

Taxation without Harmonization in the European Union

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Abstract: Given the costs associated with disparities in taxation policy between states, why do we fail to see agreements on harmonization of tax policy in the European Union? Given the potential winners and losers from harmonization, and differences in the strength of preferences, there may be no package that can achieve agreement in EU institutions more satisfying to states than the status quo. Furthermore, taxation may be placed strategically on the bargaining agenda to achieve concessions in alternative issue dimensions, such that states opposing harmonization may yield other concessions.

In a world of open borders and increased factor mobility, states often face pressures to compete with others for investment, and even consumer activity. Competition may lead to the convergence of state policies, particularly taxation policy, to minimize losses from capital flight and goods arbitrage. Tax policy harmonization may be driven by demand in an international setting, as states aim to minimize potential losses from differing standards and policies and negotiate common taxation policies. Alternatively, convergence may arise without negotiation, as competition to attract investment and consumer spending pushes taxation rates downward. However, there is little evidence of a race to the bottom of competing states lowering taxation.¹

The European Union (EU) is an advanced case of globalization, with a common market that has removed multiple barriers to trade. It has harmonized standards and regulations in numerous areas. However, there has been a lower degree of harmonization of taxation than one might expect, given, for example, the EU's achievement of other broad agreements, such as monetary union, the single market, and the removal of border controls. This is puzzling, as coordination on tax codes fits with the principles of the common market and would reduce transaction costs and other problems such as double taxation, goods arbitrage, and differences in pension taxation for mobile labor (pension taxation systems often differ between EU member countries, causing difficulty for laborers who work in one country and retire in another). More interestingly, there have been calls for harmonization from a number of sources, including European Commission, Germany, France, Italy, and Belgium. In addition, the Austrian presidency of 1998 also

¹ Swank (2002).

stated that it would aim to emphasize tax harmonization.² Despite these efforts, attempts at harmonization have for the most part not succeeded.³

How can one explain this lack of agreement? This project aims to answer the question of why we see demands for, but little agreement on, tax harmonization by examining bargaining between EU member states and institutions. I argue that there are two reasons for the lack of harmonization. First, given the potential winners and losers from harmonization, and differences in the strength of their preferences, there may be no package that can achieve agreement in EU institutions more satisfying to states than the status quo. This prompts a secondary question: given the above argument, why do we see proposals for harmonization tabled? I argue that taxation may be placed strategically on the bargaining agenda to achieve agreement in alternative issue dimensions, such that states opposing tax harmonization may yield other concessions.

Benefits of Harmonization

There are a number of reasons why states may face incentives to cooperate on taxation matters. Tanzi explains that there are a number of possible taxation-related implications of an integrated world. First, he notes that increasing consumer mobility means countries may find it desirable (and possible) to induce consumers from other countries to spend in their territory, increasing tax receipts. Other countries would of course lose in this process, as their consumers are able to purchase goods in lower tax

² "No Harm Done," *The Economist* 30 July 1998.

³ For partial list of agreements and failed proposals on harmonization, see Appendix 1. For more information on proposals see Ruding Committee *Report of the Committee of Independent Experts on Company Taxation*, European Commission (Luxembourg: 1992), and European Commission, *Tax Policy in the European Union—Priorities for the years ahead*, Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee, (Brussels, 23/05/2001), COM (2001) 260 final. Also see European Commission, *Towards and Internal Market without Tax Obstacles*, Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee, (Brussels, 23/10/2001) COM (2001) 582 final.

jurisdictions, and utilize those goods within their home borders. Second, capital and labor may find it advantageous to leave their country of origin if their tax rates are higher relative to other states', and they do not receive a compensatory level of public services. Third, individuals in one country may be induced to invest abroad, if the tax rates on the return to the investments are lower.⁴ As Steinmo notes, "globalization has dramatically increased the ease and availability of the 'exit' option for those with high value skills, large incomes and/or capital resources."⁵ In addition, there is survey evidence in the EU of multinational firms' investment decisions being affected by taxation policy.⁶ Steinmo further predicts that shifting domestic policy considerations and limitations on politicians will produce two outcomes. The first likely outcome is that taxation on not only capital, but also other bases should be lowered, with an accompanying drop in public spending. The second likely outcome, related to the first is that these shifts should offer politicians motivation to shift or delegate tax policy-making authority to supranational institutions.⁷ However, in Europe it appears that neither of these outcomes has materialized.

