Power in International Tax Policy

The Preconditions and Redistributive Consequences of Credible Sanction Threats

Lukas Paul Hakelberg

Thesis submitted for assessment with a view to
obtaining the degree of Doctor of Political and Social Sciences
of the European University Institute

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Department of Political and Social Sciences

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I confirm that chapter 8 was jointly co-authored with Mr. Max Schaub and I contributed 70% of the work.

I confirm that chapters 1 and 3, as well as section 7.4 draw upon an earlier article I published in the *Review of International Political Economy*:

Hakelberg, Lukas (2016) Coercion in international tax cooperation: identifying the prerequisites for sanction threats by a great power. *Review of International Political Economy* 23(3): 511-541.

I confirm that sections 7.3. and 7.4. draw on an earlier article published in *Journal of European Public Policy*:

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List of Abbreviations

ABA	American Bankers Association	IGA	Intergovernmental Agreement
AEI	Automatic Exchange of Information	IMF	International Monetary Fund
ATAD	Anti-Tax Avoidance Directive	IP	Intellectual Property
BEPS	Base Erosion and Profit Shifting	IRS	Internal Revenue Service
BIAC	Business and Industry Advisory Council	KYC	Know Your Customer
BIS	Bank for International Settlements	LGT	Liechtenstein Global Trust
CCCTB	Common Consolidated Corporate Tax Base	LLC	Limited Liability Company
CDD	Customer Due Diligence	MCAA	Multilateral Competent Authority Agreement
CFC	Controlled Foreign Company	MFN	Most-Favored-Nation
CFP	Center for Freedom and Prosperity	MOU	Memorandum of Understanding
CRS	Common Reporting Standard	NRA	Non-Resident Alien
DoJ	Department of Justice	OECD	Organisation of Economic Cooperation and Development
DPA	Deferred Prosecution Agreement	OFC	Offshore Financial Center
ECJ	European Court of Justice	PE	Permanent Establishment
ECOFIN	Council on Economic and Financial Affairs	PSI	Permanent Subcommittee on Investigations
EITC	Earned Income Tax Credit	PTR	Preferential Tax Regime
EU	European Union	QI	Qualified Intermediary
FATCA	Foreign Account Tax Compliance Act	R&D	Research and Development
FATF	Financial Action Task Force	SBA	Swiss Banking Association
FDI	Foreign Direct Investment	SNB	Swiss National Bank
FFI	Foreign Financial Institution	TIEA	Tax Information Exchange Agreement
FinCEN	Financial Crimes Enforcement Network	TJN	Tax Justice Network
FPI	Foreign Portfolio Investment	US	United States
G7	Group of Seven	UBS	United Bank of Switzerland
G20	Group of Twenty	UNCTAD	United Nations Conference on Trade and Development
GAO	Government Accountability Office	USCIB	United States Council for International Business
HTC	Harmful Tax Competition	USFI	United States Financial Institution
IBC	International Business Corporation	WTO	World Trade Organization

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Abstract

International cooperation against tax evasion has had a long history of failure. Tax havens protecting the income and identities of their foreign clients through financial secrecy have persistently resisted requests from major developed economies for administrative assistance. Since 2014, however, more than 100 countries, including all major offshore centers, have agreed to automatically exchange information (AEI) on capital income earned by non-residents. Why did tax havens adopt AEI after decades of firm resistance against greater financial transparency? Conventional theories of tax cooperation do not provide an answer. Contractualist approaches expect international agreements to produce joint gains. Yet, countries substituting financial secrecy for the routine reporting of account information lose relative to the status quo ante, as hidden capital flows out, and wage levels and employment decline. Constructivist approaches expect shared regulative norms of sovereignty and nonintervention to prevent major economies from using coercion against noncooperative tax havens. In contrast, I trace tax haven cooperation in multilateral AEI back to a credible threat of economic sanctions from the United States (US). The US – the only great power in tax matters for the time being – linked access to its financial market to tax haven participation in bilateral AEI. This, in turn, provided the rest of the world with an opportunity to request cooperation in multilateral AEI from them. By comparing three major tax initiatives of the Organisation for Economic Co-operation and Development (OECD), I show, moreover, that the US makes such a sanctions threat when domestic constraints prevent regressive tax reform, and it can shift the costs of regulation to foreign actors. A nested differences-in-differences analysis also reveals that a credible sanctions threat reduces the value of foreign asset holdings in tax havens relative to non-havens.

1. Introduction and Overview

Many wealthy individuals and multinational corporations do not pay the taxes they owe. As a consequence of financial market liberalization and the gradual abolition of capital controls over the course of the 1970s and '80s, they have – with increasing facility – saved and invested across borders, earning a growing share of their profits and capital income outside their country of residence.[1] As the International Monetary Fund (IMF) reports, the value of worldwide foreign portfolio investment (FPI) quadrupled between 2001 and 2014.[2] Data from the Bank for International Settlements (BIS) even suggests that the world's households and non-financial corporations deposited ten times as much financial wealth cross-border in 2014 as they had in 1987.[3] At the same time, tax authorities have continued to only take into account information that is domestically available or provided by taxpayers in their tax filings. Accordingly, individuals have an incentive to evade taxes by underreporting their foreign capital income, whereas corporations with branches in several countries can avoid taxes by making conflicting statements to different tax authorities about the location of their profits, or the character of certain payments. As a result, governments across the world lack accurate assessments of their (wealthy) residents' worldwide income, and have thus found it increasingly difficult to implement truly progressive tax systems.[4] Hence, the ability-to-pay principle – according to which high-income earners should contribute a larger share of their income to the financing of the state than low-income earners – is currently in retreat.

Tax evasion by individuals and tax avoidance by corporations is usually abetted by tax havens wishing to attract foreign capital. These jurisdictions abet tax evasion by charging low or no taxes on capital income, by concealing account-holder identities behind banking secrecy, trusts, or shell corporations and by refusing to comply with requests for administrative assistance from foreign tax authorities. They abet avoidance by offering low or no taxes on corporate profits and by exempting certain types of revenue – for example from the lease of intellectual property – from taxation. As a result, and according to the most conservative estimate,[5] tax havens hosted $5 trillion in undeclared financial wealth in 2013,

[1] Helleiner 1996.
[2] IMF 2015.
[3] BIS 2015.
[4] Ganghof 2006; Genschel and Schwarz 2013.
[5] Palan et al. (2010) put the value of financial wealth hidden in tax havens at $12 trillion.

representing eight percent of the world's households' overall financial wealth that year.[6] Likewise, US corporations booked $520 billion in profits in tax havens in 2013, representing 55 percent of their overall foreign profits that year. A mere 20 percent of these profits were repatriated and thus taxed in the United States.[7] The flipside of these numbers is an enormous loss in revenue from the taxation of capital income and corporate profits. According to Zucman, European countries lost $75 billion in tax revenue to tax evasion by individuals in 2013, whereas the US lost $36 billion. Moreover, he estimates that tax avoidance by multinational corporations cost the US Treasury up to $160 billion the same year.[8] As governments are less and less able to make the owners of capital participate in their financing, the tax burden effectively shifts to less mobile revenue sources like labor and consumption. Given that low-income earners usually earn a larger share of their income from labor than high-income earners, and also use a larger share of their income for consumption, tax evasion and avoidance are thus likely to have a regressive impact on domestic tax systems.[9]

There are remedies to both phenomena. Yet, these necessitate a high level of international cooperation. In order to curb tax evasion, governments could agree to oblige their banks to routinely report information on non-resident account holders, the assets they hold, and the capital income they earn, and then automatically exchange that data among each other. Ideally, such a regime would be backed up by a requirement for banks to look through interposed corporate structures concealing the actual identity of their clients, and governments could use global ownership registers of securities and shell corporations to verify the information received from financial institutions.[10] Such a regime would enable tax authorities to make accurate assessments of their residents' worldwide income so as to tax them accordingly. In order to curb tax avoidance governments could choose one of two broad cooperative approaches. First, they could develop a stringent global standard for controlled foreign company (CFC) rules, and transpose it into domestic law. CFC rules enable tax authorities to treat profits earned by a resident company's foreign subsidiary as domestic income. Hence, they remove the incentive for artificially shifting profits to low tax jurisdictions.[11] Second, governments could opt to treat a multinational corporation as a single

[6] Zucman 2014a.
[7] Zucman 2014b.
[8] Ibid.
[9] Genschel and Schwarz 2013.
[10] Zucman 2014a; Meinzer 2013.
[11] OECD 2015a.

entity for tax purposes, and apportion the resulting tax revenue according to a certain formula based, for example, on local staff, sales, and assets.[12]

Several international fora have discussed these proposals for decades, and different groups of countries have implemented versions of some of these instruments at a less than global scale.[13] Yet, the noncooperative behavior of tax havens, international tax competition more broadly, and concerns over losses in national sovereignty have consistently undermined such efforts.[14] On the evasion side, the longstanding refusal by countries such as Switzerland, Liechtenstein, and other tax havens to grant foreign tax authorities administrative assistance upon request in accordance with OECD standards for information exchange stands as a clear example.[15] Likewise, Luxembourg and Austria have refused to participate in European Union (EU)-wide automatic exchange of information on non-residents' interest income.[16] On the avoidance side, examples include the OECD's failed attempt at curbing the preferential tax regimes (PTRs) that are in place in many of its members,[17] and the ineffectiveness of CFC rules resulting from the deliberate maintenance of loopholes in the US,[18] and European Court of Justice (ECJ) jurisprudence defending the freedom of incorporation in the EU.[19] At a more fundamental level, most national governments are skeptical towards unitary taxation for fear of losing their sovereign right to tax corporations operating on their territory.[20]

Analysts attribute this history of failure to several strategic dilemmas. Most view international tax competition as an asymmetric prisoner's dilemma benefitting small over large countries. Assuming perfect international capital mobility, they expect small countries to find it easier than large countries to substitute revenue lost to a tax cut on their small domestic tax base with revenue generated from a foreign tax base attracted as a result of that tax cut. In the competitive equilibrium they therefore end up with lower tax rates, higher tax revenue, and disproportionate shares of global capital. Accordingly, they have no incentive to enter into cooperative arrangements that remove these benefits of competition.[21] In addition, analysts characterize tax competition as a weakest-link problem, which can only be overcome through the cooperation of all involved parties. Yet, full participation is extremely difficult to achieve as the benefit of being a tax haven is assumed to increase with the number of

[12] Picciotto 2012.
[13] Farquet and Leimgruber 2014; Rixen 2008.
[14] Genschel and Rixen 2015.
[15] Eccleston 2012; Emmenegger 2014; Rixen 2008; Sharman 2006a.
[16] Hakelberg 2015; Rixen and Schwarz 2012.
[17] Rixen 2008.
[18] Pinkernell 2013.
[19] OECD 2015a.
[20] Genschel and Rixen 2015.
[21] Bucovetsky 1991; Genschel and Schwarz 2011; Kanbur and Keen 1993; Wilson 1999.

cooperating governments. Less than global cooperation is thus expected to merely reduce competition in the tax haven market, instead of curbing the phenomena of tax evasion and avoidance. After all, hidden capital will simply be shifted to the remaining non-cooperative jurisdictions, if full participation cannot be achieved.[22] Some analysts also argue that the perception of tax competition as a weakest-link problem has caused large countries to shy away from taking the first step towards more effective tax cooperation.[23] Others claim that tax competition confronts large countries with a strategic trilemma, forcing them to choose between double taxation, double non-taxation, or a loss of sovereignty.[24]

Against this background, it seems quite remarkable that over a hundred jurisdictions – including all major tax havens – have entered into a multilateral agreement since October 2014, providing for comprehensive AEI on non-residents' capital income from September 2017.[25] The agreement requires banks and other financial institutions to look through interposed legal entities when identifying account holders, and establishes a peer-review process for the monitoring of its implementation in signatory states.[26] Unsurprisingly, the deal "was hailed by finance ministers as a watershed in the fight against tax dodgers." And even the Tax Justice Network, an NGO critical of governmental efforts, acknowledged, "finance ministers [were] right to claim historic progress."[27] Why did tax havens adopt AEI after decades of firm resistance against greater financial transparency*?* The theories cited above clearly expect the opposite. Moreover, theories conceptualizing international cooperation as a pareto-improving response to market failure cannot account for this outcome, as they operate on the assumption that cooperation creates joint gains for all parties involved.[28] Yet, countries like Switzerland, and Luxembourg, which move from providing financial secrecy to routinely reporting foreign-held assets, are clearly worse off under the new regime. Their financial sectors face important adjustment costs as their attractiveness for hidden capital declines.[29] In addition, a smaller influx of foreign capital is likely to also depress employment, wage levels, and tax revenue in these countries.[30] The multilateral AEI agreement must thus be interpreted as an instance of 'redistributive cooperation' rather than a mutually beneficial deal: "it intentionally reduces at least one other government's welfare compared to the status quo."[31]

[22] Genschel and Plumper 1997.
[23] Sharman 2008.
[24] Genschel and Rixen 2015.
[25] OECD 2016a.
[26] OECD 2014b; OECD 2014c.
[27] Vasagar and Houlder 2014.
[28] Keohane 2005; Krasner 1991.
[29] Adam 2014.
[30] Genschel and Seelkopf 2012.
[31] Oatley and Nabors 1998, 36.

Redistributive cooperation in tax matters results from a credible threat of economic sanctions by a great power. Great powers are defined by large domestic markets, which make them less dependent on international trade and investment than small countries. By making access to their markets conditional on compliance with their preferred international rules, they can thus wrestle costly concessions from small country governments.[32] In tax matters, great powers will pursue this strategy when two causal conditions coincide. First, domestic constraints need to prevent a shift of the overall tax burden to labor or consumption. A left-of-center government with an ideological or electoral interest in preserving the tax system's progressivity could, for instance, lift the issue of international tax cooperation on the agenda to address fairness concerns or budgetary needs without raising taxes domestically.[33] Ganghof, as well as Basinger and Hallerberg show that left-of-center governments faced with international tax competition are more hesitant in cutting taxes on capital than conservative ones.[34] In majoritarian electoral systems they are, moreover, clearly associated with more progressive tax systems.[35] Second, proposed international tax rules need to enhance the international competitiveness of potentially affected domestic industries. Otherwise, these organized interests will block legislation necessary to implement internationally agreed rules.[36] Especially in international financial regulation, the US – supposedly the single great power by virtue of the size of its financial market – has a history of imposing rules on other governments that mirror its domestic regulatory approach, and that benefit its financial sector at the expense of foreign competitors. At the same time, the US government regularly blocks proposed international rules that threaten the US financial sector's dominance in an unregulated field.[37]

Indeed, an analogous dynamic seems to have triggered the emergence of the multilateral AEI agreement discussed above. In 2006 and 2008 Democratic Senator Carl Levin staged congressional hearings, revealing to a general public how United Bank of Switzerland (UBS) and Liechtenstein Global Trust (LGT) had concealed the identities of their US clients to protect them from the Qualified Intermediary (QI) program.[38] The QI program had been set up by the Internal Revenue Service (IRS) under President Clinton, obliging foreign financial institutions (FFIs) to report income earned on US securities by their

[32] Krasner 1976; Drezner 2008.
[33] Bartels 2009; Hibbs 1977.
[34] 2006; 2004.
[35] Andersson 2015; Bartels 2009.
[36] Frieden 1991; Hiscox 2002.
[37] Helleiner 2014; Oatley and Nabors 1998; Rixen 2013b; Simmons 2001; Singer 2007.
[38] Levin and Coleman 2006; Levin and Coleman 2008.

American clients.[39] Most FFIs signed up, but instead of reporting their US clients' income, they set up shell corporations domiciled in third countries to hide their true identities.[40] In response to these revelations a group of Democratic senators, including Levin himself and also Barack Obama, proposed far reaching anti-tax haven legislation.[41] Once the Obama administration entered office in 2009 it sent a streamlined version of this legislation to Congress – the Foreign Account Tax Compliance Act (FATCA) – which was eventually passed in March 2010. The act obliges all FFIs doing business in the US financial market to automatically report capital income earned by US account holders, or pay a 30 percent withholding tax on payments received from US sources.[42] By November 2014, the US had reached bilateral agreements implementing the act with 112 jurisdictions, including all major offshore centers.[43] These agreements then enabled third states to request multilateral AEI from signatories, as some were bound by most-favored-nation (MFN) clauses, whereas others responded to financial sector preferences for a single set of global tax rules.[44] The main beneficiary of the resulting international tax regime, however, is the US, which receives data on US account holders bilaterally from across the world, but does not fully reciprocate the exchange under FATCA,[45] and has not signed the multilateral AEI agreement it helped bring about.[46] As a result, the US becomes more attractive for capital previously hidden in other secrecy jurisdictions.

