

# TranState Working Papers

THE POLITICAL ECONOMY  
OF BILATERALISM AND  
MULTILATERALISM:  
INSTITUTIONAL CHOICE IN  
INTERNATIONAL  
TRADE AND TAXATION

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No. 31

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Staatlichkeit im Wandel • Transformations of the State  
Sonderforschungsbereich 597 • Collaborative Research Center 597



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*Ingo Rohlfing*

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No. 31

*Sfb597 „Staatlichkeit im Wandel“ – „Transformations of the State“*

Bremen, 2005

[ISSN 1861-1176]

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(TranState Working Papers, 31)

Bremen: Sfb 597 „Staatlichkeit im Wandel“, 2005

ISSN 1861-1176

Universität Bremen

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## **ABSTRACT**

Trade relations are governed by the multilateral GATT, whereas the avoidance of international double taxation rests on a network of around 2000 bilateral treaties. Given the two regimes' similar economic rationales this difference between bilateralism in international double tax avoidance and multilateralism in the trade regime poses an empirical puzzle. In this paper we develop an answer to this puzzle.

Differentiating between different stages of international cooperation, we first describe the institutional form in the bargaining and agreement stages of cooperation. This description shows that the regimes are quite similar in the bargaining stage, both exhibiting a mix of bilateral and multilateral bargaining. However, while agreement is multilateral in the trade regime it is bilateral in taxation.

Based on stylized institutional histories of both cases we develop simple game theoretic models incorporating domestic level considerations. Building on these models we then go on to explain the institutional choice between bilateral and multilateral cooperation. We show that state concerns for the distribution of benefits can be best achieved under bilateral bargaining in both regimes. However, in order to lower transaction costs there are also elements of multilateral bargaining. Agreement is multilateral in trade in order to overcome a free-rider problem that results from an interaction of concerns for distribution and enforcement. Since such a problem of free-riding does not exist in taxation, there is no need for binding multilateral agreement.

## **CONTENTS**

INTRODUCTION .....	1
1 A BRIEF INSTITUTIONAL HISTORY OF THE GATT AND THE DOUBLE TAX REGIME.....	4
2 SORTING THE EMPIRICAL ANALYSIS .....	8
3 AN EXPLANATION OF INSTITUTIONAL CHOICE IN TRADE AND TAXATION .....	9
3.1 Strategic Structure: The Domestic Politics of Trade and Tax Cooperation .....	9
3.2 Staying Small: Bilateralism in Bargaining.....	13
3.3 Bringing Down Transaction Costs: Multilateralism in Bargaining.....	16
3.4 Avoiding the Free Ride: Multilateral vs. Bilateral Agreement .....	19
CONCLUSION .....	21
REFERENCES.....	24
BIOGRAPHICAL NOTES.....	28

## **INTRODUCTION<sup>1</sup>**

The GATT/WTO is a regime with a commitment to achieve progressive, coordinated trade liberalization. The international tax regime also serves the goal of liberalizing international economic activities. Despite this common goal, there is one marked difference between the two regimes: trade relations are governed by the multilateral GATT, whereas the avoidance of international double taxation rests on a network of around 2000 bilateral treaties.

In a classic model, Mundell (1957) shows that the free flow of goods and the resultant common prices across countries will lead to factor prices also being equalized. Likewise, free factor flows and common factor prices will lead to equal goods prices. This is the theorem of the equivalence of factor and goods flows. What can be achieved with goods flows can also be achieved with factor flows. Now, the trade regime deals with goods (and services) flows and the tax regime influences factor flows, most importantly capital (and labor). Mundell's factor-goods-equivalence would suggest that the institutional form of the tax and trade regimes should be similar or the same (Whalley 2001, 17 f.). Given the two regimes' similar economic rationales this difference between bilateralism in international double tax avoidance and multilateralism in the trade regime poses an empirical puzzle (Davies 2004; Genschel 2005). In this paper we develop an answer to this puzzle.

When turning to theories of international cooperation for potential answers, one finds that the institutional choice between bilateralism and multilateralism has hardly been dealt with directly. For one, cooperation theory has an inherent analytical bias towards multilateralism and generally disregards the antipode to this institutional form, namely bilateralism (Odell 2000, 13).<sup>2</sup> Even work that explicitly complains about the neglect of the institutional form of cooperation in international relations theory fails to contrast multilateralism with bilateralism (cf. Ruggie 1993).

Second, and more important for the empirical puzzle at hand, research was also largely blind towards the specific advantages of an institutional form (Caporaso 1993, 62). When do states cooperate bilaterally? What are the advantages or disadvantages of

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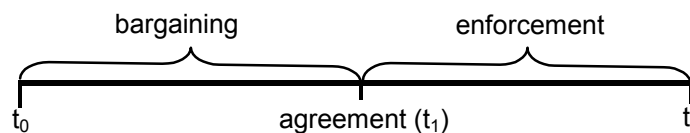
<sup>1</sup> We received helpful comments from Philipp Genschel, Robert Pahre, Frank Schimmelfennig, Holger Stritzel, Susanne Uhl, Dieter Wolf and two anonymous reviewers. Laziz Alidjanov, Julia Grieb, Stefanie Möschk and Vanina Nikolova provided research assistance. We thank all of them. The usual disclaimer applies. Generous funding was granted by the German Science Foundation (DFG).

<sup>2</sup> A particularly ironic critique in this respect can be directed towards early game-theoretic regime research that used two-person games to analyze multilateral cooperation. Even though the bilateral form of the games would suggest otherwise, one hardly finds an explicit discussion of bilateralism in this work. Some of the scarce exceptions in the earlier literature are Oye (1985) and Snidal (1985a).

bilateral compared to multilateral cooperation? Cooperation theory not only disregards bilateralism, it also does not systematically investigate the choice between bilateralism and multilateralism.<sup>3</sup>

Nonetheless, there are some building blocks available in the literature that can be used to address the empirical puzzle at hand. We use a differentiation between three stages of the cooperation process to adequately describe the institutional form of both regimes. In order to get a complete understanding of the institutional choice it is necessary to distinguish between bargaining, agreement and enforcement.<sup>4</sup> *Bargaining* refers to negotiating the terms of an agreement. *Agreement* is the stage of binding decision. It captures the formal conclusion of the bargaining period. It thus is the dividing point that separates the bargaining and enforcement stage. *Enforcement* refers to the ex post stage of the cooperation process in which countries ensure that all treaty partners comply with the agreement.

Figure 1: Three Stages of the Cooperation Process



In each of the stages countries can choose between bilateralism and multilateralism. We thus argue that cooperation is not dichotomous per se, but only in a certain stage of the cooperation process. Taking into account the whole process, cooperation can be characterized by a mix of bilateral and multilateral elements.

Using this scheme we will describe our dependent variable, the institutional form of cooperation in the tax and trade regimes. We will, however, focus on the bargaining and agreement stages only. Due to place constraints, we do not deal with the institutional form of enforcement. As our stylized institutional histories will show, both regimes ex-

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<sup>3</sup> The disregard of bilateralism in IR theory cannot be explained with the empirical irrelevance of this category. The United Nations treaty databank has collected 5130 bilateral treaties adopted from 1990 to 1999 (United Nations 2003). This figure is only the lower bound of all bilateral agreements signed in this period because states are not obliged to deposit their treaties with the UN. For a more detailed discussion of the shortcomings of cooperation theory with regard to the choice of bilateralism and multilateralism, see Odell (2000) and Rixen and Rohlfing (2005).