In addition, there are also higher costs of enforcement and collection when tax regimes differ between integrated economies. Daly notes that states may find it difficult to tax economic activity that takes place across borders, and that differences in tax policies across states exacerbate difficulties in enforcing taxpayer compliance. Increased factor mobility in the EU increases the ease with which economic actors may engage in tax evasion, as taxing foreign investment income is more difficult than taxing domestic

⁴ Vito Tanzi, *Taxation in an Integrating World* (Washington DC: The Brookings Institutions, 1995), 9-10.

⁵ Sven Steinmo, "The New Political Economy of Taxation: International Pressures and Domestic Policy Choices," *Center for Western European Studies Working Paper Series* 19 (August 1996), 2.

⁶ Michael Daly, "Harmonization of Direct Taxes in the European Community," *Fiscal Problems in the Single-Market Europe*, Mario Baldassarri and Paolo Roberti, eds., (New York: ST. Martin's Press), 1994.

⁷ Steinmo (1996), 3.

income. There are also efficiency losses when taxpayers undertake efforts at tax avoidance.⁸

In addition, European enlargement will increase the heterogeneity of the economies within the EU, further exacerbating potential problems stemming from differences in taxation policies.⁹ Despite these forces, states within the European Union have been unable to agree on most proposals for tax harmonization.

This study focuses not on the level of revenue states collect through taxation, but rather the form of taxation through which revenue collection takes place. States within the EU and worldwide differ in the type of taxes emphasized within each state, even though states for the most part tend to utilize similar types of taxation. Therefore, while revenue figures may be quite similar across countries, the choice of which types to tax most heavily or lightly may vary widely.¹⁰

Literature Review

Many have claimed that harmonization or convergence is desirable, given that fiscal externalities arise out of differences in taxation.¹¹ Most relevant here is the tax base externality: a tax (either imposition or increase) in one region or state may drive a portion of a mobile tax base into another region or state. This process will over time tend to drive tax rates downward. It may be the case that differences in income taxes between two countries may drive labor to emigrate as well, creating pressures for states, especially small states, to keep labor taxes low.¹² Others note that with the introduction of EMU, tax

⁸ Daly (1994).

⁹ Lanoo and Levin (2002).

¹⁰ Sven Steinmo, *Taxation and Democracy*, (New Haven: Yale University Press, 1993), 14.

¹¹ See Gordon (1983) and Haufler (2001)

¹² Tanzi (1995).

harmonization will occur at a faster rate because the common currency will enhance the ease with which investors may move to other countries in response to tax incentives.¹³

Early work on harmonization has suggested a number of reasons or why tax harmonization has not been achieved. However, often these hypotheses demonstrate problems, or simply add to the puzzle further demonstrating why tax harmonization is an interesting question. State sovereignty arguments claim that opposition to such harmonization exists because states may resist surrendering sovereignty.¹⁴ While this is certainly a concern of national governments delegating policy to the international level, these types of analyses raise further questions. First, these arguments assume that delegation is the key mechanism through which harmonization may be achieved. However, states may come to an agreement at the European level to harmonize taxation, but at the same time administer these policies at the state (or even federal or local) level. In these cases, delegation is no longer an issue. In addition, given this clarification, why have there been successful agreements in certain areas of European policy that one would imagine are equally important to states, such as monetary policy, while other areas prove more difficult to negotiate. Why might taxation policy be more difficult to agree upon than others?

Related to this literature are institutional arguments that note that because a top-down push for harmonization would necessitate a unanimous vote by member states, agreement on such proposals will necessarily be difficult to achieve. Alternatively, policymakers may want to achieve some form of harmonization, but cannot agree on the form that this should take. While this is a valid argument, and it is clear that decisions

¹³ Mongelli (1997), also see Sinn (1992).

¹⁴ Cnossen (1993).

involving unanimity are often difficult to reach, the achievement of other difficult agreements despite this institutional hurdle raises the question of why or how taxation may be different (or not) from other issue areas.

