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COORDINATION AND LEGITIMACY IN INTERNATIONAL BUSINESS TAXATION

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ABSTRACT

This paper will outline the changing forms of cooperation between national tax authorities in the taxation of income or profits from international business, especially transnational corporations (TNCs). The case study will illustrate broader trends of transformation both of statehood and the international state system, from the classical liberal model based on interdependence and coordination of nation-states through central governments, towards a post-liberal one of decentred multi-level global governance, in which state functions are increasingly fragmented, and coordination is increasingly by international regulatory networks.

Direct taxation of income and profits has been the centrepiece of the modern fiscal state during the past century, when the internationalization of business, especially through transnational corporations (TNCs) helped to transform the world economy. In response to the first phase of emergence of TNCs (1870-1914), arrangements were developed for allocation between states of rights to tax business income (1920-1945). These were consolidated after 1950, and helped to lay the basis for the rapid growth of foreign direct investment by TNCs in the 1950s and 1960s. Increasing strain has been placed on these arrangements for coordination in the past thirty years, both by the increased integration of international business, and the greater complexity of international finance, especially with the emergence of tax havens and offshore financial centres. The various initiatives to strengthen international tax coordination are examined, focusing especially on the problems of (i) legitimising cooperation based on governmental and professional networks, and (ii) coordination between taxation and related regulatory issues, especially supervision of financial institutions and markets (e.g. money-laundering, financial fraud, and prudential supervision).[?]

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A. TRANSFORMATIONS OF THE FISCAL STATE

Taxation is key to the character and functioning of the state, economy and society. It is often regarded, together with defence, as the touchstone of state sovereignty. Hence, changes in the forms of taxation provide a good indication of changes in the form of statehood.

The emergence of the modern capitalist state as a fiscal state, a concept developed in rather stark form by Schumpeter (Musgrave 1992), has been revised and traced in more detail by recent historical analysis (Bonney 1999). In broad terms, this sketches a transition from the feudal `domain state', in which extraction of economic surplus by the ruler did not distinguish between the public and the private. The emergence of the state as an autonomous `public' realm separate from the `private' sphere of economic activity importantly entailed struggles over taxation. Hence, the state in early modern Europe has been described as a `tax state', and certainly the ability to extract revenues, especially for military purposes, was the key to the effectiveness and power of states. Britain's success in establishing a `fiscal-military state' in the 18th century has been contrasted with the tax revolts and crises of France, where the fiscal crisis eventually sparked the French revolution (Daunton 2001: 7).

In effect, Britain was able to lead the way in establishing the modern `fiscal state', with a system of managing taxation and expenditure that was accepted and therefore effective. The need for taxation to be both legitimate and efficient was underpinned by the analyses of political economy, expressed most famously in Adam Smith's four `canons' of a good tax system (equity, certainty, convenience and economy)[1] which are still put forward today. The views of enlightenment thinkers such as Smith entailed a critique of the tax systems of the absolutist monarchies which, although they had been a key element in the formation of centralised states, were experienced as capricious and oppressive. Indeed, Britain's failure to legitimise taxation by extending representation in its overseas possessions (which was advocated by Smith) led to colonial revolts, one of which overthrew British rule in North America. Although enlightenment ideas about the basis of legitimacy of the state differed, they generally agreed that the state's central role was to safeguard its citizens and their property (Frecknall Hughes 2004). In Britain, economic growth and the absence of major wars during the 19th century enabled Peel and Gladstone to fashion a strong `fiscal constitution', establishing a high degree of mutual trust between government and taxpayers, based on restraint and efficiency in public expenditure and a shift to direct taxation of income on the principle of proportionality.[2]

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[1] *Wealth of Nations*, Book IV, Ch.II, Part II.

[2] Daunton 2001: 26-30. Fiscal discipline rested on firm Treasury control of expenditure based on the introduction of a clear and uniform accounting system, and principles of fiscal probity which Gladstone considered `at the root of English liberty'. These were, notably, budgetary unity (the rejection of hypothecated taxes), annual parliamentary votes to approve specific budgetary heads with no discretion for government to vire among them, no carry-forward of end-of-year surpluses, and no pledging of future revenue to finance spending (ibid. 66-76).

Significant further changes were necessary to cope with the needs of the welfare-warfare state of the 20th century, during which state expenditure rose from around 10% to some 40% of GDP in developed countries. The centrepiece of the modern fiscal constitution has been the income tax. This was described by Schumpeter as the quintessential `tax of bourgeois liberalism', although his view that the shift to large-scale economic activity and increased public expenditure would create a `fiscal crisis of the state' was belied by its transformation into a mass tax (Musgrave 1992). The principle of proportionality was modified by an acceptance of graduation, or higher tax rates on higher income, justified by the concept of ability to pay developed by marginalist economics (Daunton 2001: 144). Although this has greatly helped to legitimate income taxation, and seems to be surviving current debates about a `flat tax', there has always been a potential threat due to the inequities when applied to different types of income. Collection has always been more effective where tax can be deducted at source, or from income which is easily verifiable, such as a regular wage or salary. It has been more difficult, and the liability subject to contestation, for income from capital, from business, or from a self-employed trade or profession. Indeed, the very concept of income has been continually contested (Daunton 2004), both in direct interactions between tax officials and taxpayers or their advisers, and in wider public debate.

The problem of legitimacy of income taxation has been a key factor in the crisis of the Keynesian fiscal state since the mid-1970s. In many countries wage-earners became increasingly reluctant to accept tax burdens which they perceived as inequitable, especially due to the greater effectiveness of collection at source (and in advance, via pay-as-you-earn) from employment income, compared with the many opportunities for avoidance available for some types of income from capital, business or self-employment. On the other hand, it has been argued that tax burdens on business or on high earnings hinder entrepreneurship and discourage achievement. At the same time, economic liberalisation has undermined the foundations of national tax systems, and created pressures on states to reduce taxes, especially on capital income (Avi-Yonah 2000, Tanzi 2001). These forces have led to many attempts at reforms both of tax policy and administration.