<sup>4</sup> The differentiation of cooperation into two stages, bargaining and enforcement, is quite common in the literature (cf. e.g. Fearon 1998; Koremenos, Lipson, and Duncan 2001). Sometimes, bargaining is referred to as “ex ante” problem of cooperation, whereas enforcement concerns “ex post” problems (Williamson 1985). We added ‘agreement’ to this differentiation, because it is in this dimension where the most important difference between the two regimes lies. A related, though somewhat different, conceptualization is suggested by Martin (1993).



hibit a different mix of bilateralism and multilateralism in the bargaining stage. In the agreement stage the regimes are institutionally dissimilar. Agreement is multilateral in the GATT, but bilateral in tax cooperation. As we will show, the dichotomous classification of the two regimes as bilateral and multilateral is misleading since it fails to capture the existing institutional complexity.

Based on this typological description of the regimes, we will then propose a theoretical account explaining the institutional choice in the bargaining and agreement stages. Based on considerations of both the domestic and international level concerns of governments, we construct simple game theoretic models that represent the strategic structure in the two issue areas. We then derive the implications of this structure for the institutional choice. In doing so, we focus in particular on the influence that states' concerns for distribution and the absence or presence of enforcement problems have. Distribution refers to the sharing of the benefits from the cooperative effort – who gets what from whom? Enforcement problems arise if there are incentives for the actors to deviate from the agreement.

Enforcement problems and, to a lesser degree, distribution have been issues in cooperation research for a long time now. It is generally acknowledged that the interaction of enforcement and distribution matter for international cooperation (cf. e.g. Koremenos, Lipson, and Duncan 2001). However, there is little research showing exactly how the variables interact and influence actor behavior and institutional design. We draw on the existing literature on enforcement and distribution and develop an explanation of how their interaction determines institutional choice. Thus, even though we do not deal with the enforcement phase on the dependent variable, enforcement problems do play a major role as independent variables. Since the actors will know *ex ante*, whether an agreement can be enforced or not, this fact has implications for bargaining and agreement. Problems of enforcement do not only influence the design of enforcement institutions, but also the design of bargaining and agreement. It is only this latter connection that we focus on. We argue that concerns for distribution let governments choose bilateralism in order to negotiate trade respectively tax concessions. Nonetheless, there are also elements of multilateral bargaining in both regimes that serve to lower the transaction costs of bilateral bargaining. Institutional choice in the agreement stage is determined by the presence respectively absence of enforcement problems. In trade cooperation a problem of free-riding emerges because MFN treatment made trade cooperation a public good. MFN-treatment, in turn, was introduced to mitigate the risk of tariff wars inherent in bilateral trade bargaining. In double tax avoidance a similar problem of free-riding does not exist and agreement thus is bilateral. In this sense, it is a complex interaction of concerns for distribution and enforcement problems that drives institutional choice in the bargaining and agreement stage.

The rest of the paper is structured as follows. We will first provide short stylized institutional histories of the two regimes and summarize the institutional features of the regimes using the differentiation between stages of cooperation (part 1). Based on these categorizations, we will then explain the institutional choice in both cases (part 2). In the final section we summarize our findings and derive some general implications for institutional choice between bilateralism and multilateralism in international cooperation.

## **1 A BRIEF INSTITUTIONAL HISTORY OF THE GATT AND THE DOUBLE TAX REGIME**

### ***Trade***

Eight multilateral trade rounds were held since 1947 within the GATT regime.<sup>5</sup> In our treatment of institutional choice we focus on tariff bargaining on manufactured goods.<sup>6</sup> In the first five rounds tariff bargaining was *bilateral* and took place on an *item-by-item* basis (Hoekman and Kostecki 2001, 101 ff.). GATT members exchanged requests and offers in bilateral bargains on particular products.<sup>7</sup> All bilateral bargains that could be reached by a particular country were included in one *tariff protocol* that had to be signed by each country having made a concession (Jackson 1997, 144). *Agreement* thus is multilateral in the GATT. After all bilaterally made concessions had been formally approved they were extended to all GATT members through unconditional most favored nation-treatment (MFN-treatment).

Except for the first Round in 1947 the obtained results were meager. From the viewpoint of the member states the main reason were the time-consuming bilateral item-by-item negotiations (Evans 1971, 11). To achieve deeper reductions in trade restrictions a

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<sup>5</sup> Geneva (1947), Annecy (1949), Torquay (1950-51), Geneva (1956), Dillon Round (1961), Kennedy Round (1964-67), Tokyo Round (1973-1979), Uruguay Round (1986-94).

<sup>6</sup> Extending the perspective to non-tariff barriers to trade and agriculture seems promising in order to increase our understanding of institutional choice. We, however, start by focusing on tariff bargaining on manufactured goods since these were at the heart of trade bargaining for a long time. In addition, one could think about considering institutional choice inside and outside the GATT, i.e. the determinants of bilateralism and regionalism bypassing the GATT (cf. Mansfield and Reinhardt 2003).

<sup>7</sup> Bilateral bargains were held simultaneously. This gave GATT members the opportunity to link formally separate bilateral bargains if the requests and offers within one bargain did not match since this might produce a zone of agreement that is infeasible otherwise (Sebenius 1983; Tollison and Willett 1979). There are no precise figures about the extent of linkage in GATT bargaining, but there is evidence that it was employed in some instances (Brown 2003, 91). However, bilateralism can be considered the dominant bargaining mode in trade rounds (Hoekman and Kostecki 2001, 138).

change of negotiating rules was desired by the USA, the EEC and some other countries at the beginning of the Kennedy Round (Preeg 1970, 2-3). The USA and the EEC as the major trading powers favored a linear formula approach. In its simplest form a linear tariff cut means that a country reduces all its tariffs – across-the-board or in a particular sector or field, e.g. manufactured goods – by a certain rate. In effect, a linear tariff cut is multilateral since all countries make the same commitment and have to agree on the depth of the reduction multilaterally.

Though all the ‘big players’ in the GATT sought a linear reduction they could not agree on any details before the official start of the round. The main obstacle to agreement was the handling of tariff disparities. While the EEC tariffs dispersed little around the average, US tariffs spread widely. This means that the USA had a number of tariffs in effect that were comparatively high. While the US wanted to reduce all tariffs on manufactured goods by the same rate, regardless of tariff levels, the EEC favored a harmonization approach that cuts lower tariffs less than higher tariffs.<sup>8</sup> In the end, no formal decision could be reached on applying a formula. However, there was informal agreement that the linear formula approach, aiming at an across-the-board reduction of 50 percent, should be the basis for the Kennedy negotiations. Where a country refused to make an item subject to the linear approach the latter was discarded in favor of the traditional bilateral mode (Preeg 1970, 57-80). Notwithstanding that the linear cut applied to many items, the empirical record indicates that bilateralism nevertheless played a central role, in particular on items that were salient to a GATT-member (cf. Evans 1971).

