

# FROM CONVERGENCE TO DIFFUSION: THE EU'S INFLUENCE ON NATIONAL TAX SYSTEMS

By

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*Abstract:* In this article I investigate to what extent European Integration stimulates policy convergence and diffusion of various forms of tax policy. Using a mixed-methods design, I find that several causal mechanisms contribute to an EU-wide diffusion of tax policies: imposition, competition, harmonization and learning/communication. I show that these mechanisms have different effects on different forms of taxation. Even if the ultimate outcome of this influence only in few cases leads to unconditional convergence, the EU has markedly accelerated policy diffusion among its member states.

## **Introduction: The Diffusion and Convergence of Tax Policies in the EU**

From their very beginning the European Communities have generated the suspicion that they accelerate the convergence and diffusion of national tax policies. Recent research has rekindled this suspicion for some areas of taxation. Although the overall effect is still limited, the compound effect of the European Union (EU) has accelerated the competition around corporate income (Genschel *et al.*, 2008). But competition is not the only way EU institutions shape national tax systems. In some respects it may not even be a major way. To name but a few examples: the EU *acquis communautaire* indirectly transforms national income taxation guaranteeing stable investment conditions abroad; the EU adopts legislation to harmonize the system of European consumption taxes; the European Court of Justice (ECJ) produces case law that reaches deeply into the sovereignty of national tax policy makers; EU soft law spurs processes of learning and of shaming harmful tax practices (Kemmerling and Seils 2009 *fc*; Radaelli and Kraemer 2008). All in all, the EU disposes of a full arsenal of measures to shape national tax systems.

Hence, I should expect the EU to have a noticeable impact on national tax systems. This hypothesis squares with two important contradictory facts: First, the EU has no direct competences in taxation itself. Taxation is still a national domain, and decisions on tax issues are still subject to the unanimity rule of voting in the Council. It is therefore no wonder that in terms of primary legislation, taxation is one of the least dynamic areas. Second, we do not see much policy convergence on the aggregate level of tax ratios or the size of the tax state (Garrett 1998; Genschel 2002a).

To see how the EU affects national tax policies one has to disaggregate total taxation into specific areas of taxation, in which EU policy makers directly intervene. For this purpose I look more deeply into direct taxes (corporate and personal income) and indirect taxes (general consumption taxes and excises). I use several different indicators of taxation (rates, ratios and qualitative properties). This disaggregation gives us a more fine-grained, nuanced picture of how the EU affects national tax systems. In fact, I find evidence for all major mechanisms at work, at times even in interaction with each other. But these mechanisms do not work out in equal ways for each form of taxation. Moreover, we see that even if the overall outcome is not always unconditional convergence, the EU has markedly accelerated international policy diffusion among its member states.

This paper starts with a brief and selective overview of the literature on international policy diffusion and convergence. The next section reports on EU activities in the four fields of taxation. The following section presents some quantitative and qualitative information of international policy convergence for the four fields. I compare the evolutions of tax indicators of core EU countries with selected non-EU OECD countries and judge how far the available evidence is consistent with different causal mechanisms of policy convergence. The next section tests the diffusion of national tax policies within the EU using a spatial-econometrics approach. The final section concludes.

### **Causal Mechanisms of International Policy Convergence and Diffusion**

In recent years there has been a remarkable renaissance in studies about international policy convergence and diffusion (Holzinger and Knill 2005; Meseguer 2005; Simmons *et al.*, 2006). Whereas convergence is easily defined as increasing cross-country similarities in policy outputs, diffusion needs more conceptual work. In natural sciences, diffusion usually means a spread of particles in random motion over space. In social sciences it has been used to describe a ‘transition in country A [that] increases the probability of a transition in country B’ (Elkins and Simmons 2004: 2). In this general form, it is obvious that diffusion does not imply convergence: even if countries affect each other, they do not need to copy the same policy from each other. There is a large variety of theoretical explanations and approaches aiming at an explanation of convergence and diffusion. Holzinger and Knill (2005), for instance, focus on the following four (groups of) causal mechanisms: imposition, harmonization, competition, and transnational communication.

The paradigmatic case of *imposition* is when the IMF or the World Bank gives a conditional loan to countries on condition of their compliance with some established rules (Meseguer 2006). Coercion and the exercise of political power are of defining importance for this mechanism (Dolowitz and Marsh 1996). Delegation of legal powers and the judicialization of policy fields can endow international organization with enough authoritative power to impose rules and sanction nation states behavior (Zangl 2005). If this authoritative power is used to impose similar decisions and rulings on many or all states, the result is an overall convergence of policies.

International *harmonization* may also rest on the existence of internationally binding norms and of international institutions that monitor their implementation. However, harmonization always

presupposes some degree of (voluntary) cooperation between nation states. Countries must have to agree on the cooperation in a specific policy area. Compared to imposition, harmonization and, more generally, international cooperation should be interpreted not as hierarchically, but as horizontally negotiated adjustments in national policies (Dolowitz and Marsh 1996).

