Robert Schuman Centre for Advanced Studies

**The Code of Conduct Against Harmful Tax Competition:
Open Method of Coordination in Disguise**

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ABSTRACT

The European Union is experimenting with new non-binding policy instruments in business taxation, namely a voluntary code of conduct among member states against harmful tax competition. This paper raises the question to what extent can the code be considered a manifestation of the open method of coordination (OMC)? Is an open method (based on guidelines, peer review, best practice, benchmarking, learning, and diffusion of shared beliefs among policy-makers) emerging as a new governance architecture in tax policy? If so, what can the code achieve in terms of policy learning and convergence? There are similarities between the code and the open method of coordination – especially with reference to guidelines, peer review, timetables, and the identification of “worst practice”. However, the political logic of the code does not fit in well with the OMC aims of participatory governance and social learning. In terms of achievements, the code has contributed to the creation of a community of discourse and the diffusion of shared beliefs about what “acceptable” and “harmful” tax competition are. Convergence at the level of “talk”, however, should not be confused with convergence of actual tax policies in the member states.

1. THE ARGUMENT

After a long period of neglect and political stalemate, the European Union (EU) has made progress in direct tax policy. Indeed, the initiatives against harmful tax competition have now become a cornerstone of the EU policy for the single market. This paper raises the question whether recent developments in EU direct tax policy foreshadow changes in the governance architecture of European taxation. Specifically, it benchmarks innovation in policy instruments (member states are experimenting with a non-binding code of conduct on business taxation) with the innovations introduced by the open method of coordination (OMC). The latter – although already in use in some policy areas – was defined by the Lisbon Council of March 2000 and later discussed in the White Paper on Governance of the European Commission (European Commission 2001a) in the context of the changing governance architecture of the Union.

The OMC is – according to the Lisbon Council – a means of spreading best practice and achieving convergence towards the EU goals. The idea is to use the EU as a transfer platform rather than a law-making system. Thus, the OMC should assist member states in developing their own policies. The “method” is defined by the following characteristics: EU guidelines combined with specific timetables; action to be undertaken at the national and regional level; benchmarking and sharing of best practice; qualitative and, when appropriate, quantitative indicators; “period monitoring, evaluation, and peer review organised as mutual learning processes” (Presidency Conclusions, Lisbon European Council, 23-24 March 2000).

Soft-law has been around EU policy for a while, as shown by the work of Snyder (1994; see also Abbott and Snidal 2000). Almost invariably, soft-law is used where the lack of political consensus blocks the road to traditional law-making processes. The relationship between the OMC and hard law varies. Indeed, there are areas where the OMC is used in the presence of hard law, such as social policy and migration. But even in these areas political confrontation limits the development of hard law competence. In other areas, such as pensions, the OMC is not accompanied by hard law competences of the EU. Finally, there are areas where there is some degree of hard law competence, such as education and health, but the treaties strictly limit the boundaries of this competence. Accordingly, one question for this paper is what is the relationship between soft law and hard law in taxation?

Scholars looking at the OMC as emerging governance architecture (de la Porte and Pochet 2002; Trubek and Mosher 2001; Bertozzi and Bonoli 2002) stress its potential for policy learning, participatory governance, and “better regulation”. Given that that one aim in this paper is to benchmark innovation in

tax policy with the OMC, it is important to clarify what type of OMC is the yardstick. The claims about learning, participatory governance, and better regulation are applicable to the most developed forms of OMC, namely the form used for the European employment strategy. Policy-makers are experimenting with the OMC in other policy areas (such as social inclusion, pensions, education & training, migration, research & development, enterprise policy, and macro-economic policy): the degree to which governance is socially participative varies to a large extent in these areas, from a minimum in the broad economic policy guidelines to a maximum in social inclusion. In the remainder of this paper I will use these three properties (that is, learning, participation, and better regulation) of the OMC as governance architecture, but with the qualification that the benchmark is the most sophisticated type of OMC we know of – a type that comes close to the practice of the OMC in employment policy.

Let us consider the three properties. To begin with, the OMC is iterative: for example, in the European employment strategy benchmarking and guidelines at the EU level inform national action plans; the results of plans are then peer-reviewed with the aim of re-calibrating EU guidelines. It is also geared toward a governance architecture which brings society back into the EU policy process: in the case of employment policy, the OMC is expected to foster wide-ranging consultation and to encourage the participation of social partners in the making of EU policy. Another point on the OMC potential in terms of “better policy” stems from the debate on the future of EU regulation (European Commission 2002). Indeed, being based on soft-law and the inclusion of social actors, the “method” provides an alternative to traditional “command and control” regulation. As such, the OMC is expected to deliver “better regulation” (see Mandelkern Group 2001 on principles and practice of better regulation).

