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The Power Politics of International Tax Cooperation.
Why Luxembourg and Austria accepted automatic
exchange of information on foreign account holders'
interest income

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Abstract

Theories of tax competition predict that small countries competing with large countries benefit, as they find it relatively easy to substitute revenue lost in a tax cut with revenue gained from incoming foreign tax base. If small countries can only lose from tax co-operation, why are Luxembourg and Austria bound to agree to a revised EU Savings Tax Directive that will oblige them to automatically provide information on foreign account holders' interest income to residence countries? Putting emphasis on the neglected issue of power, I show that Luxembourg and Austria were first coerced into bilateral agreements on automatic exchange of information by the United States, which then activated a most-favored nation clause contained in the EU Directive on Administrative Co-operation in Tax Matters. As a result, the two countries were under a legal obligation to also extend greater co-operation to EU partners.

Keywords

International Political Economy, Tax Competition, EU Politics, Power Politics, Tax Policy, Two-Step Approach.

Introduction

Many consider tax evasion a peccadillo. In a world of globally integrated capital markets it has become incredibly easy to hide income in foreign jurisdictions that offer low or no tax on capital gains as well as strict bank secrecy. It is thus no surprise that many investors cannot resist temptation, stripping EU governments of an estimated €864 billion in tax revenue every year (Murphy 2012). In the context of the present crises this is especially troubling. Capital owners who have profited disproportionately from the previous boom now refuse to pay their fair share in support of national budgets, forcing governments to cut more in order to counterbalance the fiscal consequences of saving the banks. As a result, the costs of the crisis are socialized, whereas the original risk takers remain largely unaffected (Blyth [2013]; Streeck [2013]).

Despite the enormity of lost public revenue and related fairness concerns, theories of tax competition find effective international cooperation against tax evasion highly unlikely. This is due to two obstacles for collective action: the weakest link problem (Holzinger 2003), and the small country advantage (Wilson 1999). The former implies that the benefit of non-cooperation increases with the number of cooperating parties. After all, a tax haven among many will attract less foreign capital than the last remaining one (Genschel and Plümper 1997). There will thus always be jurisdictions offering lower tax rates and more secrecy than the average. The small country advantage implies that small countries can actually increase their tax revenues by engaging in tax competition with large countries, given that they find it relatively easy to substitute revenue lost in a tax cut with revenue gained from incoming foreign tax base (Dehejia and Genschel [1999]; Kanbur and Keen [1993]). Furthermore, these theories conceptualize tax competition as a structural constraint that even the most powerful states cannot overcome (Rixen 2013). In practice, Genschel and Schwarz (2011: 354) claim, ‘bullying small states often causes normative indignation and assertive fighting talk rather than submissive behavior.’

Against this background, it is quite puzzling that both Luxembourg and Austria – two small countries among European Union (EU) members – have recently agreed to the adoption of a revised Savings Tax Directive by March 2014 (European Council 2013b). This Directive provides for automatic exchange of information (AEOI) on non-residents’ interest income (Council 2013a: Art. 6). Austria and Luxembourg are thus committing to inform home countries about a significant part of the capital gains non-resident EU nationals earn under their jurisdiction, enabling EU partners to tax their residents’ foreign interest income at their respective domestic rates (Grinberg 2012). As a result, EU residents will no longer be able to evade taxes on interest by moving principal to either Luxembourg or Austria once the revised directive enters into force.

Why do Luxembourg and Austria agree to an EU Directive that potentially undermines their role as financial centers and endangers related tax revenue? So far, they have been the main destinations for foreign investment in mutual funds inside the EU (Dehejia and Genschel [1999]; Sharman [2008]). In 2013 they were still among the most financially opaque countries, ranking 2nd and 18th of 82 non-cooperative jurisdictions included in the financial secrecy index (Tax Justice Network 2013). Also under the current Savings Tax Directive the two countries remain the only EU members not participating in AEOI. Instead, they levy withholding taxes far below the rates imposed on interest income by other EU member states (Rixen and Schwarz 2012). In sum, both countries have so far pursued strategies to attract foreign tax evaders. Now they suddenly change tack.

As mentioned above, theories of tax competition fail to explain Luxembourg and Austria’s newly cooperative behavior. Instead, scholars often refer to domestic constraints when explaining why countries exit the tax race (Genschel and Schwarz 2011). These include institutional restrictions like the number of veto players and their political orientation (Hallerberg and Basinger 2004), or countervailing pressures like budget constraints and fairness norms prevalent among voters (Plümper

et al. 2009; Swank and Steinmo 2002). Yet, also these factors cannot clarify Luxembourg and Austria's repositioning, as they ignore the differential effect of tax competition on small and large countries (Rademacher 2013). Budget constraints, for instance, should rather motivate small countries to be tax competitive, whereas left parties in small countries often appreciate the positive effect of incoming capital on wages and the welfare state (Genschel and Seelkopf 2012).