In contrast, regulatory *competition* stems from the absence of international cooperation or any hierarchical forms of imposition. Countries are expected to converge because of the strategic incentives to over- or underbid other countries' policies. In strong notions of regulatory competition, this may lead to a race to the bottom in legal standards (Sinn 2001), but there are also examples of jurisdictional competition which lead to a race to the top (Vogel 1995). Regulatory competition can also take many forms. If, for instance, voters have imperfect knowledge about good policies, they may use policy levels of other countries as a source of information. This leads to so-called yardstick competition between countries (Besley and Case 1995). Moreover, not all countries may face similar strategic incentives. For instance, it has been argued that only small countries have a genuine incentive to cut tax rates, since the revenue losses in their national tax base are marginal compared to the inflows of foreign tax base (Kanbur and Keen 2001). It has also been argued that countries with stronger financial sectors have an additional incentive to attract foreign capital (Holzinger 2005). Either way one should not expect an absolute convergence of tax policies, but rather a conditional convergence for groups of countries of similar size or with similar financial sectors (Ganghof 2006b). The flipside of this argument is that diffusion between heterogeneous countries leads to 'negative' copying and even divergence.

The last causal mechanism, transnational *communication or learning*, accommodates many different forms, such as naïve emulation of other countries' policies or different versions of policy learning (Hall 1993; Radaelli 2000). Countries may emulate each other as a consequence of 'collective herd behavior' or global intellectual trends. They may use other countries' performance to judge the efficacy of policies, adopt successful innovations, and reform policy failures (Meseguer 2006). If this is the case, countries not only learn from their own experience, but also from the experiences of other countries (Volden *et al.*, 2008). Other versions of this causal mechanism focus on the role of epistemic communities and transnational problem solving which goes beyond bilateral learning exercises (Haas 1992).

EU scholars have used varieties of the four causal mechanisms to explain the integration or convergence of various policy fields in the EU. The impact and limits of legal imposition on nation states is a widely studied topic (Boerzel 2006; König 2007). The 'disciplinary function' of membership in the European Monetary Union (EMU) has been observed for fiscal and income policies in the EU (Enderlein 2006). Coordination and harmonization can be observed in most areas of (product market) regulation (Scharpf 1999). Various authors argue that economic competition is now the driving force for EU policy making and has deep repercussions on the national level (but cf. Majone 2005). Finally, recent initiatives by EU institutions have created a cottage industry of investigation for new modes of governance. In particular EU soft law and the open method of coordination are supposed to facilitate cross-national learning and convergence (De La Porte and Nanz 2004). Learning has been singled out as one of the key reasons for EU-wide policy transfer and convergence (Radaelli 2005).

Applying these different mechanisms to specific research questions is not always straightforward, however (Kemmerling 2008; Volden *et al.*, 2008). The boundaries of the four mechanisms are blurred. A lot of learning is done strategically along the lines of competitive pressures and harmonization can be frozen into imposition. Some of these causal claims yield very similar empirical observations on an aggregate level of cross country comparisons. For instance, it is empirically very difficult to distinguish voluntary from coercive agreement since the notion of power is a very elusive (cf. Kemmerling 2007). Bearing these caveats in mind, the four mechanisms are still important means to understand the role of the European Union in its influence on national tax policies.

### **Taking Stock of EU Activities in Tax Policies**

According to many EU scholars, the EU impact on national tax policies seems to be fairly limited (e.g. Moravcsik 2002). There is no evidence for an absolute convergence of tax levels in the EU or the OECD (Seils 2007). Tax policy has remained one of the few policy areas that have remained under the control of national jurisdiction and the direct impact on national tax policy making seems to be severely limited by the principle of unanimity and the small size of the EU budget. However, it is easy to show that the EU has continuously expanded its influence on national tax policies using a battery of indirect and direct measures (Genschel and Jachtenfuchs 2010).

Some of the activities of the EU which were not designed to affect tax policies can have a dramatic impact on national tax policy making. A complete list of these *indirect* activities is beyond the scope of this paper, but some important examples suffice to show this. First, EU market integration has powerful spillover effects on national tax systems. Enhancing the flow of goods and services affects national tax bases of consumption and labor, as well as the structure of the tax system. Second, the integration of capital markets and the adoption of a common currency strongly accelerate capital flows within the EU with direct implications for national income taxation. Third, the adoption of the *acquis communautaire* by new member states guarantees stable political and economic institutions, such as property rights and access to legal systems. Together with stable or predictable exchange rates this greatly reduces risks to investing abroad. This makes flows of capital between member states much easier and severely affects the national system of capital taxation (Kemmerling and Seils 2009).

Despite the high legal thresholds for direct action on the intergovernmental level, EU institutions have been remarkably active in the field of tax policies. Table 1 gives evidence for the three types of *direct* activities of the Commission, the Council and the ECJ: (1) ‘information’ contains activities such as recommendations, opinions and resolution, but also important communications and influential reports. These measures have in common that they are not legally binding, but that they provide important focal points for cooperative efforts and subsequent rounds of negotiations on legally binding initiatives, (2) ‘legislation’ contains all activities with legally binding character, in particular directives and regulations; (3) ‘jurisprudence’ contains court rulings with direct relevance for national tax policies.

Beginning with the first category, information, one sees an ‘explosion’ of activities in the area of tax policies in recent decades. More importantly, there is an obvious shift from information exchange on excise taxation in the beginning, to VAT in the 1970s and to corporate income taxation (CIT) in recent years. Most exchange of information takes place in the form of reports and recommendations of the Commission to other organs of the EU, such as the Council or the Parliament. Legislative acts consist of decisions, regulations and directives in the field of tax policy. With some 60 percent of all legal acts, decisions are by far the most common form. The overwhelming part of legal acts deal with indirect taxation, but in recent years there have been a few, but noticeable legal activities in corporate and personal income taxation. The activities of the ECJ primarily consist of preliminary rulings, and to a lesser extent, of infringement procedures (Genschel and Jachtenfuchs 2010). Again, most activities are found in the realm of indirect taxation, but in recent years more and more cases of direct taxation are brought to the court. In comparative terms, direct taxation seems to be driven by court rulings and informative activities of the EU, whereas legislation also has a substantive quantitative dimension in indirect taxation.