Policy reforms have generally entailed reducing high marginal rates of income tax while trying to broaden the tax base by ending tax breaks and combating avoidance, as well as widening the tax net by introducing new sources of revenue such as sales and transaction taxes. Although the virtues of tax `neutrality' have often been extolled, in practice tax rules have been extensively used for social engineering purposes, producing an ever-growing volume of complex rules, and attempts at structural reform of income taxes have largely failed. In the absence of structural reform, there has been an introduction of new managerial techniques into tax administration, which has become more professionalised, with revenue authorities often being given greater autonomy from government, although within a defined remit. The aim is to rebuild the confidence and trust of citizens in public services, mainly through technocratic approaches to efficiency. However, as tax administrations are being asked to do more with fewer resources (to achieve `efficiency gains'), there has not surprisingly been talk of a crisis in tax administration (Aaron & Slemrod 2004: 2-4).

It may be said that in taxation, as in other areas of governance, there has been a transition to a new regulatory state.[3] Many state functions have been delegated to autonomised public bodies working within a culture of service delivery, with corporate plans, customer charters, and performance targets (Hamilton 2003). The aim is to rebuild the confidence and trust of citizens in public services, mainly through technocratic approaches to efficiency. It entails new forms of networked interaction and relationships between the so-called public and private spheres . In place of the top-down model of action by a centralised state, the fragmentation of the public sphere results in networks operating through new kinds of regulation which are more diverse and interactive, or `reflexive'.

B. NATIONAL TAXATION OF INTERNATIONAL BUSINESS INCOME

The introduction of income taxation by national states took place in a period when the leading capitalist economies were already highly globalised, through extensive flows of both trade and investment.[4] The issue of tax jurisdiction throws into sharp relief the contradictions of the national state in the classical liberal internationalist system. From the beginning, the application of national taxes to income which might derive from international business, raised issues of the scope of national taxation and possibilities for international coordination. Even if tax jurisdiction is territorially-based, an income tax may still produce overlapping jurisdictional claims, since it may be applied both to persons within the territory and to income earned within the territory paid to a person outside it. The UK, which pioneered the income tax, applied it to residents on income from all sources, as well as to non-residents on income earned from UK sources. When the US introduced a federal income tax after ratification of the 16th amendment to the Constitution in 1913, it applied to citizens on income from all sources, and to US-source income.

Differences in national approaches to defining which persons should be subject to income tax also created potential jurisdictional overlaps and conflicts, as well as possible competitive inequalities between firms operating in the same markets. For example, the US citizenship basis, when applied to firms, covered only US-incorporated entities, and did not apply to a US-owned foreign subsidiary. In contrast, the UK tax applied to residents, which raised several questions: when should a company be regarded as `resident' in the UK, and what income should be regarded as attributable to a company, as well as how to characterize such income (due to the schedular structure of the UK

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[3] Many writers have used the term or the general concept (notably Teubner 1987, Majone 1993, Pildes and Sunstein 1995, Loughlin 1997, Braithwaite 2000, Scott 2000), and with different actual states in mind; clearly the changes are far from uniform but vary greatly between different national contexts (for a recent comparative overview see Jordana and Levi-Faur 2004). Nor do they lead to a settled or even clearly identifiable outcome: indeed, Michael Moran argues that a key feature, at least of the British regulatory state, is `hyper-innovation' (Moran 2003). Most recently, John Braithwaite has explicitly applied the concept to the area of tax administration (J. Braithwaite 2005).

[4] Indeed, income taxation facilitated a shift away from reliance on high tariffs, so potentially encouraging trade.

income tax).[5] The concept of residence has never been defined by statute in the UK, but the courts developed the test of `central management and control', which since a company is considered to be managed by the directors on behalf of its shareholders, was taken to mean the location of the meetings of the board of directors.

This meant that companies financed from London but carrying out operations abroad, of which there were a great many in the heyday of the City of London as the centre of world finance, were taxable in the UK on their worldwide profits. This was starkly illustrated by the leading case of *De Beers* (1906), in which the House of Lords held that the De Beers mining company, which was formed under South African law and had its head office, general meetings and all its mining activities there, was nevertheless a British resident, since `the directors' meetings in London are the meetings where the real control is always exercised in practically all the important business of the company except the mining operations'(*De Beers* 1906: 213). Some of the judges had shown an awareness of the international implications of the question. Thus, in 1876 Chief Baron Kelly remarked that the issue involved `the international law of the world', since many of the shareholders were foreign residents, so that much of the earnings of the company belonged to individuals not living in Britain and therefore `not within the jurisdiction of its laws'. However, he contented himself with the thought that if such foreigners chose to place their money in British companies, they `must pay the cost of it' (*Calcutta Jute* 1876: 88).