In order to ascertain the external validity of this reading, I test the underlying theoretical argument by comparing the emergence of AEI as a new global standard to dynamics in the two previous OECD attempts at international tax cooperation. Together they form a basic population of OECD initiatives against tax havens under conditions of international capital mobility, and cover the full range of variation in causal conditions and the outcome. In chronological order the observed episodes include (1) the Clinton administration's stance vis-à-vis the tax evasion elements of the OECD's harmful tax competition (HTC) project, (2) its stance vis-à-vis the same project's tax avoidance elements, (3) the Bush administration's removal of the latter elements from the HTC project's scope, (4) its support for the development of a largely ineffective OECD standard for Tax Information Exchange Agreements (TIEAs), (5) the Obama administration's enforcement of AEI as a

[39] Government Accountability Office 2007.
[40] Levin and Coleman 2008.
[41] Eccleston 2012.
[42] Grinberg 2012.
[43] US Treasury 2014a.
[44] Hakelberg 2015.
[45] Christians 2013.
[46] Vasagar and Houlder 2014.

global standard, (6) and its failure to follow up on an action plan against the tax planning practices of multinational firms, Each case study provides a thick description of the impact of the presence or absence of my two causal conditions on the success or failure of attempts at international tax cooperation.[48] Subsequently, the redistributive character of tax cooperation is demonstrated by means of a differences-in-differences analysis, comparing the distribution of foreign-held assets between tax havens and non-havens before and after the issuance of a credible sanctions threat by a great power.

The remainder of the thesis is structured as follows. Chapter 2 reviews the literature on tax competition and cooperation. It discusses theories of tax competition mostly developed by welfare economists, presenting the strategic dilemmas this phenomenon creates for governments across the world. The chapter then provides an overview of the legal principles, allocating the right to tax cross-border income to different governments, showing how their parallel application creates the risk of double taxation. It then reviews evidence for the responsiveness of individuals and corporations to cross-country differences in tax rates and financial secrecy, demonstrating that taxpayers do indeed make use of opportunities for tax evasion and avoidance, but are equally sensitive to changes in international tax regulation. Against this background the chapter's last subsection then discusses evidence for government responses to tax base elasticity, underlining that small countries regularly opt for competition, whereas large countries tend to participate in cooperative arrangements.

Based on the above discussion, a theory of redistributive cooperation in international tax matters is developed in chapter 3. Drawing heavily on power-based approaches to international financial regulation, this theory rejects the contractualist idea of joint gains for all involved parties being a necessary precondition for international cooperation. It shares the contractualist assumptions of (1) nation-states being the decisive actors in world politics, (2) rationally pursuing their own interests, (3) which are in turn determined at the domestic level.[49] Yet, it argues that great powers may impose their preferred regulatory outcome on small countries even if this leaves the latter worse-off than the status quo. Against this background, it provides hypotheses on a sufficient combination of necessary conditions causing great powers to enforce international tax cooperation by means of a credible threat of economic sanctions. The subsequent section of chapter 3 then discusses why the US, but not the EU or its larger member states, is a great power in international tax matters. Its last section presents the methodological approach to testing the theory, combining comparative case studies with a quantitative analysis of the redistributive impact of tax cooperation.

[48] George and Bennett 2005.
[49] Hasenclever, Mayer, and Rittberger 1996; Keohane 2005.

Chapters 4 to 7 are devoted to the comparative case studies. Chapter 4 discusses the Clinton administration's stance vis-à-vis the HTC project's tax evasion and tax avoidance elements, showing that it backed an OECD sanctions threat against secretive tax havens, but helped dilute the project's anti-tax avoidance elements. Chapter 5 recounts how the Bush administration withdrew support from the HTC project in response to competitiveness concerns voiced by US multinationals. Chapter 6 discusses the Bush administration's lack of resolve in the promotion of TIEAs despite their negligible impact on the competitive position of US financial institutions (USFIs). Chapter 7 explains how the Obama administration used FATCA to trigger the emergence of a multilateral AEI regime modeled on its own regulatory approach, but refused to fully cooperate itself, owing to financial sector opposition to additional reporting requirements that would allegedly undermine its business with non-resident customers. It also shows how the Obama administration failed in parallel to follow up on its own action plan against tax avoidance by multinational firms.

Chapter 8 is devoted to proving the redistributive impact of credible sanction threats in tax matters by means of a differences-in-differences analysis, comparing the distribution of foreign-held deposits and debt securities between tax havens and non-havens before and after the passage of FATCA. Finally, chapter 9 sums up the study's findings and explains their broader relevance for theory development in international and comparative political economy. It also discusses the implications for current international negotiations over reciprocal exchange of information from the United States, and the implementation of the OECD's Base Erosion and Profit Shifting (BEPS) project. Unless the EU manages to overcome its internal divisions and harnesses its great power potential, the US is unlikely to make concessions at the international level.

2. Competition and Cooperation in International Tax Matters

This chapter builds upon many excellent surveys of scholarship on tax competition.[1] Yet, it sets its own foci, provides important updates, pruning and adding as relevant to the proposed argument. It begins with an explanation of the baseline model of tax competition and its main extensions, then discusses the evidence for cross-border tax arbitrage by individuals and corporations, and the degree and type of international competition for this mobile tax base. It closes with a summary of the possible means of international cooperation against tax evasion and avoidance as well as their actual implementation.

2.1. Theories of Tax Competition

Wilson and Wildasin define tax competition as "noncooperative tax setting by independent governments, under which each government's policy choices influence the allocation of mobile tax base among 'regions' represented by these governments."[2] Their definition implies that capital mobility between regions, which can be understood as cities, states, or countries, is a precondition for tax competition. Although examples of the phenomenon can be found throughout modern history[3] – Keen and Konrad, for example cite the case of tax breaks granted to foreign investors by Catherine the Great[4] – it is thus no surprise that political and academic interest in the issue grew substantially in the 1980s. Over the course of that decade, governments gradually removed capital controls, and deregulated financial markets for political reasons,[5] while advances in information and communications technology made it increasingly easy even for individuals to invest across borders.[6] As a result, both foreign portfolio and direct investment have dramatically expanded ever since,[7] lending increasing validity to the assumption of perfect capital mobility underlying standard welfare economics models of tax competition.

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[1] Clausing 2015; Fuest, Huber, and Mintz 2005; Genschel and Schwarz 2011; Keen and Konrad 2014; Wilson 1999; Wilson and Wildasin 2004; Zodrow 2010.
[2] Wilson and Wildasin 2004, 1067.
[3] Farquet and Leimgruber 2014.
[4] Keen and Konrad 2014.
[5] Helleiner 1996.
[6] Zodrow 2010.
[7] Hines 2007.

Zodrow and Mieszkowski were arguably the first to formalize the much older intuition that under this condition a government's tax rate choice interacts with other governments' tax revenue.[8] Their model involves two countries sharing a mobile tax base. The countries are affected by fiscal externalities. That is, if country *x* lowers its tax rate, its revenue increases due to an inflow of mobile capital from country *y*. If country *x* increases its rate, however, the revenue of country *y* increases, as capital flows out of country *x*. Accordingly, tax rates in both countries tend towards zero, causing a suboptimal supply of tax-financed public goods, and an associated welfare loss for all citizens. It was due to this conclusion that many observers expected the "end of redistribution" when barriers to international capital mobility fell in the 1980s,[9] asking: " [has] globalization [had] gone too far?"[10] Others saw tax competition more positively, hailing its moderating effect on governments' ability to increase taxes, thereby "taming the Leviathan."[11]

In the context of the present study, the most important extension to the baseline model is the introduction of differences in population. While Zodrow and Mieszkowski expect that the impact of tax competition is the same across countries, the theory of asymmetric tax competition predicts that small countries have lower tax rates than large countries in the competitive equilibrium.[12] Small countries face a highly elastic capital supply. Relative to their small domestic capital stock they can attract a lot of foreign capital with a tax cut. Inversely, they also lose a lot of incoming capital from a tax hike. In revenue terms, small countries can compensate a lower tax rate with a broader tax base. In contrast, large countries face an inelastic capital supply. Relative to their large domestic capital stock, they can attract relatively little foreign capital. Therefore, they cannot expect to compensate revenue lost to a tax cut with revenue gained from a broader tax base. As a result, large countries "compete less vigorously for capital through tax rate reductions" than small countries.[13] As Rixen asserts, this explains, "why almost all tax havens in the world are small countries."[14]

The second type of extension concerns domestic buffers and constraints to competitive adjustment. That is, factors that prevent governments from entering tax competition. This extension was a reaction to research showing that increased capital mobility did not always depress tax rates, tax revenue, or public expenditure.[15] In their explanations for the absent

[8] Zodrow and Mieszkowski 1986.; cf. Genschel and Schwarz 2011; Wilson 1999.
[9] Steinmo 1994.
[10] Rodrik 1997.
[11] Edwards and Keen 1996.
[12] Bucovetsky 1991; Kanbur and Keen 1993; Wilson 1999.
[13] Wilson 1999, 278.
[14] Rixen 2008, 44.
[15] Garrett 1995; Garrett 1998; Garrett and Mitchell 2001; Quinn 1997.

race to the bottom, political scientists refer to two types of domestic constraints: "institutional restrictions," and "countervailing pressures."[16] The institutional restrictions strand is inspired by Steinmo's insight that a country's political institutions determine how its tax system evolves under conditions of international competition.[17] It claims that the number of veto players involved in legislation, as well as their ideological orientation determine the frequency of governments' competitive tax policy adjustments.[18] Likewise, the countervailing pressures strand argues that features of the national tax system, public debt levels, and fairness concerns of the electorate may constrain a government's ability to engage in tax competition.[19] A third group of factors – agglomeration effects – may keep governments from entering tax competition, and could be interpreted as domestic buffers rather than constraints. Analysts in this strand argue that large but geographically concentrated consumer markets, the number of proximate suppliers, and technology spillovers emanating from other companies in the same sector may be more important to capital owners in their location decisions than statutory tax rates. These factors could therefore insulate governments against tax competition.[20]

A problem with the first two strands is that they assume a consistent effect of domestic constraints across all countries.[21] Yet, this may not be realistic in every case. As we have seen, small countries in asymmetric settings are likely to increase their capital stock under competitive conditions. For them, competitive tax cuts may thus be a better means to reduce public debt than tax hikes. Moreover, incoming capital does not only raise tax revenue only. It also increases labor demand, wages, and employment.[22] Therefore, left-of-center governments in small countries should also have good reason for competitive tax policy adjustment.[23] Their position on the matter may thus be closer to their conservative opponents than to their ideological bedfellows in large countries. Drawing on the third strand on agglomeration effects, some authors even argue that tax competition is a means of self-defense for small countries that are, by virtue of their size, at a disadvantage in attracting FDI. Their consumer markets are smaller, and they tend to have fewer proximate suppliers and technology hubs than large countries. The attraction of FPI through lower tax rates may therefore be interpreted as a development strategy for small countries having little else to offer to foreign

[16] Ganghof 2000b, 624; Genschel and Schwarz 2011, 342.
[17] Steinmo 1993.
[18] Basinger and Hallerberg 2004; Hallerberg and Basinger 1998; Wagschal 1998.
[19] Ganghof 2000b; Ganghof 2006; Plümper, Troeger, and Winner 2009; Swank and Steinmo 2002.
[20] Baldwin and Krugman 2004; Borck and Pflüger 2006; Haufler and Wooton 1999.
[21] Rademacher 2013.
[22] Genschel and Seelkopf 2012.
[23] Genschel and Schwarz 2013.

investors.[24] It is, however questionable whether such an argument holds in the context of the European Union (EU), where all corporations – no matter whether they are located in a small or large member state – enjoy unconstrained access to the common market.

Next to country size, domestic constraints may also interact with each other. Plümper et al. argue, for instance, that left-of-center governments faced with little voter concern over the progressivity of the tax system are more likely to enter tax competition than conservative governments facing major voter concern despite the intuition that left-of-center governments should favor redistribution from the top to the bottom to cater to their core electorate.[25] Along similar lines, Andersson suggests that left-of-center governments may only act as veto players to regressive tax reform in majoritarian electoral systems because they cannot be sure that additional revenue will continue to be used for redistribution once their conservative opponents enter office. In contrast, proportional systems force parties into perpetual coalition and compromise, providing better preconditions for credible intertemporal commitment to a deal combining regressive taxation with redistribution on the spending side.[26] Under conditions of international tax competition it may thus be a viable strategy for left-leaning governments in proportional electoral systems to increase revenue through more regressive taxation, and use the additional tax receipts for redistributive spending.

2.2. Tax Base Mobility: Legal Framework and Arbitrage Methods

As the above discussion has shown, theories of tax competition assume that capital mobility is equivalent to tax base mobility. This would imply that the right to tax travels across borders with the underlying taxable asset. Private and corporate investments would only be taxed at source; that is, at the location where they are employed and earn a return. Under such conditions, individuals and corporations could freely engage in tax arbitrage, moving their assets to the country with the lowest rate. The concepts of tax evasion and avoidance would therefore be meaningless. As Genschel and Schwarz make clear, however, international taxation is more complex in the real world.[27] In fact, international tax law does not accord precisely with the source principle, which holds that "income is taxed by the country, and at the rate of the country, in which the income source is located."[28] Rather, it is marked by a conflict of aims between the source principle and a second one, the residence principle. This

[24] Rademacher 2013.
[25] Plümper et al. 2009.
[26] Andersson 2015.
[27] Genschel and Schwarz 2011, 342.
[28] Ibid., 343.

principle states that income and profits, no matter the location of their source, should be taxed where their beneficiaries reside.[29]

Both principles are justified by ethical arguments. Whereas proponents of the source principle put forward that governments providing "access to natural and other productive resources or to lucrative markets […] are entitled to a 'fair share' of the income that is created within [their] borders,"[30] the residence principle is motivated by the desire for an equitable domestic tax system that charges citizens in accordance with their ability to pay. As this ability is determined by a resident's foreign and domestic income, their aggregate should thus form the taxable base. In principle, most governments thus reserve the right to tax (1) income and profits earned by foreign beneficiaries under their jurisdiction, as well as (2) their residents' foreign income. This creates an overlap of tax claims that gives rise to two interrelated problems characterizing the international tax system simultaneously: double taxation and double non-taxation – that is, tax evasion and avoidance.[31]

Double taxation would arise if the source and the residence country fully enforced their tax claims. This is rarely the case nowadays as states have established unilateral rules as well as bilateral agreements to reconcile their entitlements. Bilateral agreements are typically based on the Model Tax Convention of the Organisation for Economic Co-operation and Development (OECD), which provides states with two reconciliation methods: the exemption or the credit method. Under the exemption method residence countries exempt their residents' foreign income from taxation, "effectively forgoing [their] tax claim to taxpayers' world-wide income."[32] "Under the credit method, foreign taxes are subtracted from the tax due at home."[33] In contrast to the exemption method, implying taxation at source, the credit method thus ensures taxation "at the rate of the residence country," keeping the progressivity of income taxation intact.[34] As Rixen shows, the credit method is most widespread among OECD countries, which all credit foreign taxes paid on interest, while most credit taxes on dividends, and corporate profits.

From a legal perspective, capital mobility and tax base mobility should thus be distinct when the credit method is applied. That they are indeed often the same is due to unintended effects of the double-tax avoidance regime, and the tax evasion and avoidance strategies

[29] Rixen 2008, 57.
[30] Ibid., 59–60.
[31] Ibid., 57ff.
[32] Genschel and Schwarz 2011, 344.
[33] Rixen 2008, 72.
[34] Genschel and Schwarz 2011, 344.

employed by individuals and corporations to circumvent the residence principle.[35] The problem with the credit method lies in its reliance on the co-operation of the taxpayer. In a world without tax cooperation, residence countries lack information on their residents' foreign income if it is not declared voluntarily. As a result, there is ample opportunity for taxpayers to evade taxation at home by an "intentional mis-declaration" of foreign dividend and interest income.[36] If tax authorities cannot enforce the residence principle owing to a lack of information, foreign income is effectively taxed at source. That is, the taxpayer's tax burden does not depend on the rate of her home country's personal income tax anymore, but on the rate of the withholding tax levied by the country hosting her investment.

