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The Institutional Design of International Double Taxation Avoidance[1]

Thomas Rixen[2]

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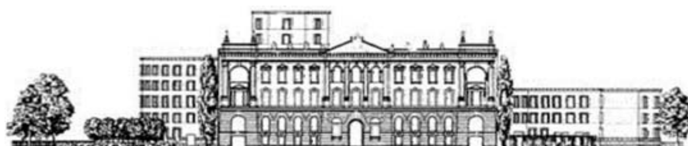

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The Institutional Design of International Double Taxation Avoidance

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Abstract

This article analyzes the institutional design of international double tax avoidance. The basic argument is that double tax avoidance exhibits the strategic structure of a *coordination game with a distributive conflict*. The distribution of tax revenues depends on the asymmetry of investment flows between treaty partners. Since investment flows are defined dyadically, *bilateral* bargaining can best accommodate countries' concern for the distribution of tax revenues and other economic benefits connected to the tax base. Moreover, because there are no serious externality problems with bilateral agreement, this solution is also viable. At the same time, there is a need for a *multilateral* organization to disseminate information and shared practices in the form of a model convention that provides a *focal point* for bilateral negotiations. The strategic structure of a coordination game can also explain why the institutions of double tax avoidance do not have to be equipped with third-party enforcement capabilities. Instead, the Mutual Agreement Procedure (MAP) is interpreted as a device to deal with the fact that double tax agreements (DTAs) are incomplete contracts.

Zusammenfassung

Das Design der internationalen Institutionen zur Vermeidung von Doppelbesteuerung

Dieser Artikel analysiert die institutionelle Form der internationalen Kooperation zur Vermeidung von Doppelbesteuerung. Es wird argumentiert, dass das Doppelbesteuerungsproblem als ein *Koordinationsspiel mit Verteilungskonflikt* verstanden werden kann. Die Verteilung der Steuereinnahmen hängt von der Asymmetrie der Investitionsflüsse zwischen den vertragsschließenden Staaten ab. Da diese Investitionspositionen notwendigerweise paarweise variieren, können die Verteilungsinteressen der Staaten am besten in *bilateralen* Verhandlungen aufeinander abgestimmt werden. Weil es außerdem bei bilateralen Doppelbesteuerungsabkommen keine Externalitäten gibt, sind solche Verträge auch durchsetzbar. Trotzdem gibt es Bedarf für eine *multilaterale* Organisation, die Informationen und gemeinsame Praktiken in Form eines Modellabkommens verbreitet. Das Modellabkommen dient als *Fokalpunkt* für die bilateralen Verhandlungen. Die strategische Struktur als Koordinationsspiel kann außerdem erklären, warum die Institutionen der Doppelbesteuerungsvermeidung nicht mit Durchsetzungskapazitäten ausgestattet sind. Das sogenannte Verständigungsverfahren zur Beilegung von Vertragsstreitigkeiten dient vielmehr als Instrument zur Bearbeitung des Problems unvollständiger Verträge.

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Introduction

Economic activities cross national borders, whereas the power to tax is bound to the nation state. One of the problems resulting from this incongruity is *double taxation*, which stems from an overlap of jurisdiction to tax between a residence state — the country where a taxpayer lives — and a source state — the country where the taxpayer's income was generated. If both countries exert to the full their power to tax, then the tax burden for international investments is much higher than for national investments. In order to prevent this, governments engage in efforts to avoid double taxation. The institutional form of international double tax avoidance, however, exhibits several remarkable features that are in need of explanation.

The most remarkable feature of international cooperation to avoid double taxation is the fact that double tax agreements (DTAs) are predominantly bilateral (Whalley 2001, 17-18, Vann 1991).[1] This bilateralism contrasts with many other international regimes in the economic sphere. Most prominent among these is the GATT/WTO — a multilateral regime with a commitment to achieving progressive, coordinated trade liberalization in simultaneous negotiations. Unlike the GATT/WTO, for example, cooperation in double tax avoidance is organized bilaterally, and negotiations take place sequentially. In a classic model Mundell (1957) shows that the free flow of goods and common prices lead to factor prices being equalized across countries. Likewise, free factor flow and common factor prices lead to equal goods prices. Hence, what can be achieved with goods flow can also be achieved with factor flow. As Whalley (2001, 17-18) has pointed out Mundell's factor-goods equivalence could be taken to suggest that the institutional form of the tax and trade regimes, which deal with factor and goods flows respectively, should be similar or the same. So the puzzle is thus: Why is the regime of international double tax avoidance not multilateral?

Posing the question in this way is somewhat imprecise, because there actually are some multilateral elements of tax cooperation. The OECD, as

1 There is one minilateral treaty among the Scandinavian countries that was signed in 1983 (cf. Mattsson 2000). This treaty is often referred to in the literature because it has remained the only treaty of its kind. Historically, there have also been other multilateral treaties (cf. Loukota 1997, 86-87). However, none of them has left a mark on the development of international taxation.

a multilateral organization, deals with double tax avoidance and other issues of international taxation. It publishes a so-called model convention (MC) that is negotiated and agreed upon by its member countries. The OECD MC is non-binding. In practice, however, nearly all of the bilateral tax treaties are based upon this instrument (cf., e.g., Vann 1991, 99). Thus, more precisely, the question is why there is no *binding* multilateral agreement. Why is the MC non-binding? What is its function in international tax cooperation? How can one account for the coexistence of binding bilateral treaties and this multilateral document that serves as a template for them?

When turning to theories of international cooperation for potential answers, one finds that the institutional choice between bilateralism and multilateralism has hardly been addressed. 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).[2] Even work that explicitly focuses on the institutional form of cooperation in international relations theory fails to contrast multilateralism with bilateralism (cf. Ruggie 1993). The disregard of bilateralism in international relations (IR) theory cannot be explained with the empirical irrelevance of this category — the United Nations treaty databank collected 5130 bilateral treaties adopted from 1990 to 1999 (United Nations 2003).[3] Second and more important for the research question 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 relative benefits and costs of bilateral compared to multilateral cooperation? Cooperation theory not only disregards bilateralism, it also does not systematically investigate the choice between bilateralism and multilateralism.

This leads to an incomplete understanding of cooperation, including multilateral cooperation. As I demonstrate, states consciously choose between the two institutional forms and often design institutions with a

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2 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. Exceptions in the earlier literature are Oye (1985) and Snidal (1985).

3 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.

mix of both bilateral and multilateral elements. A straightforward classification of a regime as bilateral or multilateral is not always possible. In many regimes, cooperation exhibits bilateral and multilateral elements, which interact in systematic ways. Therefore, if we are to gain an appropriate understanding of cooperation, it is necessary to develop theories of the strategic choice of bilateralism and multilateralism and the ways in which these forms can interact or co-exist.

My account of international tax governance demonstrates a theoretically informed way of thinking about this choice. I construct an explanation of the tax regime's particular institutional mix of bilateralism and multilateralism by employing some well-established theoretical mechanisms that have been shown to have explanatory power for the design of international institutions (see e.g., Koremenos, et al. 2001). Thus, in addition to opening up the field of international tax cooperation to international relations research, the present paper makes a theoretical contribution on the choice between bilateralism and multilateralism.

Beyond the issue of bilateralism versus multilateralism another design feature is noteworthy. There is generally no third party enforcement in double tax avoidance. A typical tax treaty only provides for a mutual agreement procedure (MAP) between the two treaty partners. Why is this so?

My answer to these questions can be summarized in the following argument: double tax avoidance is a *coordination game with a distributive conflict*. The distribution of tax revenues depends on the symmetry or asymmetry of investment flows between treaty partners. As I show in a regression analysis, the terms of bilateral tax treaties vary systematically with treaty partners' investment positions. This can be interpreted as evidence that bilateral agreements can best accommodate countries' concerns for the distribution of tax revenues and other economic benefits connected to the tax base. However, at the same time, there is a need for a multilateral organization to disseminate information and shared practices in the form of an MC that provides a *focal point* for bilateral bargains. Since the strategic structure is that of a coordination game, the institutions of double tax avoidance do not have to be equipped with enforcement capabilities. Instead, the MAP is a device for dealing with the problems of incomplete contracting.

