Accepted, non-corrected version of article published as

Rixen, Thomas and Ingo Rohlfsing (2007): The Institutional Choice of Bilateralism and Multilateralism in International Trade and Taxation. *International Negotiation* 12 (3): 389-414.
<https://doi.org/10.1163/138234007X240718>

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The Institutional Choice of Bilateralism and Multilateralism in International Trade and Taxation*

(11998 words including references, endnotes and figures)

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ABSTRACT

Trade relations are governed by a multilateral agreement, whereas the avoidance of double taxation rests on a network of around 2000 bilateral treaties. What accounts for the difference in the institutional form?

Differentiating between the bargaining and agreement stage of international cooperation, we first show that the institutional design of both regimes is more complex than commonly assumed. Both exhibit a mix of bilateral and multilateral bargaining that precedes multilateral agreement in trade and bilateral agreement in taxation.

We demonstrate that in both regimes governmental concerns for the distribution of benefits can best be achieved in bilateral bargaining. Multilateral bargaining serves to reduce high transaction costs of bilateral bargains. Agreement is multilateral in trade to overcome a problem of free-riding resulting from a particular interaction of concerns for distribution and enforcement problems. Since no such problem exists in double tax avoidance, agreement is bilateral.

(144 words)

Keywords: rational design, bargaining, distribution, enforcement, international trade, international taxation.

INTRODUCTION

The GATT/WTO is a regime with a commitment to achieve progressive, coordinated trade liberalization. The international tax regime also serves the goal of liberalizing international economic activities. Despite this common goal, there is one marked difference between the two regimes: trade relations are governed by the multilateral GATT, whereas the avoidance of international double taxation rests on a network of around 2000 bilateral treaties. Several scholars have noted this peculiar difference between both regimes, but no attempt at explaining it has been undertaken so far (Whalley 2001: 17-18; Davies 2004; Genschel 2005). In this paper we construct an explanation for the difference between multilateral respectively bilateral agreement in trade and taxation.

When turning to theories of international cooperation for potential answers, one finds that the institutional choice between bilateralism and multilateralism has hardly been dealt with directly. Cooperation theory has an inherent analytical bias towards multilateralism and generally disregards the antipode to this institutional form, namely bilateralism (Odell 2000: 13).¹ Even work that explicitly complains about the neglect of the institutional form of cooperation in international relations theory fails to contrast multilateralism with bilateralism (cf. Ruggie 1993). Therefore, there is little knowledge about the factors determining the choice of an institutional form (cf. Caporaso 1993: 62). When do states cooperate bilaterally? What are the advantages or disadvantages of bilateral compared to multilateral cooperation?² The objective of our paper is two-fold: first, we seek an explanation for the institutional difference between the trade and tax regime. Second, we aim to contribute to the recently expanding literature on the rational design of international institutions (Drezner 2000; Koremenos, Lipson and Snidal 2001) by focusing on the neglected dimension of bilateral vs. multilateral cooperation.

We use a differentiation between three stages of the cooperation process to adequately describe the institutional form of both regimes. In order to get a complete understanding of the institutional choice it is necessary to distinguish between *bargaining*, *agreement* and *enforcement*.³ Bargaining refers to negotiating the terms of an agreement. In bilateral bargaining concessions are exchanged within a dyad, whereas in multilateral bargaining all actors make the same concession. Agreement is the stage of a binding decision. It captures the formal conclusion of the bargaining period. Therefore, it becomes the dividing point that separates the bargaining and enforcement stage. Enforcement refers to the ex post stage of the cooperation process in which countries ensure that all treaty partners comply with the agreement.

[figure 1 about here]

In each of these stages countries can choose between bilateralism and multilateralism. As a result, there is no dichotomy between bilateralism and multilateralism when referring to cooperation as a whole, but only during certain stages of the cooperation process. When taking into account the whole process, cooperation can be characterized by a mix of bilateral and multilateral elements.

Using this scheme we will describe our dependent variable, the institutional form of cooperation in the tax and trade regimes, while focusing on the bargaining and agreement stages. As our stylized institutional histories will show, both regimes exhibit a different mix of bilateralism and multilateralism at the bargaining stage. In the agreement stage the regimes are institutionally dissimilar. Agreement is multilateral in the GATT, but bilateral in tax cooperation. We also contend that the dichotomous classification of the two regimes as bilateral and multilateral is misleading since it fails to capture the existing institutional complexity.