Finally, there exists a variety of cultural arguments as to why harmonization has not occurred. Different countries may exhibit different sets of values regarding the appropriate levels and purposes of taxation and government. Daly notes that states possess different notions of the purpose of taxation for not only state revenue, but also as an “instrument of economic and social policy.” These factors in turn shape the choice of taxation policy. These policies are further affected by perceptions of equity, economic efficiency, and suitability of types of taxation. Concerns over how other states will react to tax policy choices also play into these decisions.¹⁵ In addition, cultural and language differences may pose barriers to the flow of information that is necessary for tax competition to be effective in placing pressure upon taxation policy toward convergence, as information is necessary both to appeal to individual consumers, and to businesses.¹⁶ While Steinmo notes that there are advantages to these types of explanations, they also exhibit a number of problems. While studies that emphasize cultural or value-related factors do not simply assume that groups will necessarily adopt comparable interests or policy goals across different countries, there remain difficulties in applying these explanations in a predictive capacity, or to specific comparative situations. Since these values are quite ambiguous, or even contradictory, it is difficult to match these to policy outcomes. A large variety of these values may in fact explain almost any policy decision.

¹⁵ Daly (1994), 33-34.

¹⁶ Tanzi and Zee (1998).

Finally, there is evidence that the values that characterize political culture in a given state fail to predict policy outcomes.¹⁷

More recent studies of harmonization assume the existence of a “regulatory innovator” that initially may create incentives to follow with similar policy change. Simmons argues that patterns of harmonization can be explained by incentives faced by other actors to either emulate, or take contrary action (or no action) from a “regulatory innovation of the dominant financial power” and the externalities coming out of this decision for the dominant power.¹⁸ Instead of a process of “mutual adjustment,” it is instead unilateral action by a dominant power, and incentives to emulate this action, that explain recent patterns of harmonization.

The argument of this paper draws upon literature on agreements on taxation at the domestic level, and on tax competition at the international level in order to explain why most attempts at taxation policy harmonization through negotiations in European institutions fail, and secondarily suggests why, given these factors, we still see taxation placed upon (or threatened to be placed upon) the agenda.

Domestic studies of taxation policy formation yield insights on why states may have divergent preferences regarding taxation.¹⁹ Tax policy choices within countries are dependent upon the support of political groups within those states, and therefore attempts to adjust fiscal policy may be pushed or blocked by these domestic groups. Earlier interest group explanations are not supported empirically. These arguments claim that policies differ from one state to the next because of different power distributions among

¹⁷ Steinmo (1993), 5.

¹⁸ Beth Simmons, “The International Politics of Harmonization: The Case of Capital Market Regulation,” *Dynamics of Regulatory Change: How Globalization Affects National Regulatory Policies*, University of California International and Area Studies Edited Volume 1, 2002, 2.

¹⁹ See, for example, Bovenberg and Horne, 1992.

political groups. These groups utilize their power to achieve their interests, and will pressure decision makers to the tax burden on other groups, rather than themselves whenever possible.²⁰ However, empirically it seems that parties in power do not tend to tax their own supporters at a minimum, and non-supporters more heavily.²¹ Newer interest group explanations offer compelling arguments as to how groups may affect domestic policy making. Alesina and Drazen argue that even when strong pressures exist for tax increases, these are delayed by conflict over the distribution of the tax burden, resolved only when one group becomes more politically powerful than others.²² Swank argues that domestic political parties may affect choices regarding taxation policy. When incentives toward tax reform exist (in this case, tax reform by the US), countries in which right-of-center parties often control government in the time period leading to tax policy reforms by a dominant innovator should more easily enact reform. Situations in which government is dominated by conservative parties should further encourage support in the population for liberalizing measures as well as engender adoption of many neoliberal social and economic policy reforms “that lay the groundwork for a shift in tax policy paradigm.” He further points out that according to much work in political economy, the median voter position often determines the nature of policies adopted; Electoral support for tax reforms is necessary for their success.²³ The power of particular domestic groups may yield insight into why representatives of these states at the European level are unable to agree to harmonization measures. In particular, domestic politics and the position of

²⁰ Eisenstein (1961).