To develop this argument, I first present the basic stylized facts of the institutional design of double tax avoidance by differentiating between the bargaining, agreement, and enforcement phases of international cooperation (part I). From this account I derive a game-theoretic model that can explain the various design features, and subject it to an empirical test (part II). In part III, I briefly discuss a potentially competing explanation for the institutional design. Part IV summarizes the approach and findings in this paper, and draws some conclusions for future research strategies and theory development.

I. Distilling the Stylized Facts of the Institutions of International Taxation

In this part, I first give a brief overview of the history and basic workings of double tax avoidance. I then derive the stylized facts of institutional design on the basis of a differentiation between bargaining, agreement and enforcement.

The History of Double Tax Avoidance

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. The issue became more prominent in the 1920s when the League of Nations appointed economists to address the problem of double taxation, and convened several conferences of technical experts and government officials (League of Nations 1923, 1927). The objective during the "League years" was to draft a multilateral treaty. While governments persistently rejected this, they were nonetheless very supportive of developing a model convention that could be employed as a template for bilateral negotiations. They insisted on keeping the model convention non-binding, because that would allow the necessary flexibility to make nationally differing tax systems compatible to one another (Picciotto 1992, 38). The work of the League resulted in the model conventions of 1928, 1935, 1943 and 1946.

In the 1950s and 1960s 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 multi-

lateral treaty, but were supportive of further developing and adapting the MC. The OECD published its first MC and commentary in 1963, followed by a revised version in 1977. In 1991, the OECD decided to publish the model convention in loose-leaf format, in order to be able to better adapt it to changes in the economic environment. Since then the MC has been updated continuously, with consolidated versions being published in 1992, 1994, 1995, 1997, 2000, and 2003.

The growth rate of bilateral treaties increased strongly after the OECD MC was concluded. In 1958, 263 treaties were in force, gradually increasing to 333 by 1963 and 600 as of 1978. After the conclusion of the 1977 MC — and with the further liberalization of capital markets and increasing tax ratios in industrialized countries, which made the problem of double taxation more prevalent — the number of treaties increased rapidly to 1582 in 1998 (Rixen forthcoming, chapter 5). Even though countries are not obliged to use the MC in their bilateral negotiations, almost all of the more than 2000 tax treaties that are in force today follow it. Bilateral treaty making basically consists of the treaty partners agreeing on the MC and adapting some provisions to their needs.[4]

Despite these successes in confronting the issue of double tax avoidance, the development was not without conflict. The most important conflict among governments is that between the residence and source principle of taxation (see below). In general, developed countries are in favor of the residence principle, whereas developing countries prefer the source principle because it allocates a larger share of the transnational tax base to them. The conflict has accompanied the entire history of international tax cooperation. One embodiment of this conflict is the existence of different model conventions that accord different weights to both principles. Since the OECD MC accords greater weight to residence taxation, the UN developed a competitor model that leans toward source taxation.[5] However, apart from these divergences in the distribution of taxing rights, the UN MC, published in 1980 and in a modernized version in 2000, is not a distinct alternative but rather a modest modification of the OECD MC

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4 The numbers presented here are taken from a self-compiled database. For a description of the data and their sources see Rixen (forthcoming, appendix).

5 The existence of competing model conventions accompanied the history of double taxation from very early on. For example, of the two models from 1946, the so-called Mexico convention emphasized the source principle, whereas the London version suggests residence taxation (League of Nations 1946).

(Arnold and McIntyre 1995, 95). It reproduces many of the articles contained therein and, overall, the UN MC relies on the very same mechanics and principles as the OECD MC. It pinpoints those provisions of the OECD MC that developing countries should strive to modify in bilateral negotiations with developed countries. Altogether, the influence of the UN MC is limited but visible. Many developed countries subsequently granted more taxation at source in their bilateral treaties with developing or transition economies (Kosters 2004, 4).

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 MC. Often technical innovations that come up in bilateral treaties are integrated into the model; other innovations are developed within the CFA. In the process a common understanding of bilateral tax treaty making and interpretation is developed. These common understandings and remaining dissent are published in the commentary that accompanies the MC, which enjoys considerable authority with courts, lawyers and other tax practitioners (cf. Arnold/McIntyre 1995, 98-100). Unlike the OECD, the UN has not devoted many resources to international taxation and thus did not become a potent rival of the OECD as the main policy forum in international taxation (cf. Brauner 2003, 318).

The 'Mechanics' of Double Tax Avoidance: Residence vs. Source

Double taxation results from an overlap of jurisdiction to tax between a *residence state*, where the recipient of income lives, and a *source state*, where the income was generated. If both exert their power to tax to the full extent, the total burden on transborder economic activities is prohibitively high. In order to obtain the benefits of liberalization, governments have a common interest in avoiding such double taxation. In principle, there would be two solutions to this problem. Countries could delegate the power

to tax international income to an international authority (conjoint taxation) or they could agree on some rule to *share the jurisdiction to tax* between them. Leaving aside the European Union, the first option has never seriously been contemplated and is generally believed to be utopian (Tanzi 1999). Consequently, the problem of double taxation has been dealt with along the lines of the second option. Framed in this way the basic question that has to be answered is: which country has the right to tax the income, and which country must restrict its tax claims (see, e.g., Li 2003, 32-33)?

No general consensus on a best principle could be achieved. Instead, the solution embodied in the various MCs — 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 (Graetz 2001).[6] Jurisdiction to tax is assigned to either the source country or the residence country for different kinds of income. These rules, codified in Articles 6 to 22 of the OECD model, "perform the function of dividing items of income between countries. [They are] a set of arbitrary rules that were carefully crafted to support a specific compromise" (Brauner 2003, 278-79). Profits can only be taxed in the source state, if they are attributed to a permanent establishment (PE), which is defined in Article 5 of the OECD MC. Dividends, interests and royalties can only be taxed to a limited degree at source (Articles 10-12 of the OECD MC).

According to tax treaty rules, the residence country is obliged to provide relief from double taxation in cases of full or limited source taxation. This can either be done by allowing a credit for the tax paid at source on the tax due in the home country or by exempting the income taxed at source from home tax altogether (Article 23 of the OECD MC). Importantly, however, basically all countries already provide for relief of double taxation unilaterally. Their national tax codes contain provisions for either exempting foreign income from taxation, or granting a credit for taxes paid on such income in the source country. In those cases, double taxation is

6 The conflict between residence and source states on the avoidance of double taxation 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 (for an overview, see Rixen forthcoming, chapter 4).

already effectively prevented. In a few cases, the national rules only foresee partial tax relief (deduction).[7]

In order to implement this compromise solution between residence and source taxation, the model conventions refer to a series of legal constructs that establish the required nexus between the transnational tax base and a country. The constructs represent plausible assumptions (and make them legally tractable) about the correspondence between transactions across borders and the territorial base of the underlying economic activity that is the target of national taxation (Bird and Wilkie 2000, 91-3). The important point about these constructs is that they are chosen in such a way as to interfere as little as possible with national tax laws. Bilateral treaties do not contain comprehensive rules for taxation, but in essence achieve nothing more (and nothing less) than disentangling the transnational tax base and assigning it to different jurisdictions so that these can apply their own domestic rules to their share of the tax base. Once jurisdiction to tax is established, the country is then basically free to use its own national tax law on the respective income. The bilateral treaties merely help to "coordinate divergent national tax laws" (Li 2003, 33), they regulate the *interface* of autonomous national tax systems. The legal constructs, on which the tax treaty regime is based, refuse to treat the transnational tax base as a global phenomenon, but rather force it into a framework of territorial delimitation. The advantage of this approach is that governments retain almost unlimited legal independence over the taxation of "their" share of the transnational tax base. The tax treaty regime is built on *sovereignty-preserving* cooperation.[8]

Apart from their main function of avoiding double taxation by disentangling the transnational tax base, DTAs also contain provisions on the

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7 Under the deduction method, taxes paid abroad are subtracted from the tax base on which home taxation is based. Thus, double taxation is not fully relieved. All OECD countries provide unilateral tax relief and in most cases they use the credit or exemption method, i.e., the same methods that are agreed upon in bilateral treaties, and not the deduction method (cf. Yoo 2003).