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

Starting from the existing literature on enforcement and distribution, we develop an explanation of how their *interaction* determines institutional choice.⁴ Our main argument can be summarized as follows: concerns over distribution lead governments to choose bilateralism in order to negotiate reciprocal trade, respectively tax concessions. However, due to different domestic political interest constellations the two policy fields exhibit different strategic structures. Whereas a collaboration game is present in trade, a coordination game with distributive conflict can be found in taxation. Bilateral bargaining thus creates an enforcement problem in trade, but not in taxation. The enforcement problem can be overcome by unconditional most favored nation treatment (MFN), with MFN treatment having in turn a feedback effect at the bargaining level. The transaction costs of bilateral bargaining increase substantially, but can be reduced by multilateral bargaining. The bilateral-multilateral mix in trade bargaining is thus a function of countervailing concerns for distribution and manageable transaction costs. Multilateral bargaining also aims to reduce transaction costs in taxation. However, here multilateral bargaining serves to construct a focal point that decreases the costs of agreeing on one of several equilibria in the coordination game. The presence respectively absence of MFN obligations explains the difference in institutional choice in the agreement stage. MFN

treatment opens the floor for free-riding, which can be countered by multilateral agreement. Since MFN clauses are not applied in taxation free-riding is not an issue in tax cooperation and agreement is thus bilateral.

The rest of the paper is structured as follows: we will first provide short stylized institutional histories of the two regimes and summarize their institutional features, using the differentiation between stages of cooperation. Based on these categorizations, we will then develop an explanatory model for the institutional choice in both cases. In the final section we summarize our findings and derive some general implications for institutional choice between bilateralism and multilateralism in international cooperation.

A BRIEF INSTITUTIONAL HISTORY OF THE GATT AND THE DOUBLE TAX REGIME

a. Trade

Eight multilateral trade rounds were held since 1947 within the GATT regime.⁵ In our treatment of institutional choice we focus on tariff bargaining on manufactured goods.⁶ In the first five rounds tariff bargaining was *bilateral* and took place on an *item-by-item* basis (Hoekman and Kostecki 2001: 99). GATT members exchanged requests and offers in bilateral bargains on particular products.⁷ All bilateral bargains that could be reached were included in one *tariff protocol* that had to be signed by each country having made a concession (Jackson 1997: 144). Therefore, *agreement* is multilateral in the GATT. After all bilaterally made concessions had been formally approved they were extended to all GATT members through unconditional MFN treatment.

Except for the first round in 1947 the obtained results were meager. From the viewpoint of the member states the main reason were the time-consuming bilateral item-by-item negotiations (Evans 1971: 11). To achieve deeper reductions in tariffs a change of negotiating rules was desired by the USA, the European Community (EC) and some other countries at the beginning of the Kennedy Round (Preeg 1970: 2-3). The USA and the EC as the major trading

powers favored a linear formula approach. In its simplest form a linear tariff cut means that a country reduces all its tariffs – across-the-board or in a particular sector or field, e.g. manufactured goods – by a certain rate. In effect, a linear tariff cut is multilateral since all countries make the same commitment and have to agree on the depth of the reduction multilaterally.

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

In the Tokyo Round negotiations (1973-79) GATT members decided to stick to the formula approach informally employed in the Kennedy Round. The positions of the USA and the EC were still the same: the latter favored a harmonizing formula whereas the USA argued for a uniform linear cut. However, the EC and the USA agreed upon a formula proposed by the Swiss delegation and decided to apply it to manufactured products. GATT members were again allowed to table exceptions, which were then negotiated on a bilateral item-by-item

basis. In effect, GATT negotiators drafted exception lists containing numerous sensitive items that were exempted from a formula cut and dealt with bilaterally (cf. Winham 1986).

The Uruguay Round negotiations were again completely held on a bilateral item-by-item basis. A formula approach was sought by many GATT members, but strongly opposed by the USA. The US negotiators argued that most of the tariffs were already low and there would be no sense in making them subject to a formula approach. Instead, the USA pushed for a return to the bilateral item-by-item approach in order to deal on an individual basis with the remaining tariffs. Finally, the bilateral item-by-item approach again became the default mode of trade bargaining (cf. Croome 1999).

b. Taxation

The history of the double tax regime goes back to the beginning of the last century, when a few Continental European states signed bilateral double tax treaties mostly with their neighbors (Spitaler 1936). It became more prominent in the 1920s when the League of Nations appointed economists, the “four wise men”, to address the issue of double taxation and convened several conferences of technical experts and government officials (League of Nations 1923, 1927). The International Chamber of Commerce, lobbying for the conclusion of a multilateral convention against double taxation, pushed for these League activities. The objective during the “League years” was to draft a multilateral treaty. However, although states persistently rejected this idea, they were nevertheless very supportive of developing a so-called 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 with each other (Picciotto 1992: 38). The work of the League resulted in the model conventions of 1928, 1935, 1943 and 1946.

In the 1950's and 60's the OECD took 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. The countries' positions however remained unchanged. While expressing their opposition to a multilateral convention, they were at the same time supportive of further developing and adapting the model conventions. The OECD published its first model convention and commentary in 1963 and then a revised version in 1977. In 1991, in order to make it more adaptable to a changing economic environment, it was decided to transform the model into a loose-leaf format. Since then it has continuously been updated, with consolidated editions being published in 1992, 1994, 1995, 1997, 2000, and 2003 (OECD 2003, para. 7).