In the Tokyo Round negotiations (1973-79) GATT-members decided to stick with the formula approach informally employed in the Kennedy Round. The positions of the USA and the EC were still the same: the latter favored a harmonizing formula whereas the USA argued for a uniform linear cut. But, now the EC and the USA agreed upon a formula proposed by the Swiss delegation and decided to apply it to manufactured products. However, GATT-members were again allowed to table exceptions which were then negotiated on a bilateral item-by-item basis. In effect, GATT negotiators drafted exception lists containing numerous sensitive items that were exempted from a formula cut and dealt with bilaterally (cf. Winham 1986).

The *Uruguay Round* negotiations were again completely held on a bilateral item-by-item basis. A formula approach was sought by many GATT-members, but strongly opposed by the USA. The US negotiators argued that most of the tariffs were already low and there would be no sense in making them subject to a formula approach. Instead, the

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<sup>8</sup> To be precise, the USA wanted to exempt some domestically sensitive items from the linear cut. But since the EEC also wanted to do this, exempting particular items from the formula approach was not disputed among them.

USA pushed for a return to the bilateral item-by-item approach so as to deal with the remaining tariffs on an individual level. Finally, the bilateral item-by-item approach again became the default mode of trade bargaining (Croome 1999).

### ***Taxation***

The history of the double tax regime goes back to the beginning of the last century, when a few continental European States signed bilateral double tax treaties mostly with their neighbors (Spitaler 1936). It became more prominent in the 1920s when the League of Nations appointed economists, the “four wise men”, to address the issue of double taxation and convened several conferences of technical experts and government officials (League of Nations 1923; 1927). The International Chamber of Commerce, lobbying for the conclusion of a multilateral convention against double taxation, was the initiator of these League activities. The objective during the “League years” was to draft a multilateral treaty. However, states persistently rejected this, but were nonetheless very supportive of developing a so-called model convention that could be employed as a template for bilateral negotiations. They insisted to keep the model convention non-binding, because that would allow the necessary flexibility to make nationally differing tax systems compatible to each other (Picciotto 1992, 38). The work of the League resulted in the model conventions of 1928, 1935, 1943 and 1946.

In the 1950’s and 1960’s the OECD has taken over the position of the League of Nations (and briefly the United Nations) as the main multilateral policy forum for discussions of international tax issues. Countries’ positions remained unchanged. They expressed their opposition to a multilateral convention, but were supportive of further developing and adapting the model conventions. The OECD published its first model convention (OECD MC) and commentary in 1963 and then a revised version in 1977. In 1991 it was decided to transform the model into a loose-leaf format, in order to better be able to adapt it to changes in the economic environment. Since then it has continuously been updated, with consolidated editions being published in 1992, 1994, 1995, 1997, 2000, and 2003 (OECD 2003, para. 7 ff.).

Throughout the entire history there was persistent conflict among states as to whether the right to tax should be given to the country of residence, i.e. the country where a taxpayer lives, or the country of source, where the income is generated. This distributive conflict is not only interest driven. There is also persistent disagreement in the academic literature on whether the residence or source principle is preferable when measured against the normative ideals of equality and efficiency.<sup>9</sup> Since no general consensus on

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<sup>9</sup> Both residence and source principle can be justified on certain grounds. The basic question is, what kind of *nexus* between a taxpayer and a state justifies the state’s right to tax. Several theories have been suggested, for example *economic allegiance*, *administrative efficiency* or *territoriality*. In terms of economic efficiency, *capital export*

the best principle could be achieved, the conclusion of a binding multilateral treaty failed. Instead, the model solution – which remained unchanged in its fundamentals from the 1920's until today – represents the outcome of bargains in which conflicting tax claims have been traded off against each other on a case-by-case basis (Brauner 2003, 278 ff.; Graetz 2001). Jurisdiction to tax is assigned to either the source country or the residence country for different kinds of income.

Over time the arrangement of a non-binding multilateral model convention as template for bilateral treaty negotiations has become firmly institutionalized. The Commission on Fiscal Affairs (CFA) of the OECD – a body of government officials and tax experts, the same persons negotiating bilateral treaties for their countries – meets on a regular basis (Messere 1993). The CFA is *the* global forum for countries to cooperate in matters of taxation (Radaelli 1998) and non-OECD member countries also participate in these negotiations. In an ongoing process the CFA strives to modernize and adapt the Model Convention. This is done in a process of monitoring the treaty network. Often technical innovations that come up in bilateral treaties are integrated into the model. Other innovations are developed within the CFA. Thus, the work on the multilateral level serves to disseminate information and new practices within the regime. In the process a common understanding of bilateral tax treaty making and interpretation is developed. These common understandings, and remaining dissent, will be published in the commentary that accompanies the model convention and enjoys considerable authority with courts, lawyers and other tax practitioners (cf. Arnold and McIntyre 1995, 98 ff.).

The growth rate of bilateral treaties increased strongly after the OECD Model Convention was concluded. In 1955 there were only 56 treaties, slowly increasing to 85 in 1963 and 179 in 1977 (Messere 1993, 248). After the conclusion of the 1977 Model Convention their number increased rapidly to 1794 in 1997 (United Nations 1998). Even though countries are not obliged to use the Model Convention in their bilateral negotiations, almost all 2000 tax treaties that are in force today follow the Model Convention. Bilateral treaty making basically consists of the treaty partners agreeing on the Model Convention and adapting some provisions to their needs.

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*neutrality* would be achieved under residence taxation, whereas *capital import neutrality* requires source taxation (Frisch 1990). Likewise, different conceptions of fairness have divergent implications. Residence taxation is justified by the principle of *ability to pay* (Seligman 1928), source taxation by *inter-nation equity* and the *benefit theory* (Musgrave 1991). A good and accessible overview of the debate between the conflicting principles with references on all these considerations is provided by Li (2003, chapter 2).

## 2 SORTING THE EMPIRICAL ANALYSIS

The preceding discussion has shown that the trade regime and the tax regime exhibit elements of bilateralism and multilateralism. The classification of the two regimes as multilateral respectively bilateral thus does not deliver the full picture. Trade bargaining was mostly bilateral in the eight trade rounds. It was only in the Kennedy and the Tokyo Round that bargaining also involved a multilateral element. Bilateralism remained important even in these two rounds and again became the default mode in the Uruguay Round. Agreement was always multilateral in the past eight trade rounds.

In the tax regime, despite continued efforts to draft a multilateral tax treaty, agreement has persistently remained bilateral. Nonetheless, there is a high degree of uniformity between the different bilateral treaties because of a quite solid multilateral consensus on the rules of international taxation that is reflected in the model convention. There is multilateral bargaining within the OECD about the model convention, which is updated regularly. The multilateral MC serves as the basis for bilateral bargaining between potential treaty partners.

Table 1: Institutional Choice in Bargaining and Agreement in Trade and Taxation

	Trade	Taxation
Bargaining	mostly bilateral multilateral elements in Kennedy and Tokyo Round	bilateral on tax treaties multilateral on model convention
Agreement	multilateral	bilateral

The cross-case comparison of trade and taxation reveals that the institutional design proved to be quite stable in each policy field. Except of the efforts to multilateralize bargaining in the trade regime in the 1960s and 1970s and the early attempts to draft a multilateral tax treaty in taxation, the institutional mode in the bargaining as well as the agreement stage displays a high degree of stability. Moreover, the cross-case comparison shows that the two regimes are rather similar on the bargaining level. Bilateralism dominates in bargaining whereas in both cases one can also observe multilateralism. In trade, multilateralism *substituted* bilateral bargaining in those cases where no state exempted an item from the formula approach. In contrast, multilateral bargaining is *complementary* to bilateral bargaining in taxation. As was reported, bilateral bargaining takes place on the basis of the model convention.