This paper addresses the following issues: to what extent does the code of conduct on business taxation follow the template of the OMC? Is a “new governance architecture” – based on learning processes and the inclusion of social actors - emerging in EU tax policy? What are the results achieved by the code? One argument in this paper is that the tax code is consistent with the basic features of the OMC. As the code was agreed well before the Lisbon Council and no reference to the OMC was made by the Council's Group working on the code, one can talk of open method of coordination in disguise. However, it will be shown that the political logic of the tax code is not entirely similar to the logic of the OMC. For example, the aims of integrating social actors or finding alternatives to “command and control” regulation are not prominent in the code. Let us start with the aim of switching from traditional to “better” regulation. The logic of the code is one of political necessity in an area where it has been extremely difficult to develop EU regulation. Put differently, the code was not

drafted in order to improve on traditional rigid EU law and deliver more flexible regulation. Indeed, there is no “regulatory system” for EU taxation but only embryonic regulation of certain aspects of business taxation. Turning to participatory governance, the business community and non-governmental actors have so far remained outsiders in the deliberations concerning the code, although an increasing number of employers’ federations, think tanks, and social movements have made proposals concerning international business taxation¹. Hence, the potential of the code as new governance architecture should not be exaggerated.

Another argument presented here is that the code is embedded in a wider context and therefore cannot be assessed without a consideration of other interdependent initiatives to crack down on harmful tax competition. The future of soft new policy instruments in EU tax policy is therefore contingent on the progress made in the traditional law-making process. Soft and hard law remain intertwined. This makes taxation similar to those policies wherein the OMC has emerged in conjunction with traditional approaches to policy-making.

Having said that, the major result achieved by the code is convergence of EU tax policy-makers around a community of discourse, some tax policy beliefs, and a limited number of decisions. Following Brunsson (1989) and, more recently, Pollitt (2001), I will distinguish between convergence in debate, convergence in decisions, convergence in actual practice, and convergence in results. EU finance ministers share the same beliefs about the damages of harmful tax competition (although some countries have stronger beliefs than others do). They are also able to take some decisions on what should be done (although some governments agree reluctantly). However, convergence does not mean that actual national tax practice has changed dramatically: at best, empirical evidence shows that member states share more information than in the past and have not introduced aggressive tax schemes. It is too early to say whether convergence of tax policy beliefs has produced domestic policy change.

The paper is organised as follows. Section 2 presents the historical context and illustrates how the current EU tax policy emerged in the second half of the 1990s. Section 3 provides a discussion of the political aspects surrounding the use of a non-binding agreement such as the code of conduct. Section 4 illustrates the link between the code and other initiatives. Section 5 discusses what has been achieved so far. Specifically, it raises the question of whether ideational convergence (the main result achieved by the code) has also produced policy change. Section 6 presents the conclusions.

¹ See Ceps (2000;2001), the initiatives of Attac (at <http://www.attac.org/indexfla.htm>) and “The Tobin Tax Initiative” (at <http://www.ceedweb.org/iirp/>).

2. THE CONTEXT

It has always been difficult to develop direct tax policy in the EU. Additionally, there is a *prima facie* argument that this policy area is not amenable to the OMC. This is due to several reasons. First, both sovereignty and legal arguments - unanimity and the lack of a specific treaty base for direct taxation (in contrast with the relatively precise articles of the Treaty of Rome on indirect taxation) - produce a very narrow path for direct tax proposals. For example, the idea of peer review of domestic tax systems (peer review being a cornerstone of the OMC) was considered political anathema by several governments up until recently.

Second, although proposals for direct tax coordination have been aired since the 1960s, there is disagreement about the content of a Community policy in this area. It is difficult to see the end result of tax policy coordination. Contrast this with the Euro, where a simple concept (that is, one single currency for the EU) can be easily grasped by politicians and citizens. But the question of “what could a possible fiscal system for the EU look like?” does not lead to simple answers. The OMC implies that the main EU policy goals have been set (Wincott 2001). Indeed, the method stipulates that convergence should be “towards the main EU goals” (Lisbon conclusions, p.12, para.37). If the content of fundamental EU tax goals cannot be specified, convergence becomes an elusive notion.

The problem is compounded by the lack of desirable models to be imitated and diffused throughout the Union. Disagreement on what is good or best practice in terms of tax policy is yet another hurdle that has historically hindered progress. There is a fine line between “acceptable” and “harmful” tax competition. To what extent would a notion of “good tax practice” cover tax regimes designed to poach the tax base of other countries? Even at the scholarly level (not to mention the political level) different schools of thought (specifically, public choice and public finance, see Frey and Eichenberger 1996) go in different directions. Public choice finds very little harmful tax competition because it magnifies the political distortion induced by the state as Leviathan. Hence tax competition is necessary to tame the Leviathan. Public finance is more concerned about the economic distortions caused by the differential treatment of domestic and foreign capital. Consequently, this school has a higher propensity to identify instances of harmful tax competition².