Corporations, especially when they are multinational, also have ample opportunity to avoid taxation at the rate of their country of residence. This is because most countries allow corporations to defer tax payments on profits earned by a foreign subsidiary until these are repatriated as dividends to the domestic parent.[37] Many corporations therefore prefer to keep profits offshore, deferring corresponding tax payments for an indefinite amount of time, or until a repatriation tax holiday granted by the government provides them with more favorable terms.[38] As profits are effectively taxed at source, corporations thus have an incentive to either locate real economic activity where taxes are lowest, or shift profits there on paper. The first option implies actual relocations of permanent establishments and workforces (FDI), whereas the second option is based on tax avoidance methods, allowing corporations to shift profits without moving underlying productive activity.[39] The two options may even interact in that the ability to shift paper profits may reduce the incentive to actually relocate physical and human capital.[40]

Multinational firms can shift paper profits from their subsidiaries in high-tax countries to their subsidiaries in low-tax countries, for example, by manipulating transfer prices on internal transactions. To this effect, the low-taxed subsidiary simply needs to charge the highly-taxed subsidiary an exaggerated price for any given product or service it provides.[41] Following a similar logic, multinationals can also finance their branches in high-tax countries through loans granted by their branches in low-tax countries. This method is commonly known as thin capitalization, and allows multinationals to deduct the interest payment from taxes paid by its high-tax country subsidiary, while earning a lowly or untaxed

[35] Rixen 2008, 120ff.
[36] Keen and Ligthart 2006, 82.
[37] Zodrow 2010, 867.
[38] Pinkernell 2012.
[39] Genschel and Schwarz 2011, 346.
[40] Hong and Smart 2010.
[41] Clausing 2015, 9.

profit on the loan through its low-tax country subsidiary.[42] What is more, many multinationals resort to more complex avoidance methods like the "Double Irish with a Dutch Sandwich" approach, which structure ownership of intangible assets so as to create stateless income that is taxed nowhere.[43]

An often-cited example is the corporate structure Google uses to avoid taxes on its foreign profits. To this effect, Google Inc., which is domiciled in the United States (US), transferred parts of its intellectual property (IP) to Google Ireland Holdings, a so-called hybrid entity incorporated in Ireland but effectively managed from Bermuda. This subsidiary then licensed a sub-subsidiary, Google Netherlands Holdings, to use its IP. The Dutch sub-subsidiary in turn handed out a sub-license to a second Irish sub-subsidiary, Google Ireland Ltd. Google's foreign advertisement clients transact only with Google Ireland Ltd., which should thus earn a profit taxable at 12.5 percent in Ireland. However, the Irish sub-subsidiary pays license fees to the Dutch sub-subsidiary entirely eating up its profit. The Netherlands do not tax profits earned on license fees. Google Netherlands Holdings can thus pass them on to Google Ireland Holdings without deduction. Google Ireland Holdings then uses its hybrid status to claim tax residence in Bermuda vis-à-vis Irish tax authorities. Conveniently, Bermuda does not have a corporate income tax. Theoretically, controlled foreign company (CFC) rules, allowing the US to treat profits booked in tax havens as domestic income, should take effect at this point. For US tax authorities, however, Google Ireland Holdings is resident in Ireland where it was incorporated. And here's the trick: under US CFC rules Google Ireland Ltd. can opt to be subsumed under Google Ireland Holdings. The license fees it pays to Google Netherlands Holdings, and the license fees Google Ireland Holdings receives from the Dutch sub-subsidiary thus cancel each other out from a US perspective. As a result, there is zero profit to be taxed.[44]

2.3. Tax Base Mobility: Evidence for Taxpayer Arbitrage

The previous section has shown that many methods are available for taxpayers to circumvent the residence principle. This section summarizes evidence for the widespread use of these methods. I first discuss available data on tax evasion by individuals, and then review evidence for tax arbitrage by corporations.

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[42] Ibid.; Genschel and Schwarz 2011, 346.
[43] Kleinbard 2011; Pinkernell 2013.
[44] This paragraph is a summary of an in-depth analysis of Google's tax avoidance model provided by Pinkernell 2012.

2.3.1. Tax Evasion by Individuals

The majority of research on the responsiveness of individual taxpayers to tax rates and anti-tax evasion legislation uses data from the Bank for International Settlements (BIS) on foreign non-bank deposits. Non-bank deposits refer to deposits held by entities that are not banks. According to one team of authors, 50% of these are households, not corporations.[45] Exploiting this data, Huizinga and Nicodème show that an increase of one percent in the interest tax rate raises a country's external deposit liabilities by about 2.4 percent. Provisions for domestic information reporting from banks to tax authorities even increase these liabilities by 28 percent.[46] Likewise, Johannesen finds that the EU Savings Directive, obliging Switzerland to levy a withholding tax on interest income held by EU nationals, induced a 30 to 40 percent reduction in EU-owned bank deposits in Switzerland. Contrary to the hopes of policymakers, however, these deposits were not repatriated to residence countries. Instead, taxpayers transferred their wealth to other tax havens, or changed ownership to shell corporations formally located there.[47]

Along the same lines, Johannesen and Zucman show that a tax haven's signature of a Tax Information Exchange Agreement (TIEA) reduces the value of foreign bank deposits in that country by 22 percent.[48] Again, tax evaders do not repatriate these deposits but divert them to other tax havens that do not exchange information. This is a particularly striking result, given that the TIEAs studied by the authors provide for information exchange upon request. This standard requires residence country tax authorities to provide prior evidence of tax evasion by a resident when requesting assistance from a tax haven. Participation in this type of information exchange thus does not significantly increase the risk for tax evaders to be detected.[49] Still, they showed a quite sizable reaction to this type of international tax cooperation. Desai and Dharmapala demonstrate that dividend taxes also have a large impact on investors' portfolio choices. The authors exploit the impact of a US tax reform reducing the tax on dividends earned in countries that have a bilateral tax treaty with the US from 36.8 to 15 percent, but left the rate unchanged for other countries. In response, American FPI in treaty countries rose by 90 percent as compared to other countries. It is likely that much of this capital influx was due to the legalization of income previously hidden in countries without a bilateral tax treaty with the US[50]

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[45] Johannesen and Zucman 2012.
[46] Huizinga and Nicodème 2004.
[47] Johannesen 2014.
[48] Johannesen and Zucman 2012.
[49] Grinberg 2012; Genschel and Rixen 2015.
[50] Desai and Dharmapala 2010.

The cited studies yield two important conclusions. First, "the finding that the stock of offshore bank deposits respond[s] strongly to polic[ies] that only affect tax evaders is highly suggestive that a significant fraction of offshore wealth is undeclared."[51] Second, they demonstrate that the capital supply of tax havens is indeed highly elastic to changes in tax rates and regulations, as predicted by models of asymmetric tax competition. Accordingly, increasing tax rates on capital income or participation in information exchange are indeed very costly options for tax havens. This becomes even clearer when considering estimates on the overall magnitude of hidden offshore wealth. Exploiting "the anomalies that the personal wealth management activities of tax havens cause in the portfolio data of countries" – which refers mainly to the gap between global portfolio liabilities and assets – Zucman shows that global offshore wealth amounted to a total of $6 trillion in 2008, representing eight percent of all household financial wealth.[52] This matches figures provided by the Boston Consulting Group, which puts household offshore wealth at $6.7 trillion for the same year,[53] but lies significantly below estimates by advocacy groups. Palan et al. put the amount of private offshore wealth at around $12 trillion,[54] whereas Henry in a report for the Tax Justice Network suggest that its value may be as high as $21 to 32 trillion.[55] Zucman indicates that this discrepancy may be due to the inclusion of non-financial wealth in the latter estimates. Yet, other authors criticize the "ad hoc assumptions" underlying the estimates provided by advocacy groups.[56]

In sum, households in rich countries have a proven propensity to exploit international tax rate differentials and bank secrecy provisions to evade taxes. This behavior created a stock of undeclared private offshore wealth that according to the most conservative estimate amounts to $6 trillion. If this data were included in official balance of payments statistics "the Eurozone, officially the world's second largest net debtor, would turn into a net creditor."[57] This illustrates the enormous cost of tax evasion for large and rich countries, as well as the extent to which the richest part of the population has disengaged from the rest of society. After all, their ability to pay for debt reduction and the welfare state can be considered enormous. Yet, instead they conceal their wealth and thereby increase the tax burden for everyone else.

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[51] Johannesen 2014, 42.
[52] Zucman 2013b.
[53] Boston Consulting Group 2009.
[54] Palan et al. 2010.
[55] Henry 2012.
[56] Genschel and Schwarz 2011, 349.
[57] Zucman 2013b, 1322.

2.3.2. Tax Avoidance by Corporations

Previous reviews of the literature agree that "multinational firms are tax-sensitive in their economic decisions."[58] This goes for decisions on the location of actual productive activity (FDI), and even more so for the formal location of paper profits.[59] From their meta-analysis of the relevant empirical literature, Mooij and Ederveen conclude that a one percent increase in the corporate tax rate reduces the inflow of FDI by about three percent.[60] Their result matches Clausing's previous finding, but is slightly higher than the 2.28 percent found by Feld and Heckemeyer, who accommodate publication selection in their meta-analysis.[61] Interestingly, several analysts show that the semi-elasticity of FDI inflows to changes in the corporate tax rate has also grown over time.[62] Altshuler, Grubert, and Newlon, for instance, find that a one percent reduction in a country's tax rate increased FDI from US multinationals by 1.5 percent in 1984, but already by 2.8 percent in 1992.[63] Arguably as a result of this, "FDI as a percentage of total investment has increased from 5.3% during the period from 1990-1994 to 17% between 2005 and 2008 in OECD-20 countries."[64] Moreover, Palan et al., drawing on data from the United Nations Conference on Trade and Development (UNCTAD), suggest that 30 percent of global FDI is hosted by tax havens, where it serves to create holding companies, sitting at the receiving end of multinationals' profit-shifting schemes.[65]

Indeed, some simple descriptive statistics already suggest that the corporate income tax rate has an even bigger impact on the location of profits than on the location of production. Clausing, for instance, shows that seven countries with effective corporate tax rates of below 6.5 percent account for 46.5 percent of all foreign profits earned by US multinationals. At the same time, "they only account for 5 percent of total foreign employment."[66] Along the same lines, Zucman reports that US multinationals formally made 55 percent of their overall foreign profits in tax havens in 2013. At 17 percent, the Netherlands, central to the "Double Irish with a Dutch Sandwich" strategy described above, was the largest individual destination.[67] It is thus no surprise that authors agree on the negative relationship between the pre-tax profitability of a multinational's foreign affiliate,

[58] Clausing 2015, 8; Genschel and Schwarz 2011; Zodrow 2010.
[59] Mooij and Ederveen 2008.
[60] Ibid., 692.
[61] Feld and Heckemeyer 2007; 2011, 263.
[62] Feld and Heckemeyer 2011; Mooij and Ederveen 2008; Zodrow 2010.
[63] Altshuler, Grubert, and Newlon 2001.
[64] Genschel and Schwarz 2011, 349.
[65] Palan et al. 2010, 52–57.
[66] Clausing 2015, 8.
[67] Zucman 2014b, 128.

and the corporate income tax rate of its host country.[68] What is more, there is ample evidence for multinationals' systematic use of profit-shifting strategies like transfer-pricing and thin capitalization.

As to transfer-pricing, Clausing finds that a one percent reduction in the source country's corporate tax rate is associated with a two percent increase in the price of intrafirm imports from that country, relative to the price of goods traded by unrelated companies.[69] Likewise, Grubert reports that transfer-prices for the use of immaterial goods, including, for instance, license fees for the use of IP, are particularly sensitive to tax rate changes.[70] The widespread use of thin capitalization is underlined by a recent meta-analysis of 48 studies provided by Feld et al. The authors find that a ten percentage point increase in the source country's marginal corporate tax rate is associated with a 2.7 percentage point increase in the debt-to-asset ratio of multinationals' local branches.[71] This corresponds roughly to a previous review by Genschel and Schwarz, who report "that an increase in the corporate tax rate by one percentage point in the source country increases the debt ratio of subsidiaries in that country by at least 0.2 percentage points."[72]

There is thus overwhelming evidence that multinationals do not only tend to locate their actual activities where corporate tax rates are comparatively low. In fact, they shift their profits to low-tax jurisdictions to a much greater degree, making use of transfer-pricing, thin capitalization, and more complex avoidance strategies discussed above. Some authors suggest that these two forms of tax arbitrage may also interact, in that opportunities for profit shifting lower the necessity for relocations of actual activities.[73] As a result, the impact of profit shifting on the overall revenue of high tax countries may be slightly reduced. At the same time, it is unclear how far the stickiness of FDI in high tax countries is due to opportunities for avoidance rather than agglomeration effects.[74] The studies reviewed by Zodrow, at least, indicate that "the tax sensitivity of FDI is not declining and may even still be increasing."[75]

2.4. Government Responses to Tax Base Mobility

How do governments react to taxpayers' proven propensity to exploit international tax rate differentials and bank secrecy provisions? The baseline model of tax competition suggests

[68] Grubert and Mutti 1991; Hines and Rice 1994; Schwarz 2009.
[69] Clausing 2003, 2222.
[70] Grubert 2003.
[71] Feld et al. 2013, 2862.
[72] Genschel and Schwarz 2011, 351.
[73] Hong and Smart 2010.
[74] Baldwin and Krugman 2004.
[75] Zodrow 2010, 869.

that their only option is to cut tax rates to competitive levels. Yet, options may be different for small and large countries due to the asymmetric features of tax competition. They may also be more complex than simple cuts to the statutory rate of the personal or corporate income tax. Finally, government responses may not have to be competitive at all. Instead, international cooperation may alleviate competitive pressures. The baseline model does not explain which strategy governments pursue. But political scientists have developed theories on how governments compete, and why they choose competition over cooperation or vice versa. [76] In the following section, I will thus review these theories before summarizing existing evidence on government responses to tax base mobility.

2.4.1. Competitive Policy Options

The baseline model's universal prescription of statutory tax rate cuts may indeed be a viable strategy for small countries. Owing to the asymmetric features of tax competition, small countries are likely to attract enough foreign capital with a tax cut to make up for revenue losses on the initially small domestic tax base. If the difference in population between a small country and the outside world is large enough, it may even be able to overcompensate.[77] The capital inflow not only broadens the tax base, however. It is also likely to increase labor demand, employment, and wages, making tax competition a consensual policy option across political cleavages.[78] What is more, policymakers in small countries may find exploiting the "advantage of smallness" in tax competition a particularly attractive strategy because they allegedly suffer from a "disadvantage of smallness" in industry agglomeration.[79] In their calculations, the attraction of FPI by means of competitive tax cuts may thus be a good substitute for the more difficult attraction of FDI by means of large concentrated consumer markets, technology hubs, or the presence of large numbers of upstream suppliers.[80]

Beyond the simple reduction of personal and corporate income taxes, (small country) governments may also compete for foreign tax evaders and avoiders by other means. Several authors find, for instance, that the provision of secrecy is a key tax haven strategy because many tax evaders value the concealment of their identity even more than the reduced rate of tax. [81] Investor anonymity can be protected through strict banking secrecy provisions, criminalizing the dissemination of account holder information, or through the setting up of

[76] Genschel and Schwarz 2011, 351.
[77] Dehejia and Genschel 1999; Genschel and Plumper 1997.
[78] Genschel and Seelkopf 2012.
[79] Wilson 1999, 278; Rademacher 2013, 11.
[80] Baldwin and Krugman 2004.
[81] Johannesen 2014; Palan, Murphy, and Chavagneux 2010; Zucman 2014a.

trusts and shell corporations, concealing the actual beneficial owner of an income stream. Palan et al. suggest, moreover, that tax havens may specialize in specific legal arrangements that work as subparts of international evasion strategies.[82] Instead of racing to the bottom with other tax havens, many tax havens can exploit comparative advantages in niches of the offshore market that are often highly complementary to each other. Swiss banks, for instance, offer sophisticated private wealth management to individuals, whose assets they invest in mutual funds in Luxembourg, while their identities are hidden behind shell corporations domiciled in Panama.[83] Through incorporation and management fees all of these actors benefit from a single stream of concealed income.