The other side of the coin is that there is no complementary multilateral bargaining in trade and no substitutive multilateralism in taxation. In trade, complementary multilateral bargaining would mean to bargain about the GATT as an agreement on basis of which countries then bargain about trade concessions. This, however, did not happen since the central pillars remained untouched and were not subject to further bargaining

once the GATT had been established in 1947. In taxation, there is one (negligible) example of substitutive multilateral bargaining, which led to the conclusion of the only binding multilateral tax treaty between the Scandinavian countries. In the agreement stage both regimes exhibit a clear difference: agreement is multilateral in trade while it is bilateral in taxation.

### **3 AN EXPLANATION OF INSTITUTIONAL CHOICE IN TRADE AND TAXATION**

In this section we propose an explanation for institutional choice in international trade and taxation. We begin by describing the strategic structure of international cooperation in the two policy fields and proceed with explaining the mix of bilateral and multilateral elements in the bargaining stage. Finally, we turn to the agreement stage.

#### **3.1 Strategic Structure: The Domestic Politics of Trade and Tax Cooperation**

We argue that in both policy fields the strategic structure derives from domestic politics.

##### ***Trade***

The trade policy pursued by a country affects the interests of import-competers and exporters respectively domestic producers seeking cheap input factors.<sup>10</sup> We argue that import-competers prefer protectionism over trade liberalization so as to minimize competitive pressure arising from imports. The interest of exporters is to get access to foreign markets as easily as possible (see for example McKeown 1984).<sup>11</sup> Hence, the exporters' interests hinge on foreign governments' trade policies, and not on that of their own government. The domestic government can use its own barriers to trade as bargaining chips in trade negotiations in order to get foreign barriers to trade reduced (Milner and Yoffie 1989). Whatever trade policy the government pursues, it incurs domestic political costs since either import-competers or exporters will lose income. The losing group reduces its support for the government and lobbies against it while the reverse holds for the winning group. The *distributional* effect of trade cooperation on the interest groups' income thus translates into domestic *political* costs and benefits for the government. Following the Stigler-Peltzman theory of political support we argue that it is

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<sup>10</sup> Consumers are a third group affected by trade policy that benefits from low tariffs. Following Olson's *Logic of Collective Action* (Olson 1965) we assume that consumers face a collective action problem and do not organize in order to push for unilateral trade liberalization (Baldwin 1996, 148 ff.).

<sup>11</sup> Under certain conditions domestic producers might also prefer liberalization respectively protectionism *conditional* on the trade policy of third countries (Milner and Yoffie 1989). The situation then is identical to the conflict of interest between exporters and importers and hence not explicitly discussed here.

the governments' goal to at least balance the marginal domestic costs and benefits arising from trade policy (Pahre 1998).<sup>12</sup>

If governments have concerns for domestic distributional implications of trade policy, on the international level the strategic structure of trade cooperation is a *Prisoners' Dilemma* (PD) (Bagwell and Staiger 2002). Unilateral trade liberalization of other states is the most-preferred outcome since this creates benefits for exporters but no costs for import-competers. However, governments are willing to make trade concessions if they get concessions of equivalent size in return.<sup>13</sup>

Table 2: *Prisoners' Dilemma in Trade Cooperation*

		country B	
		make concession	make no concession
country A	make concession	3 ; 3	1 ; 4
	make no concession	4 ; 1	2 ; 2

It is well known that a PD entails an *enforcement problem* since there is an incentive to defect from the mutually cooperative outcome. As will be shown, this enforcement problem affects institutional choice, but it does *not* inhibit cooperation. The reason is that the strategic structure of a PD does *not* derive from non-excludability, as is often assumed in research on enforcement (cf. Barkin 2004, 364). To the contrary, if defection occurs it can be reciprocated by raising one's own barriers to trade. Punishment can be targeted to the defecting country since it is possible to only increase barriers to trade for imports from the defector. Sanctioning thus does not impose any costs on cooperators as would be the case in a public good-PD (Oye 1985, 19-20). Moreover, the shadow of the future in commercial cooperation is long (Hoekman and Kostecky 2001, 111), if not infinite. For this reason, in trade the PD does not generally inhibit cooperation as has often been argued with respect to PD situations deriving from non-excludability (Fearon 1998, 279). Cooperation thus is possible, however, the incentive to defect nevertheless exists. Trade policy during the Great Depression exemplifies that in face of economic crisis countries might prefer defection to continued cooperation (cf. Kindleberger 1989). In order to shelter the domestic economy from import competition

<sup>12</sup> The fact that governments are concerned about the domestic impact of trade cooperation has been shown in numerous studies (cf. Aggarwal, Keohane, and Yoffie 1987; Evans 1971; Milner 1999; Winham 1986).

<sup>13</sup> If governments were protectionist they would prefer non-cooperation to conditional cooperation. However, empirically most countries, at least in the post World War II era, had a general interest in realizing the benefits from trade, conditional on balancing import competitors' and exporters' interests.



many countries abandoned unconditional MFN-treatment and turned to a discriminatory trade policy. This step effectively deepened the crisis (cf. Conybeare 1987). Because of the devastating consequences of discriminatory trade policy unconditional MFN-treatment was made mandatory in the GATT (Wilcox 1949, 18 f.). MFN-treatment does not rule out retaliatory spirals and tariff wars, but they are less likely because discriminatory treatment among importers is impossible (Jackson 1997, 169). Unconditional MFN-treatment thus helps to overcome the enforcement problem arising from the PD that, in turn, has its roots in governments' concerns for distribution. In effect, MFN-treatment introduces *publicness* into trade cooperation precisely because it makes discrimination impossible. As will be shown in the following sections, this effect has important consequences for institutional choice in the bargaining and agreement stages. In order to understand this impact it will be necessary to explain the influence of concerns for distribution on institutional choice first. Before doing so we now first derive the strategic structure of tax cooperation.

### ***Taxation***

Double taxation arises from an overlap of jurisdiction to tax of a residence state and a source state, where the income has been generated. States have a common interest in avoiding double taxation, because they want to realize the national welfare benefits of economic liberalization. This is evidenced by the fact that they unilaterally grant double tax relief. All countries provide relief from double taxation in their national tax codes by either exempting or deducting foreign income from taxation, or granting a credit for taxes paid on such income in the source country.<sup>14</sup>

This is in contrast to the problem of lowering tariff barriers, where unilateral “relief” is the rare exception, even though states also have a common interest in lowering trade barriers. There are two domestic-level reasons for this difference to trade: first, unilateral relief in taxation is granted to a country's own residents, whereas lowering trade barriers gives relief to foreigners to the disadvantage of domestic producers. One can expect countries to be more willing to forgo taxation, if their own residents profit from this relief. Second, there is no domestic pressure group that suffers from the unilateral relief a country offers. Unilateral relief effectively entails giving up tax revenue (Whalley 2001). While this might have consequences for public spending, the negative effect is on the whole population of a country. However, again following Olson (1965), we assume that such a big group cannot exert effective political influence. Therefore the

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<sup>14</sup> Yoo (2003) presents tables that give an overview of the relief methods on the two most important kinds of international income, dividend and interest payments, as used by OECD member countries in 2001. These tables show that all countries provide unilateral relief and that, moreover, the unilateral relief method is almost always the same as is also agreed upon under bilateral treaties.

incentive of countries to offer double tax relief in order to reap the longer-term benefits of economic liberalization is not mitigated by the domestic concerns prevalent in trade. It follows that avoiding double taxation is a coordination game without enforcement problems.