Throughout history there was persistent conflict among states as to whether the right to tax should be given to the country of residence, i.e. the country where a taxpayer lives, or the country of source, where the income is generated. This distributive conflict is not only interest driven. There is also persistent disagreement in the academic literature on whether the residence or source principle is preferable when measured against the normative ideals of equality and efficiency.⁹ Since no general consensus on the best principle could be achieved, the conclusion of a binding multilateral treaty failed. Instead, the model solution – which remained unchanged in its fundamentals from the 1920's until today – represents the outcome of bargains in which conflicting tax claims have been traded off against each other on a case-by-case basis (Graetz 2001; Brauner 2003: 278-80). Jurisdiction to tax is assigned to either the source country or the residence country for different kinds of income.

In time, the arrangement of a non-binding multilateral model convention as a 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. The CFA strives to continuously modernize and adapt the model convention by monitoring the treaty network. Quite often the technical innovations agreed upon in bilateral treaties are integrated into the model. At the same time, other innovations are also developed within the CFA framework. Thus, work at the multilateral level serves to disseminate information and new practices within the regime. In the long run, the outcome of these negotiations is that a common understanding of bilateral tax treaty making and interpretation emerges. This common understanding as well as the remaining dissent will be published in the commentary accompanying the model convention and enjoys considerable authority with courts, lawyers and other tax practitioners (cf. Arnold and McIntyre 1995: 98-100).

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

SORTING THE EMPIRICAL EVIDENCE

The preceding discussion has shown that the trade and tax regimes exhibit elements of both bilateralism and multilateralism. The classification of these two regimes as purely multilateral respectively bilateral does not give us the full picture. Trade bargaining was mostly bilateral during the eight trade rounds. It was only in the Kennedy and the Tokyo Round that bargain-

ing also involved a multilateral element. Bilateralism remained important even in these two rounds and again became the default mode in the Uruguay Round. Agreement was always multilateral in the past eight trade rounds.

In the tax regime, despite continued efforts to draft a multilateral tax treaty, agreement has persistently remained bilateral. Nevertheless, there is a high degree of uniformity between the different bilateral treaties due to a consistent multilateral consensus – reflected in the model convention - on the rules of international taxation. Multilateral bargaining on the model convention (which is updated regularly) also takes place within the OECD. Moreover, the multilateral model convention serves as the basis for bilateral bargaining between potential treaty partners.

[figure 2 about here]

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

The other side of the coin is that there is no complementary multilateral bargaining in trade and no substitutive multilateralism in taxation. In taxation, there is one (negligible) ex-

ample of substitutive multilateral bargaining, which led to the conclusion of the only binding multilateral tax treaty between the Scandinavian countries. At the agreement stage both regimes exhibit a clear difference: agreement is multilateral in trade, whereas it is bilateral in taxation.

AN EXPLANATION OF INSTITUTIONAL CHOICE IN TRADE AND TAXATION

In this section we offer an explanation for institutional choice in international trade and taxation. We begin by deriving the strategic structure of international cooperation in the two policy fields and argue that in both of them the strategic structure derives from domestic politics. We proceed by explaining the mix of bilateral and multilateral elements at the bargaining stage. Finally, we turn to the agreement stage.

Strategic Structure: The Domestic Politics of Trade and Tax Cooperation

a. Trade

The trade policy pursued by a country affects the interests of import-competers and exporters.¹⁰ We argue that import-competers prefer protectionism to trade liberalization so as to minimize competitive pressure arising from imports. The interest of exporters is to get access to foreign markets as easily as possible (see for example McKeown 1984).¹¹ Hence, the exporters' interests hinge on foreign governments' trade policy, and not on that of their own government (Lake 1988: 71). The domestic government can use its own barriers to trade as bargaining chips in trade negotiations in order to reduce foreign barriers to trade (Milner and Yoffie 1989). Whatever trade policy the government pursues, either import-competers or exporters lose income. The losing group reduces its support for the government and lobbies against it while the reverse holds for the winning group. The *distributional* effect of trade cooperation on the interest groups' income thus translates into domestic *political* costs and

benefits for the government. Following the theory of domestic political support (Stigler 1971; Peltzman 1976; Hillman 1982) we argue that it is the governments' goal to at least balance the marginal domestic costs and benefits arising from trade policy (Pahre 1998).¹²

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

[figure 3 about here]

It is well known that a PD entails an *enforcement problem* since there is an incentive to defect from the mutually cooperative outcome. As will be shown, this enforcement problem affects institutional choice, but it does *not* inhibit cooperation. The reason is that here the strategic structure of a PD does *not* derive from the non-excludability of the object of cooperation, as is often assumed in research on enforcement (cf. Barkin 2004: 364). On the contrary, if defection occurs it can be reciprocated by raising one's own barriers to trade. Punishment can be directed towards the defecting country since it is possible to increase only the trade barriers for imports from the defector. Consequently, sanctioning does not impose any costs on cooperators, as would be the case in a public good-PD (Oye 1985: 19-20). Moreover, the shadow of the future in commercial cooperation is long (Hoekman and Kostecki 2001: 111), if not infinite. Thus, whereas cooperation is possible, the incentive to defect does nevertheless exist. Trade policy during the Great Depression shows that in the face of economic crisis countries might prefer defection to continued cooperation (cf. Gourevitch 1986; Kindleberger 1989). In order to shelter the domestic economy from import competition many countries