On the avoidance side, (small country) governments may follow a similar logic. Although analysts still consider the statutory corporate tax rate the most important determinant of a corporation's effective tax burden, and also the most visible indicator of tax competitiveness,[84] many tax havens (as well as large country governments) offer targeted tax reductions or exemptions for example for income earned on the cross border lease of IP, or resulting from research and development (R&D) activities carried out on their territory.[85] As the above example of Google's tax avoidance scheme makes clear, these Preferential Tax Regimes (PTR) are often complementary to each other, facilitating complex international avoidance strategies in the aggregate. In addition, PTRs are often ring-fenced from the domestic economy. That is, they are available for subsidiaries of foreign multinationals but not for domestic corporations. That way, governments try to attract foreign capital without losing revenue from the domestic tax base.[86]

In contrast to small countries, large countries – the likely losers of tax competition – face a trilemma when pursuing competitive strategies. Since they cannot compensate (or even overcompensate) revenue lost to a cut in statutory tax rates, they need to balance three competing goals: the preservation of revenue, fairness, and competitiveness.[87] If large country governments opt to reduce the personal or corporate income tax rate, they enhance their country's competitiveness and relieve all resident taxpayers to an equal degree. At the same time, they lose a lot of tax revenue. Large country governments should thus be unlikely to pursue this strategy, if they face important budget constraints.[88] Alternatively, large countries can opt for targeted tax cuts, lowering the tax burden on particularly mobile parts of the tax

[82] Palan et al. 2010.
[83] Zucman 2013b.
[84] Genschel and Schwarz 2011, 352.
[85] Clausing 2015; Pinkernell 2012.
[86] OECD 1998.
[87] Ganghof 2006; Plümper, Troeger, and Winner 2009.
[88] Ganghof 2000b; Swank and Steinmo 2002.

base, while increasing it for immobile parts. They can, for instance, reduce taxes on personal capital income, but not on labor income,[89] or compensate reductions in corporate tax rates with more indirect taxation.[90] Another option would be to exploit the alleged interdependence of relocations of productive activity and tax avoidance by making it easier for resident multinationals to circumvent domestic tax.[91] The pursuit of these routes allows large country governments to limit revenue losses and enhance international competitiveness. Yet, this comes at the expense of an increasingly unfair domestic tax system. Shifting the tax burden to labor and consumption increases regressivity, whereas allowing for avoidance favors foreign over domestic investment. Large countries governed by left-of-center parties that cannot expect to compensate for a more regressive tax system on the spending side should thus be less likely to go down this road.[92] The same may apply to large countries where the electorate is in favor of horizontal equity.[93]

2.4.2. Cooperative Policy Options

From the above discussion we can conclude that small countries should in principle prefer tax competition to tax cooperation as it increases government revenue and national income. In contrast, large countries should prefer cooperation to competition, as all competitive strategies come with important trade-offs. Large country governments can pursue tax cooperation that either reinforces the residence principle, or reduces the scope for tax arbitrage under the source principle. In view of this, they have unilateral as well as collective means available. Yet, analysts have identified important structural constraints that may prevent them from choosing the cooperative route.[94]

In order to enforce the residence principle in personal income taxation, governments may unilaterally try to deter taxpayers from evasion by increasing penalties for intentional misdeclarations of foreign income, regularly buying stolen account data, intensifying border controls, or increasing the number of audits. Deterrence is, however, no guarantee for compliance, especially when tax authorities have no means for systematically accessing information on their residents' foreign accounts. In order to lift cross border financial opacity, however, governments need to act collectively. The default option is to strike information exchange agreements, providing for mutual administrative assistance in the monitoring of

[89] Ganghof 2006.
[90] Beramendi and Rueda 2007; Timmons 2010.
[91] Clausing 2015; Zodrow 2010.
[92] Andersson 2015; Basinger and Hallerberg 2004; Ganghof 2006.
[93] Plümper, Troeger, and Winner 2009.
[94] Genschel and Schwarz 2011, 353ff.

foreign-held income. This exchange may happen on request, or automatically at specific intervals. Analysts consider the latter the superior option, as exchange upon request presupposes prior suspicions and only produces occasional spot checks, whereas AEI produces systematic overviews of residents' foreign held accounts, especially when backed up with look-through requirements for banks.[95]

In order to enforce the residence principle in corporate taxation governments may unilaterally opt for the credit instead of the exemption method for double tax relief, and refuse deferral of tax payments on foreign profits under CFC rules.[96] Unlike unilateral anti-evasion methods relying on deterrence, enforcement of CFC rules may already take governments a long way, as publicly listed multinationals are required to publish detailed accounts of their worldwide business. Accordingly, tax authorities are generally aware of foreign profits earned by a domestically-headquartered corporation, and could, in principle, tax it on the totality of its worldwide income. As we have seen above, however, stringent enforcement of CFC rules may also create bigger incentives for actual relocations of headquarters and productive activity.[97] Therefore, the collective harmonization of CFC rules is once more the preferable option as it removes opportunities for arbitrage between more and less stringent CFC rules by means of headquarter relocations, or inversions.[98]

Alternatively, governments can also curb tax competition while enforcing the source principle. On the personal income side, they can, for instance, agree to harmonize withholding taxes on interest and dividends to remove tax rate differentials potentially exploited by taxpayers.[99] If governments opted for the exemption method at the same time, they would straightforwardly apply the source principle. If revenue from withholding on non-residents were channeled back to their home countries, however, the result would be a hybrid between residence and source taxation. In any case, governments would lose sovereignty in setting tax rates on capital income, and in structuring their tax systems, as harmonized withholding taxes would impose a domestic dual income tax system on them.[100] Left-of-center governments with an interest in a progressive tax system may thus be hesitant to adopt such an approach, whereas conservative governments in favor of a dual income tax may use it as a means to tie their own hands domestically.

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[95] Genschel and Rixen 2015; Grinberg 2012; Meinzer 2013; Zucman 2014a.
[96] Genschel and Schwarz 2011, 353.
[97] Clausing 2015; Hong and Smart 2010; Zodrow 2010.
[98] A corporation inverts when it merges with a smaller foreign corporation, moving the official location of its headquarters to the newly acquired company's country of residence.
[99] Genschel 2002; Grinberg 2012; Rixen and Schwarz 2012.
[100] Genschel and Rixen 2015; Rixen 2013a.

In corporate taxation, governments could also opt to limit tax competition through a more stringent enforcement of the source principle. Next to the harmonization of tax rates, they also have unilateral means available. Source countries can, for instance, make sure that profits are not artificially shifted out of their jurisdiction by adopting thin capitalization and transfer-pricing regulations. Thin capitalization rules limit the amount of interest paid to a foreign affiliate that a resident company can deduct from source taxes. Transfer-pricing rules specify how prices in intrafirm transactions should be calculated.[101] Once again, unilateral application is possible, but likely to increase the risk of double taxation, and reduce the attractiveness of the applying source country for FDI. In contrast, collective application would remove the incentive for firms to locate production where thin capitalization and transfer-pricing regulations are most lenient.

As the previous discussion shows, collective action is generally superior to unilateral approaches in curbing tax arbitrage. Yet, analysts have identified two structural and one domestic constraint that complicate international cooperation in tax matters. First, the asymmetric features of tax competition lead to diverging interests between small-country and large-country governments. Small countries lose tax revenue and national income under tax cooperation. Therefore, they have no interest in complying with large country demands.[102] Of course, large countries could easily provide small countries with side payments, as they are likely to gain more from tax cooperation than small countries lose due to their higher tax rates. Yet, Sharman found the idea that policymakers consider compensating small country governments "for not poaching tax base a hard political sell" in the domestic arena.[103] Alternatively, large countries could coerce small countries into cooperation through a threat of economic sanctions.[104] Most of the existing literature suggests, however, that large countries are either not powerful enough to enforce full participation, or lack resolve for domestic reasons.[105] This brings us to the two remaining obstacles to tax cooperation.

The second structural constraint to international tax cooperation is the weakest-link problem. If capital always moves to the location with the lowest tax rate or the most lenient anti-avoidance regulation, full participation is needed to ensure effective cooperation. As the cooperating coalition grows, however, the benefit involved in remaining a tax haven grows, too.[106] In fact, less than full participation merely reduces competition in the tax haven market,

[101] Genschel and Schwarz 2011, 354.
[102] Dehejia and Genschel 1999; Genschel and Plumper 1997; Rixen 2008.
[103] Sharman 2006a, 152ff.
[104] Hakelberg 2015.
[105] Rixen 2013b; Sharman 2006a; Sharman 2008.
[106] Dehejia and Genschel 1999; Genschel and Plumper 1997.

but does not narrow the scope for tax arbitrage. As a result, defectors may benefit more from imperfect cooperation than cooperators themselves, which lead some analysts to conclude that the expected exponential rise in enforcement costs caused large countries to shy away from enforcement altogether. Instead, they listened attentively to domestic financial and economic interest groups, associating attempts at tax cooperation with increased capital flight.[107] Several authors have indeed argued that large-country governments lack resolve in the pursuit of international tax cooperation because they internalize concerns over competitiveness put forward by domestic (financial) industries.[108] As I will further elaborate below, this phenomenon is probably more important in bargaining over anti-avoidance regulation, where the organized interest affected by large-country efforts is domestic, than in bargaining over anti-evasion measures, where their efforts mostly affect foreign organized interests.

2.4.3. Evidence for Tax Competition

The previous section demonstrated that unilateral and collective options for tax cooperation are readily available. Yet, large country governments are often constrained in pursuing them either by structural features of the strategic setting, or influential domestic interest groups. It is thus no surprise that analysts consistently find a downward trend in statutory personal income and corporate tax rates since economic integration began to intensify in the early 1980s.

Ganghof as well as Genschel and Schwarz find that top personal income tax rates have significantly declined since then, although this trend is still less pronounced than in corporate taxation.[109] Small countries did not cut general tax rates significantly more than large countries; they did, however, engage more intensively in targeted tax competition. As Ganghof demonstrates, all Scandinavian countries switched to dual-income taxation during the 1990s, exempting interest and dividends from persistently high general taxes on personal income.[110] Likewise, Genschel and Schwarz find that taxes on interest income declined faster than general income tax rates, and that small countries went further in cutting interest taxes for residents and foreigners than large countries.[111] Although systematic surveys are not available, anecdotal evidence suggests that many newcomers to the tax-haven market began to either codify banking secrecy, or expand their portfolio of trusts and other legal

[107] Dehejia and Genschel 1999; Sharman 2008.
[108] Latulippe 2015; Rixen 2013b; Sharman 2008.
[109] Ganghof 2006, 150; Genschel and Schwarz 2013, 64.
[110] Ganghof 2006, 77ff.
[111] Genschel and Schwarz 2013, 67.

arrangements, thereby concealing investor identities from the late 1970s.[112] The parallel growth in the share of financial wealth hidden offshore implies that the effective tax burden on capital income has declined even further than falling statutory tax rates suggest.[113]

Moreover, previous surveys of the literature consistently report declines in statutory and effective tax rates imposed on corporate profits.[114] Clausing, for instance, shows that the average statutory corporate tax rate in OECD countries fell from 41 percent in 1981 to 23 percent in 2014. Weighing the time series by country GDP she finds, moreover, that smaller countries lower their tax rates further than larger countries.[115] Her finding is consistent with similar studies on the same subject.[116] Others confirm that rate reductions are indeed a strategic response to tax cuts observed elsewhere.[117] As to the effective tax rate, analysts agree that it has declined significantly less in most countries, owing to base-broadening measures that accompanied early cuts in the statutory rate.[118] Still, the effective tax burden declined faster in smaller than in bigger countries.[119] However, the relative stability in large-country effective tax rates observed over the course of the 1990s has more recently given way to rates of decline approaching those of small countries.[120] As Clausing and Zucman consistently report, the average effective tax rate paid by US multinationals to the US Treasury fell from 25 percent in the period 1990-1999 to 18 percent in the period 2010-2013.[121] Similar to Grubert and Altshuler, Zucman claims that "two-thirds of this decline can be attributed to increased international tax avoidance."[122] Yet, the authors do not associate this increase with the creativity of multinationals and their tax advisors, but with changes in US CFC regulations, which provided more opportunities for tax planning.[123] As Zodrow concludes from these findings, (large) home countries may increasingly enter tax competition by allowing tax avoidance, "if they believe that the gains from increased competitiveness of their [multinationals] outweigh the associated revenue losses."[124]

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[112] Apathy and Koch 2007; Palan, Murphy, and Chavagneux 2010.
[113] Piketty and Zucman 2014; Johannesen 2014; Zucman 2014a.
[114] Genschel and Schwarz 2011; Keen and Konrad 2014; Zodrow 2010.
[115] Clausing 2015, 5.
[116] Azémar, Desbordes, and Wooten 2013; Bretschger and Hettich 2002; Ganghof 2006; Genschel and Schwarz 2013; Mutti 2003.
[117] Altshuler and Goodspeed 2014; Devereux, Lockwood, and Redoano 2008.
[118] Devereux, Griffith, and Klemm 2002; Ganghof 2006; Zodrow 2010.
[119] Grubert 2001; Grubert and Altshuler 2006; Winner 2005.
[120] Grubert and Altshuler 2006.
[121] Clausing 2015, 6; Zucman 2014b, 132.
[122] Zucman 2014b, 133.
[123] Altshuler and Grubert 2006; Zucman 2014b.
[124] Zodrow 2010, 889.

2.4.4. Evidence for Tax Cooperation

From the above section we can conclude that tax competition in statutory and effective tax rates is a pervasive phenomenon. Whereas small countries are usually more competitive, at least in effective corporate taxation large countries seem to have caught up in recent years. In general, tax competition looks more intense in corporate than in personal income taxation. It is thus coherent that analysts have mostly found cooperation in anti-evasion efforts.

Large country governments have, indeed, applied unilateral methods relying on deterrence of potential tax evaders for a long time. In 1971, for instance, the German government under Willy Brandt proposed a law threatening to impose presumed capital gains tax on shareholdings held by citizens moving their formal residence to Switzerland. Owing to resistance from German business, however, the draft was severely watered down before passing the Bundestag.[125] In addition, German tax authorities have now and then raided the offices of German banks to find evidence for the abetment of tax evasion.[126] Most recently, several governments in Europe and beyond have purchased client data stolen from banks in Switzerland and Liechtenstein, triggering a wave of corrected returns submitted to tax authorities, and several lawsuits against high-profile tax evaders.[127] Next to deterrence, the US Internal Revenue Service (IRS) was also quite successful in using incentives to gather data on tax evaders. Through its whistleblower program – promising participants a stake in retrieved taxes – the IRS motivated a former UBS private banker to testify on the evasion abatement business of his former employer, providing information that formed the basis for the UBS scandal.[128]

Collective action against tax evasion has most often been bilateral, but multilateral initiatives have reached further. Bilateral action dates back to the Kennedy administration's attempt at inserting an administrative assistance clause in the OECD Model Tax Convention. Yet, the final version adopted in 1963 included guarantees for domestically-codified banking secrecy, and Switzerland upheld a reservation against the proposed clause. Farquet and Leimgruber attribute this outcome to limited support from within European ruling circles (allegedly themselves evading taxes in Switzerland), and intense business lobbying of the US Congress undermining the Kennedy administration's resolve.[129] Astonishingly, Switzerland, Luxembourg, and Austria managed to uphold reservations against administrative assistance clauses in the Model Tax Convention until the late 2000s, which analysts attribute either to

[125] Farquet and Leimgruber 2014.
[126] Ganghof 2000b.
[127] Emmenegger 2014.
[128] Hässig 2010.
[129] Farquet and Leimgruber 2014, 13.

institutional constraints emanating from the double tax avoidance regime,[130] or the prevalence of regulative norms at the international level, ruling out the use of coercion.[131] In fact, the three countries eventually lifted their reservations in 2009, after the UBS scandal had encouraged the US to threaten Swiss banks with indictment in US courts, and the LGT scandal had prompted Germany to demand a new tax-haven blacklist from the OECD.[132] Their capitulation led to a new wave of TIEAs being adopted, which, however, only provide for information exchange upon request. Moreover, the only consequence of non-participation for countries other than Switzerland was a negative peer-review rating. As a result, many tax havens remained noncooperative, or engaged in mock compliance, thus continuously providing opportunities for tax evasion.[133] The newest additions to the list of bilateral treaties are Foreign Account Tax Compliance Act (FATCA) agreements offered by the US, and withholding tax agreements offered by Switzerland.[134] FATCA agreements provide for AEI that is, however, not fully reciprocated by the US, and are backed up by a US threat of financial market closure in case of noncompliance. A few studies of their legal content, emergence, and expected impact on global tax governance exist.[135] Still, their significance for theories of tax competition and cooperation has not been fully appreciated, yet. Withholding tax agreements were briefly promoted by Switzerland to slow the spread of AEI provoked by FATCA. However, the country has merely two agreements in place, while a third deal with Germany failed in the second chamber of parliament due to opposition from social democrats and greens.[136]

Noteworthy multilateral cooperation against tax evasion has mostly taken place at the EU level with the Savings Directive as its centerpiece. In its original form, adopted in 2003, the directive provided for AEI on interest income earned by non-resident EU nationals. Luxembourg, Austria, and Belgium were, however, granted the right to levy a withholding tax on behalf of EU partners instead of exchanging account data.[137] This was a side payment most of which went to the first two countries, which were the main recipients of non-resident deposits within the EU, and had staunchly resisted any type of EU cooperation in interest taxation since the late 1980s.[138] The provision allowed them to preserve the anonymity of non-resident EU account holders, and tax them at an initially moderate rate of 15 percent.