8 Emblematic for this approach to territorial disentanglement of tax claims are the rules for allocating expenses and profits among different parts of multinational enterprises (MNE). For tax purposes, their operations with one another are treated as if they were independent market participants — exchanging goods and services at arm's length prices. This has the benefit of de-politicizing the allocation of jurisdiction to tax by referring to the seemingly natural solution of market prices (cf. Picciotto 1992, 172). Otherwise governments would have to agree on a common definition of the tax base (unitary taxation).

implementation of these rules. Article 25 lays out the *mutual agreement procedure (MAP)*. It serves to resolve any conflicts that arise between treaty partners in the application of the DTA. Often, the procedure is initiated when a taxpayer claims to have been double-taxed or otherwise disadvantaged by either state. In this case, they can ask the authorities responsible in their home country to enter into a mutual agreement procedure (MAP) with the other contracting party. Governments are not required to necessarily come to an agreement in this procedure; in case they do not, double taxation persists. However, in the overwhelming majority of cases an agreement is reached (Sasseville 2002, 1999). Since the MAP is a "political rather than a judicial procedure" (Züger 2001, 15), there have been many proposals to replace it with a binding arbitration procedure. However, governments have generally refused to agree on an arbitration procedure (Sasseville 2002, 271-72). Recently, however, the OECD added an additional paragraph to Article 25 of the MC, which foresees the submission to arbitration if the affected taxpayer so requests, and if the competent authorities do not reach agreement within two years (OECD 2007). A couple of bilateral treaties with such complementary arbitration have already been concluded (Aoyama 2004, 655).

Finally, Article 26 of the OECD MC foresees information exchange. This enables administrative ease in collecting taxes.

In summary, international double tax avoidance takes place on three interrelated levels: the unilateral, bilateral and multilateral levels. For one, all countries relieve double taxation in their national tax laws, that is, on the unilateral level. In effect, they give up entirely or partially their right to tax foreign source income, in order to avoid interfering with other tax systems. Second, in bilateral negotiations, countries conclude double tax treaties which mainly deal with the cooperative avoidance of double taxation and the division of taxing rights. Third, international tax policy takes place on the multilateral level. Technical experts, national tax administrators, and scientific advisors cooperate in international organizations to develop model conventions, disseminate information on treaty practices, standardize the bilateral treaties, and monitor the treaty network. The resultant MCs are legally non-binding, but are quite influential in practice. Basically all existent double tax treaties are based on the MC.

Sorting the Empirical Evidence: Bargaining, Agreement, and Enforcement

How can we make sense of this institutional pattern? I suggest beginning with subsuming the empirical evidence under the established distinction between bargaining and enforcement (see, e.g., Fearon 1998; Koremenos, et al. 2001). Sometimes, bargaining is referred to as an *ex ante* problem of cooperation, whereas enforcement concerns *ex post* problems (Williamson 1985). I have added "agreement" to this differentiation, which is the dividing line between bargaining and enforcement.

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. *Enforcement* refers to the *ex post* stage of the cooperation process in which countries have to ensure that all treaty partners comply with the agreement. Figure 1 depicts the three stages of cooperation on a time line.

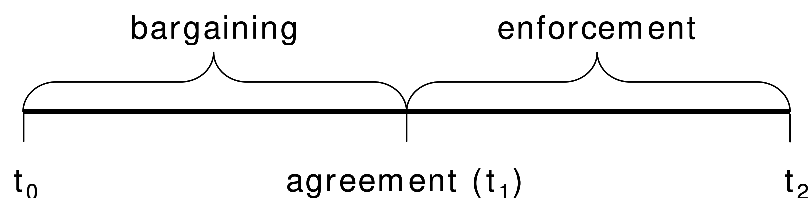

Figure 1: Three Stages of the Cooperation Process

In each of the stages, countries can choose between bilateralism and multilateralism. Thus, cooperation is not dichotomous per se. Taking into account the whole process of cooperation, cooperation can be characterized by a mix of bilateral and multilateral elements.

In terms of the three stages of cooperation, the following picture of double tax avoidance emerges: *Bargaining* is bilateral and multilateral. On the multilateral level, governments bargain about the non-binding MC. On the bilateral level, they bargain about binding double tax treaties and agree on the actual concessions they grant each other. Nevertheless, multilateral bargaining has an influence on bilateral bargaining, because the MC is the starting point of bilateral bargains. Also, the commentary to the

MC is sometimes changed in response to problems that were encountered in bilateral negotiations. Multilateral bargaining is *complementary* to bilateral bargaining. *Agreement* is bilateral in double tax avoidance. Only the bilateral treaties contain provisions which are binding on the countries. The final stage of the cooperation process is *enforcement*. With respect to this, we can first note that there is no external enforcement mechanism in double tax avoidance. Rather, disputes about the application of agreements are resolved through the bilateral MAP, which is more a diplomatic than a judicial mechanism. Table 1 summarizes these features.

Table 1: Empirical Observations on the Three Stages of Cooperation

Stage of Cooperation	Empirical Observation
Bargaining	1) *Bilateral* on (binding) tax treaties 2) *Multilateral* on (non-binding) MC
(Binding) Agreement	*Bilateral* on DTAs
Enforcement	No external enforcement, only *bilateral* MAP

II. Explaining the Institutional Choice

In this part, I set up a model of double tax cooperation and test it. From the empirical material just presented, I reconstruct the strategic structure of the problem of double tax avoidance in terms of a game theoretic model. I show that the model can explain the institutional form of *bargaining*, the weak institutions of *enforcement*, and why binding *agreement* was chosen to be bilateral.

The Strategic Structure: Double Tax Avoidance as a Coordination Game

From the fact that they have engaged in conscious efforts to this effect, we can conclude that governments have a common interest in avoiding double

taxation.[9] Further, they also have an individual incentive to avoid double taxation. This is evidenced by the fact that all countries are willing to grant double tax relief unilaterally as part of their domestic laws. This means that they are willing to grant double tax relief irrespective of whether other governments reciprocate in the same way. The problem of avoiding over-taxation can thus be framed as a *coordination game*.

This derivation of the strategic structure from governments' observed preferences is in line with two common theoretical assumptions in political economy about their preferences. First, if one assumes that a government's goal is to maximize national welfare, then the strategic interaction is represented by a coordination game (Rixen forthcoming, chapter 3; Dagan 2000). Second, if we assume that the government pursued its own egoistic goal of reelection or political profit (potentially at the expense of national welfare), the same conclusion could be drawn. While unilateral tax relief can lead to decreasing tax revenues, which may have negative consequences for public spending, this negative effect impacts the whole population of a country. Following Olson (1965), such a big group faces a substantial problem of collective action and cannot exert effective political influence. In contrast, the business lobby is a small group that can manage to make their interests heard. There is no other well-organized domestic interest group that would oppose granting full unilateral tax relief, in the form of credit or exemption, to foreign investment. Thus, even apart from the fact that providing full double tax relief may be adequate for the maximization of national income, there is an additional domestic political argument that makes such a strategy attractive for a government (cf. also Bird and Mintz 2003, 439).

Why Conclude Tax Treaties at All?

One very important implication of the model of a coordination game is that there is no enforcement problem involved in double tax avoidance. Then, however, the question arises, why governments should bother to negotiate and conclude DTAs at all. What are they bargaining about?

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9 For reasons of limited space the derivation of the strategic structure presented here is very brief. For an extensive derivation by both theoretical and empirical reasoning, see Rixen (forthcoming, chapters 3 and 7).

The answer is that the residence country still has an incentive to conclude a treaty in order to limit the source country's right to tax. There are two related reasons for this. First, a limit on source taxes reduces the tax burden of "its" investors abroad. Second, if the source tax were lowered, countries using the credit (or deduction) method to avoid double taxation could collect the residual taxes on the foreign income. In other words, while the residence country is willing to grant unilateral tax relief no matter how much tax the source country collects, it would be even better off if, at the same time, source taxation were limited. In such a situation, the level of foreign investment flows would be the same, because the overall tax level on the investment remained constant; but the residence country could have a larger share of the tax revenue and its resident investors would face a better tax treatment abroad. In other words, under the unilateral relief interaction, only the residence country achieves its second-best outcome. It could improve this outcome if taxation at the source were limited. This can be achieved through tax treaties (Dagan 2000, 982-83; Davies 2004, 779).