The issue looked very different from the viewpoint of some of the leaders of British international business. This was expressed perhaps most clearly by Sir William Vestey, who was to become well-known in UK tax law, and who with his brother had built a corporate empire from a grocery firm by importing dried eggs from China and frozen beef from Argentina. He argued for fairness in relation to his international competitors, especially the Chicago Beef Trust, which paid no UK tax by being based abroad and consigning its shipments to independent importers in the UK. He proposed a global approach based on the proportion of sales in each country:

> `In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad. That is why I suggest that you should pay a turnover tax on what is brought into this country. ... It is not my object to escape payment

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[5] Different categories of income were (and still are) taxed differently according the Schedule and Case to which they might be attributed; in particular income or profits of a trade were taxable as they arose, while income from securities or possessions were taxable only when remitted to the UK. Thus, UK shareholders of a foreign-resident company would only be liable for UK tax on dividends remitted to the UK; whereas if the company itself were regarded as UK resident, its worldwide trading profits would be regarded as directly taxable in the UK. For further details of the court decisions and interpretations involved see Picciotto 1992, 6-8.

of tax. My object is to get equality of taxation with the foreigner, and nothing else.'[6]

However, the British state was reluctant to modify its claim to tax all British residents (and companies based in the UK) on all their income, except by international agreement. The issue was taken up by the League of Nations through a Fiscal Committee, which commissioned two reports, first from economists and then tax experts, leading to a diplomatic conference in 1928. The result fell short of the multilateral agreement which some had hoped for, but took the innovative form of model tax treaties, which could be used as a template for bilateral treaties between states, with modifications to suit their tax systems and the capital flows between them. The Committee subsequently commissioned a study on the difficult issue of `allocation of business income' (later termed Transfer Pricing), which was carried out by Mitchell B. Carroll, the US representative, who visited 35 countries, meeting both officials and business representatives.[7] This study resulted in another model convention, on allocation of business income, which later was incorporated into the basic income tax treaty model (see generally Picciotto 1992, ch. 1).

The approach adopted in the model treaties was to allocate rights to tax between the home and host states of international investors. As regards foreign direct investment by TNCs, a host state could tax the business profits of a local subsidiary, as well as those of a local office or branch of a foreign firm, provided it fell within the definition of a Permanent Establishment. To prevent double taxation, the treaty should oblige the home state either to exempt foreign-source income, or allow a credit for taxes paid in accordance with the treaty.

This approach preserved to the maximum the freedom of each state to define its own income tax system, while establishing sufficient coordination to facilitate economic flows between states. The form of international cooperation it entailed was minimal and also reinforced national state sovereignty, since it required no commitment to an overarching multilateral arrangement or even any agreed international principles for defining or allocating the tax base of internationally-operating businesses. Thus, it fell significantly short of the approach suggested by William Vestey. In particular, the Carroll report resulted in an emphasis on taxation of the components of a TNC (subsidiaries and branches) on the basis of separate national accounts, treating each component as if it were an independent business, based on the so-called `arm's length' criterion. This left

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[6] UK Royal Commission on Income Tax 1920, Evidence, p. 452, Question 9460.

[7] The study was funded by a $90,000 grant by the Rockefeller Foundation. Carroll had been partly educated in Europe, and worked for the Department of Commerce on taxation of US business in Europe; he was instrumental in persuading the US to participate the Fiscal Committee, and accompanied Prof. Adams, the Treasury's Economic Adviser, to its meetings in 1927-8. He chaired the Fiscal Committee between 1938 and 1946, during which time it consolidated the model treaties which it bequeathed to the UN and later the OECD, while at the same time taking a leading part in founding the International Fiscal Association, of which he became the long-serving first President (Carroll 1978, Picciotto 1995 41-43).

legitimation of business profits taxation to each state, by avoiding the need for international agreement on an allocation formula.

This reinforcing of the national basis of income taxation created a disjuncture with the international-integrationist economic logic of TNCs. The problem was well understood by the technical specialists, as revealed in the country studies of the Carroll report, several of which showed a preference for a fractional apportionment approach. This would entail taxing the local operations of a TNC on the basis of an appropriate proportion of the worldwide profits of the firm treated as a whole. Even the UK report, which advocated separate accounting, stated that alternative approaches such as calculation of profits as a proportion of turnover were applied in nearly half the cases, and its availability was generally important in preventing taxpayers `taking up an unreasonable attitude’ (cited in Picciotto 1992, 30). The possibility of adopting an international formula apportionment approach to allocation of business profits was addressed both by Carroll and Ralph C. Jones, a Yale professor, who produced a study on the accounting aspects for the Carroll report. They recognised that, to the extent that a TNC was operated as an integrated enterprise, there would inevitably be difficulties in attributing and allocating specific items both of income and expenditure to its constituent parts. However, they considered it to be `quite inconceivable’ that states could agree on a general formula apportionment principle, especially if it would require them (in Jones’s words) to `permit income earned within their jurisdiction to be reduced by losses sustained elsewhere’ (cited in Picciotto 1992, 34).

Thus, the separate accounts and arm’s length pricing approach resulted from the view taken by technical specialists of the difficulty of reaching international political agreement on a global standard. However, the technical specialists also understood that in practice fractional apportionment would be inevitable, but it would have to be applied on a case-by-case basis. This would entail arrangements for cooperation between the national fiscal authorities, which the German report in particular presciently suggested might provide a basis for development of agreed general principles, perhaps in the form of defined allocation percentages (ibid. 35). The League treaty models included treaties for cooperation in both assessment and collection of taxes, but states proved reluctant to agree such provisions (ibid. 251-2). These proposals had originated from the report of the League’s Technical Experts (essentially national tax officials), which had stressed that arrangements to prevent international double taxation should be complemented by measures to combat fiscal evasion, while accepting that international administrative assistance should not amount to `an extension beyond national frontiers of an organised system of fiscal inquisition’. Nevertheless, in practice states were reluctant to make provision for cooperation between tax administrations, and despite various safeguards suggested by the Fiscal Committee, the model treaties eventually included only a minimal provision for exchange of information necessary for implementation of the treaty.

Indeed, the autarchic political climate of the 1930s was not conducive to the conclusion of international agreements, and even bilateral treaties to prevent double taxation based on the League models were slow to develop, although almost 60 were signed by 1939. It was not until the 1950s that an extensive network of bilateral tax treaties began to grow, and then mainly between the developed OECD countries, due to the stronger basis of reciprocal capital flows between them. Although the United Nations established a Financial and Fiscal Commission, it was riven by Cold War and North-South conflicts, and ceased to meet after 1954. The mantle of the League's Fiscal Committee was taken over by the Committee on Fiscal Affairs of the OECD, whose Treaty Models and Commentary, as well as periodic reports (produced especially since the seminal report on Transfer Pricing and Multinational Enterprise of 1979), have provided the formal backbone of the international tax system.