² Edward and Keen (1996) provide useful suggestions to bridge the gap between the two schools.

Thus, not only is the political and strategic context a very daunting one for the adoption of the OMC (lack of best practice, sovereignty as an obstacle to peer review, and no Economic and Monetary Union-like timetables for convergence around a clearly specified “final system”), it is challenging for the formulation of EU direct tax policy *tout court*. How has the Commission responded to this challenge? It is useful to situate the code in its historical context. What other techniques of coordination were used before the code was introduced? What type of learning process has led to the shift to soft law?

Up until the mid-1990s, the Commission tried to overcome the hurdles described above by making reference to the single market. The Commission, the business community, and economists argued that the efficiency of the single market required tax neutrality on international business operations (European Commission 1990; Devereux and Pearson 1989). Companies were well represented in a high-level committee set up by the Commission (the so-called Ruding Committee, European Commission 1992) with the aim of proposing a blueprint for the future of EU business taxation. At that time, the Commission proposed directives, although at least in one case (European Commission recommendation on the taxation of non residents, 21 December 1993) Brussels opted for a recommendation to member states. Overall, the focus was on traditional policy instruments.

The result of this strategy was poor. Two directives were approved in 1990. In the same meeting, the Council also approved a convention (instead of a directive, as the Commission had originally suggested) on arbitration in transfer pricing disputes³. But nothing else happened. The proposals for tax directives dusted on the shelf or were withdrawn by the Commission. No peer review of the domestic tax systems took place. More generally, the Council did not pay political attention to the proposals of the Commission. The idea of eliminating distorting taxes - whatever the technical appeal of the argument might have been - was not very attractive to ministers of finance.

³ The July 1990 package comprises three elements: a directive on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares between companies of different member states (the so-called mergers directive, 90/434/EEC); a directive against the double taxation of profits distributed between parent companies and subsidiaries of different member states (the so-called parent-subsidiary directive 90/435/EEC); and a convention aiming for the elimination of double taxation in connection with the adjustment of profits of associated enterprises (also known as arbitration convention on transfer pricing 90/436/EEC). On the political process leading to the 1990 package see Radaelli (1997).

Since 1996 the Commission has changed its strategy to overcome the obstacles to tax coordination. The new strategy is based on the necessity to crack down on harmful tax competition. This chimes with the long-term interest of revenue authorities, that is, to guard the revenue base. The response of member states was more positive than in the past. Political determination to curb certain forms of tax competition was achieved. Once the ball started rolling, the problem became to select the policy instruments suitable to the new tasks. Initially, the Commission, the European Parliament and some delegations thought of a directive on company taxation, combined with a directive on the minimum taxation of savings in the Community.

Even Luxembourg, not-so-keen on tax coordination, would have preferred a directive on company taxation rather than a non-binding instrument. But the explanation of this preference for a directive has something to do with the position of this country in the global competition for capital. Ireland and Belgium, for example, are very attractive locations for foreign companies. They were the natural targets of a possible directive against harmful tax competition in company taxation. By contrast, Luxembourg has specialised in attracting savings. In other words, Ireland and Belgium are very competitive in corporate taxation, whereas Luxembourg is more competitive in attracting portfolio income. Hence the position of Luxembourg, which saw the proposal for a directive on business taxation as the natural counterbalance to the losses to be incurred as a result of a directive on saving taxation.

Thus, at the beginning of the new anti-harmful tax competition crusade (1996-1997), there was no deliberate intention to introduce new policy instruments. The debate on taxation was not focused on the merits of non-binding instruments as alternative to traditional regulation. Neither was the debate focused on the necessity to find more flexible instruments in a policy area suffocated by too many rigid directives. As mentioned above, the legal framework of EU direct taxation remained incomplete, indeed no more than embryonic (Farmer and Lyal 1994). In terms of actors, there was no discussion about bringing the social actors back in the tax policy process. One possible reason for the failure of the Ruding Committee's proposals was that the Committee reflected the interests of business and did not pay enough consideration to the problems faced by finance ministers. All this makes the political logic of the code different from some characteristics of the OMC.

Innovation in tax policy instruments emerged as a *political expedient* when it became clear that agreement on a business tax directive was impossible to achieve. Necessity - rather than a reorientation of regulatory approaches - led the Council towards the code of conduct. The Council dropped the idea of a directive on company taxation and composed the conflicts in a deal struck in

December 1997. The ECOFIN Council agreement (OJ C 2, 6.1.1998) is based on a three-piece tax package and a fourth element concerning fiscal state aid. The tax package includes the code of conduct, a proposal for a directive on the minimum taxation of EU non-residents, and a proposal for a directive against the double taxation of multinationals. These three elements are formally bundled, which means that disagreement on one element makes agreement on the other two elements impossible. Let us now take a look at what's in the package.