abandoned unconditional MFN treatment and turned to a discriminatory trade policy. This step effectively deepened the crisis (cf. Conybeare 1987). Because of the devastating consequences of discriminatory trade policy unconditional MFN treatment was made mandatory in the GATT (Wilcox 1949: 18-19). MFN obligations do not rule out retaliatory spirals and tariff wars, but these are in any case less likely since discriminatory treatment among importers is impossible (Jackson 1997: 169). Unconditional MFN treatment does help overcome the enforcement problem arising from the PD, which, in turn, has its roots in governments' concerns over distribution. In effect, MFN provisions introduce *publicness* into trade cooperation precisely because it makes discrimination impossible. As it will be shown in the following sections, this effect has important consequences for institutional choice at the bargaining and agreement stages. In order to understand this impact, it will be necessary however to explain first the influence of distributional concerns on institutional choice. Before proceeding further, we first derive the strategic structure of tax cooperation.

b. Taxation

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

This is in contrast to the problem of lowering tariff barriers, where unilateral "relief" is the rare exception, even though states also have a common interest in lowering trade barriers. There are two domestic level reasons for this difference: first, unilateral relief in taxation is

granted to a country's own residents, whereas lowering trade barriers gives relief to foreigners to the disadvantage of domestic producers. One can expect countries to be more willing to forgo taxation, if their own residents profit from this relief. Second, there is no domestic pressure group that suffers from the unilateral relief a country offers. Unilateral relief effectively entails giving up tax revenue (Whalley 2001). While this might have consequences for public spending, it negatively affects a country's entire population. However, following Olson (1965), we assume that such a big group cannot exert effective political influence. Therefore, the incentive to offer double tax relief in order to reap the long-term benefits of economic liberalization is not mitigated by the domestic concerns prevalent in trade.

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

The second and more important advantage of treaty formation lies in countries' concerns over the *distribution* of tax revenues and other economic benefits. Overall, the structure of the 'double tax avoidance game' is that of a *coordination game with a distributive conflict*: We have a situation where adopting unilateral relief is always preferred to not relieving double taxation, but doing so leaves tax revenue to the source country and the residence country's investors face a considerable tax burden in the source country. The residence country only

achieves its second best outcome. It would be even better off, if double taxation were avoided and the right to tax were assigned to itself. Given its willingness to unilaterally grant double tax relief, the residence country still has an incentive to limit the right to tax of the source country for two reasons. First, a low withholding tax abroad reduces the tax burden of its investors and can improve the competitiveness of its multinational corporations. Second, if the source tax is lowered, countries using the credit or deduction method to avoid double taxation can collect the residual taxes on the foreign income.¹⁵ The desire to change the distributive consequences of unilateral relief is the decisive motive of countries to conclude double tax agreements. Thus, while the parties have a common interest in reaching an agreement in order to realize the Pareto improvements inherent in treaty formation, there is also a distributive conflict built into the negotiation of the treaties: Who gets how much of the tax revenue? And what is the tax burden for my resident investors abroad?¹⁶

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

Staying Small: Bilateralism in Bargaining

We argued above that the enforcement problem inherent in trade can be overcome and that there is no such problem in taxation. Bargaining thus gains in importance in the cooperation process (Fearon 1998).

a. Trade

The domestic scenario described above translates itself into *distributive bargaining* at the *international* level. The gist of the problem lies mainly in reaching an agreement that would create a domestic balance between the political costs and benefits caused by import-competers and exporters. A trade concession given by a country implies costs for domestic import-competers and benefits for foreign exporters. Correspondingly, a received concession benefits domestic exporters and disadvantages foreign import-competers. Therefore, the task of the bargaining governments is to exchange requests and offers as long as in each country the benefits are equal to or exceed the political costs (or the governments believe that such a bargain is not feasible).

The preference for bilateralism at the bargaining stage can be explained by reference to the governments' high concerns about distribution. Bilateralism is the institutional mode by means of which governments can best negotiate agreements where costs are equal to or, even better, lower than political benefits. A simple example makes this link between concerns over distribution and bilateral bargaining clear. For reasons of illustrative convenience we first assume that MFN provisions are absent. Imagine that there are three countries A, B and C. The tariff levels of these countries are 30 %, 30 % and 100 %. Each country is importing goods from the other two countries (thus each country also exports goods to the two other countries). All countries are seeking an agreement with each other. A linear tariff cut – in our terms a multilateral bargaining approach - of 20 percentage points for example would ease

market access for Cs exporters. However, Cs tariff would still be high, namely 80 percent. This tariff would still be rather high and As and Bs exporters would not benefit much from Cs reduction. A mutual reduction of 20 percentage points thus would produce a negative domestic effect for A and B. These two countries could agree on a mutual reduction of 20 points since initial tariff levels are identical, but not A respectively B and C. The concessions countries offer and demand depend on *dyadic* characteristics. In this case a multilateral bargain should be difficult to achieve since A and B expect C to make a higher concession. Multilateral bargaining would only be achievable if C is willing to reduce its barriers to trade more than A and B. Thus, multilateralism is fundamentally incompatible with the governments' pursuit of domestic balances at the bargaining stage. This incompatibility can be seen in the failed attempts of the USA and the EC to agree on a formula approach (a two-actor bargain about a linear cut of multiple items is equivalent to a multi-actor bargain about one item). From the European perspective, highly unequal tariffs deserved unequal treatment, i.e. a harmonizing formula. In contrast, US negotiators sought a uniform cut because their comparatively high tariffs would have remained high after a linear cut.

