup> We are not aware of any plan of action on this, although there have been a few very

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<sup>12</sup> This is what was reported by EuroActiv.com on 20 June 2005. The official press release of ECOFIN from 12 June 2005 is more laconic: ‘Over lunch, Ministers discussed the budgetary impact of judgements delivered by the Court of Justice in the field of taxation’. See [http://ue.eu.int/ueDocs/cms\\_Data/docs/pressData/en/ecofin/85253.pdf](http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ecofin/85253.pdf)

recent attempts to coordinate the position of some member states at major Court's tax hearings. Perhaps we are witnessing some embryonic inter-governmental coordination, without the involvement of the Commission. In the meantime, ECJ cases provide uncertainty on the future of domestic tax systems. The cases take a long time, and this may prevent the Commission from presenting proposals, knowing that a case on the issue is pending at the Court. Neither the Commission nor the Member States are gaining political capital in this governance arena.

#### **4. Conclusions**

This article has examined EU corporate direct tax cooperation by focusing on the selection of modes of governance. In contrast to traditional scholarship, we have taken a governance perspective rather than looking at tax rates or policy instruments. In contrast to explanations based only on political preferences or the consequences of globalization, we have shown how an actor-based strategic framework can also take into account the ideational dimension of politics. Ideas and knowledge, however, enter the policy process via interests and political strategy- a point made originally by Radaelli (1995) and recently developed and systematized by Jabko's strategic constructivism.

The emergence of functionally differentiated governance arenas is explained by material and ideational factors that provide the context but, crucially, actors' strategies make the difference. The Commission's preferences in terms of power relations across arenas explain the emergence of two of the three arenas.

In comparison to other studies (especially Jabko 2006), our analysis is more explicit on the limitations of political strategy. The Commission has successfully contributed to the emergence of two arenas, but although it has tried to use the ECJ jurisprudence to convince governments to go ahead with tax reforms coordinated by Brussels, the third arena is well out of control of the Commission. There has been political entrepreneurship on the part of the Commission, but this does not mean that Brussels has really succeeded in securing legitimacy for tax coordination.

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