3. THE POLITICS OF NEW POLICY INSTRUMENTS

The first element of the 1997 agreement is a voluntary code of conduct on business taxation (to be discussed below). The second component of the deal is the commitment to ensure a minimum of effective taxation of savings within the Community. In 1997, the Council requested the Commission to come up with a proposal for a directive and set a few points around which the proposal should be fleshed out. Following this invitation, the Commission presented a proposal for exchange of information or a 20 per cent withholding tax on interests paid to non-resident EU citizens in May 1998⁴. This is the proposal that raised many objections in the City of London, worried by the possibility that capital markets would react negatively to the European tax on savings, and migrate elsewhere (Baron 1999). Further to an unsuccessful attempt to mitigate the worries of the British delegation in Helsinki (December 1999), the EU debate has veered towards exchange of information as the best option. This would mean the abolition of bank secrecy for EU non-residents. The Feira EU summit (20 June 2000) recognised the possibility to opt for the coexistence model (that is, withholding tax or exchange of information) for a limited period of seven years, after which all countries will run a regime of automatic exchange of information among tax authorities.

At Feira, the EU leaders dropped the May 1998 proposal for the taxation of savings, but set the coordinates for a new one⁵. They agreed on a process that should lead to the approval (unanimity voting applies) of a three-piece package (a directive on the taxation of EU non-residents' savings, a directive on interest and royalties, and the full implementation of the code of conduct) by "no later than 31 December 2002" provided that (in the area of the taxation of savings)

⁴ Proposal for a Council directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, COM (1998) 295, 20 May 1998.

⁵ The new proposal was finalised by the Commission in July 2001: Proposal for a Council directive to ensure effective taxation of savings income in the form of interest payments within the Community COM(2001) 400 Brussels, 18/07/2001.

“third countries”⁶ implement “equivalent” measures and that the dependent or associated territories of EU countries (the Channel Islands, Isle of Man, and the territories in the Caribbean) enact the same measures as the EU member states. By 2009, all member states should switch to exchange of information as the rule for the taxation of EU non-residents’ savings. At Feira, the European Council endorsed only a timetable, but, in doing so, it generated momentum for tax coordination. It also established the principle that exchange of information (rather than withholding taxes on non-residents’ savings) is the main target of the EU. Another important step was taken at the ECOFIN Council meeting of 27 November 2000, when the French Presidency secured an interim deal for those countries that - within the time limitations set at Feira - want to use withholding taxes rather than exchange of information. Austria, Belgium and Luxembourg will levy a withholding tax at 15 per cent for three years. After that, the tax rate will go up to 20 per cent. A regime for the so-called grandfathering of Eurobonds was also agreed. Thus, some coordinates of the proposal for the taxation of savings are in place. But for the proposal to become directive, it will be necessary to demonstrate that the “third countries” listed at Feira enact equivalent measures.

The third element is the proposal for a directive on cross-border payments of interests and royalties. This is a typical single-market tax measure. Conceptually, it has nothing to do with the EU fight against harmful tax competition. As such, the proposal should have been approved long time ago. However, the three elements of the package are still linked together.

The final element concerns fiscal aids. This is an element of the 1997 agreement, although technically it falls outside the tax package that has yet to be finalised. What is the reason behind the inclusion of state aid in the 1997 agreement? Simply put, special tax regimes have too often been built under the rubric of legitimate state aid policy, thus avoiding the scrutiny of the tax Directorate of the Commission. The essential point here is the connection between tax policy and state aid policy. In a press release (23 February 2000), Monti stated that the Directorate General for competition “will examine all the relevant cases of fiscal state aids in business taxation, so as to allow the Commission to comply fully and promptly with its own institutional obligations”. The connection between state aids and taxation requires an examination of the progress made in the code of conduct. It is to the code that we now turn.

⁶ Switzerland, Liechtenstein, Monaco, Andorra, and San Marino.

The code of conduct defines harmful tax competition. It covers the fifteen countries of the EU and - the point is extremely sensitive in tax policy - their dependent territories. Candidate countries were asked to endorse the principles of the code as part of the negotiations on EU enlargement. The code - as defined by the 1997 Council agreement - includes general provisions for standstill and rollback of harmful tax regimes according to a five-year timetable. Roll-back can take two forms: (a) elimination of the tax measure or (b) elimination of the harmful components within the tax regimes without suppressing the regime itself. The Council may decide to extend some harmful tax measures beyond December 2005, but the rule is that the harmful components of domestic tax policy should disappear by then.