b. Taxation

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

different from that with D. The two graphs below illustrate the double tax avoidance game for countries with asymmetric and symmetric investment flows.¹⁷

[figure 4 about here]

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

The argument that conflict over distributive issues inhibits multilateral bargaining on one precise sharing rule can be supported by an empirical analysis of the double tax agreements concluded between states. The central provisions of the typical tax treaty concerning the extent of source taxation are the withholding tax rates on passive investment income (dividends, interests and royalties, articles 10 to 12 of the OECD model convention). First, the empirical evidence shows that the withholding rates negotiated in bilateral treaties are considerably lower than the withholding rates contained in domestic tax codes (Chisik and Davies 2004b: 114). Given the residence country's willingness to grant unilateral double tax relief, this indicates that the function of tax treaties is to 'correct' the withholding rate and the distribution of tax revenues that would result from the unilateral relief interaction. This concern for distribution is typical for coordination games (Krasner 1991; Martins and Simmons 1998). Second, there is considerable variance in the withholding rates negotiated in different bilateral treaties. It can be shown that this variance fits our model of the double tax avoidance game quite nicely in that the withholding rates are higher if the capital positions of the two countries are asymmetric.¹⁸

Bringing Down Transaction Costs: Multilateralism in Bargaining

a. Trade

As the empirical analysis showed, there is no complementary multilateral bargaining in trade, but bilateral bargaining was partly substituted by multilateralism. Both observations can be explained by reference to the experience of the Great Depression. As many argue, protectionist trade policies pursued towards the end of the 1920s contributed to the worsening of the Depression (e.g. Kindleberger 1989). The deep conviction in the necessity of limiting flexibility in commercial relations explains why multilateral bargaining on GATT rules generally did not take place after their creation in 1947.¹⁹

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

Balancing concessions in bilateral MFN negotiations is a complex task. The more countries are involved in a multilateral GATT trade round, the more bilateral bargains are interdependent. Though it is not impossible to arrive at balanced bargains, transaction costs are high

under MFN treatment (cf. Pahre 2001).²⁰ Theoretically, multilateral bargaining can reduce transaction costs. In this case all states bargain about a formula cut applying to all goods instead of bargaining in multiple dyads that are linked by MFN treatment. However, as it has been shown, multilateral bargaining is not a viable institutional mode if concerns for distribution are strong. If negotiators put much emphasis on distribution, transaction costs do not decrease when bargaining about a formula approach. As long as concerns for distribution are high it is virtually impossible for GATT members to apply a pure formula approach. The empirical record in fact shows that exemption lists were of considerable size in the Kennedy and Tokyo Round (Evans 1971; Winham 1986). Transaction costs therefore remained high, despite the introduction of substitutive multilateralism. Moreover, domestically insensitive items that could generally be made subject to a formula cut, gain in importance since they can be employed as bargaining chips on more sensitive items. These two issues set limits to a decrease in transaction costs due to multilateral bargaining. We argue that the trade-off between the salience of distributive bargaining and concerns about manageable transaction costs explain the bilateral-multilateral mix. Effectively, a bilateral-multilateral mix is the most efficient approach to trade bargaining, if governments have distributional concerns on some, but not all items. Transaction costs are lower than under a pure bilateral item-by-item approach and, at the same time, allows GATT members to exempt sensitive items in order to achieve a domestic balance.

b. Taxation

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

Due to the nature of the double tax avoidance game, one can expect very tough bargaining in these bilateral treaty negotiations. This is due to the fact that there is no enforcement problem in double tax avoidance, while at the same time the distributive conflict is strong. Under this combination countries have an incentive to hold out quite long before coming to a favorable agreement, because they know that the agreement, since it can be enforced easily, will stick for quite a long time (Snidal 1985a: 936; Fearon 1998: 270-71). In order to moderate this bargaining intensity countries have an interest in constructing a focal point for bilateral negotiations. Such a focal point serves to ensure that bilateral treaty negotiations have some point of common departure, which limits the potentially endless possibilities for allocating jurisdiction to tax. These focal points are defined as social conventions that are not questioned but rather followed ‘automatically’, because they have become self-evident (Schelling 1980: 54-80). However, as has been detailed above, there is no self-evident solution to the distributive conflict about the allocation of taxing rights. Neither the academic, nor the political debate about the proper allocation of jurisdiction to tax to the residence or source country has ever been settled. Therefore, states engaged in the intentional creation of a focal point.