This still raises the question of why the source country should be willing to enter into a treaty that limits its right to tax, given that the residence country has already given up its right to tax unilaterally and thus double taxation is already avoided? The answer is that countries are generally residence and source countries at the same time. Residents of one state invest in the other state and vice versa. Consequently, investment as well as the resulting income flow in both directions. Thus, the interest in limiting other countries' taxation at source should hold irrespective of relieving double taxation unilaterally as a residence country. The decisive point about this consideration is that governments, while they are able and willing to unilaterally forego residence taxation, can only achieve a limit on source taxation in other countries if they cooperate with them. Country *A*, in its capacity as a residence country, can only achieve a limit on country *B's* source taxation through a binding cooperative agreement with the latter. In other words, both countries hold a bargaining chip, in that they can make concessions on the extent of source taxation. Tax treaties are a cooperative mechanism for the reciprocal lowering of source taxation.

In addition, there are further benefits consisting of two aspects inherent in treaty formation. For one, tax treaties lower the administrative costs of taxation, for example, through information exchange. Another advantage is the increased legal certainty that is required by international

investors. Rather than having to rely on potentially conflicting national rules, the taxation of international income falls under the rules of an international agreement. The conclusion of tax treaties has a signaling function to international investors that goes beyond that of favorable unilateral policies (Dagan 2002, 67). Again, by their very nature, these benefits can only be obtained through cooperation with other governments.

So far, it has been established that countries are willing to provide tax relief unilaterally, but that they may have an additional, mutual interest in concluding tax treaties. This line of reasoning does not, however, make a case for a particular institutional form of double tax avoidance, but merely makes the case for *any* cooperative agreement. In order to explain the particular institutional form, the strategic structure has to be analyzed in more detail.

Bilateral Bargaining Accommodates Distributive Concerns: The Model

There is a distributive conflict built into double tax avoidance, which stems from the fact that investment flows between countries are often not symmetric. While countries are generally residence and source countries at the same time, they are so to different degrees. A country that is a net capital importer favors more extended source taxation; it has "source interests." A net capital exporter is in favor of residence taxation; it has "residence interests" (Kingson 1981, 1158; Rigby 1991, 409-10). Governments often disagree about the extent of limitations on source taxation depending on whether they have residence or source interests. In a nutshell, the distributive conflict is about who gets how much of the tax revenue and what is the tax burden for a country's resident investors abroad?

Overall, the structure of the double tax avoidance game is that of a *coordination game with a distributive conflict* ("battle of the sexes"): adopting unilateral relief is always preferred to not relieving double taxation, but the distributive consequences of that strategy are more or less favorable to the country depending on whether they are net capital exporters or importers. Now, being a net exporter or net importer is a relational attribute that can vary with respect to different countries. Country *A* could have source interests in relation to country *B*, if *A* is a net capital importer from *B*. At the same time, *A* might have residence interests in relation to coun-

try *C*, exporting capital to *C*. In relation to country *D*, there might not be any distributive conflict, if capital flows between *A* and *D* are symmetric. Hence, the nature and intensity of the distributive conflict depend on *dyadic* characteristics. Therefore, as I argue in the following, bilateral bargaining can accommodate countries' conflicting distributive interests. I first describe the mechanics of this bargaining game and then provide empirical evidence for my claim.

Figure 2 depicts the bargaining situation for the case of symmetric and asymmetric capital flows between potential treaty partners. The payoffs of country *R* are shown on the *x*-axis, those of country *S* on the *y*-axis. The diagrams show three different welfare levels represented by the diagonal lines. By moving from no tax relief to a situation of unilateral tax relief and then to coordinated relief under a treaty, both countries gain and can thus reach a higher welfare line. In the case of symmetric capital flows, the unilateral relief interaction results in an equal distribution of the benefits. In the case of asymmetric capital flows the net capital importer, country *S* in figure 2, gets a bigger share of the benefits (compare point *A* on the left hand side to point *A* on the right). The difference in benefits stems from the difference in national income that the countries receive from the foreign investment. The source country can exert some taxation at source without reducing the inflow of capital from the other country. Since double tax relief is in place, source taxation, at least in the form of withholding taxes, does not drive away foreign investment. Since investment flows are exogenous to source withholding taxes, the source country can gain some tax revenue at the expense of the residence country.[10] The residence country has an incentive to lower the withholding taxes at source, because the withholding taxes directly diminish its national income either in the form of private income (in exemption countries) or tax revenue (in credit countries).

The starting point of treaty negotiations (point *A* in both graphs) lies in the middle of the welfare line for the unilateral relief interaction of symmetric countries, whereas in the case of asymmetric countries, it is

10 The most obvious case in which imposing source taxation does not drive away foreign investment is that of the residence country granting a foreign tax credit. Taxation at source merely results in a revenue transfer from the treasury of the residence country to the source country. However, even under different constellations the imposition of source withholding taxes does not drive away foreign investment (Hartman 1985; Sinn 1993).

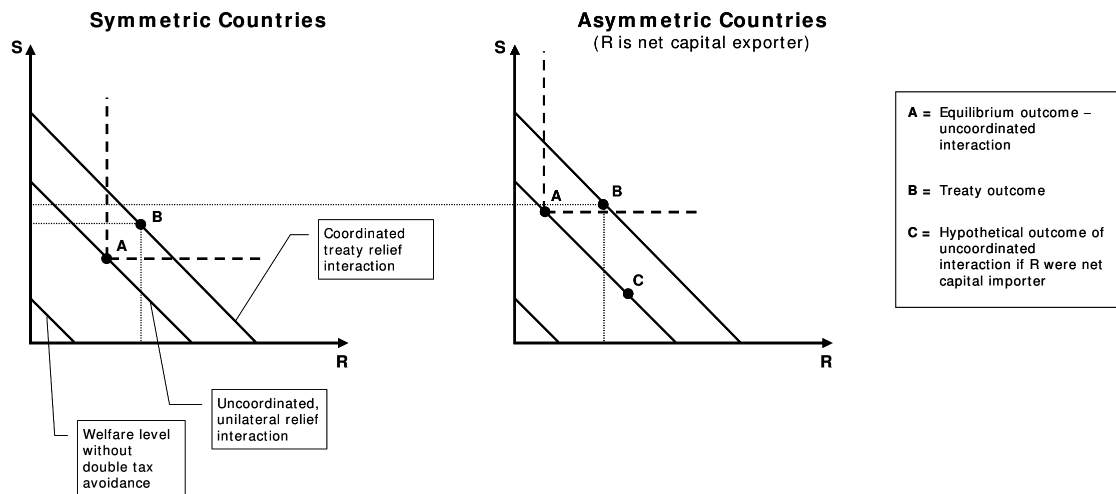

Figure 2: Tax Treaty Bargaining between Symmetric and Asymmetric Countries

tilted towards the net capital importer. Accordingly, the bargaining space, which is the room for Pareto improving negotiation outcomes and is demarcated by the dotted lines, is different in both cases. The extent of source taxation in the case of symmetric countries should not be controversial. They both benefit equally from a reduction of source taxes. Thus, the expectation is that source taxes are lower in the case of symmetric countries. In contrast, there should be conflict over this question in the case of asymmetric countries with net capital exporters in favor of low and net capital importers in favor of high source taxes. Since the bargaining space is tilted towards the net importer's interests, the outcome of this bargain should be higher source taxes than in the case of symmetric countries. This is indicated in the diagram by the fine dotted lines that facilitate comparison of the outcomes of treaty negotiations between symmetric and asymmetric countries (point *B* in both graphs).

If the preferred treaty rate depends on the symmetry or asymmetry of capital flows, this could be an argument for bilateral treaties, since capital flows are defined bilaterally. The qualitative evidence on the conflict between developing and developed countries presented in part 2 would support this. One of the reasons governments refused to conclude a multilateral treaty was the distributive conflict over the allocation of the tax base between countries with residence and source interests.