Instead of referring to domestic constraints, I argue that it was ultimately the United States, the dominant power in international financial affairs, that forced Luxembourg and Austria into cooperation at EU level by threatening their financial institutions with partial closure of the U.S. financial market in case of non-participation in AEOI. They achieved this via the Foreign Account Tax Compliance Act (FATCA) passed by Congress in 2010 and entering into force on 1 July 2014. FATCA obliges foreign financial institutions (FFI) to provide U.S. tax authorities with information on U.S. residents' account balances and capital income, or be subject to a 30% withholding tax on payments from U.S. sources (Grinberg 2012). The act impacted Luxembourg and Austria's position via two channels. Because of a most-favored nation clause contained in the EU Directive on Administrative Cooperation in the Field of Taxation (European Union 2011: Art. 19), compliance with FATCA legally obliges both countries to share equivalent information with EU partners. Moreover, the act alleviates the aforementioned weakest link problem by increasing the likelihood of tax cooperation beyond the EU (Grinberg [2012]; Zipfel [2013]).

Framed this way, my study has broader relevance in several respects. First, it shows that great power initiative may solve collective action problems at the international level (Drezner [2007]; Krasner [1976]), which are often portrayed as inevitable in political and scientific discourse (Rixen [2013]; Sharman [2008]). Second, it underlines the usefulness of a two-step approach to International Political Economy that combines the liberal idea of domestically defined state preferences with the realist postulate of actors' material resources determining international outcomes (Legro and Moravcsik 1999). Third, it illustrates how the U.S. paves the way for tax increases as an alternative to austerity in its response to the financial crisis. As Blyth (2013: 242-3) shows, advisors to the U.S. government question that cutting the budget restores economic growth or reduces sovereign debt. Instead, many 'argue that higher taxes on top earners can pay for debt reduction.' For this strategy to be successful, however, the U.S. first needs to exclude the possibility of tax evasion by imposing AEOI on tax havens.

The remainder of this article is structured as follows. In the next section I provide an historical abstract of EU negotiations on interest taxation, culminating in Austria and Luxembourg's acceptance of AEOI. Subsequently, I review potential explanations for their repositioning and specify my analytical model. The following section presents the empirical evidence drawn from official documents, secondary sources, and two expert interviews.¹ The conclusion sums up my findings and explicates their broader empirical and theoretical relevance.

Inching Towards Automatic Exchange of Information

Legislative Initiatives

The taxation of non-resident interest income has been an issue at EU level since the 1960s. Initially, the Commission considered two possible solutions: harmonized withholding taxes levied by the source country, that is, the country in which income is earned, and an exchange of information among national tax authorities, enabling home countries to tax their residents' foreign income. Due to

¹ Phone interview on 24 May 2013 with Germano Mirabile, Head of Sector Savings Taxation, DG TAXUD, European Commission; phone interview on 8 May 2013 with Florian van Megen, tax policy adviser to MEP Sven Giegold, member of the European Parliament's Committee on Economic and Monetary Affairs.

member state concerns over national bank secrecy provisions, its first two proposals of 1967 and 1989 foresaw the introduction of harmonized withholding taxes. Still, they did not pass Council because of member state disagreement over the common rate (Rixen and Schwarz 2012), and opposition from the UK and Luxembourg, arguing that the tax would push business out of the common market (Genschel and Plümper 1997).

Still, the Commission made a third proposal in 1998, leading to the adoption of the EU Savings Tax Directive in 2003. Conditions for agreement had become more favorable in the mid-1990s. First, member states had to consolidate their budgets due to economic recession and the limits for sovereign debt contained in the Maastricht criteria. Second, the further international liberalization of capital markets had exacerbated the problem of tax evasion (Genschel 2002). The 1998 proposal foresaw the so-called co-existence model, that is, the introduction of AEOI with an option to levy a withholding tax instead, and a mandate for the Commission to negotiate agreements with relevant third countries, guaranteeing the equivalent taxation of interest earned by EU residents under their jurisdiction (Holzinger 2003).