However, the sinews of the system have been the professional specialists in international taxation, mainly acting on behalf of business firms and associations. As professionals working for private clients or public bodies (and often both), these `creative ideologists' operate between the state and the market, and play a crucial role in creating regulatory arenas (Dezalay 1996). Mitchell Carroll himself kept in close touch with business firms and associations even while working for the government, and went into private practice in 1933, although also still serving as the US representative on the League's Fiscal Committee, as well as acting as consultant to the State Department on international tax. His tax practice appears to have consisted of helping to resolve major anomalies and difficulties experienced by large TNCs, such as Unilever, Morgan Guaranty Trust, and ITT. The cases he recounts generally involved interceding directly with governments, including persuading negotiators to include appropriate provisions in treaties under negotiation (Carroll 1978, 113-15). While he was clearly an old-style `gentleman-lawyer', he helped to create a regulatory arena which later became dominated by bureaucratised law and accountancy firms producing complex tax-avoidance `products' such as double-dip leasing or currency/interest rate swaps (Picciotto 1995).

C. LEGITIMACY STRUGGLES OF INTERNATIONAL TAXATION

Paradoxically, the state-based system for taxation of international business income and profits greatly helped to stimulate international integration of economic activities under the aegis of TNCs. Far from acting as an impediment, the partial and imperfect coordination of national tax systems established by the formal legal structures stimulated these large firms to develop their own arrangements. Despite the improvements in international communications, and contrary to common assumptions, the organization of businesses on a global scale is not easy, indeed its history is littered with disastrous ventures into foreign markets, as well as successes. The competitive advantages of TNCs were not due to closer international political integration, but the converse: it was their ability to take advantage of and manage *differences* in the social, political and economic conditions between countries which powered their rapid growth.[8] Clearly, some obstacles are too difficult to surmount, such as discrimination against foreign ownership, or severe volatility in conditions between countries. However, the institutional framework

[8] J. H. Dunning, a leading theorist of TNCs, explains their growth in terms of ownership-specific and location-specific advantages, deriving from their `privileged ownership of, or access to, a set of income-generating assets, or from their ability to coordinate these assets with other assets across national boundaries' (2001, 176).

developed after 1945 was very propitious for FDI, precisely because it involved a strong but limited form of economic coordination between states. TNCs became adept at selecting and combining the most appropriate locations for their operations, based not only on social and economic conditions (such as skilled but relatively low-cost labour), but also political and regulatory factors. Among the most important of these was taxation. But the success of giant TNCs at coordinating activities across the globe drew along with them a wider range of smaller and medium sized firms, and resulted in deeper international integration, undermining some of the mechanisms of national state economic management.

In effect, the various interactions between the tax authorities and the professional advisers of internationally-operating businesses over a long period of time helped to *construct* the international tax system. This entails conflicts and negotiations over the limits of legitimacy of taxation, largely waged through legal practices of interpretation of legal texts, aptly described by Bourdieu as struggles to appropriate the `symbolic power which is potentially contained within the text', or to `control' the legal text (Bourdieu 1987: 818; Picciotto forthcoming). This is perhaps especially prevalent in a field such as income taxation, which depends to a great extent on abstract and indeed artificial concepts, not least that of income. Determination of the national jurisdictional scope of taxation depends on the concept of residence, which is especially problematic for artificial legal persons such as the company.

Among the reasons given for adopting the test of `central management and control' by the House of Lords in *De Beers* was that the alternative test, put forward on behalf of the company, of the place of incorporation, could easily be avoided `by the simple expedient of being registered abroad and distributing its dividends abroad' (De Beers 1906: 213). Indeed, this was exactly (and has remained) the position for US TNCs, which benefit from deferral of US taxes on income earned by their foreign subsidiaries. But the `control' test was highly indeterminate, and as applied to artificial legal persons such as companies or partnerships was not defined by statute in the UK.[9] In practice, the Revenue interpreted it to mean the place where the key strategic decisions of Directors were taken, as against the `passive' control exercised by shareholders. However, this provided at best a shaky basis for asserting a right to tax the worldwide profits of multinational company groups (TNCs). In the 1970s, as the pace of internationalisation accelerated, and TNCs evolved more complex patterns, the control test could be used to enable companies to arrange financial or servicing functions in affiliates whose central management and

[9] Under the `control' test, even a company formed under UK law could be a foreign resident: Egyptian Delta Land and Investment Co. Ltd v. Todd (1929). This decision created a loophole which in a sense made Britain a tax haven: foreigners could set up companies in the UK, which would not be considered UK resident under British law because they were controlled from overseas, but might be shielded from some taxation at source because they were incorporated abroad. This possibility was ended by the Finance Act of 1988 (s. 66), which provided that companies incorporated in the UK are resident for tax purposes in the UK, bringing the UK substantially into line with many states (especially European Community members), which use both incorporation and place of management as tests of residence. However, the control test still applied to companies incorporated outside the UK, as well as to unincorporated associations such as partnerships, and remained relevant for tax treaties.

control could be said to be located elsewhere, and thus reduce UK tax by deducting interest charges, management fees or insurance premiums from the UK trading profits of their related entities.

Furthermore, tax planners could set up foreign-resident companies to ensure that individuals resident in the UK could escape tax on income from foreign activities. Thus, the entertainer David Frost in 1967 set up a foreign partnership with a Bahamian company to exploit interests in television and film business outside the UK (mainly his participation in television programmes in the USA); the courts rejected the views of the Revenue that the company was a mere sham to avoid tax on Frost's global earnings as a professional - the company and partnership were properly managed and controlled in the Bahamas and their trade was wholly abroad (*Newstead* 1980).