Testing the Model

In order to substantiate this explanation I subject it to a quantitative test. The central provisions of the typical tax treaty concerning the extent of source taxation are the withholding tax rates on passive investment income. An observable implication of the model is that these treaty rates should be higher, the more asymmetric the bilateral investment flows. In addition, the outcome of negotiations should also depend on the relative bargaining power of countries. A more powerful country should be able to press for its preferred treaty rate more successfully. To test these propositions, I set up a regression model.

The *negotiated withholding tax rate*, as the dependent variable, is taken from a set of 80 DTAs.[11] A treaty contains four kinds of withholding taxes: on dividends, dividends between associated enterprises, interest, and royalties (Articles 10 to 12 of the OECD MC); thus the number of observations on the dependent variable is 320. Since I am using all four kinds of treaty withholding rates simultaneously, the standard errors are adjusted for clustering. The coefficients can be interpreted as the relation between the respective independent variable and the average level of withholding taxes rather than a specific tax.

The dyadic *investment position*, i.e., the asymmetry of bilateral foreign direct investment (FDI) stocks, is the first independent variable of interest. It is measured as the difference between the "outward FDI stock," the stock that the first country holds in the second country, and the "inward FDI stock," which is the stock of the second country held in the first.[12] Since all country pairs have been arranged in such a way that the net capital exporter is in first position, this is always a positive number.

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11 For a description of all the quantitative data used in this paper see Rixen (forthcoming, appendix). The data and the regression results not reported here are available from the author upon request.

12 There are two kinds of FDI data. There is the FDI flow in a given year, measuring the new investment flowing into and out of a country, and the FDI stock accumulated over time in a country. This latter measure should be expected to be relevant for tax treaty negotiations, since it is the income generated from the stock of foreign investment that is to be subjected to taxation. Given this difference, the preceding discussion of the effect of "capital flows" might appear incorrect. However, it can be justified because the stock measure represents the long-term capital flows between two countries more accurately than the annual measures of capital flows, which fluctuate significantly. In addition, using the stock data instead of the flow data can ameliorate potential endogeneity problems — if one thought that the flow of FDI depended on the negotiated withholding rate rather than the other way around.

The expectation is that the more unequal the investment position (that is the higher the asymmetry of FDI stocks), the higher the negotiated rate. The coefficient should be positive.

As a proxy for *bargaining power*, the other independent variable, I use the concept and the data of the "correlates of war project", which constructs its "capability index" as a mix of military expenditure and personnel, energy consumption, iron and steel production, total and urban population (COW 2001).[13] I measure the bargaining power of the first country, i.e., the capital exporter, as the relative share of the sum of the bargaining power of both treaty partners. Since the capital exporter should favor lower over higher withholding rates, the variable should have a negative effect on the treaty rate. Since the outcome of negotiations should depend on the investment position and the bargaining power at the time of treaty conclusion, the data for all variables are those for the year in which the treaty was signed.

Additionally, I control for the wealth of treaty partners, measured as the *sum of per capita GDP*. It is conceivable that wealthier countries are less dependent on trying to tax the foreigner and thus the expectation is that the coefficient has a negative sign. Furthermore, in an analysis similar to mine, it was found that this variable influenced the negotiated tax rate (Chisik and Davies 2004, 1136).

Column 2 of table 2 shows the results of this first regression model. Under this specification, the overall explanatory power of the model is low. Only 6.4 percent of the variance of the dependent variable can be explained. A possible reason for the low R^2 could be that a particular withholding rate can best be explained by reference to the income on which it is levied. In order to test for this possibility, I include dummy variables for each kind of withholding rate. The dummy variable for, let us say, dividend taxes is 1, if the respective dependent variable is the dividend tax rate, and 0, if it is any of the other tax rates. Thus, the coefficients report the average tax rate for the respective type of income. The result of the second regression model is depicted in column 3 of table 2. The inclusion of the control variables increases the overall explanatory power of the model. 43.8 per cent of the overall variance can be explained.

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13 In regressions not reported here, I have also experimented with other possible specifications of bargaining power. Using the relative share of GDP or the relative share of military expenditure yields similar results as those reported below.

Table 2: Determinants of Negotiated Withholding Taxes — Linear Regressions

	Model 1	**Model 2**
(Constant)	12.35 *** (7.44)	18.41 *** (11.52)
Investment position (Asymmetry in FDI stock)	0.0000553 *** (3.63)	0.0000553 *** (3.62)
Bargaining Power (Share of Capability Index)	0.95 (0.85)	0.95 (0.84)
Sum of per capita GDP	– 0.000125 *** (– 3.59)	– 0.000125 *** (– 3.57)
Dividend tax dummy		N.A.
Associated dividend tax dummy		– 8.325 *** (– 17.05)
Interest tax dummy		– 7.838 *** (– 11.35)
Royalty tax dummy		– 8.075 *** (– 12.67)
Number of observations (N)	320	320
R^2	0.064	0.449

t-values in parentheses
(Robust Standard errors)

*** significant at 0.1 per cent level
** significant at 1 per cent level
* significant at 5 per cent level

The results confirm the idea that negotiated withholding rates vary systematically with respect to the *investment position*. The coefficient has the expected sign and is significant at the 0.1 per cent level.[14] It suggests that an increase in the asymmetry of capital flows by one million dollars leads to an increase in the withholding tax of 0.0000553 percentage points. While this number may appear small, it can be shown to be highly plausible. The estimation suggests that the average withholding rate in a treaty

14 Note that the dataset is actually biased against my prediction. Due to problems of FDI data availability, the set contains mostly OECD countries. The capital flows between these countries is generally more symmetric than that between developed and developing countries.

between the United States and Japan, where the asymmetry of investment stock in the year of signing was $102,458 million, should be 5.5 percent higher than that between Australia and New Zealand (asymmetry of $2,430 million). In other words, since there are sizeable differences in countries' capital positions, the resultant differences in tax rates are also sizeable.

The expectations concerning the influence of bargaining power do not hold. The coefficient has a positive sign and is insignificant. This result contradicts anecdotal evidence in the literature that more powerful nations try to pressure less powerful countries to agree on the tax rate as the former see fit (cf., for example, McIntyre 1993, 318).[15]

The dummy variables on the different tax rates are all highly significant. The coefficient of the constant, which is 18.41, can be interpreted as the effect of the *dividend tax dummy* on the withholding rate. The effect of the *associated dividend tax dummy* is 10.085 (– 8.325 + 18.41), that of the *interest tax dummy* 10.572 (– 7.838 + 18.41), and that of the *royalty tax dummy* is 10.335 (– 8.075 + 18.41). Together with the increase in R^2 this suggests that the tax dummies can explain the general level of the respective rates. This may be interpreted as evidence that there are focal points of generally accepted rates for different kinds of income and the variance around these rates can be explained by the asymmetry in the stocks of FDI.

Interestingly, the estimated effect of the *dividend tax dummy* and the *interest tax dummy* are quite close to the suggestions of the OECD MC (15 and 10 percent respectively). However, the coefficients of the *associated dividend tax dummy* and the *royalty tax dummy* diverge considerably from the suggestions of the MC (5 and 0 percent respectively). This implies that, for the latter two kinds of income, the OECD MC is not as well accepted as a focal point as it is for interest and dividend income. This interpretation can be further substantiated by an analysis of the commentary to the OECD MC. Governments have entered far more reservations and observations on the suggested rates for associated dividends and royalties than for dividend and interest payments (OECD 2005, Commentary, Reservations and Observations on Articles 10, 11 and 12).

15 This interpretation presumes that the capability index is an adequate proxy for bargaining power. As is well recognized in the political science literature it is notoriously difficult to measure power (Baldwin 2002).

Finally, the negotiated rate is indeed lower if treaty partners are wealthy. The coefficient of *sum of per capita GDP* is negative and highly significant.

These results are in line with the results of Chisik and Davies (2004), who did a similar analysis with different data from those used here. Thus, my analysis is complimentary and, to the extent that my dataset includes newer treaties, provides an update of theirs.