[130] Rixen 2008.
[131] Sharman 2006a.
[132] Emmenegger 2014.
[133] Johannesen and Zucman 2012; Genschel and Rixen 2015; Woodward 2015.
[134] Grinberg 2012.
[135] Eccleston and Gray 2014; Emmenegger 2014; Grinberg 2012.
[136] Emmenegger 2014; Rixen 2013a.
[137] Rixen and Schwarz 2012.
[138] Genschel 2002.

Dehejia and Genschel as well as Sharman argue that the (perceived) risk of capital flight from the common market, underscored by the EU's inability to extend AEI to Switzerland in an analogous Savings Agreement, undermined effective cooperation within the EU.[139] In fact, I show in previous work that Luxembourg and Austria only accepted participation in comprehensive intra-EU AEI after the US had forced them (and Switzerland) to enter into FATCA agreements. Their signature of these agreements activated a most-favored nation clause in another EU directive, whereas Swiss acceptance of AEI reduced the risk of capital flight from the common market.[140]

Likewise, the literature suggests that international cooperation against tax avoidance has its roots in unilateral efforts by the Kennedy administration. In 1962, it enacted Subpart F of the Internal Revenue Code, obliging individuals and corporations resident in the US to include passive income from CFCs in their tax returns.[141] To counteract business concerns over the rules' impact on its competitiveness, the US promoted this model among other developed-economy governments, eventually leading to a formal OECD recommendation that all member states should adopt corresponding regulations.[142] Throughout the '60s, and '70s, the US used the same approach of first adoption – and subsequent promotion at OECD level – for transfer-pricing and thin capitalization rules. In the case of transfer-pricing rules, this led to formal OECD endorsement in 1979.[143] As Genschel and Schwarz report, most OECD members had transfer-pricing rules in place by 2008, whereas adoption rates for CFC and thin capitalization rules were somewhat lower.[144]

According to Rixen, multilateral cooperation against tax avoidance only became an issue after the US and other Group of 7 (G7) governments realized that the constant need to update CFC rules had caught them in a perpetual "proliferation spiral."[145] Others attribute increased activism to International Monetary Fund (IMF) and OECD reports quantifying the amount of corporate profits routed through tax havens.[146] In any case, G7-Finance Ministers delegated the OECD in 1996 to develop a project against "harmful tax competition."[147] The secretariat presented recommendations in 1998, suggesting that tax havens should no longer be allowed to host foreign profits in the absence of any related productive activity under their jurisdiction. In addition, it also aimed at the termination of PTRs, serving its large member

[139] Dehejia and Genschel 1999; Sharman 2008.
[140] Hakelberg 2015.
[141] Rixen 2011, 17.
[142] Eden and Kudrle 2005, 115.
[143] Genschel and Schwarz 2011, 360; Rixen 2008.
[144] Genschel and Schwarz 2011, 360.
[145] Rixen 2011, 19.
[146] Eccleston 2012, 63; Kudrle 2003, 63.
[147] OECD 1998.

states "to attract foreign capital by offering better treatment than was available to domestic investors."[148] Analysts agree that the initiative, which made good progress under the Clinton Administration, eventually failed because the Bush Administration withdrew US support in 2001.[149] There is, however, disagreement concerning the Administration's motivation. Whereas Rixen emphasizes concerns over competitiveness voiced by US multinationals,[150] Sharman underlines the importance of normative arguments put forward by tax haven governments and libertarian lobbyists in the US[151] Further multilateral initiatives discussed in the literature include a voluntary code of conduct, encouraging EU members to terminate PTRs,[152] and the OECD's newest project against base erosion and profit shifting (BEPS), which has received some coverage in legal studies, but is not yet fully terminated.[153]

The literature reviewed above makes clear that capital held by households and corporations is indeed mobile across borders, and increasingly so since economic integration intensified from the early 1980s. In accordance with the theory of asymmetric tax competition, small countries have been more competitive than large countries in setting statutory tax rates, and codifying financial secrecy. At the same time, large countries have recently reduced their multinationals' effective tax burden to small country levels by allowing for increased tax avoidance. Still, international cooperation against tax arbitrage is consistently initiated by large countries, but complicated by the weakest-link problem. That is, full participation (including from tax havens) is needed to ensure an effective outcome. This structural constraint, as well as recurrent and intense lobbying from domestic business groups caused otherwise powerful and highly-capable states to show a lack of resolve in the enforcement of international tax cooperation. The importance of domestic business lobbying in constraining tax cooperation may also be reflected in the higher number of cooperative initiatives against tax evasion, as compared to tax avoidance. After all, from the perspective of large countries, the affected organized interests in anti-avoidance efforts are mostly domestic multinationals, whereas the affected organized interests in anti-evasion efforts are mostly foreign banks in small countries. Drawing on these core insights from the above literature review, I will develop a power-based theory of international tax cooperation in the next chapter, emphasizing the importance of credible sanction threats and international redistribution.

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[148] Rixen 2011, 19.
[149] Eccleston 2012; Eden and Kudrle 2005; Kudrle 2003; Rixen 2008; Sharman 2006a.
[150] Rixen 2011.
[151] Sharman 2006a.
[152] Genschel and Schwarz 2011.
[153] Pinkernell 2013.

3. Redistributive Tax Cooperation

The preceding chapter made clear that international tax policy has been marked either by ineffective cooperation, or its total absence. Therefore, theorists have focused on explaining that absence. Recent developments in international tax policy suggest, however, that we can finally observe cooperation occurring in the real world. In contrast to previous approaches, my goal in this chapter is thus to develop a theory of the determinants of international tax cooperation. In view of this, I will first sketch out the empirical puzzle motivating this study, and the research question it raises, before explaining why existing approaches do not yield a satisfactory answer. Drawing on power-based theories of international financial regulation, I will then develop the theoretical framework proper, and derive corresponding hypotheses.

3.1. The Puzzle: Tax Cooperation Without Joint Gains

3.1.1. The Empirical Basis

On 29 October 2014 51 jurisdictions signed a multilateral competent authority agreement (MCAA) at the 7th Meeting of the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) in Berlin. Since then a further 50 have acceded to the agreement.[1] In the MCAA, signatories commit to implement the common reporting standard (CRS) for automatic exchange of information (AEI) developed by the Organisation for Economic Co-operation and Development (OECD), and to start exchanging information by September 2017 or 2018.[2] The CRS obliges jurisdictions to implement rules requiring financial institutions to regularly report all capital income held by non-resident individuals and entities, as well as their account balances.[3] In addition, they have to oblige domestic banks to follow strict due diligence procedures when determining the actual beneficial owner of an account. That is, banks need to look through interposed trusts or other legal entities when opening new accounts, and also review ownership data for existing accounts with a value of more than $250,000.[4] Global Forum members will check the accuracy of a

[1] OECD 2016a.
[2] Global Forum 2014a.
[3] OECD 2014d, 10. Capital income to be reported includes "interest, dividends, account balance, income from certain insurance products, sales proceeds from financial assets and other income generated with respect to assets held in the account or payments made with respect to the account" (Ibid.).
[4] Ibid., 11.

signatory's CRS implementation in regular peer reviews, and publish corresponding country reports.[5]

Table 3-1: CRS Adoptions Among Top 25 Secrecy Jurisdictions

Jurisdiction	OECD CRS Standard	
	Signed MCAA (agreed AEI start)	Political Endorsement (pledged AEI start)
Switzerland	YES (September 2018)	
Luxembourg	YES (September 2017)	
Hong Kong	NO	YES (September 2018)
Cayman Islands	YES (September 2017)	
Singapore	NO	YES (September 2018)
USA	NO	NO
Lebanon	NO	NO
Germany	YES (September 2017)	
Jersey	YES (September 2017)	
Japan	NO	YES (September 2018)
Panama	NO	NO
Malaysia	NO	YES (September 2018)
Bahrain	NO	NO
Bermuda	YES (September 2017)	
Guernsey	YES (September 2017)	
UAE	NO	YES (September 2018)
Canada	NO	YES (September 2018)
Austria	YES (September 2018)	
Mauritius	YES (September 2017)	
British Virgin Islands	YES (September 2017)	
United Kingdom	YES (September 2017)	
Macao	NO	YES (September 2018)
Marshall Islands	NO	YES (September 2018)
Korea	YES (September 2017)	
Russia	NO	YES (September 2018)

Sources: OECD 2015; TJN 2013.

Initial signatories already included a large number of tax competitive small countries, joined by Switzerland in March 2015. What is more, a further 37 jurisdictions had politically endorsed the CRS by then, and pledged to begin exchanging information by September 2018.[6] As *Table 3-1* reports, all but four of the top 25 secrecy jurisdictions ranked by the Tax Justice Network had either signed or politically endorsed the MCAA in May 2015. Luxembourg and Austria, the longstanding adversaries of intra-EU AEI, had moreover agreed to a revised Administrative Cooperation Directive in the Council of Ministers, transposing the CRS into European law.[7] This implies that many tax havens legally committed to dismantle the banking secrecy provisions and incorporation schemes they had successfully used to attract foreign tax evaders and their hidden capital. Accordingly, even a critical non-governmental organization (NGO) like the Tax Justice Network stated that "finance ministers were right to claim historic

[5] Global Forum 2014a.
[6] OECD 2014a.
[7] Council of Ministers 2014.

progress,"[8] while KPMG, one of the leading global tax advisory firms, called the agreement "a major international tax development and an important new step toward greater tax transparency."[9] Given their previous resistance, *why did tax havens eventually adopt AEI?*

3.1.2. What Happened to Structural Constraints?

The theories of tax cooperation reviewed above suggest that we should look for an attenuation of structural constraints like the asymmetric prisoner's dilemma or the weakest-link problem when trying to explain the sudden upsurge in cooperative behavior. The asymmetric prisoner's dilemma predicts that small countries are more tax competitive, and therefore host disproportionate shares of global capital. As their large capital stocks boost tax revenue, labor demand, and wage levels, governments across the ideological spectrum should thus resist cooperation in tax matters. As the previous chapter made clear, this is indeed what analysts have observed over the last decades. If, however, asymmetry had become less of a constraint to tax cooperation – letting small country governments relax their positions – we should thus be able to see a decline in financial wealth held in offshore centers before negotiations on the multilateral adoption of AEI began.

As Eccleston and Gray point out, the OECD did not pursue this goal until mid-2012 when G20 leaders endorsed a corresponding report and called on all countries to adopt the practice.[10] Previously it had still been unclear whether the G20 would support the establishment of AEI as the new global standard for tax cooperation. Germany and the UK, for instance, were negotiating withholding tax agreements with Switzerland at the time that preserved the anonymity of account-holders.[11] If the abetment of tax evasion had somehow become a less interesting business model for tax havens before this development, we should thus see a decline in offshore wealth ahead of June 2012. Yet, Zucman reports that the share of Europeans' financial wealth held in tax havens increased from ten percent in 2010 to 12 percent in 2013. Even Switzerland, which hosted 50 percent of worldwide offshore wealth during that period, but had already been under strong pressure as a result of the UBS scandal, still benefitted from a small increase in assets under management.[12] This is consistent with Johannesen and Zucman's finding that the adoption of the upon request standard by many tax havens mostly led to transfers of formal account ownership to shell corporations, but not to a

[8] Vasagar and Houlder 2014.
[9] KPMG 2014.
[10] Eccleston and Gray 2014, 4; G20 Leaders 2012.
[11] Grinberg 2012.
[12] Zucman 2013a, 33.

decline in financial wealth held offshore.[13] Accordingly, it seems as if many tax havens that adopted AEI in 2014 were still benefitting from the management of hidden wealth in 2012. The asymmetric prisoner's dilemma was thus in place when negotiations on AEI adoption began.

What about the weakest-link problem? Studies reviewed above suggest that noncooperation by the outside world hinders agreement on tax cooperation among a less than global group of countries.[14] The poster case for this constraint is EU negotiations on cooperation in interest taxation, blocked mainly by Luxembourg and Austria, which used the potential for capital flight to Switzerland as a scarecrow to undermine agreement.[15] If capital flight to noncooperative jurisdictions had become less of a problem ahead of AEI negotiations, we should thus see a more conciliatory approach to EU-internal tax cooperation from the Austrian and Luxembourgish governments. As I show in previous work, however, both continued throughout 2012 to staunchly defend their transitional privilege of levying a withholding tax instead of participating in EU-internal AEI. In doing so, they continued to request the establishment of a level-playing field, a euphemism for Swiss participation, ahead of their consent.[16] Moreover, they did so despite an automatic increase in the agreed rate of the withholding tax to 35 percent in 2011,[17] most likely because EU account-holders in these countries had already hidden their identities behind corporations domiciled in third countries by then, and were therefore unconcerned by changes in the statutory rate.[18] Again, we can thus observe the persistence of the weakest-link problem at the outset of negotiations on multilateral AEI. We can therefore conclude that changes in the significance of structural constraints preceding – and thus external to – negotiations on the adoption of AEI cannot explain its eventual emergence.

3.1.3. No Pareto-Improvement for Small Countries

Most existing theories of tax cooperation are embedded in Keohane's contractualist approach to international relations. This approach claims that governments only cooperate if they can expect joint gains. That is, all parties to the deal have to be better off under the agreement than under status quo conditions. They have to have a common interest in the establishment of a regime.[19] Differences in power may lead to a skewed distribution of joint gains,

[13] Johannesen and Zucman 2012.
[14] Genschel and Plumper 1997.
[15] Dehejia and Genschel 1999; Sharman 2008.
[16] Hakelberg 2015.
[17] Rixen and Schwarz 2012.
[18] Johannesen 2014.
[19] Keohane 2005.

disproportionally benefitting a benevolent hegemon. Yet, the agreement has to remain Pareto improving in the sense that no party is left worse-off. Countries can thus move along the Pareto-frontier in their quest for cooperation, but they cannot cross it.[20] As Hasenclever et al. put it, "the existence of [common] interests is a necessary, but not sufficient, condition for cooperation" according to this approach.[21] Therefore, analysts writing within this tradition seek to explain situations in which states could reap joint gains but fail to cooperate nonetheless because of transaction costs, or flawed institutional design.[22] My puzzle is the exact opposite. I seek to explain the presence of cooperation in the *absence* of joint gains.

As the studies reviewed above suggest, small tax-competitive states have nothing to gain from tax cooperation. Instead, they are likely to suffer from an outflow of the offshore capital that forms the basis for their economic success and generous welfare states.[23] Luxembourg, for instance, generates 40 percent of its gross domestic product (GDP) in the financial sector.[24] In a larger country like Switzerland this share still amounts to 10.5 percent. Moreover, finance has contributed a third to Swiss economic growth during the last 20 years.[25] Given the responsiveness of capital owners to regulatory changes in these countries that only affect tax evaders, it seems reasonable to assume that much of their competitive advantage in this sector relies on the provision of secrecy and low tax rates.[26] Hence, they risk significant economic losses when transitioning from banking secrecy to routine reporting of non-resident accounts. In fact, the Luxembourgish statistics office predicts a decline of five to ten percent in the financial sector's contribution to gross value added as a result of AEI, leading to a 0.5 percent decline in overall employment.[27] Likewise, the Swiss Federal Council expects economic losses from the adoption of AEI, warning against "relatively high implementation costs for financial institutions," and expecting a "certain outflow of assets managed in Switzerland on behalf of foreign private clients" that may not be compensated by new inflows.[28] Unfortunately, it does not provide quantitative estimates of the size of these phenomena.