The Vestey family were pioneers of international tax planning, which became the focus of a long-running conflict with the Revenue, resulting in a series of court judgements, most of which they won. The Vestey brothers had left the UK in 1915 and moved the control of their business to Argentina, to avoid the consequences of the British rule on residence of companies. In his evidence to the Royal Commission in 1919 for measures against international double taxation, mentioned above, William Vestey stated that while his tax position in Argentina suited him admirably, he would prefer to come back to Britain to live, work and die. He also wrote to the Prime Minister, Lloyd George, stating that if the brothers could be assured that they would pay only the same rate of tax as the American Beef Trust paid on similar business, they would immediately return. Failing to receive such assurances, they took legal advice from 1919 to 1921, as a result of which they established a family Trust in Paris. Returning to London, they leased all their properties, cattle lands and freezing works in various countries to a UK company, Union Cold Storage, stipulating that the rents should be payable to the Paris trustees. The trust was set up so that its income should be used for the benefit of their family members (but not themselves); the trust deed also gave the Vestey brothers power to give directions to the Trustees as to the investment of the trust fund, although subject to such directions the Trustees were given unrestricted powers (Knightley 1993). When it eventually discovered the existence of these (and no doubt other similar) arrangements, the Revenue put through Parliament in 1936 and 1938 the first provisions against foreign trusts. These became the focus of long-running legal battles in the courts, in which the Vesteys eventually prevailed, leading to revisions of the legislation, and inevitably further litigation.

Thus, it was through debates about the legitimate limits of national taxation of international business, mediated by technical practices of textual interpretation and statutory revisions, that the international tax system was constructed. Thus, the claim to tax the worldwide profit of residents was mitigated by the introduction of foreign tax credit arrangements. Conversely, the use of intermediary companies to shelter overseas income was tackled by most developed countries, which introduced measures in the 1970s and 1980s to combat such use of foreign `base' companies, by treating the income of `controlled foreign corporations' (CFCs) as attributable to their parent companies. However, CFCs must be defined, often by complex rules, and the attributable income is generally limited to `passive' investment income. Thus, some services can be provided to internationally-operating businesses which, if they can arguably be said actually to be carried out `offshore' (and hence produce `active' income), may benefit from a low tax rate in the chosen jurisdiction, as well as reducing tax on trading profits of the operating companies which pay for these services.

The extent to which these types of arrangements are valid depends on an increasingly complex maze of different national rules and their interactions. Thus, what constitutes compliance continues to be negotiated. However, the concern of national tax authorities to ensure their `fair share' of the tax base of international business is also counterbalanced by concerns to ensure their country maintains its international competitiveness in attracting investments and as a base for such business.

There are genuine issues and disagreements about the definition and jurisdictional allocation of the income from international business, which are fought out in these struggles to `control the text'. The problem is that these issues have become largely obscured because the texts are so complex and esoteric that they are accessible only to a small number of specialists. Even these experts would find it hard to explain the underlying justification for many of the rules.

D. TAX HAVENS AND `OFFSHORE'

A key element in the strategies of management of regulatory interactions has been the resort to `havens' or `offshore' centres, which act as jurisdictions of convenience for regulatory avoidance. Their main use has been for avoidance of tax, although this has been linked with, and has spread to, avoidance of other types of regulation, especially of financial regulation.

International regulatory avoidance strategies essentially entail choosing a convenient jurisdiction in which to create a legal entity, such as a corporation, partnership or trust, which can be used as a vehicle to own assets or through which to channel transactions. This is in a sense a type of forum shopping, since the aim generally is to relocate activities (at least nominally) to a jurisdiction which not only offers more favourable rules, but more importantly can provide a shelter from the regulations of other jurisdictions. This type of shelter, which originated with the desire to avoid taxation, is generally referred to as a haven.

Other kinds of activities have also made use of the `offshore' phenomenon. Commercial radio stations mushroomed in the 1960s aiming at breaking the monopoly of state broadcasting (such as Radio Luxembourg and Radio Caroline). They were described as `pirates', since some of them actually broadcast from ships on the high seas, and this analogy was perhaps the source of the term offshore (Palan 2003, 22). Similarly, `flags of convenience' (FoC) in international shipping began to boom after the 2nd world war, growing from under 4% of world tonnage in 1948 to 14% in 1960, 26% in 1970 and 34% in 1990 (Kassoulides 1993, 83). This also had a longer history, as US shipowners had begun to use the Panama registry in the 1920s, initially to avoid the liquor prohibition laws, and in the 1930s firms such as Standard Oil of New Jersey and United Fruit reflagged their ships there. They were joined by others, notably Erling Naess, a

Norwegian who had set up a whaling company in London in 1928. He found that by reregistering his ships in Panama and moving the residence of his company to Paris, the company's shipping profits would be tax-free (Naess 1972, 2-3). Thus, the FoC system could combine avoidance of tax and other regulations, including vessel safety rules and labour laws (Murphy 2004, ch.2). By the 1990s, the growth of the Internet opened up new possibilities for `offshore', such as online gambling, which also was a development of the earlier phenomenon of casinos being located in favourable jurisdictions.

`Offshore' became a generalized phenomenon by the 1970s, and acted as a catalyst for a dual process of national deregulation and international reregulation. Controls over economic activity based on direct state command over `national' firms often had to be abandoned, but as a result international regulatory networking gradually emerged. In some contexts, national deregulation entailed the creation of onshore enclaves. For example, the US Federal Reserve created an International Banking Facility in New York in 1981, yielding to pressures from US banks, and in response to the rebirth of London as an international finance centre, mentioned above. The intention of the US authorities was to pressurize the Bank of England to agree reserve requirements for international banking (Hawley 1984). They did not succeed until 1988, but gradually the central banks, acting mainly through the Basle Committee on Banking Supervision, did evolve coordinated arrangements for prudential supervision of banking and finance, although this has been a painful process marked by dramatic failures (Kapstein 1994, Wood 2005).