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

countries with relatively symmetric capital flows. Therefore, the distributive conflict between these countries is not very strong.

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

Avoiding the Free Ride: Multilateral vs. Bilateral Agreement

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

a. Trade

MFN obligations affect institutional choice at the bargaining stage by increasing the transaction costs of bilateral bargaining. In addition, MFN treatment influences institutional choice

during the agreement stage. Since MFN provisions introduce publicness into trade cooperation an incentive is created for *free-riding* on the concession-making of third countries. The possibility to free-ride derives from unconditional MFN treatment since this effectively introduces publicness into trade cooperation (Hoekman and Kostecki 2001: 119). Free-riding is a problem that can occur *ex post* if a country defects from a previously agreed upon cooperative outcome. However, free-riding in trade can also occur *ex ante*. In this case a country just “lays back” and watches the concession making activity of other GATT members. Since concessions are generalized through MFN treatment, it receives concessions without having to make any. This behavior is effectively a form of free-riding without defection, since the respective country never agreed upon an outcome it could defect from. Multilateral agreement is an institutional safeguard by means of which free-riding can be prevented. After all bilateral bargains have been settled, each member country can consider the bargains made in conjunction, taking into account their effects given MFN obligations. If one country believes that another GATT member intends to free-ride on its concession-making, it can withhold some of the concessions previously granted, insist on concessions by the potential free-rider or renegotiate some bilateral deals.²²

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

b. Taxation

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

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

It can be speculated whether the issue of international tax avoidance and evasion will force countries to switch to multilateralism in the agreement stage in the future. It can be shown that the issue of tax avoidance introduces an enforcement problem that can only be addressed effectively multilaterally, because of its underlying problem structure as an asymmetric prisoners' dilemma (cf. e.g. Dehejia and Genschel 1999). Actually, in response to the problems of tax avoidance and "tax arbitrage" the OECD has initiated its "harmful tax practices pro-

ject” (OECD 1998) that is the first broad multilateral effort at curbing tax evasion and avoidance (for an overview see Rixen 2007a). However, it is more likely that this initiative will leave the bilateral tax treaties untouched and rather aims at constructing a kind of multilateral support structure, which is distinct from the tax treaty network.²³ While it is true that a more principled solution would integrate the two problems of double tax avoidance and tax evasion in an “international tax institution structured like the GATT” (Vann 1991: 100), it seems unlikely that the institutional trajectory of bilateral tax treaty making can be left – at least in the short run.²⁴ However, since the international efforts to curb tax avoidance and evasion are very recent and have not been firmly institutionalized, it is too early to come to definite conclusions about their impact on the institutional form of the double tax regime.

CONCLUSION

In this paper we have addressed the question why the international trade regime is multilateral, whereas the international tax regime is bilateral. Two important conclusions emerge from our explanation. First, a dichotomous classification of the two regimes as multilateral respectively bilateral misses out on some important similarities between them. We have showed that there is more multilateralism in taxation and more bilateralism in trade than is generally perceived to be the case. In taxation the multilateral model convention is very influential. A high degree of uniformity between the different bilateral treaties and a quite solid multilateral consensus on the rules of international taxation was achieved. The effective multilateralism is in contrast to the general perception of the tax regime as a paradigmatic case of bilateralism. This multilateralism was achieved, because the overall nature of the game as a coordination game facilitated the diffusion of the ‘standards’ laid down in the model convention. By contrast, bilateralism is more important in international trade than the simple characterization of the regime as multilateral would lead one to expect. Bilateral bargaining is vital

for countries seeking to realize their concerns over distribution. However, unconditional MFN treatment drives up transaction costs. GATT members thus followed multilateral bargaining where possible in order to reduce transaction costs. Overall, both regimes exhibit a different mix of bilateral and multilateral bargaining.

Second, despite these similarities, one important difference between the two regimes remains: agreement is bilateral in taxation, whereas it is multilateral in trade. This dissimilarity is due to diverging interactions of concerns over distribution and enforcement problems in the two fields. Concerns regarding the distribution of benefits create a private good PD in trade, whereas a coordination game results in taxation. The risk of retaliatory spirals inherent to trade cooperation is mitigated by unconditional MFN treatment. MFN obligations, in turn, make trade cooperation a public good which gives rise to free-riding that is countered by multilateral agreement. The absence of MFN treatment in the tax regime renders protection against free-riding unnecessary and agreement can thus be bilateral. To sum up this point: while the two regimes have the same economic rationale, i.e. economic liberalization, the domestic political structures connected to this goal are quite different in the two issue areas. Ultimately, it is this divergence that explains the different patterns of agreement characterizing the two regimes.