²¹ Steinmo (1993), 4.

²² Alesina and Drazen (1991).

²³ Duane Swank, “Tax Policy in an Era of Internationalization: An Assessment of a Conditional Diffusion Model of the Spread of Neoliberalism,” *Paper presented at UCLA International conference on International Diffusion of Democracy and Markets* March 2003, 12-13.

the median voter limit the degree to which state representatives can negotiate at the EU level. In addition, these explanations also suggest why states produce different taxation policies.

Steinmo instead argues that given that citizens are poorly informed about taxation policy, they have little direct effect on taxation policy. Rather, they constrain the state. As the electorate exhibits preferences for low taxation, but a high level of public spending, politicians that are able to overcome public distaste for taxes are able to expand public welfare programs and satisfy voter demand for spending. While politicians have acted similarly across states in terms of general patterns of taxation during crises and economic growth, the tax policies chosen have differed. However, as some forms of taxation are less popular than others, “those governments that are best able to create more efficient or less visible tax structures are in the best position to expand the realm of public activity.”²⁴

Institutional characteristics also may play a part in affecting the degree of change that may be feasible for a country’s taxation policy, and at the European level suggest why domestic politicians may be constrained in the level of adjustment to which they may agree. Hallerberg and Basinger find that veto players influence the degree of reform that states may enact. When one veto player’s agreement is necessary for bill passage, the state is able to undertake more significant reform than states possessing multiple veto players (these veto players include political parties, institutions, and political interest groups).²⁵ These studies demonstrate that domestic factors are clearly important in analysis of the choice of taxation policy. I aim to systematically analyze the manner in

²⁴ Steinmo (1993), 195.

²⁵ Hallerberg and Basinger (1998).

which these preferences affect interstate bargaining to yield further insights into why EU members often fail to agree on a set of harmonized tax policies.

The literature on Public Finance has also examined why tax structures differ across European Countries. It argues that taxation policy must “spread the distortions that taxes create; the marginal disutility from the last revenues raised should be equalized across all revenue sources.”²⁶ The most suitable tax policy will differ according to what is being taxed and must also take into account collection costs. It notes that the ease of taxing certain goods and services may differ between regions. As a result, it is unlikely that the different countries in the European Union will all exhibit the same optimal tax policy, for the same set of activities. But, since the determining factors of optimal tax rates differ between geographical areas, and therefore “one might expect that the public finance view will call for many different inflation taxes and many small currency areas.”²⁷ Given these concerns, it is unclear why empirically, we see instead the Euro established over a geographically large currency area to facilitate trade.

Fiscal federalism approaches argue that decentralization of governmental functions may lead to optimal policies because heterogeneous preferences can be best addressed by decentralized policy-making.²⁸ These approaches imply that at early stages of integration, tax harmonization agreements are likely to take place, and that these should be relaxed over time as mobility of factors increases. However, empirically this has not occurred.

²⁶ Matthew B. Canzoneri, and Carol Ann Rogers, “Is The European Community an Optimal Currency Area? Optimal Taxation Versus the Cost of Multiple Currencies,” *The American Economic Review* 80, 3 (June 1990), 420.

²⁷ Canzoneri and Rogers (1990), 420.

²⁸ Oates (1972, 1991), and see subsidiarity debates among EU scholars.

Arguments surrounding agglomeration offer some indication of why costs of not harmonizing taxes may not be as severe as claimed. Capital may be concerned with other factors specific to investment location, such as the presence of other capital. Businesses benefit from being clustered in particular locations, creating advantages that offset the costs of non-harmonization.²⁹ This literature offers advantages in the study of the choice of tax policies at both the domestic and international levels. Specifically, it demonstrates that the costs of non harmonization are not as high as often assumed. However, this body of literature neglects the role that domestic and international politics play in decisions over fiscal policy. The agglomeration literature, and the literature outlined above all offer a point of departure for explaining why little agreement on harmonization has been achieved, and furthermore, why little agreement is likely in the future.