Overall, these results provide strong quantitative support for the notion that the politics of double tax avoidance are driven by the distributive conflict between residence and source states. The systematic variation of bilateral tax treaties according to bilaterally defined investment positions of countries provides a strong argument for bilateral bargaining. In dyadic bargaining, the terms of the tax treaty can be designed to accommodate each country's particular investment situation. Under multilateral bargaining, governments would find it difficult or impossible to agree on one precise sharing rule that serves their revenue interests in relation to all of the others. In other words, multilateral bargaining would be very expensive in terms of transaction costs.

However, if countries prefer bilateral bargains, this then raises the question of why governments engage in complementary multilateral cooperation on the development of the MC.

The Interaction of Bilateralism and Multilateralism: Constructed Focal Points

In order to answer this question, one has to differentiate between the technical side of the problem of double tax avoidance and the problem of the distribution of benefits. Both issues have to be resolved through bargaining. On the technical side, the legal constructs to implement the avoidance of over-taxation have to be decided upon. This is represented by a pure coordination game. It may not matter so much which concepts are chosen; the important point is that agreement on any solution is attained. Since all governments were in favor of sovereignty-preserving solutions, there was no serious bargaining problem involved in coming to an agreement on the legal constructs employed in DTAs. On the other hand, the distributive conflict can be expected to be very tough. This is because there is no serious enforcement problem in double tax avoidance, while at the

same time the distributive conflict is strong. Under this combination, governments have an incentive to "hold out" for a long time to come to a favorable agreement, because they know it will stick for a long time (Fearon 1998, 270-71). Of course, holding out incurs costs for both countries, so that there is a mutual interest to moderate the intensity of bargaining in order to minimize transaction costs. The instrument chosen to achieve this is the multilateral MC. In order to show this, I consider how bargaining problems are resolved.

Bargains very often find their solution in so-called *focal points*, which is the point of convergent expectations of actors with an overriding interest to agree on a coordinated outcome. Focal points are defined as social conventions that are not questioned but which are followed "automatically" because they have become self-evident. They are more obvious, conspicuous, and prominent points of agreement than other possible solutions. Depending on the particular bargaining problem at hand, a focal point can have different sources. It may come from history, social norms, and culture, or simply represent a status quo. If actors are in a bargaining situation where such a focal point exists, bargaining should consume less time and effort because the solution gravitates towards the focal point (Schelling 1980, 57-80).

As shown above, there is no self-evident solution to the problem of double tax avoidance. 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 (Rixen forthcoming, chapter 4). In other words, a focal point is not available. The creation of institutions "can fill this void. By embodying, selecting, and publicizing particular paths on which all actors are able to coordinate, institutions may provide a *constructed focal point*" (Garrett and Weingast 1993, 176). In the case at hand, governments engage in the intentional creation of a focal point in the form of model tax conventions that limit the range of possible solutions.[16]

Of course, when negotiations at the League of Nations began, the initial goal was not to construct a focal point for bilateral bargains, but to

16 Note that the nature of the model convention as a constructed focal point is somewhat different than the case discussed by Garrett and Weingast (1993, 187-91). They consider the decisions of a third party, the European Court of Justice, to be a constructed focal point, whereas, in my case, the governments themselves are involved in the construction of the model conventions.

come to a binding multilateral DTA. However, this proved to be elusive, so governments contented themselves with coming to an agreement on a model convention for bilateral bargains. The attempt to find a focal solution was subject to bargaining problems similar to those faced in negotiations about binding agreement itself. Importantly, it proved to be comparably easy to come to agreement on the technical side of the problem, i.e., to agree on legal constructs that are capable of achieving the coordination of different national tax laws. While there were important technical problems to be resolved that required some ingenuity from tax experts, all actors agreed that the technical solution should be sovereignty preserving. However, the distributive conflict was more difficult to solve; the difficulties encountered in trying to forge agreement on the MC within international organizations and the fact that there are two competing models in terms of the distribution of benefits are evidence of this.

The fact that the OECD MC is non-binding can explain why it was nonetheless possible to forge an agreement. Since governments know *ex ante* that they are allowed to deviate from the convention in their bilateral agreements, they are more willing to subscribe to a model, even if it may not entirely conform to their distributive preferences. The flexibility inherent in soft law is one of the main reasons that it is chosen by governments. Rather than having to "accommodate divergent national circumstances within a single text," it leaves "flexibility in implementation" (Abbott and Snidal 2000, 445). The multilateral MC pre-structures the bilateral bargains, but it does not predetermine them entirely. It is merely the starting point for bilateral negotiations, in which a binding solution to accommodate parties' distributive interests is achieved.

Importantly, the non-binding nature of the MC does not matter for its effectiveness with respect to the technical side of double tax avoidance. Since all countries have the desire to be coordinated, any workable solution that is found is accepted and there is no reason to deviate from this solution in bilateral bargains. In this sense, the OECD MC provides standards, which countries voluntarily adopt in their bilateral bargains. As is the case in most standard-setting regimes, while making the rules binding on countries would not meet with resistance, there is no need to do so, because they wish to follow them in any case. The rules are self-enforcing. At the same time, since there are indeed various technical problems involved in developing these standards, there is a demand for pooling the expertise

and information, and making it available to other governments. A multilateral institution that is specialized in collecting, creating, and disseminating information can fulfill this task (cf. Snidal 1985, 928).

The fact that distributive problems and not technical issues are at the heart of difficulties in achieving agreement on a focal point is evident in the historical development. As shown, agreement on the technical side of the problem emerged earlier under the League of Nations. However, the League years ended with two technically identical conventions, the Mexico and London models, but each with different distributive implications – one emphasizing the source, the other the residence principle. Agreement on one model convention was elusive because of the heterogeneous group of countries in the League of Nations. During the OECD years, governments managed to agree on one model. This success was facilitated by the fact that the OECD is made up of a relatively small group of countries with relatively symmetric capital flows between them. Therefore, the distributive conflict between these countries is weaker. Accordingly, in combination with the non-binding character of the model, agreement was easier. Importantly though, the technical solutions that were developed in the previous period were not challenged ,but merely further developed and refined.

The adoption of a model by a such a small and exclusive group of countries also has consequences for the countries remaining outside the agreement. Given the sophistication and resources devoted to double tax avoidance at the OECD, the MC became the technically best developed model. Due to the overall nature of double tax avoidance as a coordination game, countries generally accept the OECD MC, since it provides such a technical standard. Even though it was not developed by an all-inclusive group of countries, the outsiders voluntarily follow the standards adopted within the OECD. The OECD MC eventually became entrenched as the “natural” solution to the problem of avoiding double taxation.

This may also have consequences for the question of the distribution of benefits. Since OECD countries were the “first at the table,” they could implement a system that favored residence countries. The best that the “last at the table” — the developing countries — could do was to follow the OECD, even though the rules were less favorable to the latecomers than their preferred source principle (Horner 2001, 183-84). The *first-mover advantage,* a feature of coordination games, may account for the fact that,

in general, the rules are of such a nature that they favor developed countries. The disadvantaged countries have tried to change this situation and attempted to counter-balance the OECD MC through the UN MC. While the UN did not explicitly attempt to challenge the technical solutions, its MC aims to be a corrective to the distributive solution that emerged within the OECD. The OECD MC has quite clearly not achieved universal acceptance as a focal point with respect to the issue of the distribution of benefits. The empirical evidence about the influence of the tax dummy variables on the level of different withholding rates supports this view. The suggested rates for royalties and associated dividends are less well accepted than those for dividends and interest.

But even the coexistence of two distributively divergent model conventions facilitates bilateral bargaining. The fact that the disagreement about the distribution of benefits is embodied in multilateral model conventions sponsored by well-respected international organizations legitimizes the distributive conflict. The discussions of these problems in multilateral forums allow treaty negotiators to anticipate the areas where conflict can be expected, and thus enable a quicker resolution of the distributive issues in the bilateral setting. Multilateral bargaining about focal solutions rationalizes the distributive conflict and thereby mitigates it to a certain extent.