Initially, traditional member state divisions prevailed, as the UK, Austria, and Luxembourg made the cooperation of all relevant third countries ‘a precondition for the European solution’ (Holzinger 2003: 8). A breakthrough was not achieved until the UK surprisingly quit the opposing coalition. Thereby, the British government took the withholding tax option off the table for good, which it considered more harmful to its banking sector than AEOI (Genschel 2002). Hence, the only remaining opponents of AEOI were Luxembourg and Austria, affirming they would only abandon bank secrecy, if relevant third countries did so as well. Increasingly isolated due to consensus among all remaining member states, they eventually agreed to the Savings Tax Directive in its current form (Genschel 2002).

The EU Savings Tax Directive

Adopted in 2003, the Directive’s ultimate objective is the introduction of EU-wide AEOI on non-residents’ interest income (European Community 2003: Preamble). As a side-payment to Luxembourg and Austria, it provides for a transition period during which the two countries and Belgium² may levy a withholding tax instead (Art. 10). Its initial rate was fixed at 15%, increased to 20% in 2008, and to 35% in 2011. The resulting revenue is divided between the source country (25%) and the residence country (75%) (Art. 12). Formally, the transition period ends once the EU reaches an agreement with Switzerland and four other small European states on exchange of information upon request³ (European Community 2003: Art. 10). However, in agreements with the EU these countries had merely accepted to implement the withholding option at the time of writing (Rixen and Schwarz 2012).

Together the above elements created several loopholes that have facilitated intra-EU tax evasion also after the Directive entered into force in 2005. At least until 2011, Austria and Luxembourg were able to levy withholding taxes far below taxes on interest income applicable in other EU member states. Hence, there remained an incentive for tax evaders to shift principal under their jurisdictions. Because both countries are still not participating in AEOI, their bank secrecy provisions continue to provide protection for these acts. Moreover, the Directive’s narrow definition of interest allows investors to avoid both AEOI and withholding by simply changing their type of investment from debt to equity, whereas its exclusive focus on the income of natural persons provided tax evaders with the

² Belgium did not prefer the withholding tax model per se. It followed Luxembourg’s decision due to the tight integration of the two countries’ capital markets (Holzinger 2003). The country participates in AEOI since 2010 (Commission 2013).

³ Unlike AEOI, exchange of information upon request presupposes a reasonable suspicion of tax evasion on the part of the residence country. This requires data that tax authorities either do not have or can only acquire through the purchase of stolen data (Grinberg 2012).

option to operate through a legal person in order to circumvent the Directive (Rixen and Schwarz 2012).

Current Revision

In 2008 the Commission presented an amending proposal, addressing some of these loopholes. First, it proposed to extend the scope of the Directive to include all payments that could be considered equivalent to interest by investors (Commission 2008). Second, it suggested obliging financial institutions to apply a ‘look-through approach’ to identify the actual beneficial owner of an interest payment made to an interposed legal entity (Commission 2008: 3). In contrast, the co-existence model, exempting Luxembourg and Austria from AEOI, was left untouched.

Member states did not take immediate legislative steps towards the adoption of the proposal, but discussions on AEOI progressed at the international level. The G20 declared at their 2009 summit in London that ‘the era of banking secrecy [was] over,’ and they would take agreed action against jurisdictions not complying with OECD standards for tax cooperation (G20 communiqué cited in Grinberg 2012: 8). In parallel, the OECD published a list of incompliant countries that for the first time also included some of its own members. In response, targeted jurisdictions like Switzerland, Liechtenstein, San Marino, Monaco, and Andorra, eventually adopted OECD standards for exchange of information upon request (Grinberg 2012), making fulfillment of the most important condition for an end to the transition period specified in article 10 of the Savings Tax Directive more likely. Meanwhile, the OECD also amended the Convention on Mutual Administrative Assistance in Tax Matters, turning it into a ‘full-fledged vehicle for automatic information exchange’ (Grinberg 2012: 54). The United States, on its part, adopted FATCA, obliging foreign financial institutions (FFI) to automatically report information on U.S. held accounts or be subject to a 30% withholding tax on ‘payments from US sources’ (Grinberg, 2012: 24).

These developments seemed to make AEOI the new global standard for tax cooperation. In response, EU countries first adopted the Directive on Administrative Co-operation in the Field of Taxation in 2011. This Directive provides for the gradual phasing in of AEOI on all types of personal income until 2017, excluding interest and equivalent income covered by the Savings Tax Directive (European Union 2011: Art. 8). Nonetheless, comprehensive AEOI on interest income was back on the agenda, given that the Administrative Cooperation Directive recognized AEOI as ‘the most effective means of enhancing the correct assessment of taxes in cross-border situations and of fighting fraud’ (European Union 2011: Preamble). Accordingly, heads of state and government called for the Savings Tax Directive’s swift revision in European Council Conclusions of June and October 2012 (European Council [2012a]: para. (j); European Council [2012b]: para. (h)).