Our main concern was to explain the institutional similarities and differences in the trade and tax regimes. However, our findings also allow us to draw some general conclusions about institutional choice between bilateralism and multilateralism in international relations. In the literature it has been hypothesized that distributive conflicts in bilateral bargains can be solved by increasing the number of bargaining actors (Koremenos, Lipson and Snidal 2001: 784-85; Sebenius 1983: 309-12). According to our findings in the field of trade and taxation this hypothesis deserves qualification. Theoretically, a bargaining stalemate between two countries can be overcome by adding a third country to this bargain. This, however, will only

work when adding a new party does not create new distributive conflicts between the two old and the “new” parties. If the distributive conflict depends on dyadic characteristics, it will be even more difficult to reach an agreement. Thus, the precise conditions under which an increasing number of participants enhances or worsens the chances for agreement need to be further specified.

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

However, it can be hypothesized that multilateralism might become the preferred choice in the face of enforcement problems. More particularly, it can be speculated that cooperation on *non-excludable* goods is biased toward multilateralism in the bargaining and agreement stage. As shown in our analysis of trade cooperation, under MFN treatment multilateral agreement is necessary to prevent free-riding. In addition, multilateral bargaining becomes more likely under non-exclusion since there is little gain in holding multiple bilateral bargains if third countries cannot be excluded from the outcome of the bargain. Non-excludability thus can be assumed to be a factor overriding concerns over distribution in determining institutional choice. Cooperation on non-excludable goods has been intensively researched during the last 20 years (see for example Barkin 2004; Oye 1985; Snidal 1985). The major point of concern was if cooperation could be established at all because of non-excludability of free-riders. Bilateralism and multilateralism did not explicitly play a role in these studies. However, there is the implicit notion that *if* cooperation can be established, it will be multilateral.²⁵ If the goal is

to explain whether cooperation does come about, then studying cooperation on excludable goods is certainly a less interesting endeavor (Barkin 2004). However, comparing cooperation on excludable and non-excludable goods is indispensable if one aims to understand institutional choice for bilateralism and multilateralism. A useful line of future inquiry seems to be the analysis of institutional choice under three different scenarios: (1) excludable goods where the strategic structure does not involve an enforcement problem (e.g. double taxation), (2) excludable goods where the strategic structure does involve an enforcement problem (e.g. trade), (3) non-excludable goods (e.g. environmental protection). A systematic analysis of institutional choice under different kinds of goods and strategic structures is a promising research avenue for a better understanding of bilateralism and multilateralism in international relations. Our comparison of trade and tax cooperation makes a first step into this direction.

ENDNOTES

Authors' Note: We received helpful comments from Hans-Jürgen Bieling, Claudia Bogedan, Philipp Genschel, Achim Helmedach, Robert Pahre, Frank Schimmelfennig, Holger Stritzel, Susanne Uhl and Dieter Wolf and an anonymous reviewer. Laziz Alidjanov, Julia Grieb, Stefanie Möschk, Vanina Nikolova, Dana Trif and Irina Wiegand provided research assistance. We thank all of them. The usual disclaimer applies. Generous funding from the German Science Foundation (DFG) is acknowledged.

¹ A particularly ironic critique in this respect can be directed towards early game-theoretic regime research that used two-person games to analyze multilateral cooperation. Even though the bilateral form of the games would suggest otherwise, one hardly finds an explicit discussion of bilateralism in this work. Some of the scarce exceptions in the earlier literature are Oye (1985) and Snidal (1985a).

² The disregard of bilateralism in IR theory cannot be explained with the empirical irrelevance of this category. The United Nations treaty databank has collected 5130 bilateral treaties adopted from 1990 to 1999 (United Nations 2003). This figure is only the lower bound of all bilateral agreements signed in this period because states are not obliged to deposit their treaties with the UN. For a more detailed discussion of the shortcomings of cooperation theory with regard to the choice of bilateralism and multilateralism, see Odell (2000).

³ The differentiation of cooperation into two stages, bargaining and enforcement, is common in the literature (cf. e.g. Fearon, 1998; Koremenos Lipson and Snidal 2001). Sometimes, bargaining is referred to as “ex ante” problem of cooperation, whereas enforcement concerns “ex post” problems (Williamson 1985). We add ‘agreement’ to this differentiation, because it is the natural dividing point between bargaining and enforcement. Martin (1993) suggests a similar conceptualization.

⁴ Even though we do not deal with the enforcement phase on the dependent variable, enforcement problems do play a major role as independent variable. Since actors will know *ex ante*, whether an agreement can be enforced or not, this fact has implications for bargaining and agreement. Problems of enforcement do not only influence the design of enforcement institutions, but also the design of bargaining and agreement. It is only this latter connection that we focus on.

⁵ Geneva (1947), Annecy (1949), Torquay (1950-51), Geneva (1956), Dillon Round (1961), Kennedy Round (1964-67), Tokyo Round (1973-1979), Uruguay Round (1986-94). Even though recent years have seen a proliferation of regional cooperation outside of the GATT/WTO, we decided to focus exclusively on cooperation *within* the multilateral framework because we think that this yields many interesting observations that have not received due theoretical attention compared to regional cooperation (cf. Mansfield 1999). Moreover, it is possible to frame the question of regionalism in terms of bilateralism and multilateralism. A look at the WTO's database on regional agreements (WTO 2007) shows that almost all regional arrangements are bilateral. Only few agreements, e.g. the MERCOSUR, are multilateral. Hence, our bilateral-multilateral framework is generally able to deal with regional trade cooperation.