If there are incentives to unilaterally provide double tax relief, the question arises, why countries bother to conclude treaties at all, if unilateral relief is in place? The answer lies in the additional benefits that are inherent in treaty formation and consist of two aspects. For one, tax treaties lower the administrative and enforcement costs, e.g. through information exchange that make tax evasion and avoidance more difficult. Another advantage is the increased legal certainty that is required by international investors. Rather than having to rely on the potentially overlapping national rules, the taxation of international income falls under the rules of an international agreement (Dagan 2002). Unlike the benefits from removing double taxation, which could also be realized by unilateral action, these extra gains, by their very nature, can only be captured through cooperation with other states.

The second and more important advantage of treaty formation lies in countries' concerns for the *distribution* of tax revenues and other economic benefits. Overall, the structure of the 'double tax avoidance game' is that of a *coordination game with a distributive conflict*: We have a situation, where adopting unilateral relief is always preferred to not relieving double taxation, but doing so leaves tax revenue to the source country and the residence country's investors face a considerable tax burden in the source country. The residence country only achieves its second best outcome. It would be even better off, if double taxation was avoided, but the right to tax was assigned to itself. Given its willingness to unilaterally grant double tax relief, the residence country still has an incentive to limit the right to tax of the source country for two reasons. First, a low withholding tax abroad reduces the tax burden of its investors and can improve the competitiveness of its multinational corporations. Second, if the source tax is lowered, countries using the credit or deduction method to avoid double taxation can collect the residual taxes on the foreign income.<sup>15</sup> The desire to change the distributive consequences of unilateral relief is the decisive motive of countries to conclude double tax agreements. Thus, while there is a common interest of parties to come to an agreement in order to realize the Pareto improvements inherent in treaty formation, there is also a

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<sup>15</sup> In the uncoordinated version of the game, the overall structure is that of the well-known *battle of the sexes* game. Since every country has two choice variables, providing double tax relief or not and levying source taxes or not, the situation cannot easily be depicted in a two-dimensional matrix. However, in the next section, we will illustrate the strategic interaction by means of a bargaining diagram.

distributive conflict built into the negotiation of the treaties: Who gets how much of the tax revenue? And what is the tax burden for my resident investors abroad?<sup>16</sup>

This, in a nutshell, is the distributive conflict over the allocation of the tax base between the residence and the source state that has accompanied the development of the international tax regime, as we have shown above. While this account captures the essence of the distributive conflict, it is not a correct description of the situation in reality, because states will generally be residence and source states at the same time. Residents of one state invest in the other state and vice versa; consequently, investment flows as well as the income flows resulting from the investments will generally move in both directions. Nonetheless, there will be a distributive conflict, because investment flows will often not be symmetric. A country that is a net capital importer favors the source principle, whereas a net capital exporter favors the residence principle and a limited role of source taxation.

### **3.2 Staying Small: Bilateralism in Bargaining**

We argued above that the enforcement problem inherent in trade can be overcome and that there is none in taxation. Bargaining thus gains in importance in the cooperation process (Fearon 1998).

#### ***Trade***

We contend that the domestic scenario described above translates itself into *distributive bargaining* on the *international* level. The problem lies in coming to an agreement that creates a domestic balance between costs and benefits caused by import-competers and exporters in all countries involved in the negotiations. A trade concession given by a country implies costs for domestic import-competers and benefits for foreign exporters. Correspondingly, a received concession is to the benefit of domestic exporters and the detriment of foreign import-competers. The task of the bargaining governments then is to exchange requests and offers as long as in each country the benefits are equal to or exceed the costs (or the governments believe that such a bargain is not feasible).

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<sup>16</sup> The withholding rate on investment income that is at the heart of the distributive conflict is actually the one aspect, where there could be a minor enforcement problem in tax treaty making. Just as the residence country has an interest in a low withholding tax, the source country should have an incentive to levy a high withholding rate. Thus, the source country could have an incentive to defect from the treaty rates on investment income (cf. Chisik and Davies 2004b; Green 1998, 115 ff.). This incentive does not, however, invalidate the argument that the overall strategic structure is that of a coordination game. It can be shown that this is the typical “enforcement problem in the small” that is part of every coordination game with a distributive conflict (cf. Snidal 1985a, 933 f.). Besides that, source countries’ concerns to attract FDI will also mitigate their propensity to set high withholding rates.

The prevalence of bilateralism on the bargaining stage can be explained with the governments' high salience of distributive bargaining. Bilateralism is the institutional mode by which governments can best negotiate agreements where the costs are just equal or, even better, below political benefits. A simple example makes this link between concerns for distribution and bilateral bargaining clear. For reasons of illustrative convenience we first assume that MFN-provisions are absent. Imagine that there are three countries A, B and C. The tariff levels of these countries are 30 %, 30 % and 100 %. Each country is importing goods from the other two countries (thus each country also exports goods to the two other countries). All countries are seeking an agreement with each other. A linear tariff cut – in our terms a multilateral bargaining approach - of 20 percentage points for example would ease market access for Cs exporters. However, Cs tariff would still be high, namely 80 percent. This tariff would still be rather high and As and Bs exporters would not benefit much from Cs reduction. A mutual reduction of 20 percentage points thus would produce a negative domestic effect for A and B. These two countries could agree on a mutual reduction of 20 points since initial tariff levels are identical, but not A respectively B and C. In this case a multilateral bargain should be difficult to achieve since A and B expect C to make a higher concession. Multilateral bargaining would only be achievable if C is willing to reduce its barriers to trade more than A and B. Multilateralism thus is fundamentally incompatible with the governments' pursuit of domestic balances in the bargaining stage.<sup>17</sup>