The Endgame

A revision of the Savings Tax Directive was in the interest of all EU member states. Luxembourg and Austria wanted to avoid rulings by the European Court of Justice (ECJ) forcing them to adopt AEOI based on either article 19 of the Administrative Cooperation Directive (most-favored nation clause), or article 10 of the Savings Tax Directive (transition clause). Their aim was to extend the transition period by making their adoption of AEOI conditional on the adoption of similar measures by Switzerland and the other small European states, who had moved towards fulfilling conditions for an end to transition by accepting OECD standards for information exchange upon request.⁴

In contrast, large member states saw an opportunity to finally extend AEOI to Luxembourg and Austria. To increase pressure on the two countries, finance ministers of France, Germany, Italy, Spain, and the United Kingdom announced in a letter to EU Tax Commissioner Semeta that they were

⁴ Interview with Germano Mirabile.

working with the U.S. on the elaboration of ‘a pilot multilateral exchange facility between our countries using [FATCA] as the basis for this multilateral exchange’ (G5 Finance Ministers 2013: 1). Determined to make their pilot the template for global AEOI, finance ministers invited other EU members to join and called for swift progress on comprehensive AEOI within Europe. Particularly, they urged ‘effective application’ of the most favored nation clause and called for swift adoption of the revised Savings Tax Directive (ibid.).

The following day, Luxembourg’s Prime Minister Juncker announced that, due to the ‘radical position of the United States’ and the international trend towards AEOI, the country would participate in automatic exchange of information on income covered by the Savings Tax Directive from 1 January 2015 (Juncker 2013: 17). Still, both the Luxembourgish and Austrian finance ministers refused to agree to the revised Savings Tax Directive at the ECOFIN meeting of 14 May 2013, jointly stating that a level international playing field had to be established ahead of their consent (Le Soir 2013). In view of this, they agreed to a mandate for the EU Commission to negotiate treaties based on the draft revised Savings Tax Directive with Switzerland, and the European micro-states (Council [2013b]; Standard [2013b]).

At the European Council of 22 May 2013 the Austrian chancellor and Luxembourgish Prime Minister then pledged along with their EU counterparts ‘to extend the automatic exchange of information at the EU and global levels’ and, ‘noting the consensus on the scope of the revised Directive on the taxation of savings income, [...] called for its adoption before the end of [2013]’ (European Council 2013a: 6-7). Hence, Luxembourg and Austria have in principle agreed to the implementation of AEOI on ‘a full range of income’ (ibid.), but made formal consent conditional on the progress of negotiations with Switzerland. After the European Council of 18 December 2013 had postponed formal adoption of the Directive to March 2014 (European Council 2013a), the newly elected Luxembourgish Prime Minister Bettel further relaxed this condition, stating ‘Luxembourg will be sure to accept this Directive as soon as the Commission confirms negotiations with Switzerland and these five states that go in [the] direction [of AEOI]’ (Bettel 2014).

Explaining Tax Cooperation by Small States with Big Banks

Austria and Luxembourg are thus bound to end bank secrecy by participating in AEOI on foreign held accounts, making themselves less interesting destinations for tax evaders; a decision that should be against their own best interest due to the likely outflow of foreign capital. In what follows, I will present the baseline model of tax cooperation and review potential explanations for Austria and Luxembourg’s repositioning before presenting my own hypothesis.

The Baseline Model

The baseline model of tax competition makes two fundamental assumptions: jurisdictions share a common tax base in a world of mobile capital, and seek to maximize their tax revenue (Dehejia and Genschel 1999). Due to potential capital flight, jurisdictions are constrained in their choice of unilateral strategies: they cannot maximize tax revenue by increasing the tax rate. Instead, they try to widen their tax base by attracting foreign capital with low or no taxes, triggering a competitive dynamic that eventually reduces every jurisdiction’s tax revenue (Genschel and Schwarz 2011). To get out of this pareto inefficient situation jurisdictions need to cooperate either by harmonizing their tax rates or by exchanging information on foreign held accounts (Holzinger 2003). This, however, is complicated by two structural factors. First, not all countries suffer equally from tax competition. For small states it is indeed much easier than for large states to compensate a revenue loss from a tax cut on their small domestic tax base with a revenue gain from the influx of part of the large foreign tax base (Genschel and Schwarz 2011). Because they are more likely to gain from tax competition, small states are thus expected to undercut cooperative efforts pushed forward by large, capital exporting

states (Dehejia and Genschel [1999]; Keen and Ligthart [2006]). Second, an eradication of tax evasion can only be achieved, if all potential tax havens cooperate. However, the benefits of staying outside the coalition increase with its size, since being a tax haven among many is less profitable than being the only remaining one (Genschel and Plümper 1997). Hence, there is only a slim chance for cooperators to persuade the weakest link country of joining their ranks. The baseline model thus makes two propositions as to the likelihood of a government's cooperative behavior in capital taxation:

P1: In asymmetric settings small states compete whereas large states cooperate.