### **Evidence of Tax Policy Convergence: EU vs. OECD**

Are these activities strong enough to substantially affect national tax-policy making? Since there is little reason to expect evidence for absolute policy convergence in the size of the tax state, one has to dig a little deeper into the tax structure and composition of taxation. For this purpose we need to distinguish between different forms of taxation and different tax indicators. I focus on major tax forms only, i.e. corporate (CIT) and personal (PIT) income taxation for direct taxes,

and general consumption taxes (usually VAT) and excises as the major indirect taxes. I will compare nominal tax rates, tax-to-GDP ratios and qualitative indicators of the tax system and use simple statistical indicators such as the mean and the standard deviation.<sup>1</sup> I will track the changes of these indicators across time for some 25 years. To sort out effects of Europeanization from general effects of globalization (Verdier and Breen 2001) I compare long-standing EU members (EU-10)<sup>2</sup> with OECD countries that have never become EU member states (OECD-11).<sup>3</sup>

### ***Corporate Income Taxation***

Some trends in corporate income taxation (CIT) are related to genuinely international reasons. CIT is an area in which global competition should matter: the tax base of incorporated firms is mobile, its key agents, multinational firms, are versatile optimizers of international tax arbitrage (Devereux *et al.*, 2008; Ganghof 2000; Slemrod 2004). CIT is also subject to major intellectual and ideological trends that are not confined to the EU (Swank 2006). An example is the trend in OECD countries towards cutting rates and broadening the tax base (Loretz 2008). Moreover, the EU treaty provides little guidance in the field of income taxation (Cnossen 2001), since it mentions income taxes only in as far as they interfere with the goal of a functioning single market. In fact, EU history is full of failed initiatives to coordinate or harmonize tax rates and tax bases. As early as 1962 the Commission experimented with the idea of a harmonization of the effective tax burden (Neumark Bericht 1962) and drafted directives several times (e.g. 1967, 1975) in that direction (Genschel 2002b). In the 1990s the Commission redoubled its efforts: it

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<sup>1</sup> For a more sophisticated analysis of tax-policy convergence in the EU see Kemmerling (2010).

<sup>2</sup> EU-10 countries are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands and the United Kingdom.

<sup>3</sup> OECD-11 countries are Australia, Canada, Iceland, Japan, Korea, Mexico, New Zealand, Norway, Switzerland, Turkey and the United States of America.

endorsed a common minimum tax rate and even proposed a common definition of the tax base. So far these initiatives have led nowhere, as some member states have severe reservations about CIT harmonization.

And yet, the EU was not without influence. On the one hand, it achieved some cooperation on preferential tax regimes and ‘harmful tax practices’ (Kemmerling and Seils 2009; Radaelli and Kraemer 2008). On the other hand, it paved the way for capital to harvest the gains from tax arbitrage (Cnossen, 2001): it made cross-border movements of firms easier through a number of directives such as the parent–subsidiary directive (Directive 90/435/EEC) or the merger directive (Directive 90/434/EEC). In addition, a battery of influential court rulings strengthened the position of multinational firms and weakened member states’ attempts to unilaterally defend their eroding corporate tax base (Genschel *et al.*, 2011). Finally, as expected the reduction of investment risks dramatically spurred transnational movements of capital (Cnossen 2001).

What does the data say? Table 2 shows some stylized information for CIT in OECD countries. We see that nominal tax rates have dramatically declined, but not the standard deviations. Mean ratios have increased in all countries, but in this case standard deviations have decreased in the EU. These facts imply two things: first CIT has followed the international trend of a rate cut with base broadening that more than compensated the losses in revenues; second there is some additional impact of the EU on absolute convergence in corporate tax ratios (and rates) as shown by the falling standard deviations. This finding is corroborated by the literature on conditional convergence (Genschel *et al.*, 2011; Kemmerling 2010).

In qualitative terms the EU has a more visible impact. The table contains information on the way dividends are treated (Graetz and Warren 2007a). Taxing dividends produces two problems: first dividends may be taxed at the levels of firms or stock owners; second dividends of foreign stock owners may be taxed either in the country of the firm or the stock owner. Hence corporation tax systems are commonly differentiated by how they use dividend relief. The so-called classic system does not provide any relief, whereas imputation systems give shareholders a tax credit against their personal income tax. Apart from these two major systems there are also other techniques, such as taxing dividend income with a separate (scheduler) rate for personal income. Under the imputation system it is difficult to treat foreign and domestic shareholders equally. This discrimination has led the ECJ to effectively prohibit the use of the imputation system (Graetz and Warren 2007a). Table 2 shows that between 1981 and 2006 EU countries switched to (modified) classic systems or new hybrid forms, whereas imputation systems became the typical form of dividend treatment in the OECD-11. In fact, in 2006 none of the EU members except for the UK continued to operate an imputation system. Even the British imputation system had to be adjusted due to the interventions of the ECJ.<sup>4</sup> This is a clear indication that imposition of judgments from the ECJ has a visible effect on the convergence of structural characteristics of tax systems in Europe.