### ***Taxation***

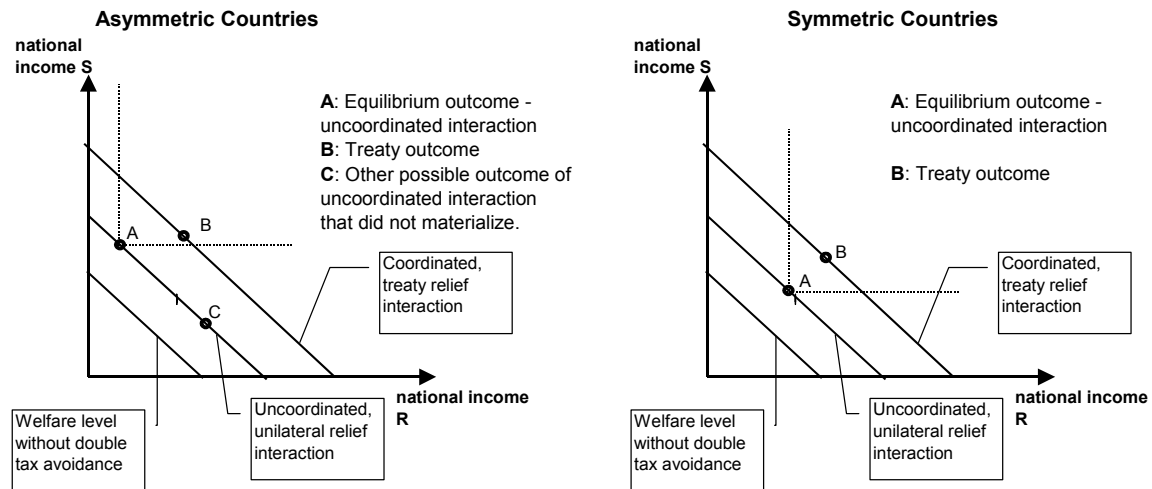
In international taxation, as we have seen above, there is a distributive conflict between countries favoring the residence principle and those favoring the source principle. The strength of the distributive conflict depends on *dyadic* characteristics. For example, country A could have “source interests” in relation to country B, if it is a net capital importer from B. At the same time it might have “residence interests” in relation to country C, exporting capital to C. In relation to country D there might not be any distributive conflict, if A and D are symmetric in capital flows. Due to the pair-wisely differing distributive positions, the withholding tax rate negotiated with B will be different from that negotiated with C, which will in turn be different from that with D. The two

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<sup>17</sup> This incompatibility can be seen in the failed attempts of the USA and the EEC/EC to agree on a formula approach (a two-actor bargain about a linear cut of multiple items is equivalent to a multi-actor bargain about one item). From the European perspective, highly unequal tariffs deserved unequal treatment, i.e. a harmonizing formula. In contrast, US negotiators sought a uniform cut because their comparatively high tariffs would have remained high after a linear cut.

graphs below illustrate the double tax avoidance game, as we have just sketched it, for countries with asymmetric and symmetric investment flows.<sup>18</sup>

Figure 2: The Double Tax Avoidance Game



Thus, multilateral bargaining would be very costly in terms of transaction costs. States would find it very difficult to agree on one precise sharing rule that serves their revenue interests in relation to all others. The bargain can be fine-tuned to the relative investment positions of the countries, if the bargains are kept bilateral. Since the distributive consequences depend on dyadic characteristics, states have good reason to insist on bilateral instead of multilateral bargaining.

The argument that conflict over distributive issues inhibits multilateral bargaining on one precise sharing rule can be supported by an empirical analysis of the DTAs concluded between states. The central provisions of the typical tax treaty concerning the extent of source taxation are the withholding tax rates on passive investment income (dividends, interests and royalties, articles 10 to 12 of the OECD MC). First, the empirical evidence shows that the withholding rates negotiated in bilateral treaties are considerably lower than the withholding rates that are contained in the domestic tax codes (Chisik and Davies 2004b, 114). This is first evidence that, given the residence country's willingness to grant unilateral double tax relief, the function of tax treaties is to 'correct' the withholding rate and the distribution of tax revenues that would result from

<sup>18</sup> The diagram illustrates the Pareto improvements inherent in unilateral relief over no double tax relief and the Pareto benefits of treaty relief over unilateral relief. If there were not any additional gains to be realized through the treaty, the advantaged state in the uncoordinated interaction would not have reason to commence treaty negotiations. The disadvantaged country can include the withholding taxes in the bargaining process, because the other country is dependent on its cooperation in order to realize the extra gains of treaty formation. The distributive consequences of the 'unilateral relief interactions' are changed through the treaty (cf. Chisik and Davies 2004a, 1124 f.).

the unilateral relief interaction. Second, there is considerable variance in the withholding rates negotiated in different bilateral treaties. It can be shown that this variance fits the model of the double tax avoidance game sketched above quite nicely in that the withholding rates are higher if the capital position of the two countries is asymmetric.<sup>19</sup>

### **3.3 Bringing Down Transaction Costs: Multilateralism in Bargaining**

#### ***Trade***

As the empirical analysis showed, there is no complementary multilateral bargaining in trade, but bilateral bargaining was partly substituted by multilateralism. Both observations can be explained by the experiences made during the Great Depression. In the eyes of many, protectionist trade policies pursued toward the end of the 1920s contributed to the worsening of the Depression. The deep conviction in the necessity to limit flexibility in commercial relations explains why multilateral bargaining on GATT rules generally did not take place after their establishment in 1947.<sup>20</sup>

The introduction of substitutive multilateral bargaining in the Kennedy and Tokyo Rounds can be explained by the distributional effect of unconditional MFN-treatment in bilateral bargains (Jackson 1997). Under MFN-treatment, a tariff concession on a particular product of country A to B is a concession given to all other countries. This concession is directly only reciprocated by B with which A is bargaining bilaterally. Country A can only achieve a balanced bargain if the other benefiting countries make a concession in turn, or if B compensates A for the domestic costs arising from MFN-treatment. B will refuse to do this since this implies a domestic imbalance for B. However, in the GATT numerous bilateral bargains are held simultaneously. MFN-treatment thus works in both directions: a country has to extend all concessions it gives, but at the same time receives concessions from other bilateral bargains in which it is not involved. Bilateral bargains thus are *nested* (Tsebelis 1990). If a balance of domestic costs and benefits is the goal a government has to take into account the spill-over effect of MFN-treatment.

Balancing concessions in bilateral MFN-bargains is a complex task. The more countries are involved in a multilateral GATT trade round, the more bilateral bargains are

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<sup>19</sup> Chisik and Davies (2004a) regressed the withholding rates of US tax treaties with other countries that were concluded between 1966 and 1999, and the withholding rates of treaties between all OECD members in force in 1992 on the bilateral investment positions. They have specified several models using both stock and flow data of bilateral FDI and find that the correlation is significant under all specifications.

<sup>20</sup> To be sure, the GATT still grants flexibility to members' trade policy by allowing exemptions from GATT obligations under certain conditions (Ruggie 1982, 397). However, flexibility is much more restricted as compared to the pre-GATT time (Irwin 1993, 99 ff.).

interdependent. Though it is not impossible to arrive at balanced bargains, the transaction costs are high under MFN-treatment. Theoretically, transaction costs can be reduced by multilateral bargaining. In this case all states bargain about a formula cut applying to all goods instead of bargaining in multiple dyads that are linked by MFN-treatment. However, as has been argued and shown, multilateral bargaining is not a viable institutional mode if concerns for distribution are strong. If negotiators put much emphasis on distribution, transaction costs do not decrease when bargaining about a formula approach. As long as concerns for distribution are high it is virtually impossible for GATT members to agree upon a pure formula approach. The empirical record in fact shows that exemptions lists were of considerable size in the Kennedy and Tokyo Round (Evans 1971; Winham 1986). Transaction costs therefore remained high, despite the introduction of substitutive multilateralism. Moreover, domestically insensitive items that could generally be made subject to a formula cut gain in importance since they can be employed as bargaining chips on more sensitive items. These two issues set limits to a decrease in transaction costs due to multilateral bargaining. We thus argue that the trade-off between salience of distributive bargaining and concerns for manageable transaction costs explain the bilateral-multilateral mix. In effect a bilateral-multilateral mix is the most efficient approach to trade bargaining if governments have concerns for distribution on some, but not all items. Transaction costs are lower than under a pure bilateral item-by-item approach and, at the same time, allows GATT members to exempt sensitive items in order to achieve a domestic balance.