P2: Third states are more likely to compete as the size of the cooperating coalition increases.

Domestic Factors

Next to the abovementioned structural factors the literature identifies several domestic motivators and constraints that may impact a country's decision to cooperate or compete. Holzinger (2003) argues that revenue from capital taxation is not the only factor in a government's utility function. Rather, it may value political and economic benefits linked to a dynamic financial sector more than a given level of tax revenue and therefore have an incentive for cuts. Whether a government prefers a dynamic financial sector to revenue from capital taxation or vice versa then depends on its budget constraints, and on the importance of financial services for the national economy (*on budget constraints see also: Plümper et al. [2009]; Swank and Steinmo [2002]; Hallerberg and Basinger [2004]*). The following propositions result from this argument:

P3: States with a large financial sector compete, whereas states with a small financial sector cooperate.

P4: States with low public debt compete, whereas states with high public debt cooperate.

Further domestic factors that may impact a government's preference for competition or cooperation include its ideological orientation, the number of institutional veto players it faces, and fairness concerns voiced by the electorate. Hallerberg and Basinger (2004) state that left-of-center governments are more likely to cooperate than conservative governments because they aim to shift the tax burden towards capital and away from labor to relieve their core electorate. In addition, the authors claim that governments facing a high number of domestic veto players are more likely to cooperate than governments with little opposition, since a competitive strategy, involving successive tax cuts, is difficult to pursue, if legislative procedures for tax reform are cumbersome. Moreover, Plümper et al. (2009) maintain that a high degree of voter attachment to fairness norms, potentially affecting their electoral choice, should induce a government to cooperate rather than compete.

P5: States with left-of-center governments cooperate, whereas conservative governments compete.

P6: A government becomes more likely to cooperate, as the number of domestic veto players increases.

P7: A government becomes more likely to cooperate, as voter attachment to fairness norms intensifies.

International Constraints

Theories of tax competition assume a lack of hierarchy and institutional constraints at the international level, leading to an impoverishing race-to-the-bottom among nation-states (Steinmo 1994). Its proponents argue that not even great powers are able to induce cooperation through unilateral measures (Rixen 2013). Sharman (2006) claims side payments to tax havens are politically hard to defend for democratically elected governments. Genschel and Schwarz (2011: 354) assert 'bullying small states often causes normative indignation and assertive fighting talk rather than submissive behavior.'

In contrast, I argue that a credible threat by a great power will force competitive states into cooperation. In the financial market context, the only great power, that is, a government that oversees an internal market considered indispensable by outside economic actors (Drezner 2007), are the United States (Simmons 2001). This is illustrated by World Bank data presented in *Table 1*. Between 2008 and 2012 the U.S. stock market was between three and five times as big as the second largest market, consistently accounting for over 55% of the combined value of top 5 stock markets. Indeed, it is hard to imagine that a financial institution would voluntarily renounce to doing business on Wall Street. Hence, when the U.S. government demands certain behavior from a foreign government and announces consequences for the access of that country’s financial institutions to the American capital market in case of noncompliance, deference by the foreign government is most likely. As Stephen Krasner (1976) and Robert Gilpin (1975) postulated almost 40 years ago, the hegemon’s threat to close its market to foreign economic actors entails cooperative behavior from targeted governments.

H1: If a great power requests tax cooperation from a foreign government, issuing a credible threat of market closure in case of noncompliance, the foreign government will cooperate.