Similarly, a number of developed states reacted to the growth of flags of convenience for international shipping by introducing special `captive' registries of their own for nationally-owned vessels, offering tax breaks and allowing employment of foreign seafarers.[10] This followed the failure of attempts to bring shipping back under national state control, by multilateral treaty provisions requiring a genuine connection with the flag state.[11] Nevertheless, regulatory arrangements have emerged, largely in response to sustained campaigns especially by the trade union body the International Transport Federation (ITF). Thus, a form of global governance of shipping has emerged, albeit with some significant gaps and deficiencies (Couper et al. 1999, 172-6; Gerstenberger &

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[10] Some of these are through offshore dependencies, such as the Isle of Man, Madeira, the Netherlands Antilles, or the French Kerguelen Islands; while others (such as Denmark, Germany, Luxembourg and Norway) are special facilities, sometimes established in cooperation with other states (Luxembourg, which is landlocked, established its registry as a facility for Belgium).

[11] A requirement of a genuine link between a ship and its flag state was included, at the instigation of the Netherlands, in the 1958 Geneva Convention on the High Seas, and repeated in identical terms in art. 91 of the 1982 UNCLOS. However, `genuine link' was not defined, and the article explicitly states that `each state shall fix the conditions for the grant of nationality to ships'. Art. 94 of UNCLOS requires flag states to administer their fleets and take measures to ensure safety at sea, but only in general terms. Attempts through UNCTAD to negotiate an agreement defining the `genuine link' produced a 1986 UN Convention which was a weak compromise, effectively legitimizing the FoC (Kassoulides 1993, 83): it specifies that there must be either `appropriate' participation in the ownership of ships by nationals of the flag-state, or a `satisfactory' proportion of the crew must be its nationals. The convention received too few ratifications to enter into force.

Welke 2002). It combines international standards for safety both of ships and of shipboard employment conditions,[12] with enforcement by port state inspection systems of ships, and by the ITF of employment conditions, coordinated through international networks.

The offshore phenomenon is not just a matter of a few rogue jurisdictions, but the result of the mutual interactions of states more generally. As we have seen, the jurisdictional interaction inherent in the classical liberal system of inter-dependence could be exploited by the strategies of jurisdictional selection and regulatory avoidance, designed by transnational lawyers and other specialists. As national regulation became more rigorous, techniques of avoidance became more sophisticated. As one such specialist put it, 'For the professional, "offshore" is now a structural tool in the efficient management of clients' affairs' (Cabral 1995, 24). Operating at the interface between the private and the public, these specialists were active not only in creating regulatory avoidance devices for private clients, but also in designing favorable regulatory provisions by acting as advisers to governments. As part of attempts to restore confidence and credibility in the financial security of OFCs, some countries have had their laws designed by global professional firms acting as government consultants (Gallagher 1990). Although this role of `double agent' is a delicate one and therefore confined to a small elite in large developed countries such as the US (Dezalay 1996, 66), small jurisdictions can be prone to advice of a less scrupulous character.[13] Particularly radical advice was provided by a team of US lawyers aiming to promote Nepal as an `offshore' financial center. They suggested that, rather than developing its own regulatory system (even if based on foreign models), Nepal should directly incorporate the laws of other countries. This would allow foreign

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[12] The International Maritime Organisation (IMO), the intergovernmental body with primary responsibility for shipping, was committed to the principle of regulation by the flag state, despite the failure to establish a genuine link requirement. However, the ITF campaigns led to the adoption by the International Labour Organization (ILO), of Convention 147 on Minimum Standards in Merchant Ships in 1976. This requires flag states to exercise effective jurisdiction over their ships and to establish laws and regulations covering a range of safety standards and shipboard employment conditions 'substantially equivalent' to those in a specified list of related ILO conventions. Importantly, however, article 4 gave jurisdiction for port states to enforce these standards, including taking measures necessary to rectify conditions 'clearly hazardous to safety or health', though they must also not 'unreasonably detain or delay the ship'. This provided encouragement and authority for the development of a network of arrangements for inspection to enforce international standards using Port State Control (Kassoulides 1993), beginning with the Paris group of European countries, followed by Asia-Pacific, Caribbean and Latin American groups. In this way, cooperating maritime authorities have established sophisticated inspection systems, based on checklists of internationally-agreed standards, deficiency reporting, a computerised database, and the ultimate sanction of detention: see material available on http://www.parismou.org. This has been further strengthened by the IMO's reorientation to accepting that its standards should be internationally enforceable, rather than relying entirely on the flag state.

[13] Thus the Cayman Islands Trusts Act of 1967 resulted from advice from `private interests' in the UK, causing great concerns to the Inland Revenue (PRO file T295-892).

firms registering in Nepal to choose the laws under which they and their transactions would be regulated.[14]

Although specially-designed laws may be found everywhere, some states or statelets offer a more comprehensive package of arrangements specifically devised for avoidance purposes of one sort or another, so they may be considered designer jurisdictions. This phenomenon has been described as the `commercialization of sovereignty' (Palan 2002, 2003, 59-62). The competition among such jurisdictions makes it hard to take counter-measures against them, since if one is targeted another is likely to take its place. This competition also leads to differentiation. Typically, states which established themselves early as leaders, such as Liberia for shipping, or Switzerland for private banking, or the Cayman Islands for offshore bank accounts, are more willing to try to safeguard their reputations (and hence their market share) by ensuring high standards in other aspects of regulation, such as maritime safety or prudential regulation of banks. Their later competitors entering the market are likely to be less scrupulous, and willing to relax more standards. They are therefore more likely to become the targets of international counter-measures, which paradoxically results in the leading offshore states being held up as good examples, and legitimizing their use for avoidance of other rules, especially taxes.