### ***Personal Income Tax***

Personal income taxation (PIT) is a very complex issue since people may have very diverse forms of labor and capital income with different degrees of mobility. Due to these differences,

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<sup>4</sup> See ECJ cases C-397/98 and 410/98 on Metallgesellschaft, Hoechst et al., of the year 2001.

*Kemmerling, "EU's Influence on National Tax Systems," ACES Cases 2011.1, p. 13*

countries are left with several trade-offs between efficiency, and vertical and horizontal equity (Ganghof 2006a). Countries have chosen different paths ranging from a flat tax treating all forms of income equally (e.g. Slovakia) to dual or scheduler income tax systems (Sweden). Again there are several arguments why countries have chosen these paths, but overall there is little convergence visible towards either of the extremes. On the contrary, domestic politics seems to be a major driving force that shapes tax policies in income taxation (Kemmerling 2009; Steinmo 1993).

As seen above, the EU has undertaken few direct steps at harmonizing income taxes. However, in as much as national legislation interferes with the four freedoms and the single market, income taxation is nowadays indirectly controlled by the EU. The clearest example are rulings by the ECJ (Genschel *et al.*, 2008). Much of the stimulus of EU initiatives comes from the fact that interest income and dividend income, and thereby, corporate and personal income taxation, are tightly linked in an integrated economy. The EU has exacerbated the situation, since the abolition of interest rates and exchange rates in the monetary union have left tax arbitrage as the only meaningful form of arbitrage for interest income (Schratzenstaller 2003). It is therefore no wonder that the incidence of tax evasion and avoidance in this area is particularly high in Europe, and that it has narrowed the chances for tax savings unilaterally (Dehejia and Genschel 1998). This has prompted the EU to undertake several initiatives to coordinate the taxation of interest income. Most prominently, the Council adopted the savings directive in 2004 which leaves member states with two options: they can either choose to exchange information on interest income or they can charge a minimum withholding tax at the source of the income (Holzinger 2005). It remains to be seen whether this cooperation will effectively confront some of the collective action problems in international savings taxation (Genschel and Schwarz 2011),

but the savings directive has so far been the most ambitious effort to harmonize part of national income taxation on the European level.

What does the data say? Table 2 shows that the means and standard deviations of top marginal income tax rates have fallen in all countries. Ratios have remained roughly stable in all countries, again showing that rate-cuts-cum-base-broadening has been an international trend. Moreover, PIT systems have become somewhat simpler as the falling number of tax brackets shows. There is still a debate as to why tax progressivity has been in decline in recent years: global tax competition (Ganghof 2006a; Genschel 2002a), efficiency considerations (Swank 2006) or domestic politics (Kemmerling 2009). Either way, neither rates nor ratios speak for EU-induced policy convergence. What we do see, however, is that even before the savings directive, withholding taxes converged more visibly within the EU than in the rest of the OECD world.<sup>5</sup> This suggests that the EU and, in particular, the abolition of capital controls, made national deviations prohibitively costly and policy experiments need to be coordinated across EU countries, if not world wide.

### ***General Consumption Taxes***

In the case of general consumption taxes there are also important international trends unrelated to the EU. Value-added taxes (VAT) are arguably the most important tax innovation of the 20<sup>th</sup> century and have displaced most specific consumption taxes (Cnossen 1998). The spread of VAT has provoked a lot of scholarly debate on its origins. Across the world governments seem to have

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<sup>5</sup> It has to be mentioned that national systems of savings taxation are very complex so that these country means are very delicate. We only used data on the taxation of bonds and only for clear cases of withholding taxes at the source of income.

*Kemmerling, "EU's Influence on National Tax Systems," ACES Cases 2011.1, p. 15*

learned about the efficiency, competitiveness, or the alleged ‘invisibility’ of VAT (Beramendi and Rueda 2007; Kanbur and Keen 2001; Kato 2003).

Contrary to direct taxation, the EU has always been a key driving force of general and specific consumption taxes. Article 99 of the old EU treaty explicitly requires the harmonization of sales taxes and excises. In 1967 member states agreed on the conversion of sales taxes to VAT, but only ten years later did the EU pass the 6<sup>th</sup> VAT directive. The latter adopted the destination principle to govern cross-border flows of goods and services. The directive also defined a minimum standard rate of 15 per cent and the use of reduced and maximum rates for certain products. Since then both EU legislation and jurisprudence have been very active in scrutinizing national tax systems and their compatibility with the four freedoms.

This is also visible in Table 2. Nominal standard rates have increased in both EU and non-EU countries, but only in the EU have they also converged (Kemmerling 2010). Yet, even the EU has so far not been successful in diminishing the use of reduced rates in old member states. The existing national exemptions were codified in the EU VAT directive of 1992. The EU was successful, however, in curtailing the use of super-rates for luxury and other goods which were at times as high as 110 per cent in Portugal. VAT ratios broadly move along the lines of VAT rates. As for the timing of the introduction, the EU clearly differs from the rest of the OECD. EU-10 countries adopted VAT around 1972, whereas it took the rest of the OECD almost 15 more years to do so. And some countries such as the US still have not introduced VAT at all. These differences show the influence of EU harmonization on national systems of general consumption taxes. However, it is also true that the motives for complying with Europe differ greatly from country to country. Whereas Germany and France wanted to solve problems of cross-border

consumption and revenue generation, the UK embraced VAT as a substitute to inefficient and unpopular taxes, such as the selective employment tax (Kemmerling 2009). One may conclude that VAT may still be the dominant form of general consumption tax in Europe even without the EU, but the EU endorsement considerably speeded up its diffusion and partial convergence.