Proponents of harmonization often claim that there are costs to non-harmonization that can be overcome through coordination at the EU level, if not through competition. However, not all countries, and not all groups within them, would be affected in the same manner by tax harmonization. There are potential benefits of not harmonizing, as specialized markets may in fact discourage harmonization. While students of globalization direct their attention to taxation, it may be that governments and businesses desire primarily the output of a growth-inducing environment. Much work demonstrates that investment is not only dependent upon taxation, as businesses may value public goods, such as an education and transportation systems.³⁰ The transaction cost arguments for harmonization assume harmonizing taxation would reduce uncertainty, but, the benefits of non-harmonization are potentially diffuse. Harmonization benefits may be

²⁹ Baldwin and Krugman 2002.

³⁰ See Kahler (1998), Wilson (1993), and Grewal (1988).

shared by few groups within states, and tax harmonization may matter more for small states than for large states. Capital flight and goods arbitrage may matter primarily in border areas, as consumers and businesses situated in border regions may find traveling a short distance to avoid higher taxes more attractive than those in interior regions.³¹

In addition, while much of the globalization literature presumes convergence through tax competition or an explicit agreement, they do not specify to what level; Convergence can take place at different levels. For the sake of simplicity, I assume convergence can occur at three levels (defined comparatively): either at high levels of taxation (maximization of extraction by the state), low, or medium. Even if states accept the principle of harmonization, each would desire an agreement on taxation policy at their preferred level. As Baldwin and Krugman note, when agglomeration is present, any effort to harmonize taxation policy will likely put one state (or group of states), or all states at a disadvantage in relation to the status quo. While the strength of preferences may vary, the range of potential outcomes of negotiation may be such that no win-set exists. In addition, with unanimity rules for voting on taxation policy, states with strong preferences regarding taxation play the role of veto player in international negotiations.

In order to demonstrate member state preferences over the preferred level of taxation for agreements on harmonization, I use estimates of current member state taxation levels as an indicator of the level of taxation around which they would like to coordinate. The table below demonstrates the level of taxation in each member state, categorized along three categories of corporate taxation, taxation on labor, and consumption taxes.

³¹ Fitz Gerald (1992)

Table 1: Country variation across three taxation categories³²

Corporate Taxation	Labor Taxation	Consumption Taxation
<i>High taxation</i>	<i>High taxation</i>	<i>High taxation</i>
Belgium	Austria	Austria
Denmark	Denmark	Denmark
France	Finland	Finland
Italy	France	Ireland
Sweden	Netherlands	Portugal
United Kingdom	Sweden	
<i>Medium taxation</i>	<i>Medium taxation</i>	<i>Medium taxation</i>
Austria	Germany	Belgium
Finland	Italy	France
Germany	Spain	Greece
Greece	Belgium	Netherlands
Luxembourg		Sweden
Netherlands		
<i>Low taxation</i>	<i>Low taxation</i>	<i>Low taxation</i>
Ireland	Greece	Germany
Portugal	Ireland	Italy
Spain	Portugal	Spain
	United Kingdom	United Kingdom

This categorization demonstrates the likely level at which each of the member states of the EU would hypothetically prefer to harmonize taxation policy. In other words, the categorization above offers an indication of where the ideal point for each country would be regarding an agreement on harmonization. The choice of taxation policy for each country, as they currently stand, is dependent upon domestic characteristics and preferences over taxation policy. It is clear that any attempt to harmonize taxation at a

³² Estimates from David Carey and Harry Tchilinguirian, "Average Effective Tax Rates on Capital, Labour, and Consumption," *OECD Economics Department Working Paper* no. 258, (Paris: Organization for Economic Cooperation and Development, 2000).

low level (perhaps by instituting a ceiling or a maximum level of taxation) that is attractive to the states on the low end of each taxation spectrum will be unsatisfying to the states on the high end of the spectrum. Similarly, proposals to harmonize taxation at high levels will be unsatisfactory for states at the low end of the spectrum. While splitting the difference and harmonizing at a medium level of taxation may be an option, it is also quite likely that these proposals would also fail to satisfy those states on the extremes of high and low taxation preferences.