Table 1: Top 5 Stock Markets as Indicated by Market Capitalization of Listed Firms (Million Current US\$)

Year	United States	China	Japan	United Kingdom	Canada/ France	U.S. % of Top 5
2008	11.738	2.794	3.220	1.852	1.492 (FR)	56
2010	17.139	4.763	4.100	3.107	2.160 (CN)	55
2012	18.668	3.697	3.681	3.019	2.016 (CN)	60

Source: World Bank 2013

Analyzing the Evidence

The Strategic Setting and Its Environment

From the historical abstract of EU negotiations on the taxation of interest income provided above I deduct a simplified strategic setting in which small Luxembourg and Austria bargain with large France, Germany, Italy, Spain, and the UK over the adoption of AEOI on non-resident’s interest income inside the EU. The strategic environment is made up of the United States and Switzerland. The United States’ position on interest taxation is relevant to all bargaining parties because of its dominant financial market. Switzerland’s position has in the past been emulated by the four small European tax havens outside the EU (Sharman 2008), and thus determines the likelihood of capital flight from the common market.

Preferences

Eager to preserve bank secrecy to remain attractive for foreign tax evaders, Austria and Luxembourg clearly disliked the idea of cooperation in AEOI. Under the current Savings Tax Directive that in principle already provides for automatic information exchange, they have merely levied a withholding tax at an initially minimal rate, the proceeds of which they have partly channeled to foreign account holders’ home countries, albeit without disclosing information that could have enabled foreign tax authorities to enforce the residence principle (European Community 2003: art. 10). Also during negotiations on the revision of the Directive, Austria and Luxembourg maintained their common preference. Luxembourg’s Prime Minister Juncker affirmed in his 2013 state of the nation speech that his government favored the withholding tax model as ‘retention at source [is] more effective than the very complex system of automatic information exchange’ (Juncker 2013: 16). Likewise, the country’s minister of finance Frieden affirmed in an interview that ‘he remained of the opinion that a

withholding tax is the better and more efficient model' (Finanz und Wirtschaft 2013). Meanwhile, Austria's minister of finance Fekter declared Austrian participation in European AEOI was unnecessary and she 'will fight like a lion' to defend the country's bank secrecy provisions (Kurier 2013).

Large member states, on the other hand, had already been exchanging information with each other under the Savings Tax Directive of 2003, and thus were eager to extend the scope of AEOI also to the last remaining opponents. In a joint letter to EU Tax Commissioner Algirdas Semeta, the finance ministers of France, Germany, Italy, Spain, and the UK affirmed their objective 'to promote [AEOI] as the new international standard,' expressed their hope 'that Europe can take a lead in promoting a global system of automatic information exchange,' and called on EU member states to 'agree without delay on the amending proposal to the Savings Tax Directive of 2003' (G5 Finance Ministers 2013: 1). Hence, they did not only push for universal AEOI inside the EU, but also saw European cooperation as an important stepping-stone towards global agreement.

P1 and *P2* thus perfectly match the preferences of bargaining governments. Small countries benefiting from tax competition favored non-cooperation, whereas large countries – the likely capital exporters – pushed for AEOI not only at the European but also at the global level. Likewise, the two remaining non-cooperative governments at EU level were eager to preserve their special status as withholding tax countries. The same holds for budgetary constraints (*P4*). Luxembourg's state deficit is at very low 21% of GDP, whereas Austria – with a deficit of 73% of GDP – is still less indebted than all of the large EU member states (Eurostat 2013a). Moreover, in accordance with theoretical assumptions on the outcome of bargaining in asymmetric settings, Austria's minister of finance feared a reduction of tax revenue in case of co-operation in AEOI due to a likely narrowing of the tax base (Frankfurter Allgemeine Zeitung 2013). Large member states, on the other hand, faced deficits from over 80 (Germany, Spain) to more than 120% of GDP (Italy) (see Table 2). Hence, in accordance with *P4* large member states had a strong incentive to raise their tax revenue, whereas small member states could not only afford low tax rates, but also relied on them to maintain the size of their tax base.

Evidence for the remaining domestic constraints is less clear. As indicated in Table 2 Luxembourg features by far the largest financial sector relative to GDP, whereas Austria's financial sector is of average size. Among large countries, the UK's financial sector is of disproportionate size as compared to other countries. Accordingly, *P3* matches the data only imperfectly. Furthermore, Austria and Luxembourg were both governed by grand coalitions of conservative and social-democratic parties, and both had a conservative minister of finance during most of the endgame negotiations. Among the five large member states in favor of tax cooperation three had a conservative and two a social-democratic or socialist government (Germany, Spain, United Kingdom vs. France, Italy). Hence, *P5* does not explain observed preferences very well, which is likely due to the positive effect of tax competition on wages and welfare state size in small countries that also left-of-center parties there appreciate (Genschel and Seelkopf 2012).