### *Specific Consumption Taxes*

Excises have a long history, but in the 20<sup>th</sup> century their relative importance declines considerably. Yet some excises, namely those on alcohol, tobacco and fuel are still important sources of public revenue. They also have an important regulatory function in addition to revenue collection. Since excises come in many different forms and with many different purposes, the foremost cause of international divergence lies in domestic politics. Specific consumption patterns differ widely across countries not least due to differences in cultural habits of drinking, smoking or driving (see e.g. Cnossen 2007). For all these reasons it is obvious that national trajectories in excise taxation have been very different and that national policy makers ‘cherish’ their cultural peculiarities. If there are any common global trends in excise taxation they must be due to either ‘contagious’ technical innovations, such as the invention of ‘eco-taxation’ (Heichel *et al.*, 2005) or due to competitive pressures (Egger *et al.*, 2005).

Yet, competition and harmonization may matter much more within the EU. The harmonization of excises has always belonged to the mandate of the European Communities/EU. In the wake of the Single Market of 1992/3, the EU passed important directives, such as 02/84/EEC which replaced the old duty-free regime by a comparatively lenient system of regulating cross-border

shopping (Lockwood and Migali 2008). Moreover the directive introduced minimum excise duties on alcohol and tobacco and ruled that the standard VAT rate had to be applied to these goods. This also applies to fuel taxation. Finally, imposition by court rulings plays a role. The ECJ has made a number of influential decisions especially against the discriminatory taxation of domestic and foreign products containing alcohol (Cnossen 2007).

Table 2 shows that tax revenues from all excises relative to GDP have been in decline in all countries, but that only EU countries have converged (but see Kemmerling 2010). If I arbitrarily focus on the rates for diesel taxes, we see that rates (in constant USD per liter) went up in all countries, and that they have diverged more strongly outside the EU. Evers *et al.*, (2004) even find that harmonization has led to some upward convergence, but that competition within the EU remains strong. For excises on alcohol and cigarettes Lockwood and Migali (2008) find competition effects after the introduction of the single market in 1993. They conclude that economic competition on excises has significantly increased because of the deepening of European integration. However, it has to be noted that there is a marked upward trend in fuel, alcohol and cigarettes taxes which is somewhat at odds with Lockwood and Migali's idea of strategic competition. In general, econometric studies do find country-level contagion, but it is not always clear whether this is due to simple competition or rather governments' learning from each other in terms of the taxability of these items.

### **Horizontal Diffusion of Tax Policies within the EU**

We have seen that there is mixed evidence for the role of the EU in creating policy convergence in different fields of taxation. But the impact of the EU may transcend any simple form of

convergence if it accelerates the international diffusion of tax policies between its member states. To test the relevance of different mechanisms of diffusion, I use the econometrics of spatial lag variables (Anselin 1988; Franzese and Hays 2007). A normal regression equation has a simple form of  $P_{it} = a + b_k * \sum x_{it} + e_{it}$ , where  $a$  is a constant,  $P_{it}$  is a (tax) policy for country  $i$  at time  $t$ , a batch of independent variables for each  $i$  and  $t$ , with the  $k$  regression coefficients  $b$  and an error term  $e$ . If you want to control for the possibility that countries affect each other, one can use a spatial lag, i.e. a weighted average of all other countries  $j$  excluding country  $i$ . Such a regression has the form  $P_{it} = a + b_k * \sum x_{it} + d_m * \sum (W_{jt} * P_{jt}) + e_{it}$ , where there are  $m$  regression coefficients for the spatial lags,  $P_{jt}$  are the tax policies for a given year for all other countries  $j$ , and  $W_{jt}$  are matrices with weights for the influence of each other country. Let us make an example. If we think that countries are more likely to copy policies of large economies such as the US than to copy policies of smaller economies, the  $W$  matrix may consist of the weights of each economy in the total GDP of all economies combined. This would suggest that, say, Belgium takes into consideration the tax policy of the US much more than the tax policy of the Netherlands. But there are other possibilities for the weights.

In the following I use five different forms of  $W$ . The first one uses the notion of geographic proximity. In particular, I use a weight for contiguous countries. A country will take into consideration only those tax policies of neighboring countries.<sup>6</sup> This variable has been used in the literature as a measure of exposure to economic competition in which distance matters. The second spatial lag uses the size of GDP as weights. These weights control for the problem of asymmetric influence of economically powerful countries. The third spatial lag uses GDP per capita as weights. Here, countries are more likely to copy policies of richer countries, possibly

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<sup>6</sup> We have experimented with many different alternatives, such as normalizing the total number of bordering countries, using border length or using distances of the capitals in each country. Results are available on request.

aiming at learning from those countries traditionally considered successful. The fourth spatial lag uses GDP growth as weights. Here countries are supposed to learn from those countries that have a particularly good recent performance in economic growth. Finally, the fifth spatial lag uses the ideological similarity between the home country and the other countries. The more similar a partisan government is compared to the home country, the more likely the home country's government should learn from this country. I use the so-called Schmidt-index for the cabinet composition of parties (Armingeon *et al.*, 2010) to calculate these weights. All five weights are related to the causal mechanisms of convergence and diffusion, but focus on different aspects of horizontal learning and competition.