Still, we can conclude that the Swiss and Luxembourgish governments did not sign the MCAA to benefit from joint gains, but rather did so despite expecting significant economic losses from it. Under these circumstances, cooperation is clearly not Pareto improving in the

[20] Krasner 1991.
[21] Hasenclever et al. 1997, 30.
[22] Gilligan 2009; Stone 2009.
[23] Genschel and Seelkopf 2012.
[24] Zucman 2013a, 93.
[25] EFD 2014, 24.
[26] Johannesen 2014.
[27] Adam 2014, 3.
[28] Schweizerischer Bundesrat 2015, 52.

sense that at least one party benefits while no other is left worse-off. Something other than the regime itself must thus have motivated these governments to cooperate. As I will begin to elaborate in the next section, I argue that this something is coercion by a great power.

3.1.4. Bargaining over Tax Cooperation: A Zero-Sum Game?

The MCAA is clearly not Pareto improving. But does this mean that bargaining over tax cooperation is per se a zero-sum game? Sharman argues that some tax havens gain surprisingly little from the inflow of foreign capital as they naturally impose low taxes and negligible management fees. In contrast, large countries would benefit massively from a repatriation of capital hosted in tax havens, owing to their higher tax rates. As large countries gain more from tax cooperation than tax havens lose, they could compensate tax havens for their losses. In theory, there is thus enough scope for a Pareto-improving deal. In practice, however, policymakers have discarded this option as politically hard to defend.[29] Using the money of honest taxpayers to pay tax havens for not hosting tax evaders indeed seems like a difficult sell for democratically-elected governments.[30] In addition, compensation is most likely costlier than a credible threat of economic sanctions that does not require any monetary commitments. A large country powerful enough to issue such a threat should thus have no incentive to offer compensation to small countries. What is more, tax havens would also lose their sovereign right to set tax rates, and trade in a self-sustaining business model for handouts that large countries could withdraw at any moment.[31] It is therefore questionable whether they would be willing to turn themselves from independent actors in world markets to passive recipients of aid money, especially since powerful large countries could not credibly commit to permanent transfers.

As a result, bargaining over competition versus cooperation in tax matters is more likely to resemble a zero-sum than a positive-sum game in practice. If small countries mange to resist large countries, they continue to benefit from tax competition at the expense of large countries. Yet, if large countries manage to enforce tax cooperation, they are most likely to establish a regime that benefits them at the expense of small countries. Bargaining under these conditions does not resemble a zero-sum game because countries care about relative gains per se. Large countries merely seek to enforce their legitimate tax claim. They are indifferent to the impact this has on the power or welfare of small countries. Instead, it is the combination of the distributive outcome of asymmetric tax competition and the political obstacles to a

[29] Sharman 2006a, 152.
[30] Genschel and Schwarz 2011, 354.
[31] Bucovetsky 1991, 181.

compensatory solution that leave credible threats by powerful states as the only means to produce a cooperative outcome in tax matters.[32] If large countries are indeed able to issue credible threats in the sense that they can impose economic sanctions that are less costly for themselves than for small countries, they should thus also be able to impose redistributive outcomes on them, as seems to be necessary for the establishment of cooperation in the practical world of international tax policy.[33] Despite these considerations, the game remains positive sum from a formal analytical perspective, given that side payments are mathematically possible.

3.2. Power in International Tax Policy

The above analysis suggests that power rather than joint gains is the key to understanding cooperation in international tax matters. In developing an updated theory of tax cooperation, I thus draw on power-based approaches to the neighboring policy field of international financial regulation. Unilateral government action in this field is equally constrained by capital mobility, and the addressees of regulation are often the same: international financial institutions. Therefore, comparisons across the two fields are not uncommon.[34] The literature strand, like my own approach, shares many of contractualism's fundamental assumptions. It perceives nation-states as the decisive actors in world politics, rationally pursuing their own interests. Rationality implies that nation-states "make purposive choices, […] survey their environment and, to the best of their ability, choose the strategy that best meets their subjectively defined goals."[35]

In contrast to classic contractualism, however, the strand follows Moravcsik in his assumption that "states do not automatically maximize fixed, homogenous conceptions of security, sovereignty, or wealth per se […]. Instead, […] they pursue particular interpretations and combinations of security, welfare, and sovereignty preferred by powerful domestic groups."[36] In short, government preferences in international bargaining are determined by domestic politics.[37] More importantly still, power-based approaches to international financial regulation depart from contractualism in the importance they accord to joint gains. In fact, authors within this strand argue that a dominant financial center can impose its preferred international rules on other governments even if this leaves them worse off than the status

[32] Legro and Moravcsik 1999, 17.
[33] Krasner 1976; Oatley and Nabors 1998.
[34] Genschel and Plumper 1997; Rixen 2013b.
[35] Lake and Powell 1999, 6–7.
[36] Moravcsik1997, 519–520.
[37] Simmons 2001, 595.

quo. It achieves this by conditioning access to its financial market on compliance, leaving other governments no choice but to conform to its demands.[38] As a result, the impact of these rules "sometimes will be intentionally redistributive," in that they are conceived by dominant financial center politicians to shift the costs of regulation away from domestic financial institutions and onto foreign financial institutions (FFI).[39] It is such redistributive cooperation that we have recently observed in international tax matters.

3.2.1. The Material Sources of Power

Legro and Moravcsik suggest that the outcome of international bargaining is determined by nation-states' relative material resources, enabling them to issue more or less credible threats and inducements in view of making other states do what they would not otherwise do.[40] The credibility of threats and promises is determined by the discrepancy between the costs they impose on the sender, and the costs they impose on the recipient. "The less costly [they] are to the sender, and the more costly or valuable they are to the target, the more credible and effective they will be."[41] There is broad and longstanding agreement among authors within the relevant literature that the size of a country's internal market is its decisive power resource, determining to what extent it is able to make credible threats and promises in international economic and financial affairs.[42] A large internal market implies that "a smaller proportion of [a country's] economy [is] engaged in the international economic system."[43] Accordingly, market closure by a large state is less costly for the large state than for a small state whose economic actors do a comparatively high proportion of their business in the large state's market. Inversely, market closure by a small state does not affect the large state's economic actors because they only do a minimal proportion of their business in the small state's market. Because the large state is thus less vulnerable to market closure than the small state, the former is able to exert power over the latter.[44] As a result, the large state can wrestle concessions from small states when conditioning market access on compliance with its demands.

In international bargaining over cooperation against tax evasion the relative size of financial markets should be the most relevant source of state power. After all, regulation in this field essentially targets banks in offshore centers, the most likely custodians of hidden

[38] Helleiner 2002; Oatley and Nabors 1998; Simmons 2001; Singer 2007.
[39] Oatley and Nabors 1998, 37.
[40] Legro and Moravcsik 1999, 17; Dahl 1957, 203.
[41] Legro and Moravcsik 1999, 17.
[42] Drezner 2008; Krasner 1976; Helleiner 2014; Simmons 2001.
[43] Krasner 1976, 320.
[44] Drezner 2008, 35.

wealth. They need to be obliged to correctly identify their customers, and report that information to tax authorities to put any type of information exchange to work. The incoming foreign capital earns them substantial additional revenue from management fees, and increases their net equity. At the same time, they need to invest their clients' capital worldwide to provide them with competitive rates of return. Here, they rely especially on large financial markets, which by definition account for large shares of worldwide capital demand. Should they be shut out of these markets, they would lose a substantial part of their revenue, and could no longer offer their clients the promised rates of return on their investments. Therefore, a government controlling a large financial market should be able to coerce other states into tax cooperation. To this effect, the dominant financial center has several levers at hand. It can, for instance, levy a withholding tax on payments an FFI receives from financial agents under its jurisdiction, or withdraw its local banking license altogether.[45] Given that a dominant financial center usually also hosts infrastructure that is crucial to the entire financial system, including interbank settlement systems, and clearing houses, it is even able to exclude FFIs from the international financial circuit, if they do not do business in its market.[46] The risk of FFIs divesting in response to a sanctions threat is thus very low, owing to the dominant financial center's share in global capital demand, and its control of central financial infrastructure. Instead, foreign banks are more likely to lobby their home governments for the provision of a legal framework enabling compliance.

In international bargaining over cooperation against tax avoidance the relative size of consumer rather than financial markets should be the decisive source of state power.[47] In this context, the targets of regulation are multinational corporations engaging in profit shifting. Multinationals seek to sell their products and services across the world, and to as many customers as possible. Hence, they often earn a substantial share of their profits outside their home country.[48] As the Google example has shown, however, these profits are often not taxed in the source country – that is, the country where sales take place, and customers reside[49] – but artificially shifted to tax havens. Countries with small consumer markets that are negligible to a company's global results risk divestment if they try to counter these practices.

[45] Emmenegger 2014; Grinberg 2012.
[46] Helleiner 2002; Simmons 2001.
[47] Drezner 2008, 34.
[48] Zucman 2014b.
[49] The OECD Model Agreement links source country status to the presence of a permanent establishment (PE). A PE is a place of effective management or production. This may also include an Internet server wholly owned or controlled by a foreign company that is used to process product sales and payments. Yet, tax authorities have to determine in every individual case whether the automatic processing of sales and payments is a core element of corporate activity. Source country status in e-commerce therefore remains a contested issue (Pinkernell 2014, 28ff.).

In contrast, countries with large consumer markets that account for an important fraction of a multinational's global sales should be able to impose counter measures without risking the presence of a foreign multinational in their markets. In view of this, a powerful source country could, for instance, impose a diverted profits tax on multinationals it suspects of shifting profits to low-tax jurisdictions.[50] Under certain circumstances it could also inquire whether the tax rebates a multinational receives in a low-tax jurisdiction constitute illegal state aid under anti-trust legislation, and impose corresponding fines.[51] Still another possibility is the targeted response to specific profit-shifting strategies by means of transfer pricing or thin capitalization rules.[52] Through a combination of these measures a powerful source country could target jurisdictions it suspects of abetting tax avoidance – for instance, by offering preferential tax rulings and special exemptions – or those that lack effective controlled foreign company (CFC) rules. In sum, large financial and/or consumer markets provide governments with enough leverage to counter both tax evasion and avoidance. The next step is thus to identify the countries that can actually wield such power.

3.2.2. Great Powers in International Tax Policy

In bargaining over cooperation against tax evasion great power status falls on the country that analysts have consistently considered the world's dominant financial center: the United States. In terms of stock market valuation, interbank transactions, and trade in options and futures the US has repeatedly been identified as the biggest financial market in the world.[53] Measured by market capitalization of listed companies, the US stock market was three to five times the size of the second-largest market between 2008 and 2012.[54] Between 2009 and 2012, the value of transactions processed by interbank funds transfer systems and clearing houses located in the US was by far the highest among all reporting countries.[55] Moreover, the Futures Industry Association (FIA) reports that 37 percent of worldwide derivatives contracts were traded and/or cleared in North America, compared to 34 percent in Asia-Pacific, and 20 percent in Europe.[56] The extent of international participation in the American market is reflected in FPI statistics. As the International Monetary Fund (IMF) reports, 19 percent of worldwide FPI goes to the US, compared to eight percent going to the runner-up,

[50] Houlder 2015b.
[51] Oliver, Boland, and Houlder 2014.
[52] Genschel and Schwarz 2011, 355.
[53] Simmons 2001; Singer 2007.
[54] World Bank 2013.
[55] BIS 2013.
[56] FIA 2014.

the United Kingdom.[57] Hence, the US is also the preferred FPI destination for all but one of the top five offshore centers on the financial secrecy index, which ranks countries according to the effort they put into concealing account-holder identities (*Table 3-2*). As FFIs depend on its financial infrastructure for processing dollar-denominated transactions, and receive substantial revenue from their portfolio investment in the country, the US has several levers to make them comply with its regulatory demands. It could threaten to exclude them from interbank settlement or clearing mechanisms – which would cut them off the international capital circuit – or withhold on their US-source revenue. The risk of FFIs divesting in response is low, as the American share of worldwide capital demand is too big to allow for smooth absorption of US-bound FPI in third countries. Indeed, it is hard to imagine that any FFI would readily abandon its business on Wall Street. We can thus safely consider the US the dominant nation-state in bargaining over financial transparency and information exchange. But what about the EU as a whole?

Table 3-2: Portfolio Investment of Top Five Secrecy Jurisdictions in the US, and in Main FPI Destinations Inside the EU (% of Total)

	Destinations						
	US	UK	FR	DE	NL	LU	EU 5
Switzerland	16	7	8	7	7	14	43
Luxembourg	21	8	9	10	5	-	32
Hong Kong	7	6	1	1	1	4	13
Cayman Ils.	44	1	1	1	1	1	5
Singapore	27	5	2	3	2	2	14

Sources: IMF 2015; TJN 2014.

As *Table 3-2* indicates, the common market – when treated as a single unit – absorbs even more FPI from three out of the five top secrecy jurisdictions than the US Owing to its size, the number of analysts also considering the EU a great power in international economic, and financial affairs has recently been on the rise.[58] Indeed, there is evidence of the EU's ability to impose its regulatory preferences on third states.[59] In international bargaining over cooperation against tax evasion, however, the EU has been unable to translate market size into power. This is because decisions on sanctions and taxation require unanimity in the Council of Ministers. As a result, EU members profiting from financial secrecy – essentially Luxembourg and Austria – were not only able to refuse participation in intra-EU AEI on interest payments but also blocked mandates for Commission negotiations on the matter with

[57] IMF 2015.
[58] Drezner 2008; Leblond 2011; Posner 2009.
[59] Bradford 2012.

Switzerland. Whereas Switzerland could thus resist AEI with the EU by referring to the non-participation of Luxembourg and Austria, Luxembourg and Austria could justify their non-participation by pointing to potential capital flight to Switzerland, simultaneously blocking progress at the EU and international levels. Large member states, in turn, were unable to coerce Luxembourg and Austria into participation owing to common market legislation providing for non-discrimination and the free movement of capital.[60] In sum, the EU was internally paralyzed at the outset of international negotiations on AEI.

Table 3-3: Measures of Countries' Economic Power in 2013

Indicators	US	EU	CN	JP	RU	IN
Market Size						
Population (millions)	316	507	1357	127	144	1252
GDP (current US$, billions)	16800	17352	9240	4902	2097	1877
GDP (current PPP US$, billions)	16800	17402	16158	4624	3461	6774
Merchandise trade (%, global imports)	12.33	14.78	10.32	4.41	1.82	2.47
Commercial services (%, global imports)	9.85	19.74	7.52	3.70	2.81	2.84
FDI (inbound, % world total)	19.4	33.7	3.8	0.7	2.3	0.9
Vulnerability						
Trade to GDP ratio (2011-2013)	30.1	34.9	51.9	33.6	51.5	54.2
FDI (outbound, % GDP)	37.6	61.2	6.6	20.1	23.4	6.2

Sources: UNCTAD 2015; WTO 2015

In bargaining over cooperation against tax avoidance great power status is harder to determine than in financial/anti-evasion affairs. Following Drezner, I report data on great power candidates' market size, and vulnerability to external disruptions in *Table 3-3*.[61] According to these numbers, the EU, US, and China all control sizable consumer markets. Yet, the first two still dominate the latter in inbound FDI. That is, all three seem to be indispensable for multinationals seeking to sell their products and services, but the EU and US still are the most popular destinations for the location of permanent establishments. As source country status, which enables a government to tax profits earned by a foreign multinational under its jurisdiction, is defined by PE presence, this should thus be the most relevant indicator in the context of anti-avoidance affairs. On the vulnerability side, we can observe that developed economies, including the EU and the US, are significantly less

[60] Hakelberg 2015.
[61] Drezner 2008, 36.

affected by disruptions in international trade than emerging economies. EU and US multinationals are, however, heavily invested outside their home countries and thus potentially vulnerable to increased source country taxation. This vulnerability does, however, not generally apply to disruptions in the rest of the world. Instead, the US and EU are essentially vulnerable to each other, given that 50 percent of the US' FDI stock abroad is located within the EU,[62] whereas 34 percent of the EU's FDI stock in the rest of the world is located in the US[63] Given its larger market, and lower vulnerability in comparison with the US, the EU should thus be the greatest power in bargaining over anti-avoidance measures. Like in anti-evasion affairs, however, it is constrained in wielding its power by internal disunity and European law.