Table 2: Comparative Country Data on Propositions 1, 3, 4, and 7

Country	Population (millions)	Debt Level (% of GDP)	Balance Sheet Total in Banking (% of GDP)	Gini-Coefficient
Austria	8.404	73	322	0.26
Luxembourg	512	21	2441	0.27
France	64.978	90	337	0.29
Germany	81.752	82	315	0.30
Italy	59.365	127	214	0.34
Spain	46.667	84	280	0.31
United Kingdom	63.023	90	503	0.34

Sources: DICE [2012]; Eurostat [2013a], [2013b]

Likewise, the number of institutional veto players is not very indicative. Germany and Austria, for instance, have almost matching legislative systems, and were governed by coalition governments during negotiations, but had divergent preferences on tax cooperation. The same holds true for fairness norms when approximating their importance with national inequality levels as proposed by Plümper et al. (2009). Austria, the most equal country with a Gini-coefficient of .26 favored tax competition, whereas Italy and the UK, the most unequal countries with Gini-coefficients of .34 favored cooperation (DICE 2012). Accordingly, both *P6* and *P7* do not fit observed preferences.

In sum, the preferences of bargaining EU member states are best explained by country size, weakest-link status, and budgetary constraints. In accordance with their values on these variables, Luxembourg and Austria clearly preferred non-co-operation to participation in AEOI. Still, they eventually accepted the latter as shown in *section two*. A change in preferences motivated by domestic factors can thus not account for their change of tack. Rather, their repositioning is most likely a reaction to constraints at the international level.

International Constraints

The most significant international constraint within the domain of capital taxation is the Foreign Account Tax Compliance Act adopted by the U.S. Congress in 2010 and entering into force on 1 July 2014. FATCA obliges FFIs to provide the Internal Revenue Service (IRS) with information on the balance of accounts held by U.S. persons or entities, and the amount of interest, dividends, and other income upon investments credited to these accounts (Grinberg 2012). It threatens noncompliant FFIs with the imposition of a 30% withholding tax ‘on the gross amount of certain payments from U.S. sources and the proceeds from disposing of certain U.S. investments’ (Grinberg 2012: 24). It is the stated aim of the U.S. administration to apply FATCA rules to all financial centers that do business in the United States. Accordingly, Luxembourg and Austria were quasi coerced to enter negotiations over FATCA agreements with the U.S.. At the time of writing, Luxembourg had just concluded an agreement, whereas Austria was engaged in negotiations (Grand Duchy [2013]; Standard [2013a]). The U.S.’s adoption of FATCA and Luxembourg and Austria’s deference to it impact the two countries’ positioning as to the revised Savings Tax Directive through two different channels.

First, the conclusion of FATCA agreements with the United States activates a most-favored nation clause contained in the EU Directive on Administrative Cooperation in the Field of Taxation. This clause stipulates that ‘where a Member State provides a wider cooperation to a third country than that provided for under this Directive, that Member State may not refuse to provide such wider cooperation to any other Member State’ (European Union 2011: Art. 19). By concluding FATCA agreements, Austria and Luxembourg are thus under a legal obligation to automatically share information provided to the U.S. also with their EU partners. What is more, EU Tax Commissioner Semeta in several interviews as well as the G5 finance ministers in their letter to the Commissioner have underlined their willingness to enforce the most-favored nation clause via the ECJ, if Luxembourg and Austria did not agree to intra European AEOI in the legislative arena (Standard [2013c]; Spiegel [2013]; G5 Finance Ministers [2013]). In his state of the nation speech PM Juncker confirms the impact of this constraining constellation at the international level:

‘If we now modify our position, we do it because the Americans do not leave us a choice. They restrict their financial operations to countries, which accept automatic exchange of information. If we do not comply with this condition, there won’t be any financial operations with the USA. Yet, an international financial center cannot cut itself from the American financial circuit. [...] We cannot refuse to also extend to the Europeans the concessions that we have to make to the Americans within the context of a bilateral treaty’ (Juncker 2013: 16-17).

Along the same lines, Germano Mirabile, Head of Sector for Savings Taxation at the EU Commission, asserts that

‘there is a sense of urgency among member states because in article 19 of the Administrative Cooperation Directive there is a most-favored nation clause. This means that member states, having concluded a FATCA agreement with the US, need to decide now on a legal basis for their equivalent cooperation with EU partners.’⁵