As argued above, the choice of a voluntary code was the result of political necessity. Most governments felt that a directive would erode political sovereignty and would be too difficult to manage. By contrast, the notion of a non-binding instrument hinging exclusively on political determination calmed political apprehension.

When the code was introduced, the then Commissioner for the single market and tax policy did not start any comprehensive review of non-binding instruments in EU policy. Although at that time non-binding instruments were already in use in other policy areas, the Commissioner felt that there was neither time nor staff available for an inquiry on what these instruments could achieve and their transferability to tax policy. Neither was the discussion on the code linked to the emerging debate on the OMC in the years preceding the Lisbon summit. Consequently, the problem of how to make the code work was very much a learning by doing exercise for the Commission and the member states.

A Council group (the so-called Primarolo Group, dubbed after its chair, the British Paymaster General MP Dawn Primarolo) was established to manage the code. The challenges for this group were formidable. To begin with, there was the problem of experimenting with the first example of soft law in corporate taxation. The other challenge was political. For the first time in history, fifteen high-level tax policy-makers were sitting with the Commission around a table to undertake a peer-review of potentially harmful tax measures. To see an Irish delegate commenting on the potential harm created by the Belgian coordination centres was a sea change in the tax history of the EU - a history dominated by the notion of sovereignty in domestic direct tax legislation. How to find agreement by dint of peer review in sensitive areas such as special tax regimes for foreign multinationals, the tax systems of the Channel Islands, the legislation of the Trieste (Italy) financial services and insurance centre was a bit of a political mystery.

The third challenge was cognitive. The 1997 agreement defines in general terms harmful tax competition. It also provides a list of criteria to find out the harmful characteristics of tax competition (see box 1). Note that there is no scientific consensus on the theoretical definition of harmful tax competition (see Section 2 above) and that even the empirical evidence is somewhat disputed by economists and political scientists (Basinger and Hallerberg 2000; Ceps 2000; Dehejia and Genschel 1999; Gordon and Bovenberg 1996; Swank 1998). The criteria identified by the Council do not derive from a list on which a representative panel of economists would agree. Some economists might agree, but others would simply argue that there is tax competition, but it is nonsense to discriminate between harmful and non-harmful competition (see Devereux's statement in House of Lords 1999).

The agreement on the code's criteria - in a situation where economics does not provide single answers to specific problems - is therefore a remarkable achievement. The criteria provided the fundamental concepts around which a community of discourse was able to emerge. Tax policy-makers have now found a vocabulary describing reality. The creation of a community of discourse is an indicator of convergence in "talk" (Pollitt 2001). In this case at least, it also implies shared tax policy beliefs and norms about "good" and "bad" tax competition. Peer review has now become a standard method in the making of EU corporate tax policy. Argument, mutual adjustment, and persuasion have a fundamental role to play in peer review. However, following Brunsson (1989), one should not assume that people or organisations belonging to the same community of discourse take the same decisions. Convergence in "talk" may not produce convergence in decisions. Neither does it produce the same actions: even if a decision is taken, implementation may differ. Pollitt (2001:940) adds that even when there is convergence in action the actual results may differ: "even determined implementation (actions) does not necessarily lead to uniform or expected results".

Was the tax community of discourse able to produce convergence in decisions then? Can abstract criteria work in decisions covering specific tax regimes? The Primarolo group set out to produce convergence on the practical meaning of the criteria. In addition, the code asks member states to commit themselves to re-examining existing tax laws and established practices "having regard to the principles underlying the code" (par.D of the code) and to "inform each other of existing and proposed tax measures which may fall within the scope of the code" (par.E of the code). Has all this happened? In order to address this question, we now turn to empirical evidence on how the Primarolo Group managed the code.

The Primarolo group worked on a long list of 271 potentially harmful tax measures in member states and dependent territories. After a series of meetings

and peer review sessions, the group reported on the implementation of the code to the Council on 29 November 1999 (document SN 4901/99). The Helsinki summit (December 1999), however, was unable to examine and endorse the Primarolo report. The important political point is that while the *criteria* listed in the Code of Conduct were discussed and formally agreed by all Member States on 1 December 1997, the 1999 Group's *report* was not, although a few months after Helsinki it was made public on the EU web-site. The report shows that some delegations entered reservations to the decisions of the Group on specific tax regimes. Whenever Council documents refer to the "code of conduct group's deliberations", they indeed refer to broad consensus but not necessarily unanimity⁷. This is an objective limitation to how far can the Group go in terms of pressing for convergence in decisions (at the table of the Group) and action (at the level of changes in national tax laws).