The dependent variables of the regressions are yearly changes in rates and ratios of corporate income, personal income, and value-added taxation. I include all EU countries for a time period of some 30 years (unbalanced panel). I use a random-effects model and robust standard errors to control for problems of pooled cross-sections and heteroscedasticity.<sup>7</sup> One additional problem of spatial lags is that they are codetermined by the dependent variable, i.e. they are endogenous. I use for all spatial-lag variables the value of the previous year to control for this. Franzese and Hays (2007) show that as long as this endogeneity is not overly strong, a normal regression equation with ordinary least squares is still feasible. Finally, I include a battery of control variables. Most importantly, I use the level of the dependent variable of the previous year which effectively controls for effects of catching up between different countries. Next, I include total population and GDP per capita to control for the size and wealth of each country. The share of people above 65 and the unemployment rate should control for the size of the dependent population and automatic adjustments of payroll taxes. Finally, there is one variable coding left,

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<sup>7</sup> This is clearly insufficient since it does not control for fixed country or time effects. Unfortunately, there is no optimal solution in sight for these econometric problems (Beck 2011).

Kemmerling, "EU's Influence on National Tax Systems," *ACES Cases 2011.1*, p. 20

partisan governments and another one controlling for economic openness, i.e. imports and exports as a proportion of GDP. Again I use for all independent variables the values of the previous years.

Table 3 shows the results of six different tax indicators for CIT, PIT and VAT. Due to the lack of fixed effects the model fit is very moderate. The dependent variable is always significant and negative, implying that there is some overall convergence in rates and ratios over time. In other words countries with smaller rates or ratios catch up with a rate of some five to ten percent per year, the exception being the CIT ratio with convergence up to 20 percent per year (see Kemmerling 2010 for details). As for the other control variables, larger countries see less growth in PIT or VAT, and richer countries see more growth in CIT rates and PIT ratios. Old-age increases CIT ratios and VAT rates, whereas unemployment rates only affect CIT ratios. Somewhat paradoxically, economic openness enhances CIT ratios, and decreases PIT rates and ratios, as well as VAT ratios.

For our purposes the diffusion variables are much more relevant. We see some degree of competition between neighboring countries for CIT ratios. If neighboring countries decrease on average CIT ratios by one percentage point, the country will increase its ratio by some 0.1 percent. This effect is quite small but in line with the expectation of negative externalities between tax bases. However, there is a positive spillover effect in PIT for both rates and revenues. The effects of competition are less ambivalent for the spatial lag using the relative size of GDP. As expected both CIT rates and ratios are negatively affected. If the weighted average of all other countries increases by one percentage point, the respective country will

decrease its CIT rate by some two percent. We also see negative spillovers for the case of PIT ratios.

On the other hand we see that learning also plays some role. Countries seem to copy CIT and PIT policies of those countries with higher GDP per capita. More importantly, countries with higher growth rates are more likely to be copied in their CIT rates and ratios. Somewhat surprisingly, countries react negatively to growth rates in the case of VAT rates, i.e. they rather copy countries with worse performance, but the effect is quite small. Finally, ideological closeness to the governing party only seems to matter in the case of the CIT rate. If other countries, weighted by ideological distance, increase their CIT rates by one percentage point, the respective country's rate increases by a third of a percentage point.

How about the influence of the EU on international diffusion? There are no easy ways to detect this, but one assumes that significant legal changes in the EU affect the speed and nature of diffusion across countries. One way to test this is to model structural breaks in the time series. Following Lockwood and Migali (2008), I test whether the single market in 1992 provides such a watershed. For that purpose I ran the same regressions as in Table 3 for the years from 1993 onwards only (results available on request). Although it is difficult to perfectly identify the structural break in 1993, we see a strong increase of international policy diffusion after 1993. Almost all coefficients of the spatial-lag variables go up, some of them considerably and significantly. For CIT rates, for instance, the coefficients of the border-weighted and the GDP-weighted lags are now significant and negative, as expected. VAT rates now are also significantly influenced by spatial lags using the size of GDP and the growth rates as weights.

## Conclusion: The Diffusion Nobody Talks About

The article shows the diverse impact of EU activities on national tax policies. Several findings are worth repeating. First, the output of EU institutions in terms of information, legislation and jurisprudence has increased tremendously in the field of taxation, in particular after 1992. Combined with indirect effects mainly coming from market integration, the EU nowadays deeply penetrates national tax policies. Its actual impact, however, depends on the specific form of taxation and the aspect of the tax structure under scrutiny. Whereas, for instance, the EU seems to stimulate competition in CIT, it has significantly harmonized VAT systems. At times, this leads to visible policy convergence. But more than often, the EU makes systems diverge, or converge conditionally. The study of international policy diffusion within the EU shows that the EU seems to have accelerated processes of competition and learning, especially after 1992.