As discussed above, the Council of Ministers has to take decisions on taxes and sanctions unanimously. If member states with large consumer markets wanted to introduce EU-wide countermeasures against profit shifting, they would thus need the consent of Ireland, Luxembourg, and the Netherlands. As illustrated by the Google example, however, these countries form important pillars in the avoidance strategies of US multinationals. They are the gateways through which US firms channel profits earned in large EU member states out of the common market.[64] In return, they profit from an important inflow of FDI from the US, essentially in the form of holding companies. As data from the United Nations Conference on Trade and Development (UNCTAD) shows, 55 percent of the US FDI stock in the EU is located in these three countries.[65] They should thus have little interest in joining a united EU front against profit shifting, and indeed they have a long history of blocking EU cooperation in corporate taxation. As a result, competition in this field has been stronger inside the EU than in the rest of the world.[66] What is more, large member states are constrained by European law and ECJ jurisprudence in going it alone.[67] Multinationals running their EU business from Ireland, Luxembourg, or the Netherlands enjoy unconstrained access to the entire common market. One of the principles of European law guaranteeing their access is the freedom of establishment. That is, member states cannot discriminate against corporations domiciled in another member state. Therefore, large member states cannot apply CFC rules against multinationals that shift their profits to these destinations. As the ECJ made clear in its judgment of the *Cadbury Schweppes* case, CFC rules can only be applied, if a corporation's

[62] UNCTAD 2014.
[63] Eurostat 2015.
[64] Pinkernell 2012; Pinkernell 2014.
[65] UNCTAD 2014.
[66] Genschel, Kemmerling, and Seils 2011, 591; Kemmerling 2010, 1068; Wasserfallen 2014, 429.
[67] Genschel and Jachtenfuchs 2011; Genschel, Kemmerling, and Seils 2011; Kemmerling 2010.

presence in another member state is "wholly artificial."[68] Owing to the ECJ's narrow definition of this term, however, only complete letterbox companies fall within the reach of national CFC rules.[69]

Owing to the combination of European disunity and common market legislation, large member states are thus constrained in countering tax avoidance from multinationals located outside and within the EU. They have no control over effective source taxation of multinationals operating in the common market, and cannot apply CFC rules against intra-EU profit shifting. Against this background, it is once more the US that emerges as the single great power in bargaining over cooperation against tax avoidance. Despite the underlying economic data, it is effectively less vulnerable to EU anti-avoidance measures than vice versa. In the hypothetical event of a tax conflict it could thus wield more power over EU multinationals than the EU (or its member states) over US multinationals. In the following section, I will thus develop hypotheses as to the conditions under which the US employs its power in international tax policy to enforce redistributive cooperation.

3.3. Great Power Preferences

The literature review made clear that competition rather than cooperation has marked international tax policy over the last three decades. Accordingly, the US seems to use its power to enforce cooperation only under very specific circumstances. Following, the power-based approaches to financial regulation discussed above, as well as Legro and Moravcsik's two-step framework, I submit that these circumstances have to be found at the domestic level. In contrast to popular comment, however, I argue that budget constraints are not at the origin of increased great power activism in international tax policy. Instead, it is the coincidence of domestic political constraints to regressive tax reform, and scope for redistributive cooperation in proposed international tax rules that leads a great power to enforce international tax cooperation by means of a credible threat of sanctions. Left-of-center governments, especially in majoritarian electoral systems, are, for instance, more concerned about the tax system's effective progressivity than their conservative opponents, whereas scope for redistributive cooperation allows the great power to appease domestic organized interests by shifting the costs of regulation to their foreign competitors.

[68] ECJ 2006, para. 51.
[69] Pinkernell 2014.

3.3.1. Partisan Patterns in Economic and Tax Policy

Hibbs developed the partisan theory of political economy in 1977, arguing that "governments pursue macroeconomic policies broadly in accordance with the objective economic interests and subjective preferences of their class-defined core political constituencies."[70] His theory is indeed consistent with studies on party behavior in tax policy. Ganghof, for instance, concludes that "right parties are more likely to flatten the income tax schedule and to embrace the ideal-type of a flat income tax [whereas] left parties are more likely to defend the progressivity and the revenue raising potential of the income tax."[71] Along the same lines, Basinger and Hallerberg show that left-of-center governments are more hesitant than conservative ones in making competitive cuts to the corporate tax rate.[72] Moreover, Garrett associates left-labor power with more capital taxation unless an economy is highly integrated in world markets. He explains that left parties favor high taxes on capital, but are often constrained by capital mobility.[73] Similarly, Beramendi and Rueda find that left-wing governments are associated with more progressive tax systems unless they are bound by corporatist commitments. In the latter case, they concede capital relief in exchange for redistribution on the spending side, financed by more indirect taxation.[74] Andersson, in turn, demonstrates that left-wing governments are associated with more progressive tax systems in majoritarian electoral systems, but not in proportional ones. The latter, he argues, allow them to enter into long-term agreements with conservative parties on pairing capital relief with redistributive spending financed, again, by indirect taxes.[75] Given that the US has the power to model international regulation in financial and tax affairs according to its domestic needs, and features low levels of corporatism, as well as a majoritarian electoral system, Democrats should thus be consistently associated with preserving – or even increasing – the progressivity of the tax system.

In fact, Bartels demonstrates that Democrats and Republicans implement economic and tax policies consistent with the objective interests of their core political constituencies. Whereas key Democratic policymakers develop their positions based on the views of "affluent egalitarians" and the middle class, key Republican policymakers respond to the views of their most affluent constituents only, who want to see their material interests rather

[70] Hibbs1977, 1467.
[71] Ganghof 2006, 47.
[72] Basinger and Hallerberg 2004.
[73] Garrett 1995, 675.
[74] Beramendi and Rueda 2007, 638.
[75] Andersson 2015, 11.

than their egalitarian convictions defended.[76] Accordingly, all Democratic administrations between 1948 and 2005 reduced the gap between the 20th and 80th percentiles of the income distribution notwithstanding the business cycle and other economic shocks. They achieved this through increased public investment and spending on employment programs, as well as higher social transfers and more progressive taxation. The former set of policies fostered economic growth and reduced unemployment, disproportionately benefitting the pre-tax incomes of the lower class. The latter set of policies bolstered the post-tax incomes of the lower class, while limiting the growth of the upper class' post-tax incomes. In contrast, all Republican administrations between 1948 and 2005 presided over strong income growth for those in the 20th percentile of the income distribution and low or no income growth for the rest. They achieved this through cuts in spending on employment and social programs, inflation containment, and – most importantly – tax reform. Republican administrations have shared the conviction that "in order to be successful, tax cuts had to be directed primarily to the wealthy because of their larger role in saving and investment."[77] The Reagan and Bush administrations thus reduced tax rates imposed on top incomes and capital gains, with George W. Bush excluding corporate dividends from taxation at the individual level altogether.[78] Against this background, I expect that *domestic constraints to regressive tax reform are a necessary part of a sufficient combination of conditions for a great power to enforce international tax cooperation by means of a credible sanctions threat (H1).*

3.3.2. The Imperative of Preserving Domestic Competitiveness

Analysts have debated the "privileged position" of business in politics since the 1970s. Lindblom claimed the crucial role of private investment for employment and growth in market-oriented systems allowed businessmen to get most of what they want from politicians; the alternative being economic recession or stagnation.[79] Others have taken less extreme positions, conditioning the impact of business on legislation on its unity, the institutional setting, or the public salience of debated policies.[80] In International Political Economy, most authors agree that government preferences are shaped by the position of those domestic organized interests that are most affected by an international regulatory project.[81]The US position in international bargaining over financial regulation has, indeed, been shaped by an

[76] Bartels 2009, chap. 9.
[77] Tobin and Weidenbaum 1988, 48; cited in ibid., chap. 2.
[78] Ibid., chap. 6.
[79] Lindblom 1977.
[80] Culpepper 2010; Hacker and Pierson 2002; Swenson 2004.
[81] Drezner 2008; Frieden 1991; Hiscox 2002.

overarching concern for the competitiveness of US finance. Several authors consistently demonstrate that the US government protects its financial institutions from the costs of international regulation by enforcing agreements that mirror its domestic regulatory model. Accordingly, US banks are provided with a competitive advantage over their foreign rivals, since they neither face adjustment costs, nor disadvantages from comparatively stringent domestic regulation.[82] Along these lines, Singer shows that US regulators resort to international agreements when they are no longer able to balance the conflicting goals of economic stability and American competitiveness by means of domestic regulation. Drawing, as Oatley and Nabors have, on negotiations over the Basel accord, the author explains that US regulators scrutinized by members of Congress over the economic perils of American banks' high leverage imposed comparatively high US capital requirements on the rest of the world. In doing so, they prevented foreign banks form operating with higher leverage than their American rivals, thus removing their competitive advantage, and shifting adjustment costs entirely towards them.[83] According to Helleiner, the same dynamic has been at play more recently in the G20's regulatory response to the financial crisis.[84]

In contrast, proposed international regulation that fails to create a comparable win-win situation in US politics is likely to flatline as a result of American opposition. As Rixen shows, negotiations over capital requirements for the shadow-banking sector stalled as members of Congress voiced concern over the impact of such regulation on the American financial market. Unlike conventional American banks that were being overtaken by lightly regulated foreign competitors at the end of the 1980s, American players dominate the largely unregulated shadow banking business. Hence, there is no competitive advantage to be gained, but an additional regulatory burden to be carried as a result of international regulation.[85] Applied to international tax policy, this dynamic suggests that the US should be more likely to act against tax evasion than against tax avoidance. In the former case, the affected organized interest is predominantly foreign: banks located in tax havens hosting hidden capital beneficially owned by US residents. There is thus plenty of scope for redistributive cooperation shifting the costs of international regulation towards FFIs. In the latter case, the affected organized interest is as much foreign as it is domestic: multinational corporations. Regulation in this field is therefore most likely to impose an additional regulatory burden on US companies, which will in turn try to prevent the US from fostering international efforts.

[82] Helleiner 2014; Oatley and Nabors 1998; Simmons 2001; Singer 2007.
[83] Oatley and Nabors 1998; Singer 2007.
[84] Helleiner 2014.
[85] Rixen 2013b.

Against this background, I expect that *scope for redistributive cooperation is a necessary part of a sufficient combination of conditions for a great power to enforce international tax cooperation by means of a credible sanctions threat (H2)*.

As the hypotheses make clear, I expect that only the combination of a Democratic Administration, and the possibility for redistributive cooperation leads to US enforcement of international tax cooperation. If a Republican president is in office the issue will not make it onto the political agenda, as it contrasts with the flat tax ideal. Rather than through redistributive cooperation, the competitiveness of US business will be preserved by competitive tax cuts. If a Democratic administration fails to demonstrate that international tax cooperation benefits business, agreements or implementing legislation will not pass Congress, no matter which party holds control over its two chambers. In consequence, the US government is obliged to block progress at the international level, causing the respective regulatory initiative to fail (also see *Table 3-4*). In the following section I present the analytical strategy applied to test my hypotheses and their expected interaction.

Table 3-4: Interaction of Conditions 1 and 2 in Producing the Outcome

		Domestic Constraints to Regressive Tax Reform	
		YES	**NO**
Scope for Redistributive Cooperation	**YES**	Great power makes credible threat of economic sanctions.	Great power pays lip service, but does not credibly threaten tax havens.
	NO	Business opposition prevents the government from making a credible threat.	Great power blocks tax cooperation at the international level.

3.4. Analytical Strategy: Comparative Case Studies and Diff-in-Diff

My aim in the following chapters is to test the theory of power in international tax policy developed in the previous section. The phenomenon I seek to explain is US enforcement of international tax cooperation by means of a credible threat of economic sanctions. In the context of this study, the definition of cooperation focuses on the behavior of tax havens. It is present when they fulfill tax policy demands from large developed economies, and absent when they resist such requests. I therefore focus on attempts by large developed economies to devise global rules and standards meant to curb tax haven abetment of either tax evasion by individuals, or tax avoidance by multinational corporations. The relevant forum for such initiatives from major developed countries has consistently been the OECD.[86] However, since my approach is based on theories of tax competition, which assume perfect capital mobility, I only consider anti-tax haven initiatives the OECD launched after this precondition had emerged at the international level. As the previous chapter has shown, international capital mobility is usually associated with the abolition of capital controls, the establishment of the double tax avoidance regime, and the EU's Single European Act. As governments had only achieved these objectives by the end of the 1980s, the universe from which my study draws its cases – and on which it seeks to make generalizable causal statements – consists of anti-tax haven initiatives launched by the OECD in or after 1990.

As the so-defined basic population contains fewer than ten events, quantitative analysis based on randomized case selection is unreliable, owing to the "problem of precision."[87] Therefore, I opt for the "structured and focused comparison" of my universe of cases.[88] It includes the OECD's initiatives on harmful tax competition, tax information exchange agreements, and automatic exchange of information. A fourth post-capital barrier initiative is the OECD's base erosion and profit shifting project. Yet, its implementation was still ongoing at the time of writing. It is thus too early to come to empirical and theoretical conclusions based on this case. Still, I will apply this study's findings to this fourth case in the conclusion. A controlled comparison of these cases – which could also be interpreted as a most-similar or paradigmatic subset of all OECD tax initiatives based on the presence of international capital mobility, and the strong focus on them in the relevant literature[90] – allows me to ascertain a causal effect of my conditions on the outcome. However, it does not

[86] Farquet and Leimgruber 2014; Rixen 2008.
[87] Gerring 2007, 87.
[88] George and Bennett 2005, chap. 3.
[90] cf. Eccleston 2012; Palan, Murphy, and Chavagneux 2010; Rixen 2008; Sharman 2006b.

reveal the causal mechanism linking the two. Beyond checking for simple congruence, I will therefore rely on "process verification" in my within-case analysis.[91]

3.4.1. Operationalization of Outcome and Conditions

I measure variance in the outcome and conditions on categorical indicators. *The outcome* – US enforcement of international tax cooperation by means of a credible threat of economic sanctions – implies that the US explicitly links other countries' access to its internal market to compliance with its demands in bargaining over cooperation against tax evasion or avoidance. The term explicit means that the US has to formally establish this link in an official act with extraterritorial reach. This may include legislation, regulation, and court orders. In contrast, mere political declarations without legal force do not qualify as credible threats, given that economic sanctions have to be implemented by private actors in the US In the absence of a corresponding legal obligation, these actors will not follow through with measures announced by the government. As to the content of the threat, the US does not have to announce full closure of its internal market in response to noncompliance. Given the importance of its financial and consumer markets for foreign banks and multinationals, the prospect of a partial restriction of access in the form of additional taxes should be daunting enough to induce compliance.

Identifying the party in office during bargaining over cooperation against tax evasion or avoidance is a straightforward exercise, as it is based on the executive branch only. Majorities in congressional chambers are not taken into account given that business will be able to effectively lobby Congress so as to prevent the closure of loopholes no matter which party is formally in control. An administration's actual position towards tax cooperation is reflected in official letters and statements by decision-makers in the Treasury Department, and most importantly in the Green Book accompanying the President's budget proposal, which spells out the measures for revenue raising Treasury seeks to implement. Whereas the actual budget proposal is merely a summary of the administration's political positions, the Green Book provides detailed descriptions of proposed legislative initiatives as well as their estimated budgetary impact. If a measure is thus announced in the budget proposal, but not included in the Green Book, the administration does not seriously consider pursuing it. A simple reference in the president's budget proposal is therefore not enough to ascertain the administration's intent to implement a given measure. Next to including it in the Green Book, the administration also needs to take verifiable administrative steps, or demonstrably lobby

[91] Bennett and George 1997, 5.

Congress in view of its implementation. The formal launch of a regulatory process, or Treasury cooperation with members of Congress in drafting a corresponding bill are the relevant indicators in this regard.

The scope for redistributive cooperation is determined by the focus of international bargaining over tax cooperation. If the focus is on anti-evasion measures there is plenty of scope for redistribution, as the US only needs to target FFIs to curb tax evasion by its citizens. Tax evading citizens behave illegally and therefore cannot lobby openly in their own defense. In addition, US financial institutions are only concerned, if the administration offers fully reciprocal information exchange to foreign governments, entailing additional reporting requirements. By virtue of its market power, however, the US does not have to make this concession to obtain requested information from other countries. It is therefore unlikely to pick a fight over this issue with its domestic financial industry, as it does not obtain any additional benefit from extending information reporting. If the focus is on avoidance, however, the scope for redistributive cooperation is small, since the government needs to impose additional costs on US multinationals in order to curb these practices. In contrast to anti-evasion measures it is therefore faced with a powerful organized interest in the domestic arena that is opposed to enhanced cooperation. To ascertain the impact of this constraint, I will match the positions of business associations revealed in communication with Congress and the executive with the actual course of action taken by the US Significant overlap between the two serves as proof for the affected organized interest's influence on government action.