Given the unanimity voting procedures for taxation in the Council of Ministers, it seems that all actors must have similar preferences in order to make harmonization a feasible outcome. However, this assumes that the bargaining over issues in the European Union occurs on only one dimension. In reality, bargaining across issues is possible, as states opposing particular measures or agreements may be able to be induced to agree by the offer of other benefits, or some trade-off. Given that states do not have similar preferences regarding any policy, with unanimity voting, certain states may offer side payments to others in order to make agreement on harmonization less costly for those actors. Bargaining within the EU institutions over policy often produce “package deals” which bind “a series of usually unrelated but often controversial policy issues together to make sure everyone benefits, providing a sugarcoating for the pill.”³³ This particular feature of policy-making at the European level demonstrates that when bargaining across issue dimensions is possible, institutional factors such as unanimity voting are not the primary reason for why little agreement on harmonization has been achieved. Rather, it seems that taxation may be one area of European integration in which it is unlikely significant agreements will be achieved. The domestic politics within each European

³³ John McCormick, *The European Union: Politics and Policies* (Boulder: Westview Press, 1999), 202.

member state offers an explanation for the incongruent preferences of member states, and also an indication of why taxation may be different from other policies, in that there are few harmonization agreements that are possible to achieve at the EU level.

The purposes of taxation systems are manifold. Taxation policy historically has been more than a simple revenue raising and redistribution mechanism. Rather, tax systems are a mechanism through which states may also pursue normative goals such as promoting saving practices, discouraging consumption, and affecting growth and investment within the domestic economy. Steinmo notes that states through their taxation system are able to undertake efforts at “rewarding certain values while punishing others... Indeed, taxation is a major instrument, if not *the* major instrument, through which governments try to affect the private sector.”³⁴ Taxation policy is undoubtedly one of the most important areas of policy enacted by governments. Therefore, while incentives to coordinate taxation policy may exist, governments may find it extremely difficult to enact changes to existing policy.

Taxation is also a highly politicized domestic issue. Changes to tax policy tend to be incremental when they do occur due to factors such as domestic political groups, and the nature of domestic political institutions. Domestic institutional factors, and the preferences of key political actors are influential, as demonstrated by Alesina and Drazen, as well as Hallerberg and Basinger. Therefore, it is difficult to explain why issues raised at the supranational level will reduce or supercede the difficulties of dealing with a considerable domestic problem.

In addition, as Swank argues, the nature of the domestic economy may also create disincentives for harmonization. He argues that the more the state exhibits national or

³⁴ Steinmo(1993), 3.

sector coordination of the economy, the higher the costs experienced by politicians attempting to enact tax policy reform. The benefits of remaining with the current tax policies, or attempting to institute incremental reform will be higher in these economies.³⁵ These factors offer further indication of why it is difficult for states to agree on a harmonization package for tax policy.

Conclusion

European integration has produced a number of a number of agreements on harmonization in numerous areas. Given the incentives produced by tax competition in this integrated economy, it seems puzzling that harmonization in the area of taxation has for the most part failed in EU negotiations.

I have argued that given the domestic preferences regarding taxation, and the potential winners and losers coming out of various forms of harmonization, that there is no package that can achieve agreement among member states that is more satisfying to them than the status quo.

However, despite these disincentives against significant agreements on harmonization, there remain instances where harmonization is placed upon the bargaining table by actors such as the EU Commission, France, Germany, Austria, and Belgium. This then leads to a second question: given that one can assume actors can predict that strong efforts towards harmonization are likely to fail, why is it that they are tabled regardless?

I argue that significant measures towards harmonization are placed strategically on the EU agenda. Facing potential losses in other issue areas, actors may push initiatives for tax harmonization, but subsequently back down with the negotiation of concessions in

³⁵ Swank (2003).

other policy dimensions. Given that taxation is an important domestic policy issue, and given the difficulty in achieving any broad harmonization agreement, certain states may be willing to compromise on other issues if threatened with harmonization. For example, states may place taxation on the agenda in order to extract concessions from other states on proposed reforms of the Common Agricultural Policy, measures related to the expansion of the European Union, or the loss of structural funds. The key questions in these situations are whether or not the costs of the harmonization measures proposed within European institutions are high, and whether or not these states are willing to trade on other issues in order to avoid negotiation on taxation. This question is the focus of my future research.

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