### ***Taxation***

So far we have argued that bilateral bargaining is preferred in international taxation because concerns for distribution inhibit multilateral bargaining. The question then is why there is complementary multilateral bargaining about the model convention that is the template for all bilateral bargains.

Due to the nature of the double tax avoidance game, one can expect very tough bargaining in these bilateral treaty negotiations. This is due to the fact that there is no enforcement problem in double tax avoidance, while at the same time the distributive conflict is strong. Under this combination countries have an incentive to hold out quite long to come to a favorable agreement, because they know the agreement will stick for quite a long time, because it can easily be enforced (Fearon 1998, 270 f. ; Snidal 1985a, 936). In order to moderate the bargaining intensity countries have an interest in constructing a focal point for the bilateral negotiations. Such a focal point serves to ensure that bilateral treaty negotiations have some point of common departure that limits the potentially endless possibilities for allocating jurisdiction to tax. Focal points, as Schelling (1980, 57 ff.) introduced them to the literature, are defined as social conventions that are not questioned but are followed ‘automatically’, because they have become self-evident.

However, as has been detailed above, there is no self-evident solution to the distributive conflict about the allocation of taxing rights. Neither the academic nor the political debate about the proper allocation of jurisdiction to tax to the residence or source country has ever been settled. Therefore, states engaged in the intentional creation of a focal point.

Of course, in bargaining about such a focal point the distributive conflict, as we have seen, will also come up. So in a first take, one would expect that it will not be possible to agree on a model convention and that the resultant model would not be accepted by states for their bilateral bargains. However, there are two features of the model convention that in companion with the underlying strategic structure of the double tax game can explain its success. First of all, the OECD MC is non-binding. By making the Model Convention non-binding the edge is taken out of the issue. If states know *ex ante* that they will be allowed to deviate from the convention in their bilateral agreements they are more willing to subscribe to a model, even if it does not entirely accord to their preferences. The second feature that facilitated the construction of a focal point is the fact that the OECD is made up of countries with relatively symmetric capital flows between them. Therefore, the distributive conflict between these countries is not very strong.

In a coordination game states have an overriding interest in concluding treaties. For that reason they want to avoid endless hold out. Thus, they are willing to accept the OECD MC as a focal point. The OECD MC does eventually get entrenched as the ‘natural’ solution to the problem of avoiding double taxation. Once this focal point is established, this will also be true for less wealthy countries and pairs of countries with asymmetric capital flows.<sup>21</sup> The double tax regime exhibits the typical features of a regime “pertaining to coordination problems” as it has been described by Snidal (1985a, 938): the multilateral institution is “concerned primarily with facilitating the choice, interpretation, and observance of a particular convention. This will involve information gathering and informal consultation about the preferences and policies of states as well as providing a forum for the resolution of bargaining problems”. In order to fulfill this function, there is multilateral bargaining about the MC that complements the ensuing bilateral bargains. This interaction of bilateral and multilateral bargaining enhances efficiency in that it lowers the transaction costs of reaching agreement.

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<sup>21</sup> On the initiative of the developing countries the United Nations have developed their own Model Convention that was published in 1980. This Model, however, is identical in form to the OECD MC, but puts more emphasis on the source principle (Surrey 1978). Usually, the differences between the two Models, and the corresponding conflict of interest between developing and developed countries, is accommodated on the bilateral level, e.g. by agreeing on higher withholding taxes.



### 3.4 Avoiding the Free Ride: Multilateral vs. Bilateral Agreement

As was shown in the empirical part, agreement has been multilateral in the GATT whereas it is bilateral in taxation, notwithstanding that the driving forces behind institutional choice in the bargaining stage are rather similar. To solve this empirical puzzle the strategic structures of trade and tax cooperation have to be reconsidered.

#### *Trade*

It was shown above that MFN-treatment affects institutional choice in the bargaining stage by increasing the transaction costs of bilateral bargaining. In addition, MFN-treatment influences institutional choice in the agreement stage. Since the MFN-provision introduces publicness into trade cooperation an incentive is created to *free-ride* on concession-making of third countries in the course of a trade round. The possibility to free-ride derives from unconditional MFN-treatment since this effectively introduces publicness into trade cooperation. Free-riding is a problem that can occur *ex post* if a country defects from a previously agreed upon cooperative outcome. However, in trade free-riding can also occur *ex ante*. In this case a country just “lays back” and watches the concession making activity of other GATT-members. Since concessions are generalized through MFN-treatment it receives concessions without having to make any. This behavior is effectively free-riding, but without defection since it never agreed upon an outcome it could defect from. Multilateral agreement is an institutional safeguard by which free-riding can be prevented. After all bilateral bargains have been settled, each member country can consider the bargains made in conjunction, taking into account their effects given MFN-treatment. If one country believes that another GATT-member intends to take a free-ride on its concession-making, it can withhold some of the concessions previously granted, insist on concessions by the potential free-rider or renegotiate some bilaterally made deals.<sup>22</sup>

Free-riding implies an intentional element, i.e. a country purposefully aims to benefit from third-countries’ concession-making. However, an unfavorable, i.e. imbalanced bargaining outcome can also result accidentally. Even if no country takes a free-ride the bilateral bargains made in the course of one trade round may produce a negative domestic net balance for some countries for the reasons mentioned above. Whatever the source of an unfavorable bargaining outcome is, multilateral agreement serves to prevent this.

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<sup>22</sup> The GATT entails more institutional safeguards against free-riding. To name but one prominent element, the principal supplier rule regulates that only principal suppliers can exchange concessions. A “principal supplier” is defined by the world market share of a particular item. The rationale behind the principal supplier rule is to prevent central trading countries from free-riding.

## ***Taxation***

Nothing prevents countries from coming to multilateral agreement in double tax avoidance. They could, in principle, agree on a multilateral tax treaty that would leave them distributional flexibility, e.g. through agreeing on different withholding rates for different pairs of countries. The withholding rates for the pairs could still be determined in bilateral bargains and subsequently all countries involved could agree on one multilateral document that consisted of a series of bilateral bargains. Such a multilateral instrument would look quite similar to the way the GATT looks.

However, as opposed to trade, there is no pressing need for such a binding multilateral framework. As we have argued the underlying strategic structure of the double tax game is that of a coordination game. Countries are willing to provide tax relief unilaterally. There is no incentive to defect from a tax treaty. More importantly, there is also no *ex ante* problem of enforcement in the sense of free riding on the concessions of other countries, since MFN treatment is not proscribed in the tax regime and uncommon in bilateral treaties. The rareness of MFN treatment in double tax treaties can be explained by the fact that it is not needed to prevent retaliatory spirals in double tax avoidance (for a discussion of MFN treatment, see Rixen and Rohlfsing 2005). Because of this there is no need to come to multilateral agreement. Thus, the absence of a free-rider problem in taxation and its presence in trade is the crucial difference between the two regimes. It explains why agreement is multilateral in trade whereas it is bilateral in taxation.