As we have seen above, the exploitation of jurisdictions of convenience relies on taking advantage of fictions such as corporate personality, and the indeterminacy of abstract legal concepts such as income and residence. It is not usually, as is sometimes asserted, a matter of the greater international mobility of `capital', since this type of avoidance normally involves little or no genuine economic activity in the haven jurisdiction. Thus ships registered under a flag of convenience have little contact with their state of registry; offshore radio stations will generally broadcast programmes recorded elsewhere; companies formed in tax havens to receive tax-avoiding income are usually no more than `brass plate' entities to which assets have been notionally transferred; and banking or financial transactions attributed to offshore centres have only a fictional relationship with them. Thus, a distinction can in principle be made between a legitimate jurisdictional choice, for example if a person chooses to be a tax exile by deciding to live in a low-tax state, in contrast to avoiding tax in a country of residence by accumulating foreign earned income in a trust or company formed in a haven. However, the distinction can be very hard to maintain, especially for financial services (e.g. insurance), and these are therefore the main users of the offshore system.

E. The Growth and Character of Business Regulatory Networks

Regulatory authorities have also tried to strengthen coordination of their activities through international networks. As regards business taxation, tax authorities, at least

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[14] Collins et al 1996, Jackson 1998. The main attraction would be the India-Nepal tax treaty, which allows exemption from withholding taxes to residents of Nepal, like the India-Mauritius treaty, which led to a boom of incorporations of intermediary companies in Mauritius. Although Nepal did introduce some legislation with this aim, its attractiveness to investors was marred by political instability, notably the massacre of the Royal family by the Crown Prince in 2001, and a resurgence of Maoist guerilla activity.

those of the main OECD countries, have developed quite sophisticated arrangements to coordinate the assessment and audit of TNCs, under the authority of the tax treaty provisions for exchange of information, as well as consultations between the `competent authorities', in order to ensure that taxation is in accordance with the treaty. These include simultaneous examinations of TNCs, and coordinated Advanced Pricing Agreements, which entail international consultations between the two (or sometimes more) tax authorities and the TNC (or its advisers, usually the large accountancy firms), to negotiate the methodology the firm uses for setting transfer prices between its affiliates.[15] Even more informal modes of cooperation have also sprung up at various times, such as the Group of Four (France, Germany, the UK and the US) which since 1972 organised meetings both at Commissioner level, as well as developing programmes at staff level for joint study of specific problems, which led to establishment of the Simultaneous Examination procedures. Other even more ad hoc groups have exchanged information about and discussed specific industries, such as oil and gas and forestry products. More recently, Australia, Canada, the UK and the US established a Joint Tax Shelter Information Centre.[16]

An important node of these networks has been the OECD's Committee on Fiscal Affairs, and its various subcommittees. It has worked in a typically technicist and low-key manner, despite the sometimes highly conflictual and potentially far-reaching nature of the issues with which it deals. It is only in recent years that its work has been given some political impetus and has become more visible. This resulted partly from increased concern by some leading governments about revenue losses due to international tax avoidance, as well as preferential tax regimes being adopted by some countries to attract investment. A second, perhaps more important, reason was that these concerns, especially regarding the problem of tax havens, became linked to broader issues raised by offshore financial centres, such as their use for money-laundering (and more recently still, terrorist financing), as well as global financial instability risks.

Even though there are clear linkages between these issues, they have been dealt with by separate regulatory groupings, which have worked along their own distinct functional tracks. This results from the informal, ad hoc and even opportunistic manner in which regulatory networks have grown, as well as their technicist character. Their almost random nature, and their often disparate membership, has made it hard to achieve coherence between related although functionally separate areas, and even between groupings with overlapping memberships dealing with the same of similar issues. At the same time, their single-function focus means that it can be hard to achieve agreement

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[15] These have become quite extensive and hence highly formalised and bureaucratised: the US IRS now has 17 teams dealing with APAs, and between 1991 and 2004 has carried out a total of 557 APAs, virtually all of which involve bilateral negotiations with treaty partners, some multilateral (see *Announcement and Report Concerning Advance Pricing Agreements*, Internal Revenue Bulletin 2005-16, http://www.irs.gov/irb/2005-16_IRB/ar13.html, last accessed 22/6/2006.

[16] See http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2004029b.htm, last accessed 22/6/2006.

among participants, unless there is a strong common interest, since there is no scope for trade-offs through package deals. For example, a variety of regulatory bodies and networks have emerged to deal with various aspects of regulation of banks, other financial institutions and financial markets, including the Basel Committee of Banking Supervisors (BCBS), the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS), as well as the International Accounting Standards Committee (IASC). Although their work on developing international standards for example on capital requirements is clearly related, the attempts at coordination between them have met some difficulties (Picciotto 1997, Picciotto and Haines 1999).

Coherence and coordination between regulatory networks has been hard to achieve even though they may be linked through an institutional node, or by a broader political initiative. This is well illustrated by the issue of tax havens and offshore financial centres. Concern about the use of these jurisdictions for money-laundering led to the setting up of the Financial Action Task Force (FATF), which was formed in 1989 under the auspices of the G7, but actually housed at the OECD in Paris.[17] Its work deals with similar issues to that of the OECD Fiscal Committee, such as exchange of information, and problems, notably bank secrecy. Tax authorities would greatly benefit from being able to exchange information with agencies dealing with money-laundering, and this is possible at national level in some countries. Joint action might also be helpful in putting pressure on jurisdictions which may be reluctant to accept or enforce regulatory standards. Attempts have certainly been made to encourage links and cooperation. Indeed, another initiative by the G7 explicitly tied together the issues of financial stability, financial crime, money-laundering, and international tax evasion.[18] This certainly succeeded in giving a much stronger impetus to the work of the Fiscal Committee on tax havens, resulting in the more high-profile project on Harmful Tax Practices, launched by a report in 1998. However, this project has so far achieved only limited success, and links with the FATF have been minimal.