However, the Group was able to produce agreement on the decision to list 66 (out of 271) measures as harmful. This is evidence that at least some convergence in decisions has occurred. Further to the publication of the report, the Group met quite regularly. It achieved consensus on the principles of standstill and rollback. This is yet another example of convergence of "talk" (definition of principles). But the link between discourse and actions at the national level (note that standstill and rollback have to take place at the level of member states) is fragile. This is demonstrated by a progress report presented to the Council in November 2000, in which all delegations agreed on the principles of standstill and rollback, but one delegation objected to the specific criteria used to implement the principles. At every meeting of the Group there is some area of agreement, but if one scratches below the surface one finds that there are at least two or three views on what the real implications of the agreement are!

The uncertainty on the level of substantive agreement on actions is increased by the fact that the code is still a component of the tax package to be agreed by the end of 2002. As noted above, this means that the success of the code depends on the possibility to finalise the directive on savings and the directive on interest and royalty payments. Luxembourg and Austria have made this link explicit when they wrote in the ECOFIN's minutes (27 November 2000) that they will agree to the directive on savings only if the Council reaches a binding decision on the roll-back of harmful company tax measures by using the code. The soft nature of the code is therefore linked to the "hard" components of the tax package. Additionally, the reference to "binding

⁷ The ECOFIN conclusions of 9 March 1998 state that the reports of the code of conduct group can reflect either the unanimous opinion of the members of the group or the various opinions, not necessarily unanimous, expressed in the course of the discussion.

decisions” made by Austria and Luxembourg introduces a somewhat “hard” component in the code.

4. AN INSTRUMENT EMBEDDED IN A WIDER CONTEXT

Before we turn to an assessment of the code, it is useful to observe that this instrument is embedded in other political initiatives against harmful tax competition. In terms of policy dynamics, the future of the code - to use a metaphor - overlaps with three circles. The circle which is most immediate to the code is the one of the tax policy package. As averred, if the Council cannot agree on a directive of savings, some member states will be ready to terminate their contribution to the code policy process - or at least they will urge a new discussion of roll-back. In this sense the code is contained in the circle of the tax package. Consequently, the autonomy (in terms of what can be achieved autonomously by the instrument) of the code is severely constrained. Put differently, if the old-style directive on savings cannot be finalised by the Council, the non-binding instrument will not go far.

There is a second policy circle (that is, fiscal aids) which overlaps with the code. This is not a matter of concentric circles, but one of political interplay. As noted above, the Council gave a broad mandate to the Commission (in December 1997) to re-assess those fiscal aids possibly in breach of the fair tax competition paradigm outlined in the code. Now, there is a big difference between a non-binding instrument, the code of conduct, and state aids, where the Commission has considerable power. However, politically the arenas of the code and state aids are connected.

The Commission gains considerable leverage from these nested arenas. When the decisional speed in the code of conduct arena decreases (because governments disagree on how to make progress with the implementation of certain steps), the Commission gets ready for action in terms of competition policy. When the process in the area of the code (and more generally the tax package) re-starts, DG Competition seems inclined to a prudent wait and see policy. For example, during Autumn 2000, when the chances of making progress on the code and the tax bundle appeared low, the EU Commissioner for competition policy loaded the gun by starting preliminary investigations on selected fiscal aids. Formal state aid procedures were not open however, to keep pressure on the national delegations negotiating in the code arena. The gun was loaded, but the trigger was not pulled. Soon after an agreement on the tax package was achieved (27 November 2000), DG Competition manifested no intention to open formal procedures against the fiscal aids object of the preliminary investigation. Clearly, this is a political mechanism of threats, sanctions, and rewards. Member States are rewarded for their “good behaviour”

at the code of conduct table by putting a hold on state aid procedures. Concluding on this point, the link between state aids and the code advantages the Commission by giving it some political leverage in terms of threats, rewards, and sanctions.

The third policy circle is outside the EU. It refers to the OECD forum against harmful tax practices (OECD 1988). Although the EU code of conduct and the OECD initiative against harmful tax practices share different goals and cover different types of economic activity (see the analysis contained in Ceps 2000), *politically* the EU policy against harmful tax competition benefits from a similar orientation at the OECD level. Further to the OECD report on harmful tax competition (1998) - which contained 19 detailed recommendations to combat unfair tax practices both within the OECD and in tax havens outside the organisation - a second report was published in June 2000 (OECD 2000). This report identifies 47 tax regimes in OECD countries which are “potentially harmful”. Unsurprisingly, the list includes the Belgian coordination centres and the Irish international financial service centres. The point is that the determination of governments to roll-back the harmful measures identified by the Primarolo Group can be increased to a great extent by the acknowledgement at the OECD table that those measures contradict OECD good tax practice. If the OECD project flops, there will be yet another reason in national capitals to show less enthusiasm in complying with the recommendations of the Group. Overall, the OECD table represents an additional potential element of peer pressure.