All things considered, the EU questions the tax sovereignty of its member states, arguably much more than international trends of competition and policy learning do. The mix of direct and indirect activities, as well as the different causal channels the EU uses, are far beyond the means of any other international organization. At the same time, little does the European public opinion know about the influence of the EU. The national arena is still the exclusive forum for tax policy debates. Ironically, national politicians at times make proposals such as special exemptions for VAT that ceased to be feasible on the national level a long time ago (Genschel and Jachtenfuchs 2010). Without public attention it is unlikely though that tax policy is going to be politicized on the supranational level (Hooghe and Marks 2008). Under these circumstances, two options for tax policy in the EU remain. First, the EU could not only harmonize existing national tax systems

even more, but introduce its own taxes. The Commission recurrently puts this issue on the agenda, but member states have been very reluctant to cede authority to the supranational level. And yet, if the old idea of no-taxation-without-representation bears fruits, lifting taxes to the EU-level will lead to a new level of political contestation in EU institutions. Second, the EU could delegate important tasks of taxation back to the level of member states. Some legal scholars already argue that the ECJ has gone too far (Graetz and Warren 2007b). Balancing the norm of anti-discrimination against the public interest of national revenue generation is an important aspect in such a recalibration of competences.

**Table 1 Direct EU activities in the field of taxation**

	<b>Information</b>		<b>Legislation</b>		<b>Jurisprudence</b>	
	58-80	81-07	58-77	78-07	58-77	78-07
<b>by tax area</b>						
VAT	6	84	8.5	197.5	18	357.5
Excise and other indirect tax	14	28	7.5	110.5	21	219.5
Corporate tax	3	27	0	5	1	56.5
Personal tax	3	15	0	11	3	68.5
Administrative Cooperation and miscellaneous tax	8	17	6	36	0	12
<b>Total</b>	<b>30</b>	<b>134</b>	<b>22</b>	<b>360</b>	<b>43</b>	<b>714</b>

## Sources and notes:

Information contains recommendations, resolutions, communications, opinions and selected reports of the Council and the Commission. For earlier years data comes from own research in the archives of the Council and the Commission. For later years I also used information from prelex and eurlex databases and information from DG TAXUD.

Legislation contains directives, regulations and decisions (Genschel and Jachtenfuchs 2010).

Jurisprudence contains rulings of the ECJ (Genschel and Jachtenfuchs 2010).

**Table 2: Trends in Tax Indicators between 1981 and 2006**

		EU-10		OECD-11	
		Mean	Std. Dev	Mean	Std. Dev
CIT	Rates	-17.11	0.46	-16.23	0.90
	Ratios	1.26	-0.5	1.58	1.40
	Other	Full imputation disappears		Full imputation en vogue	
<i>Major Causal Mechanism</i>		<i>Competition, Imposition</i>		<i>Competition</i>	
PIT	Rates	-17.97	-0.97	-24.47	-13.46
	Ratios	0.44	0.06	-1.23	-0.95
	Other	Less brackets, convergence in withholding taxes		Less brackets, no convergence in withholding taxes	
<i>Major Causal Mechanism</i>		<i>(Competition, Learning)</i>		<i>Competition, Learning</i>	
VAT	Rates	2.47	-1.59	0.13	1.31
	Ratios	0.56	0.64	1.79	2.44
	Other	Early Introduction		Later Introduction	
<i>Major Causal Mechanism</i>		<i>Harmonization, Learning</i>		<i>(Learning)</i>	
Other indicators	Rates	0.37	0.06	0.30	0.26
	(diesel)				
	Ratios	-0.7	-1.25	-0.99	0.7
Other		Number of excises on decline			
<i>Major Causal Mechanism</i>		<i>Harmonization (Learning)</i>		<i>(Competition, Learning)</i>	

Note: The numbers are the differences between group-specific means or standard deviations for EU-10 or OECD-11 countries between 1981 and 2006. Causal mechanisms in parentheses are less evident than those without.