The Enforcement Phase and the Mutual Agreement Procedure

After the discussion of the institutional design as it applies to the bargaining phase of international tax cooperation, I now turn to the enforcement phase. As argued above, there are no enforcement problems in DTAs. Turning to a closer investigation, I further substantiate this claim in the following.

First of all, one of the most important sources of enforcement problems is strongly mitigated in double tax avoidance: *monitoring* is not problematic at all in the case of tax treaties. Any violation of a treaty can be easily detected because there is a natural third party to the agreement to ensure this — namely, the taxpayer. If one of the treaty partners violates a DTA, the taxpayer will notice this violation and notify the competent authorities in his/her home country. The countries then enter into

MAP negotiations in order to try to reach an agreement over the treaty violation.

The absence of a serious enforcement problem does not, however, mean that there are no conflicts in applying the provisions of the treaty. As shown, the MAP is employed quite often. However, rather resulting from conscious and deliberate efforts to cheat treaty partners, the disputes often stem from problems in interpreting the agreement correctly. Given that domestic and international tax rules are complicated, avoiding double taxation can be understood as a complex transaction. The main feature of such complex transactions is that not all future contingencies can be dealt with at the time of concluding the contract, because they are not known, or, even if they can be anticipated, the transaction costs of agreeing on contractual provisions for all contingencies would be too high. For example, given the long life expectancy of a treaty, it is often necessary to adapt the treaty to changes in domestic tax laws (Vann 1998, 725). Tax treaties are thus necessarily *incomplete contracts* that involve indeterminacy, and often have to be amended to accommodate new circumstances *ex post*. Contract theory suggests that, in such circumstances, treaty partners should not try to agree on what will be done in each contingency *ex ante*, but instead should keep the treaty more general and agree on a procedure to be followed, should a dispute arise over the application of the provisions.[17] The procedure chosen in tax treaties is the MAP. Its major function is that of a flexible mechanism of *ex post treaty negotiations*. It enables "*ad hoc* and *ex-post* agreement" between governments through which divergent treaty interpretations can be brought into line and "temporary or unforeseen problems" be addressed (Aoyama 2004, 653). The MAP is an "ongoing treaty negotiation" (Lindencrona/Mattsson 1981, 24).[18]

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17 Parties to an agreement will nonetheless try to make their contracts as precise as possible *ex ante*. Thus, the expectation is that treaties will become more and more complex over time, as negotiators learn about potential contingencies that have arisen in other treaties. Sasseville (1999, 54) demonstrates the growing complexity of treaties, using the example of Austrian DTAs concluded since 1950. While the average number of words in treaties concluded before 1950 was 2764, and between 1950 and 1960 5034, it has grown to 5599 (1960-70), 6444 (1970-80), 6787 (1980-90) and 9189 (since 1990).

18 This can be substantiated by the kinds of cases that are treated under the MAP. According to the OECD commentary, the "most common cases" involve transfer pricing disputes, determining the taxable profits of a PE, the tax treatment of associated enterprises, the classification of payments as interests or dividends, and lack of information of the authorities about taxpayers' actual situations, especially concerning their residence or the existence of a PE (OECD 2005, Commentary on Article 25, para. 8). The

Given that the *ex post* negotiation over the agreement is the major function of the MAP, it is understandable that governments did not choose an external enforcement mechanism, and generally resisted the introduction of binding arbitration. They wish to determine the terms of agreement by themselves and retain the flexibility to adapt the agreement to new circumstances, rather than grant the power of treaty interpretation and *ex post* amendment to a third party (cf. Green 1998, 129-37). In addition to its desirability, the absence of a major enforcement problem makes such a solution viable. The fact that the MAP enables the *ad hoc* and *ex post* adaptation of tax treaties to new circumstances may also be a good explanation for the fact that, on average, treaties between OECD countries are changed formally only every 14 years (Sasseville 1999, 56). Given the flexibility of the MAP, formal treaty renegotiations may not be considered necessary.

If an external mechanism is not needed in the enforcement of tax treaties, why then has the OECD recently (OECD 2007) suggested arbitration in tax treaty matters? The answer lies in the difficulties of bargaining. The *ex post* negotiations under the MAP are subject to the same bargaining problems as *ex ante* negotiations. Given the distributive conflict, there is the danger that treaty negotiations could become protracted, because negotiators have an incentive to hold out. This is not only undesirable from the perspective of taxpayers who remain in a situation of uncertainty regarding their tax payments; it is also undesirable for negotiators who have a mutual interest in speeding up the MAP. The development described above — the adoption of several treaties with arbitration *complementary* to the MAP and the OECD promoting such solutions — is evidence for this. Complementary arbitration provides an incentive for negotiators to speed up the procedure. If spelled out as complimentary to the MAP, arbitration can be understood as a credible commitment device. A provision for arbitration makes this commitment credible. "[T]he entire mechanism is designed to help the MAP work more effectively" (Aoyama 2004, 663). The fact that few cases have actually moved to the stage of arbitration is evidence that complimentary arbitration is indeed successful in achieving this goal.

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common feature of all these cases is that double taxation results from domestic bodies interpreting certain facts or treaty provisions in a different manner (Züger 2001, 2).

Contrasting Cases: Bilateral Agreement and the Absence of Free-Rider Problems

So far, it has been argued that bilateral bargaining is well suited to accommodate governments' distributive concerns. In addition, there is no major enforcement problem that would require third party enforcement. But this does not explain why binding agreement is bilateral in tax treaty making. As we have seen, there is an important role for complementary multilateral bargaining in order to provide focal points for bilateral bargains. This raises the possibility that countries could also come to a binding multilateral agreement. In fact, it is easy to draft a multilateral tax treaty that contains the same provisions as the OECD MC (Lang, et al. 1997; Lang 1997). Governments could, in principle, agree on a multilateral tax treaty that would leave them distributional flexibility. The distributively sensitive aspects could still be determined in bilateral bargains and subsequently all countries involved could agree on one multilateral document that included a series of bilaterally varying provisions.[19] Why, then, is agreement not multilateral in double tax avoidance?

The answer is that there is no need for such a binding multilateral framework in double tax avoidance because there is no free rider problem. This point can be worked out by contrasting the cases of the international trade and tax regime (the following argument is developed in more detail in Rixen and Rohlfing 2007): In international trade liberalization, which has for a long time been achieved through bilateral agreement, countries have to balance the interests of "their" import-competers and exporters. They generally do not engage in unilateral trade liberalization and can best achieve this balance in bilateral agreements. However, once they have struck a deal, the balance achieved in relation to one country may be upset by a subsequent trade agreement between their treaty partner and a third country. If that agreement is more favorable to the third country, the exporters of the first country may suffer. In order to prevent this, governments introduced Most Favored Nation (MFN) clauses into their bilateral agreements, so that their exporters would always be given the best treatment that their treaty partners grant to any country. Thus, MFN treatment, which became mandatory under the GATT, is intended to ensure

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19 In fact, the one instance of multilateralism (or rather minilateralism) — the Scandinavian tax treaty — is of this kind (Vann 1991, 151).

that the domestic balance between import-competers and exporters is not disturbed. However, once a series of bilateral agreements with MFN treatment is in place, a positive externality for other countries is produced. Governments have an incentive to lean back and wait for other countries to conclude agreements, which they are able to access without granting any concessions themselves. In this situation, *multilateral agreement* is an institutional safeguard by which such free riding can be prevented. After all concessions have been exchanged, each member country can consider the bargains in conjunction. If one country believes that another intends to free ride on its concessions, the former can withhold some of the concessions previously granted and insist on additional concessions by the potential free rider.