It can be speculated whether the issue of international tax avoidance and evasion will force countries to switch to multilateralism in the agreement stage in the future. It can be shown that the issue of tax avoidance introduces an enforcement problem that can only be addressed effectively multilaterally because of its underlying problem structure as a prisoners' dilemma (cf. e.g. Dehejia and Genschel 1999). Actually, in response to the problems of tax avoidance and "tax arbitrage" the OECD has initiated its "harmful tax practices project" that is the first broad multilateral effort at curbing tax evasion and avoidance (OECD 1998). However, it is more likely that this initiative will leave the bilateral tax treaties untouched and rather aims at constructing some kind of multilateral support structure, which is institutionally distinct from the tax treaty network.<sup>23</sup> While it is true that a more principled solution would integrate the two problems of double tax

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<sup>23</sup> Empirically, this seems to be the direction international tax policy is taking. It clearly, is the solution the OECD envisages. The most important effort at creating a support structure is the multilateral Convention on Mutual Administrative Assistance in Tax Matters that was drafted in 1988 (Council of Europe and OECD 2003). This convention, which allows for a broader exchange of information than the typical clause in a bilateral DTA, entered into force recently, but so far only Belgium, Denmark, Finland, Iceland, Netherlands, Norway, Poland, Sweden and the USA have ratified it.

avoidance and tax evasion/arbitrage in an “international tax institution structured like the GATT” (Vann 1991, 100), it seems unlikely that the institutional path of bilateral tax treaty making can be left – at least in the short run. However, since the international efforts to curb tax avoidance and evasion are very recent and have not been firmly institutionalized, it is too early to come to definite conclusions about their impact on the institutional form of the double tax regime.

## **CONCLUSION**

In this paper we have addressed the empirical puzzle why the international trade regime is multilateral, whereas the international tax regime is bilateral. Two important conclusions emerge from our explanation. First, a dichotomous classification of the two regimes as multilateral and bilateral respectively misses important similarities between the two regimes. We showed that there is more multilateralism in taxation and more bilateralism in trade than is generally perceived to be the case. In taxation the multilateral model convention is very influential. A high degree of uniformity between the different bilateral treaties and a quite solid multilateral consensus on the rules of international taxation was achieved. This effective multilateralism is in contrast to the general perception of the tax regime as a paradigmatic case of bilateralism.<sup>24</sup> It could be achieved, because the overall nature of the game as a coordination game facilitated the diffusion of the ‘standards’ laid down in the model convention. In contrast to that, bilateralism is more important in international trade than the simple characterization of the regime as multilateral would lead one to expect. Bilateral bargaining is vital for countries to realize their concerns for distribution. But, as was demonstrated, unconditional MFN-treatment drives up transaction costs. GATT-members thus followed multilateral bargaining where possible in order to reduce transaction costs. In effect both regimes exhibit a different mix of bilateral and multilateral bargaining.

Second, notwithstanding these similarities, one important difference between the two regimes remains: agreement is bilateral in taxation, whereas it is multilateral in trade. This dissimilarity is due to diverging interactions of concerns for distribution and enforcement problems in the two fields. Concerns for the distribution of benefits create a private good-PD in trade whereas a coordination game results in taxation. The risk of retaliatory spirals that is inherent to trade cooperation is mitigated by unconditional

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<sup>24</sup> Vann (1991, 152) sums up the multilateralism of the double tax avoidance regime in the following statement: “The Models are sponsored by international organizations set up under multilateral treaties. Members are encouraged in as strong as terms as feasible to use the Models (by and large they do so) and are expected to abide by the official Commentaries (tax administrations and courts regularly have recourse to the Commentaries). Hence a large degree of effective multilateralism has been achieved which indeed may be thought to have neutralized any sustained push for a general multilateral treaty”.

MFN-treatment. MFN-treatment, in turn, makes trade cooperation a public good giving rise to free-riding that is countered by multilateral agreement. The absence of MFN-treatment in the tax regime render protection against free-riding unnecessary and agreement can thus be bilateral.

To pointedly sum this point up: while the two regimes have the same economic rationale, i.e. economic liberalization, the political structure connected to this goal is quite different in the two issue areas. Ultimately, it is the difference in the domestic political constellation that explains the difference in the agreement stage of the two regimes.

Our main concern was to explain the institutional similarities and differences in the trade and tax regime. However, our findings also allow us to draw some general conclusions about institutional choice of bilateralism and multilateralism in international relations. In the literature it has been hypothesized that distributive conflicts in bilateral bargains can be solved by increasing the number of bargaining actors (Koremenos, Lipson, and Duncan 2001, 784 f.; Sebenius 1983, 309 ff.). According to our findings in the field of trade and taxation this hypothesis deserves qualification. Theoretically, a bargaining stalemate between two countries can be overcome by adding a third country to this bargain. This, however, will only work when adding a new party does not create new distributive conflicts between the two old and the “new” parties. If new distributive conflicts arise it will be even more difficult to come to an agreement. The precise conditions under which increasing number enhances or worsens chances for agreement thus need closer investigation.

Moreover, ‘number’ is related to flexibility and transaction costs (Koremenos, Lipson, and Duncan 2001, 794). Bilateralism entails more flexibility than multilateralism, which is of tremendous importance if countries have distributional goals. However, flexibility comes at the expense of high transaction costs. The analysis suggests that multilateralism is employed so as to reduce transaction costs. In this sense, a mix of bilateralism and multilateralism can be a very efficient solution and we expect to find such mixtures in other issue areas of international cooperation.

However, it can be hypothesized that multilateralism might become the preferred choice in the face of enforcement problems. More particularly, it can be speculated that cooperation on *non-excludable* goods is biased toward multilateralism in the bargaining and agreement stage. As could be shown in trade cooperation under MFN-treatment, multilateral agreement is necessary to prevent free-riding. In addition, multilateral bargaining becomes more likely under non-exclusion since there is little gain in holding multiple bilateral bargains if third countries cannot be excluded from the outcome of the bargain. Non-excludability thus can be assumed to be a factor overriding concerns for distribution in determining institutional choice. Cooperation on non-excludable goods has been intensively investigated during the last 20 years (see for example Barkin 2004;

Oye 1985; Snidal 1985b). The major point of concern was if cooperation can be established at all because of non-excludability of free-riders. Bilateralism and multilateralism did not explicitly play a role in these studies. However, there is the implicit notion that *if* cooperation can be established, it will be multilateral.<sup>25</sup> If it is the goal to explain if cooperation comes about, studying cooperation on excludable goods is certainly less interesting (Barkin 2004). However, comparing cooperation on excludable and non-excludable goods is indispensable if one aims to understand institutional choice for bilateralism and multilateralism. A useful line of analysis seems to be to analyze institutional choice under three different scenarios: (1) excludable goods where the strategic structure does not involve an enforcement problem (e.g. double taxation), (2) excludable goods where the strategic structure does involve an enforcement problem (e.g. trade), (3) non-excludable goods (e.g. environmental protection). A systematic analysis of institutional choice under different kinds of goods and strategic structures is a promising avenue for increasing understanding of bilateralism and multilateralism in international relations. Our comparison of trade and tax cooperation makes a first step into this direction.

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<sup>25</sup> According to the k-group approach a public good can be provided by any subset k of all actors, depending on the benefits actors receive from providing the public good independently of the action of other actors (Snidal 1985b). Theoretically, cooperation on public goods thus can involve any number of actors ranging from one to n. Empirically, however, we are not aware of any public good provided by one or two countries. In practice one thus can expect k to be larger than two (Genschel and Plümper 1997).

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