F. STATE FRAGMENTATION AND TRANSFORMATIONS

This problem of functional fragmentation may be seen as part of a larger one of technicisation and legitimation in the modern state (Picciotto 2001, Picciotto 2006). In the traditional Weberian perspective, technocracy is seen as a means merely of implementing policies which have been formulated through political processes. From this viewpoint, the growth of delegation to specialist regulators is a response to the problems of governing increasingly complex societies, by giving greater autonomy to technocratic decision-makers within a policy framework set by government. However, the new forms of governance are more decentralized and interactive, which further exacerbates the

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[17] It is in fact in the main OECD building, whereas the Fiscal Committee is in an Annex.

[18] See Economic Communiqué, *Making a success of globalization for the benefit of all*, of the Lyon Summit of 1996, and the Conclusions of G7 Finance Ministers, London 9 May 1998, both available from University of Toronto G8 Information Centre website http://www.g7.utoronto.ca/.

legitimacy problems which Weber already identified with the `iron cage' of bureaucracy when it loses its accountability to social values.

This is especially relevant to global governance, since much of the activity of international regulatory networks has been generated by technical specialists or `epistemic communities'. This concept was developed within a neo-functionalist paradigm, to suggest that a stronger basis for international cooperation may be provided by delegating specific issues to be dealt with in a depoliticized manner by specialists deploying scientific, managerial or professional techniques and working within shared universal discourses (Haas 1992). This concept seemed to maintain the Weberian assumption that broad policy goals should be decided politically, so that the delegation should be of practical details of implementation, facilitating the resolution of global policy issues by `narrowing the range within which political bargains could be struck' (Haas 1992, 378). From this perspective governance networks could be said to strengthen the liberal state system, since they simply entail cooperation between government officials, who can be held accountable by citizens through national state mechanisms (Slaughter 1997).

There is certainly evidence that global expert action networks have been extremely effective in mobilizing and sustaining global governance regimes, for example Canan and Reichman's sociological study of the `global community' of environmental experts and activists which formed around the Montreal Protocol (2002). Far from being depoliticized, however, such networks often include activists as well as technical specialists; and even if the issues are specialized, the participants share common social values. The contribution of technical specialists to international diplomacy is often to help gain acceptance for proposals which are put forward as objective and scientific, although actually carefully calibrated for political acceptability. Indeed, even some liberals such as Anne-Marie Slaughter now seem to concede that global governance networks do raise some accountability problems, which perhaps requires them to operate as `a kind of disaggregated global democracy based on individual and group self-governance' (Slaughter 2004a, 240). In a recent analysis (Slaughter 2004b) she suggests that this may entail democratic accountability which is either `vertical', through the classical liberal national state, or `horizontal', which suggests a new conception of the state. The latter, more radical alternative points towards new approaches to democratic legitimation of governance based on democratic deliberation (Picciotto 2001).

Indeed, functional fragmentation may also be seen as reflecting broader changes in the nature and relationship of the `public' and the `private' sphere. The transfer of specific public functions to what have been described as `non-majoritarian' regulators (Coen & Thatcher 2005) is often justified in terms of the need to insulate some areas of decision-making from influence by private special interests and the short-term considerations which dominate electoral politics. Hence, it also reflects changes in political processes, with the breakdown of representative government, which `public choice' theorists have argued is prone to capture by private interests (Buchanan & Tollison 1984). In place of party-democracy there has been the emergence of what Bernard Manin has called `audience democracy' (Manin 1997), increasingly based on populist forms of political mobilization. This in turn poses the question of whether the decentralization or fragmentation of hierarchical government based on formal or instrumental rationality, and the shift to networked governance requiring reflexive interactions and based on communicative rationality, may offer a basis for new forms of deliberative or discursive democracy (Dryzek 1990, 1999). The changes in public-private interactions make it vital to find ways to remodel the sphere of political debate and decision-making. Central to this are questions about the nature of technocratic governance and the basis of its legitimacy.

In this context, the importance of expertise suggests that the dangers of technicism must be addressed. This is especially the case since so many decisions now entail inputs often from different specialist or expert fields, as well as an evaluation from the general public perspective. Technical rationality can operate in an autocratic way, if it seeks to claim a spurious authority. This can be counter-productive, as has occurred in the frequent episodes when it has resulted in a spiral of public mistrust of science, and scientists' despair at public ignorance. To avoid technicism, specialists need to acknowledge the ways in which their techniques rest on formal models based on assumptions which allow them to abstract the specific aspects of an issue or the data with which they are concerned from the entirety and complexity of the issue in the real world. Since the conclusions they can reach based on such assumptions can only have a partial or conditional validity, they should not be treated as determinative of the issue as a whole, but as important contribution towards more general public debates. Scientific responsibility should therefore include cognitive openness and reflexivity (Dryzek 1990, 1999).[19]

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[19] Michael Froomkin has provided an interesting account and analysis of the governance of the Internet, suggesting that the success of the Internet Engineering Task Force (IETF) in terms of both efficacy and legitimacy was due largely to its essentially democratic participative procedures, which he argues is an exemplar of Habermasian practical discourse ethics; in contrast, the Internet Corporation for Assigned Names and Numbers (ICANN) suffered a legitimation crisis, because its operations were secretive and claimed legitimacy from a rigid corporatist representation system (Froomkin 2003).

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