Next to creating a legal obligation to enter negotiations on equivalent cooperation with EU partners, FATCA had an impact on the positioning of Luxembourg and Austria by alleviating the aforementioned weakest link problem. It is not only the United States’ objective to conclude FATCA agreements with every financial center doing business in the U.S., but also to ‘use FATCA as a vehicle to achieve a multilateral system’ (Grinberg 2012: 25). To this end, the U.S. has already signed FATCA agreements with 18 jurisdictions, including Switzerland, the reference country for Luxembourg, Austria, and the European micro-states (U.S. Treasury 2013). As a result of its bilateral agreement with the U.S., the Swiss government announced a change in its financial market strategy in August 2013, accepting that AEOI will become ‘the global standard for tax compliant business with foreign clients,’ and pledging to actively participate in the elaboration of a global AEOI standard at OECD level (Eidgenössisches Finanzdepartement 2013). Moreover, an expert group appointed by the Swiss ministry of finance recommended offering AEOI to the EU before it is formally established as a global standard (Brunetti 2013). This change of tack seems to be felt by Swiss banks already, which have threatened to close the accounts of their German and Dutch clients if they do not straighten their relationship with the tax authorities of their home countries (Greive and Seibel 2013).

In addition to their bilateral efforts, the U.S. successfully promoted AEOI as a model for international tax cooperation at the G8 and G20 (New York Times 2013), which is reflected in the most recent declarations of these two bodies. Whereas G8 leaders declared that ‘tax authorities across the world should automatically share information to fight the scourge of tax evasion’ (Prime Minister’s Office 2013: para. 1), G20 heads of state and government stressed they ‘are committed to automatic exchange of information as the new global standard’ and tasked the OECD to develop a functioning model until mid-2014 (G20 Leaders 2013: para. 51). Hence, the likelihood that further tax havens outside the EU will soon have to participate in AEOI has substantially increased, lowering the potential for capital flight from Austria and Luxembourg to these destinations. Along these lines also Germano Mirabile points out that many financial centers outside the EU will start cooperating with the U.S. under FATCA, and are thus ‘under pressure to provide the same kind of information to the EU.’ More generally, he affirms that the potential for capital flight from the common market has been greatly reduced:

‘In the present environment there is no durably safe financial place. The pressure at the international level has made the situation clear even for financial centers far from the EU. This does not mean that the problem of tax evasion is solved, but it has become much more difficult to hide assets in tax havens. You have to set up ever more screens and this increases the risk for investors to lose their money.’⁶

Accordingly, even without formal multilateral agreement, current international initiatives driven by FATCA have increased transaction costs for tax evaders to the point that capital flight from Luxembourg and Austria to other tax havens is less probable. U.S. insistence at the international level has thus greatly reduced the costs of cooperation within the EU for the two countries.

⁵ Interview on 24 May 2013.

⁶ Interview on 24 May 2013

Conclusion

Since the beginning of EU negotiations on interest taxation in the 1960s, Luxembourg was opposed to any kind of cooperation that would undermine its competitiveness as a financial center. Likewise, Austria insisted on the maintenance of its bank secrecy provisions since entering the EU in 1995. Still, the two countries remain the only EU member states that do not automatically exchange information on foreign account holders' interest income. Their recent commitments to participate in AEOI within the scope of a revised Savings Tax Directive and potentially beyond can thus be qualified as a major breakthrough in the fight against tax evasion. As I have pointed out in the last sections, this breakthrough has not been brought about by a change in preferences determined at the domestic level. Rather, FATCA legislation by the United States forced Luxembourg and Austria to accept AEOI in a bilateral agreement. This eventually activated a most-favored nation clause contained in the EU Directive on Administrative Cooperation in the Field of Taxation, legally obliging the two countries to also cooperate with EU partners. Not submitting to U.S. pressure would have meant limited access to the American financial market for Luxembourgish and Austrian FFIs. Not making the same concessions to EU partners as to the US would have led to condemnation by the ECJ. In addition, the U.S. induced trend towards multilateral agreement on AEOI at the international level lowered the risk of capital flight from Luxembourg and Austria to third countries, alleviating the weakest link problem.

More generally, the case of Luxembourg and Austria's repositioning illustrates that great power initiative may induce cooperation in policy fields that scholars have qualified as inherently resistant to international agreement. As expected by realist theory, the U.S. government was able to issue a credible threat of market closure to countries not exchanging information on U.S. account holders' capital gains, prompting widespread cooperation instead of circumvention of the American capital market. After all, capital flight does not seem to be as imperative a consequence of regulation as it is often portrayed. Instead, there still seem to be significant transaction costs that inhibit perfect capital mobility, allowing even less than universal regulatory initiatives to be effective. As a result, taxing the rich to reduce sovereign debt may become a viable and increasingly popular government strategy in the coming years. Alleviating fears of its near end, U.S. sponsored international tax cooperation may thus usher in the renaissance of redistribution.

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