5. WHAT HAS BEEN ACHIEVED? IDEATIONAL CONVERGENCE, POLICY CHANGE, AND CONTESTED LEGITIMACY

The “ideational dimension” of politics includes two activities, that is, making sense of reality and “the ability of actors to judge on the basis of values and norms” (Braun 1999:13). Cognition provides causal beliefs, that is, mental models that allow policy-makers to see what “is”. When beliefs are integrated, one can speak of a belief system. Belief systems are socially constructed (Braun 1999:14). Values and norms allow policy-makers to distinguish between what is “good” and “bad” and to guide action.

The main achievements of the code refer to the ideational dimension of politics. There are four main points describing achievements in the ideational domain:

1. In terms of sense-making activity, shared beliefs on harmful tax competition provide a system to tackle fundamental issues in EU taxation. This convergence is remarkable because the creation of mental models has not

been assisted by epistemic communities. By and large, economists disagree on whether one can really set a boundary between “good” and “bad” tax competition. Divergence in the social sciences has not hindered convergence among tax policy-makers, however.

2. Social interaction within the Primarolo group has been intense. The method of peer review is an innovation for tax policy. This is an important result, although - as observed above - there is still disagreement on how to implement certain elements of the 1999 report of the Primarolo Group. The code has been “a very successful laboratory for trust and mutual understanding” – as one Council officer put it in a private conversation.
3. The notion of harmful tax competition implies judgement and evaluation. The criteria contained in the code of conduct make evaluation of specific tax regimes possible in the EU context.
4. The social construction of principles and norms is an important aspect of the process. Socialisation, interaction, and partisan mutual adjustment have enabled to discover the direction and content of EU policy in this sensitive area. “We did not know how far we could get when we met the first time: we were about to experiment with the boundaries of what is politically feasible” – said one officer representing the Commission at the table of the Primarolo group.

The empirical evidence presented in this paper shows that a community of discourse has emerged. Interestingly, authors working on the OMC in other policy areas (such as employment) conclude that so far the major impact of the method on domestic policy-makers is “on the level of ideas” (Bertozzi and Bonoli 2002). Convergence in concepts, beliefs, and norms is an important element of OMC politics. But – Brunsson and Pollitt would add – this is just convergence in “talk”. What about convergence in decisions, convergence in actual practice, and convergence in results? It is to this question that we now turn. There is empirical evidence of consensus at the level of major tax decisions, such as the agreement found on the list of harmful measures. But the fact that the report of the Primarolo Group (November 2000) was not endorsed by the Helsinki Council (December 2000) limits the range of convergence at the level of decisions.

Has ideational convergence produced policy change in the sense of “convergence in actions” (Brunsson 1989) then? It is too early to provide an answer to this question because the tax package is still the object of negotiation. Although the Primarolo Group has been able to meet regularly and to take decisions, the political determination to roll-back harmful tax regimes may

vanish in the absence of agreement on the whole tax package. Being a non-binding measure, no legal action can be taken against a country unwilling to scrap its own tax regimes. In this connection, changes in governments may also represent a problem for the code, although up until now there has been no policy U-turn on the code following national elections.

There is evidence that, notwithstanding this state of uncertainty, the code is already generating some changes. For example, recent changes in the Netherlands' intermediate royalty and interest companies, advance pricing agreements and advance ruling practices have been linked to the intention of the Dutch government to comply with the criteria listed by the code⁸. Should further evidence point in this direction, one should conclude that the code has acquired a life of its own - that is, the power to create domestic policy change independently of the approval of the whole tax package. At the moment, however, to speak of "convergence in action" would be premature.

Roll-back is the real acid test of the code. However, progress has already been made in other areas such as notification. Governments have been willing to submit proposals for new tax policy regimes. This has increased the transparency and the commitment to peer review. It would be politically difficult to propose now the same type of beggar-thy-neighbour regimes which were so popular up until the mid-1990s. This is evidence that the policy beliefs enshrined in the code are not irrelevant. Of course, this is not the end of tax competition. One type of competition may be less popular than in the past, but governments may turn to other types of competition. And it remains to be seen whether competition limited to a handful of special tax regimes (this is the type covered by the code) is less harmful than "across-the-board" tax competition (the point is explored by Keen 1999). Therefore, the question of "convergence in actual results" cannot be addressed at this stage. There is still considerable uncertainty on whether the European tax systems will converge or diverge.

6. CONCLUSIONS

The code of conduct on business taxation fits in rather well with some characteristics of the OMC. Voluntary agreement, peer review, and timetables make the code consistent with the thrust of the method. Turning to best practice, at first glance it seems that the code has nothing to say on this component of the OMC. The criteria identified by the code do not define best practice directly. Best practice works well for problems (like employment) that all member states face at the national level, whereas tax competition is a problem among member

⁸ See *World Tax Digest* 91-2, 8 May 2001 and (on intermediary companies) *Tax Notes International*, 23 April 2001 (p.2048).

states⁹. However, by highlighting the harmful dimension of tax competition, the code shows indirectly what good tax practice is. The latter does not make sense in EU tax policy - as argued in Section 1, there is no idea of what the “best” fiscal system should be. To determine “worst” practice is therefore the closest EU business tax policy can get to the OMC emphasis on best practice. On balance, the code can be considered an example of the method, although EU tax policy-makers have not mentioned this connection. In a sense, it is an instance of OMC in disguise.