**Table 3 Diffusion of Tax Policies between EU Countries**

	$\Delta$ CIT rate	$\Delta$ CIT ratio	$\Delta$ top PIT rate	$\Delta$ top PIT ratio	$\Delta$ VAT rate	$\Delta$ VAT ratio
Control Variables						
Dependent <sub>(t-1)</sub>	-0.10*** (0.017)	-0.18*** (0.0046)	-0.074*** (0.019)	-0.10*** (0.014)	-0.057* (0.031)	-0.061*** (0.018)
Population <sub>(t-1)</sub>	-7.0e-09 (1.3e-08)	4.4e-09 (3.4e-09)	-6.5e-08** (2.8e-08)	-2.9e-08*** (6.0e-09)	4.5e-09 (6.9e-09)	-4.4e-09** (2.1e-09)
GDP per cap. <sub>(t-1)</sub>	9.1e-07* (5.5e-07)	-4.8e-08 (1.2e-07)	1.3e-06 (9.8e-07)	6.2e-07*** (1.6e-07)	-5.8e-07** (2.7e-07)	3.2e-08 (7.0e-08)
Left Government <sub>(t-1)</sub>	0.0020 (0.0031)	-0.00058 (0.00049)	0.00086 (0.0037)	-0.00070 (0.00077)	0.0012 (0.0028)	0.00027 (0.00050)
Unemployment <sub>(t-1)</sub>	-0.029 (0.040)	0.017** (0.0071)	-0.042 (0.035)	-0.00043 (0.011)	0.066 (0.046)	0.0041 (0.0049)
Economic openness <sub>(t-1)</sub>	-0.00036 (0.0047)	0.0039*** (0.0015)	-0.014*** (0.0037)	-0.0054*** (0.0016)	0.00074 (0.0018)	-0.0013* (0.00074)
Old-age Population <sub>(t-1)</sub>	-0.10 (0.11)	0.036** (0.017)	-0.14 (0.095)	-0.014 (0.032)	0.11** (0.048)	0.0089 (0.012)
Diffusion Variables						
Borders <sub>(t-1)</sub>	-0.0014 (0.0030)	-0.0011* (0.00062)	0.0071*** (0.0023)	0.0022** (0.00087)	-0.00032 (0.0051)	0.0013 (0.0011)
GDP <sub>(t-1)</sub>	-0.017* (0.0087)	-0.0023* (0.0014)	-0.0047 (0.0051)	-0.0021* (0.0013)	-0.0082 (0.0060)	-0.00044 (0.0017)
GDP per cap. <sub>(t-1)</sub>	-0.016 (0.021)	0.014*** (0.0048)	0.13* (0.074)	0.029** (0.013)	0.040 (0.053)	-0.0030 (0.013)
GDP growth <sub>(t-1)</sub>	1.2e-08*** (4.2e-09)	1.4e-09* (7.5e-10)	-5.2e-10 (2.3e-09)	-4.4e-10 (5.6e-10)	-1.1e-08*** (1.9e-09)	5.6e-10 (4.2e-10)
Government Ideology <sub>(t-1)</sub>	0.37*** (0.11)	0.020 (0.020)	-0.034 (0.082)	0.010 (0.020)	0.063 (0.086)	-0.00062 (0.021)
Constant	0.34 (2.39)	-0.49 (0.46)	5.03** (2.46)	1.36 (0.84)	-0.61 (0.63)	0.61*** (0.21)
Observations	465	465	465	465	465	465
Number of countries	15	15	15	15	15	15
R <sup>2</sup>	0.13	0.78	0.09	0.28	0.07	0.07

Robust standard errors in parentheses; \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Appendix:

**Table A-1: Corporate Tax Rates, Ratios and Systems in 1981 and 2006**

	<b>Nominal Rate</b>		<b>Ratio</b>		<b>System<sup>1</sup></b>	
	1981	2006	1981	2006	1981	2006
<b>EU-10</b>						
Mean/ Mode	47.09	29.98	2.33	3.59	I	C,O
Std. Dev.	6.14	6.60	1.26	0.73		
Coeff. Var.	0.13	0.22	0.54	0.20		
<b>OECD-11</b>						
Mean/ Mode	45.48	29.25	3.20	4.78	O	I
Std. Dev.	6.50	7.40	1.86	3.24		
Coeff. Var.	0.14	0.25	0.58	0.68		

Note: own calculations on the basis of OECD tax database.

1 System of Dividend Treatment: Mode in EU-10 and OECD-11 respectively. I = Imputation System, C = Classic System, O = Other.

**Table A-2 Indicators of Personal Income taxation for 1981 and 2006**

	<b>Top Nominal Rate</b>		<b>Ratio</b>		<b>No. of Brackets</b>		<b>Withholding Tax</b>	
	1981	2006	1981	2006	1981	2006	1985	2002
<b>EU-10</b>								
Mean	64.16	46.19	10.42	10.86	13.38	4.56	13.75	16.90
Std. Dev.	7.36	6.39	5.14	5.20	9.41	2.36	13.19	10.85
Coef. Var.	0.11	0.14	0.49	0.48	0.70	0.52	0.96	0.64
<b>OECD-11</b>								
Mean	69.12	44.65	10.28	9.05	11.71	4.00	13.75	18.33
Std. Dev.	17.86	4.40	4.92	3.97	8.12	1.33	17.02	17.56
Coef. Var.	0.26	0.10	0.48	0.44	0.69	0.33	1.24	0.96

Note: own calculations on the basis of OECD tax database and (BMF 1985; Schratzenstaller 2003) for withholding taxes.

**Table A-3 Standard and Reduced VAT Rates, Ratios and Year of Introduction**

	Nominal Rate		Reduced Rates		Ratio		Year of Introduction
	1980	2006	1980	2006	1980	2006	
<b>EU-10</b>							
Mean	16.84	19.31	4.81	4.71	5.88	6.44	1971.80
Std. Dev.	4.27	2.68	2.89	1.45	1.97	2.61	5.46
Coeff. Var.	0.25	0.14	0.60	0.31	0.34	0.41	
<b>OECD-11</b>							
Mean	13.33	13.46	5.00	3.67	3.36	5.15	1986.20
Std. Dev.	5.77	7.08	0.00	3.79	1.96	2.40	8.78
Coeff. Var.	0.43	0.53	0.00	1.03	0.58	0.47	

Notes: own calculations on the basis of OECD tax database.

**Table A-4 Ratios for all Excise Taxes and Rates on Diesel taxation**

	Ratio 81	Ratio 06	Diesel tax rate 80	Diesel tax rate 05
<b>EU-10</b>				
Mean	4.49	3.79	0.12	0.49
Std. Dev.	1.86	0.61	0.09	0.15
Coeff. Var.	0.41	0.16	0.72	0.30
<b>OECD-11</b>				
Mean	4.73	3.74	0.03	0.33
Std. Dev.	1.58	2.28	0.05	0.31
Coeff. Var.	0.33	0.61	1.72	0.93

Notes: own calculations on the basis of OECD tax database and International Energy Agency

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