In international taxation the situation is different. A third-country effect of the kind that led to the introduction of MFN treatment in international trade does not exist. Initially, it is conceivable that a government would like to ensure that no third country gets a better deal from one of its treaty partners. One motive might be concerns about competitiveness; a country might want to make sure that its own investors get at least the same concessions as investors from other countries. Accordingly, it could insert an MFN clause into its treaties to ensure that, if its treaty partners agree on more favorable terms with other countries, these will also be extended to its own investors. The fact that MFN clauses are sometimes found in tax treaties indicates that such considerations may play a role in tax treaty making. However, MFN treatment is more an exception than the rule in tax treaties. In fact, the quantitative evidence presented above suggests that the kind of third-country effects that would make MFN treatment desirable cannot be very strong. Otherwise, the correlation between withholding tax rates and bilateral investment positions would not be as strong, because an MFN clause clearly upsets the distributional balance that constitutes the main reason for reciprocal concession making in bilateral bargains. And indeed, it can be shown that the way MFN clauses are used in tax treaties has more to do with the desire to balance bilateral, reciprocal deals, than to actually grant benefits to third countries (Lennard 2005, 99-100).[20]

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20 The treaty between Norway and Australia may serve as an example. Norway was not able to push through its desired low withholding rates. In order to at least “win” something in the negotiations, it managed to introduce an MFN clause that foresees the

The decisive difference between taxation and trade is that, in the trade regime, MFN treatment has become mandatory for solving an enforcement problem: if there is no mandatory MFN treatment, the fear is that an unraveling of all bilateral bargains would occur due to the third-country effect. This fear is clearly not present in the case of the tax treaty regime. If a government dislikes the fact that a third country has been granted more favorable tax treatment by one of its treaty partners, this does not induce the government to defect from the treaty. In trade, the domestic balance between import-competers and exporters that has been disturbed by the third country effect provides an incentive to defect from the prior treaty. In international taxation, since a comparable politically salient conflict does not exist, a country would not defect from prior agreements, even if one made the questionable assumption of a strong third-country effect. This explains why there is no mandatory MFN treatment in double tax avoidance and why it is rarely used in practice. Consequently, the possibility to free ride on the concessions other countries have made is not a relevant factor, and thus there is no need for a binding multilateral agreement.

In consequence, whereas bilateral agreements in international trade create externalities that countries wish to internalize by means of binding multilateral agreement, externalities of this kind do not exist in double tax avoidance.[21] Governments do not come to a binding multilateral agreement, quite simply because there is no need for it. The fact that the tax regime has a strong bilateral element and a switch to a multilateral tax treaty did not occur, challenges the claim that "solving coordination problems is institutionally neither complex nor particularly demanding, and it

renegotiation of the treaty, should Australia grant lower withholding taxes in the future (Lennard 2005, 99). In most tax treaties, MFN treatment is not granted automatically, but only consists of a commitment to renegotiate (Hofbauer 2005).

21 This reasoning leaves aside negative externalities resulting from issues of tax evasion, avoidance or competition ("double non-taxation"). While it is certainly true that these externalities may pressure countries to find multilateral solutions, the abstraction from these externalities is justified by the empirical record. The problem of double non-taxation is addressed by constructing a multilateral support structure, which is institutionally distinct from the bilateral tax treaty network. While it is true that a more principled solution would integrate the two problems of double tax avoidance and double non-taxation 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 easily. The bilateral double tax regime develops in a path-dependent fashion (Rixen forthcoming, chapter 8).

was the domain in which multilateralism […] flourished in the nineteenth century" (Ruggie 1993, 22). My argument turns Ruggie's logic around. Precisely because the underlying strategic structure does not necessarily require multilateral agreement, binding agreement could remain bilateral. The multilateral institutions of double tax avoidance "only" have a facilitating role for resolving *bargaining* problems — a task that they accomplish successfully, as the continuing growth and substantial degree of homogenization of the treaty network shows.

III. A (Potentially) Competing Explanation: Bilateralism Preserves Sovereignty

Only to the extent that the mechanisms just identified fare better than other potential explanations can we put some trust in their validity (see, e.g., George and Bennett 2005, 117-19). Because I do not have the space for an in-depth analysis of competing explanations here, I briefly consider just the most common one. It is quite common to "explain" the bilateral nature of double tax agreements by a broad and often unspecified reference to the desire of countries to maintain their tax sovereignty (cf., e.g., Abbott and Snidal 2000, 441). While this claim is hardly ever spelled out in a fully developed account of the institutional design of international tax governance, it could be understood as a competing explanation.

First of all, it is true that governments want to preserve their tax sovereignty. The institutional setup is constructed in a sovereignty-preserving way, so that double taxation can be avoided by interface regulation. Governments cherish the flexibility of this setup which allows them to design their domestic tax laws independently of other countries. However, this fact by itself is not a sufficient condition for the bilateral nature of tax treaties. For one, it would be conceivable to conclude a multilateral tax treaty based on the very same legal constructs and technical solutions currently used in bilateral tax treaties. Such a treaty would be just as sovereignty-preserving as a bilateral treaty. This shows that multilateralism does not restrict sovereignty *per se*. Likewise, the bilateral form as such need not necessarily be more sovereignty-preserving than multilateralism. Rather, the substantive provisions contained in a treaty determine whether it preserves national sovereignty or not. For example, bilateral tax treaties that were not based on separate accounting but would instead use

unitary taxation with formulary apportionment would require the definition of a common tax base. This would restrict a single government's tax sovereignty more than a multilateral treaty based on the arm's length standard.

Second, as shown elsewhere (Rixen forthcoming, chapter 8), governments are, if only grudgingly, willing to compromise some of their national tax sovereignty in the fight against tax evasion and avoidance. This is a reaction to the functional requirements of this problem, which are fundamentally different from those of double tax avoidance. The difference in the reaction to the two problems shows that the sovereignty-preserving and bilateral approach in the realm of double tax avoidance hinges on the underlying strategic structure. While the desire to preserve national sovereignty may be one of the reasons why governments find this particular setup attractive, the fact that such a solution was viable cannot be explained by reference to this desire. Consequently, the notion that countries' desire to preserve their tax sovereignty can explain bilateralism is incomplete.

IV. Conclusion

In this paper I have constructed an explanation of the design features of international tax cooperation. Bilateral bargaining is preferred over multilateral bargaining, because the asymmetry of investment flows can be better accommodated in bilateral bargains. Despite this preference for bilateral bargains, governments have an interest in developing model conventions and a multilateral forum for discussion, serving as a constructed focal point. Concerning the *ex post* phase of cooperation, it was shown that there is no need for external enforcement mechanisms. The mutual agreement procedure is best understood as a device for dealing with the problems of incomplete contracting. Concerns for third country benefits, i.e., externalities of bilateral agreements, are not relevant, so that there is no free-rider problem and thus no need for multilateral agreement.

In the case of double tax avoidance, the problems of cooperation lie mainly within the sphere of bargaining. Cooperation is made difficult not by the fact that enforcement is problematic but by struggling over the terms of the agreement. Since the question of "who gets what?" is difficult to resolve, most of the governance design elements — for example, con-

structured focal points and the MAP — concern the facilitation of successful bargaining between countries. This finding lends support to the argument that considering bargaining and distribution problems is just as important as enforcement — the problem much of cooperation theory has focused on in the past — and should receive more attention by international relations scholars (Simmons and Martin 2002, 204; Fearon 1998, 297-99; Koremenos, et al. 2001, 765). However, as shown, this does not mean that the enforcement phase can be ignored. To the contrary; it is crucial to understand that the (relative) absence of enforcement problems amplifies the intensity of bargaining problems. It also accounts for the fact that multilateral agreement is not necessary. This points to the need to understand both the bargaining and enforcement phase, and their interaction in order to make sense of institutional design (see, for a similar argument, Drezner 2000; Barkin 2004).

These findings exemplify, first, that a straightforward and dichotomous classification of international cooperation into bilateral or multilateral cooperation is unhelpful. Rather, as the comparison with international trade suggests, it is quite likely that different policy fields exhibit different mixes of bilateralism and multilateralism at different stages of the cooperation process.

Second, these findings suggest that the choice between a bilateral and multilateral form of cooperation is contingent on a particular configuration and interaction of distribution and enforcement problems. An important conclusion to be drawn from my findings for future efforts at theory development is to pay close attention to issues of bargaining and distribution and their interaction with enforcement problems. It is worthwhile to explore other issue areas that may exhibit different configurations of distribution and enforcement problems, in order to generate generalizable knowledge on the choice between, or the co-existence of, bilateralism and multilateralism.

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