Turning to the wider issue of the OMC as emerging governance architecture, what is the political logic of the code? Does the code aim at bringing society back in the tax policy process? Does it provide “better regulation” in the sense of being an alternative to traditional regulation? Is it a platform for “mutual learning processes”, to paraphrase the conclusions of the Lisbon summit?

So far the business community has been excluded by the deliberations of the Group in charge of the code. There have been several complaints from employers’ confederations and think tanks. They think that the harmful tax competition campaign of the EU will produce a loss of legitimacy precisely because the code was managed in secret, without involving social actors (Ceps 2001). Neither were national parliaments involved. In 1999, some parliaments debated the issue of harmful tax competition (French Senate, 1999; House of Commons Hansard Debates, 5 July 1999) without having access to the results of the Primarolo Group. In London, at the House of Commons, two MPs expressed their disappointment with the following words:

“Is it not an insult to democracy and to all that we are meant to stand for that the government are agreeing to measures in so-called tax loopholes without the House of Commons or the people being told?” (Sir Teddy Taylor)

“The House deserves to know what tax measures are being discussed elsewhere, as it practically came into existence to take the means of taxation away from the Crown or the Executive and put it in the hands of those who are answerable to the electorate” (Mr. Heatcoat-Amory). [Source: House of Commons Hansard Debates, 5 July 1999]

According to some politicians, secrecy has made the code “nothing but a PR disaster” (Lord Desai, see House of Lords, 1999: 163). The conclusion is that the code does not score well in terms of transparency, inclusion of social actors, and perhaps even legitimacy – three key aims of the most sophisticated forms of OMC, such as the one used for the European employment policy, and, in relation to social actors, the one used in the policies for social inclusion. The

⁹ I am grateful to Katharina Holzinger for this observation.

code is more the response to the problem of calming political apprehension over EU tax coordination than a way to bring the society back in the EU policy process. The political cost of preserving consensus among member states may have been high in terms of legitimacy. Recent proposals of the Commission¹⁰ target the tax problems of multinationals: this may be a political counterbalance to the emphasis on the problems of governments that has characterised the code.

What about the code as alternative to traditional regulatory approaches then? The tax code has not been designed to make regulation more flexible. It did not emerge on the wake of dissatisfaction with a large body of “rigid” regulatory directives. It was not devised as a change towards “better regulation” as defined by the Commission in its annual reports on this topic. For the reasons explained above, the code emerged as political expedient.

The code does not operate in the shadow of a relatively mature body of EU tax legislation. The code operates however in the shadow of other tax policy initiatives, both at the EU and the OECD levels. It cannot be assessed on its own merits. Thus, the future of the OMC in direct tax policy hinges on the progress of more traditional instruments of tax policy and on the effectiveness of the Commission in its fight against fiscal aids.

Finally, the results in terms of convergence of policy makers are striking and at the same time limited. Striking, because for the first time in history finance ministers share a common definition of what the main EU tax problem is (that is, harmful tax competition), use the same vocabulary and concepts to make sense of reality, share criteria and norms to peer review their potentially damaging tax regimes, look at tax policy in terms of interdependence, and take commitments for stand-still and roll-back. Of course, these beliefs and commitments are better grounded in the tax culture of certain countries than in others, as shown by some perplexities in Britain, Luxembourg, and the Netherlands. But all fifteen countries have so far shared the approach and the most important implications of the campaign against harmful tax competition. The Primarolo Group has been platform for socialisation and ideational convergence. Convergence remains limited, however. There is more convergence in “talk” and (to some extent) decisions than in implementation and policy results. The governance architecture of EU taxation remains fragile and uncertain in terms of what it can deliver.

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¹⁰ See European Commission (2001b) and the company taxation website of the Commission, http://europa.eu.int/comm/taxation_customs/taxation/company_tax/index.htm

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BOX 1 - HOW THE CODE OF CONDUCT DEFINES HARMFUL TAX COMPETITION

- A. Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community. Business activity in this respect also includes all activities carried out within a group of companies. The tax measures covered by the code include both laws or regulations and administrative practices.
- B. Within the scope specified in Paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of, inter alia:

- 1) whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or
- 2) whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or
- 3) whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
- 4) whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or
- 5) whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.

Source: Official Journal C 2, 6.1.1998