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

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

⁸ To be more precise, the USA wanted to exempt some domestically sensitive items from the linear cut. However, since the EC had adopted a similar agenda exempting particular items from the formula approach was not even a disputed issue among them.

⁹ Both residence and source principle can be justified on certain grounds. The basic question is what kind of *nexus* between a taxpayer and a state justifies the state's right to tax. Several theories have been suggested, for example *economic allegiance*, *administrative efficiency* or *territoriality*. In terms of economic efficiency, *capital export neutrality* would be achieved under residence taxation, whereas *capital import neutrality* requires source taxation (cf. e.g. Frisch 1990). Likewise, different conceptions of fairness have divergent implications. Residence taxation is justified by the principle of *ability to pay* (Seligman 1928), source taxation by *inter-nation equity* and the *benefit theory* (Musgrave 1991). Li (2003 chapter 2) provides a good and accessible overview of the debate with further references on all these considerations.

¹⁰ Consumers are a third group affected by trade policy that benefits from low tariffs. Following Olson's *Logic of Collective Action* (Olson 1965) we assume that consumers face a collective action problem and that they do not organize in order to push for unilateral trade liberalization (Baldwin 1996: 148-49).

¹¹ Under certain conditions domestic producers seeking cheap input factors might also prefer liberalization or protectionism *conditional* on the trade policy of third countries (Milner and Yoffie 1989). In this case, the situation is identical to the conflict of interest between exporters and importers and hence not explicitly discussed here.

¹² The fact that governments are concerned with the domestic impact of trade cooperation has been discussed so far in numerous studies (Evans 1971; Winham 1986; cf. Aggarwal, Keohane and Yoffie 1987; Milner 1999).

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

¹⁴ Yoo (2003) presents tables that give an overview of the relief methods on the two most important kinds of international income, dividend and interest payments, as used by OECD member countries in 2001.

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

¹⁶ The withholding rate on investment income that is at the heart of the distributive conflict is actually the one aspect, where there could be a minor enforcement problem in tax treaty making. Just as the residence country has an interest in a low withholding tax, the source country should have an incentive to levy a high withholding rate. Thus, the source country could have an incentive to defect from the treaty rates on investment income (Green 1998: 115-17; cf. Chisik and Davies 2004b). This incentive does not, however, invalidate the argu-

ment that the overall strategic structure is that of a coordination game. It can be shown that this is the typical “enforcement problem in the small” that is part of every coordination game with a distributive conflict (cf. Snidal 1985a: 933-34). Besides that, source countries’ concerns to attract foreign direct investment (FDI) will also mitigate their propensity to set high withholding rates.

¹⁷ The diagram illustrates the Pareto improvements inherent in unilateral relief over no double tax relief and the Pareto benefits of treaty relief over unilateral relief. If there weren’t any additional gains to be realized through the treaty, the advantaged state in the uncoordinated interaction would not have reason to commence treaty negotiations. The disadvantaged country can include the withholding taxes in the bargaining process, because the other country is dependent on its cooperation in order to realize the extra gains of treaty formation. The distributive consequences of the ‘unilateral relief interactions’ are changed through the treaty (cf. Chisik and Davies 2004a: 1124-25).

¹⁸ Chisik and Davies (2004a) regressed the withholding rates of US tax treaties with other countries that were concluded between 1966 and 1999, and the withholding rates of treaties between all OECD members in force in 1992 on the foreign bilateral investment positions. They have specified several models using both stock and flow data of bilateral FDI and find that the correlation is significant under all specifications.

¹⁹ To be sure, the GATT still grants flexibility to members’ trade policy by allowing exemptions from GATT obligations under certain conditions (Ruggie 1982: 397). However, flexibility is much more restricted as compared to the pre-GATT time (Irwin 1993: 99-101).

²⁰ One might argue that the transaction costs of bilateral bargaining are low if the involved countries are asymmetric because the large country can impose its will on the small country. We do not deny that large countries might employ their bargaining power in bilateral settings.

Nonetheless, MFN treatment keeps transaction costs high since bilateral bargains are interlocked. The concessions a big country reaps from a small country have to be extended to other large countries that do not have to return a concession. Hence, the problems of bargaining under MFN-treatment are also present in asymmetric settings.

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

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

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

²⁴ While the enforcement problem inherent to the problem of tax competition and tax avoidance led to efforts at layering additional institutional arrangements onto the network of

bilateral treaties, the treaties themselves are left unchanged because there are certain mechanisms of institutional reinforcement at work (Rixen 2007b, chapter 8). One aspect that makes institutional reform difficult is the resistance of business interests against more effective regulation of tax competition.

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

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FIGURES

Figure. 1: Three Stages of the Cooperation Process

Figure 2: Institutional Choice in the Bargaining and Agreement Stage in Trade and Taxation

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

Figure 3: Prisoners' Dilemma in Trade Cooperation

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

Figure 4: The Double Tax Avoidance Game