3.4.2. Case Selection

Based on the above operationalization, Table 3-5 summarizes the variance in causal conditions and outcome across my universe of cases. As described above, this universe is made up of all OECD initiatives against tax havens launched after the emergence of full international capital mobility in the 1980s. Still, some additional differentiation is necessary. The HTC initiative, for instance, initially dealt with tax evasion and tax avoidance. When entering office, however, the Bush administration removed its tax avoidance elements, and transformed it into a new initiative on tax information exchange agreements focused entirely on tax evasion (*see chapter 5*). Therefore, the HTC initiative provides two cases under Clinton: one combining a Democratic administration with anti-tax avoidance measures and the other combining a Democratic administration with anti-tax evasion measures. Since it is hard to disentangle the two, however, I discuss them jointly in chapter 4. In addition, I discuss

a shadow case in chapter 7 on the Obama administration, which again combines a Democratic administration with tax avoidance. Here, I discuss the Obama administration's inability to follow up on its action plan against the tax planning practices of multinational firms, but without linking this to the BEPS initiative, which cannot be fully assessed yet.

Based on the above considerations, I thus study the following cases in chronological order: (1) the Clinton administration's behavior vis-à-vis the anti-tax evasion elements of the OECD's HTC initiative, (2) as well as its behavior vis-à-vis the initiative's anti-tax avoidance elements; (3) the removal of the HTC initiative's anti-tax avoidance elements by the Bush Administration, owing to concerns over its impact on the competitiveness of US multinationals;[92] (4) the development of OECD standards for TIEAs proposed by the Bush Administration as an alternative to the HTC project, but pursued without conviction despite a large scope for redistributive cooperation;[93] (5) the emergence of AEI as the new global standard for tax cooperation pushed forward by the Obama administration's FATCA legislation; (6) and the Obama administration's inability to achieve similar progress on its action plan against tax avoidance.

Table 3-5: Data Matrix Representing Variation in H1, H2, and the Outcome Across Selected Cases

Case	**H1** (Domestic constraints)	**H2** (Scope for redistributive cooperation)	**Outcome** (US enforces tax cooperation)
Evasion/Clinton (HTC)	YES	YES	YES
Avoidance/Clinton (HTC)	YES	NO	NO
Avoidance/Bush (HTC)	NO	NO	NO
Evasion/Bush (TIEA)	NO	YES	NO
Evasion/Obama (AEI)	YES	YES	YES
Avoidance/Obama (Shadow Case)	YES	NO	NO

As these cases cover the full range of variance in my causal conditions, their controlled comparison allows me to ascertain a causal effect on the outcome by checking for congruence with my hypotheses. Based on this comparison, I can show that only the coincidence of my two causal conditions produces the outcome. Hence, the research design

[92] Eden and Kudrle 2005; Rixen 2008; Sharman 2006a.
[93] Eccleston 2012; Palan, Murphy, and Chavagneux 2010; Rixen 2008.

readily accommodates my theoretical framework, which George and Bennett would qualify as typological theory. That is, it "provides not only hypotheses on how […] variables operate singly, but contingent generalizations on how and under what conditions they behave in specified conjunctions or configurations to produce effects on specified dependent variables."[97] As I study all cases making up the basic population defined above, my argument's external validity is given. I ascertain its internal validity by means of process verification in within case analysis described in the next section. Thorough process verification will also help me address the lack of independence between my cases. Since they stand in chronological sequence, the lessons actors draw from experiences with early initiatives may influence the outcome of subsequent initiatives. Such learning processes certainly took place, but the case studies show that the willingness to learn from past experience depends on the administration's ideological predispositions.

3.4.3. Process Verification in Within Case Analysis

Process verification denotes the application of process tracing in theory testing. According to Bennett and George, "the general method of process tracing is to generate and analyze data on the causal mechanisms […] that link putative causes to observed effects."[98] Its proponents argue that a causal explanation is insufficient, if it relies merely on the establishment of a causal effect based on observed covariance in independent and dependent variables. Instead, it is necessary to study all intervening variables linking causes to effects to ascertain that a cause really matters for the reasons assumed by the researcher. What is more, process tracing provides a more complete test of a causal theory in that it obliges the analyst to check whether all stages of the causal mechanisms are consistent with theoretical expectations.[99] For these reasons, I will augment my controlled comparison of cases with process tracing in within-case analysis. Using the indicators for Treasury commitment and action, as well as for business influence on government positioning operationalized above, I will thus check whether Democratic administrations do in fact intend to enforce international tax cooperation, and take purposive action in view of this goal. Moreover, I will verify whether organized interests affected by tax cooperation do indeed form counter positions, communicate these to the executive and legislative branches of government, and induce the US to pursue redistributive cooperation, or refrain from it altogether.

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[97] George and Bennett 2005, 235.
[98] Gerring1997, 5.
[99] Ibid., 11.

In doing so, I rely on data drawn from official documents and statistics, previous academic research, coverage in the specialized press, and 35 interviews with experts on international tax policy form international organizations, national governments, and the private sector. I conducted semi-structured face-to-face interviews over the course of one and a half years in five different countries, and also had conversations by phone with experts located in a sixth country. My goal was to obtain a balanced ratio of testimonies from all professional backgrounds and political leanings, as well as from small and large countries. Moreover, I gave priority to speaking to actual decision-makers rather than informed bystanders. As a result, I am usually able to triangulate obtained data on a specific event from several sources. As most interlocutors agreed to provide information, including on international negotiations, only under the condition of anonymity, I will use a general description of their function (e.g. OECD tax official) when citing them, and add the date of the interview. A list of all conducted interviews is attached in the appendix.

3.4.4. Differences-in-Differences Analysis

As an additional building block I include differences-in-differences (DiD) analysis in my empirical strategy. This analysis is not meant to test the causal effect of my conditions on the outcome, but to ascertain the redistributive character of effective tax cooperation. DiD is a method for establishing causal inference often used in economics to assess the effect of policy reforms on wage levels, or unemployment, and has already been fruitfully applied in studies of tax competition, evasion, and avoidance.[100] Its fundamental logic is to compare two groups of units before and after an event that is expected to only affect one group, or to affect both groups in opposed directions. The underlying assumption is of course that both groups had followed the same trend in the absence of the event under study. Following this logic, I study tax base sizes in small and large countries directly before and after a great power issues a credible sanction threat in negotiations over tax cooperation. Moreover, I test the common trends assumption by presenting the time trends for tax havens and non-havens for the five years preceding the issuance of a threat. The formal model is presented in chapter 8.

[100] Card and Krueger 1993; Desai and Dharmapala 2010; Johannesen 2014; Rademacher 2013; Sberna and Olivieri 2014, 9.

4. Clinton and the OECD's HTC Initiative

Analysts agree on the Clinton administration's decisive role in putting the issues of tax evasion and avoidance on the agenda of the Group of Seven (G7), and subsequently the Organisation for Economic Co-operation and Development (OECD).[1] There is, however, disagreement as to the reasons for its failure to lead the Harmful Tax Competition (HTC) initiative to success. While some authors refer to timing, arguing that the Clinton administration was simply unable to finish its work on the issue before the end of its term in 2000,[2] others claim that tax havens successfully exploited the regulative norm of non-intervention to defend themselves against OECD requests for more cooperation in tax matters.[3] This chapter shows that the Clinton administration was, indeed, concerned about the impact of tax havens on the perceived fairness of the United States (US) tax system, international financial stability, and the US sanctions regime, and thus promoted an international campaign against underregulated financial centers. Yet, the OECD made the strategic mistake to tackle tax evasion by individuals, and tax avoidance by multinationals in a single project, creating opposition from business associations in the US and elsewhere. Instead of credibly linking non-compliance with OECD recommendations to economic sanctions, the US thus accepted the severe dilution of the HTC initiative even before the Bush administration took office in 2001. A nested comparison of two unilateral tax initiatives moreover reveals that the Clinton administration generally failed to pass regulations curbing tax avoidance, owing to business opposition, but succeeded in passing regulations against tax evasion.

4.1. The Clinton Administration's Tax Policy Agenda

William J. Clinton's election as President of the United States in 1992 ended 12 years of Republican government. Under Presidents Ronald Reagan and George H.W. Bush income inequality and public debt had dramatically increased, owing to regressive tax reforms, cuts to public investment in job training and wage subsidies, and a massive surge in military spending.[4] Catering to widespread public disenchantment with inequality and an "unfair" tax

[1] Eccleston 2012, 63; Kudrle 2003, 63; Rixen 2005, 24.
[2] Palan, Murphy, and Chavagneux 2010, 217.
[3] Sharman 2006a, 148.
[4] Bartels 2009; Danziger and Gottschalk 1997; Steinmo 1993; Streeck 2014.

system perceived as "benefitting the rich,"[5] Clinton had thus promised an income tax cut for the middle class during the electoral campaign. After the election, however, Lloyd Bentsen, Secretary of the Treasury, and Robert Rubin, Chairman of the National Economic Council, argued that priority should be given to deficit reduction, as this might impress financial market analysts, and thus trigger more private saving and investment and reduce interest rates. Their idea of restoring business confidence defeated proposals for Keynesian stimulus in internal debate.[6] Hence, the Clinton administration removed the middle class tax cut from its first budget proposal for 1994. Instead, it proposed an expansion of earned income tax credits (EITC) for the working poor, financed by higher taxes for upper-income individuals, and corporations.[7] As President Clinton explained in his first state of the union speech, the goal of EITC expansion was to "reward the work of millions of working poor Americans by realizing the principle that if you work forty hours a week and you've got a child in the house, you will no longer be in poverty."[8]

The measure was indeed retained in the Omnibus Budget Reconciliation Act of 1993, which was supposed to cut the deficit by $500 billion over five years, and also introduced new tax brackets and higher rates for top personal and corporate incomes, as well as slightly higher taxes on motor fuel consumption. Owing to large Democratic majorities in both chambers of Congress, the act passed in summer 1993 despite 41 Democratic representatives, and six Democratic senators voting against the bill.[9] These deputies justified their opposition with concerns over the electoral impact of supporting increased taxes on income and energy consumption.[10] On balance, however, "the net effect in 1993 was to give more to low-income families, leave the middle class more or less untouched, and zap the rich."[11] By passing the Omnibus Budget Reconciliation Act, the Clinton administration thus managed to reconcile deficit reduction with increased tax progressivity, which some even interpreted as a reversal of Reaganomics.[12] Still, the political cost of increasing taxes was enormous, as 50 percent of survey respondents, even those with low incomes, felt affected.[13] According to Robert Rubin, "the mischaracterization of our deficit reduction as a tax increase on the middle class" was a major reason for Democratic defeat in Congressional elections of 1994.[14] As a result,

[5] Steinmo 1994, 13.
[6] Steuerle 2008, 164.
[7] Graetz 1993, 566.
[8] cited in: Hotz 2003, 146.
[9] Sabo 1993.
[10] Rosenbaum 1993; Sullivan 1993.
[11] Steuerle 2008, 166.
[12] Fram 1993.
[13] Steuerle 2008, 166.
[14] Rubin and Weisberg 2003, 153.

Republicans regained full control of Congress for the first time since 1951, subsequently preventing the Clinton administration from pursuing major legislative initiatives. Its focus therefore shifted to the international level where the Treasury, in particular, aimed to foster projects that could support deficit reduction by creating additional revenue and growth. As Brad DeLong and Barry Eichengreen explain:

> "following the loss of Democratic control of the Congress in 1994, all ambitious domestic initiatives were obviously dead in the water. If this didn't exactly create a political vacuum and a demand for newspaper headlines that could only be filled by international events, it at least facilitated the efforts of Treasury and other economic agencies to bring these issues to the attention of the president and his core political advisors."[15]

Among the international issues raising concerns within Treasury was the proliferation of offshore financial centers (OFCs) and their increasing use by US investors. This concern was based on a number of economic studies questioning the survival of capital taxation in open economies,[16] which were taken up by international bureaucracies like the OECD, the International Monetary Fund (IMF) and the European Union (EU) Commission, and empirically supported by massive capital flight from Germany to Luxembourg following the introduction of a withholding tax on interest in 1988.[17] At the time, the increasing role of OFCs in financial intermediation following the removal of barriers to capital mobility over the course of the 1980s had become apparent. Owing to the "tax cut cum base broadening strategy" OECD governments had devised in response to tax competition,[18] however, increased capital mobility had not yet impacted their revenue from the taxation of corporate profits and capital income.[19] Still, proponents of the welfare state bought into economic projections of declining capital taxation, anticipating the near "end of redistribution."[20] Against this background, the Treasury's International Tax Counsel, Joseph Guttentag, as well as his deputy, Philip West, argued for enhanced cooperation in tax matters within the OECD, citing the abuse of transfer-pricing, hybrid entities, and lack of information exchange as major areas of concern.[21] According to Reuven Avi-Yonah, they were the main players behind a transition in US international tax policy from the "age of competition" to the "age of cooperation."[22]

The potentially erosive impact of OFCs on the US tax base was, however, not the only reason for the Clinton administration's preoccupation with them. From its perspective, the

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[15] DeLong and Eichengreen 2001, 2.
[16] Gordon 1992; Frenkel, Razin, and Sadka 1991.
[17] Cassard 1994; Owens 1993; Ruding 1992; Tanzi 1995.
[18] Ganghof 2000a, 611.
[19] Webb 2004; Zucman 2014b.
[20] Steinmo 1994, 9.
[21] Guttentag 1995; Field 1995; West 1996.
[22] Avi-Yonah 2005, 314.

financial opacity they provided to investors also abetted money-laundering, and corruption, and likely undermined the stability of the financial system as well as the US sanctions regime.[23] At the time, cases of drug cartels using Caribbean OFCs to launder their proceeds from narcotics sales in the US had multiplied. Financial institutions and law firms there not only helped to hide the true origin of funds through the provision of banking secrecy, or shell corporations; they also invested illicit funds in financial, real estate, and arts markets on behalf of criminal organizations.[24] In parallel, the belief spread among senior law enforcement officials that draining the money supply of criminal organizations was the most effective way to reach their senior figures.[25] Accordingly, legislation enabling tougher prosecution of the placement of illicit funds in US banks was passed throughout the 1980s, leading to an increasing number of cases and convicts.[26] Ultimately, however, this only led to a shift in transfer strategies from simple bank transfers to physical smuggling and the use of non-bank financial institutions. The prevention of money laundering in OFCs after illicit funds had been successfully transferred out of the US thus required international action.[27] A fortiori this was the case because the laundering of funds that had never been in the US could still affect US interests. For instance, financial sanctions against particular individuals or governments could easily be circumvented through the setup of shell corporations and nominee accounts in OFCs.[28]

Based on these tax and law enforcement concerns, the Clinton Treasury came to the conclusion that a new strategy against OFCs was needed. Moreover, "any strategy had to be global and multilateral, since unilateral actions would only drive dirty money to the world's other major financial centers."[29] However, it was believed that such an OFC initiative should not be pursued via the United Nations (UN), where countries with underregulated financial markets were a majority. Instead, the Clinton administration preferred working with the G7 and OECD to first establish consensus among large industrialized countries. Once international standards had been developed in these more exclusive formats, non-compliant jurisdictions would be pressured into cooperation through naming and shaming as well as collective sanction threats.[30] Within the area of taxation, this strategy led to, and was pursued

[23] Wechsler 2001.
[24] Sultzer 1995, 150; Williams 1997, 75.
[25] Sultzer 1995, 146.
[26] Ibid., 177.
[27] Ibid., 206ff.
[28] Wechsler 2001, 48.
[29] Ibid., 49.
[30] Ibid.

via, the OECD's Harmful Tax Competition initiative, the genesis of which is the subject of the next subsection.

4.2. International Politics

Based on the reasoning described above, the Clinton administration initiated discussions on an international initiative against tax evasion and avoidance in the G7 in 1995.[31] The idea was welcomed by European G7 members, which were at the time struggling to contain intra-EU tax evasion and avoidance. Following the liberalization of capital flows through the Single European Act, and the capital markets directive of 1987, EU member states witnessed an increased volume of cross-border transactions and investments. However, owing to the unanimity requirement in matters of direct taxation, and fears that tax harmonization within the EU would lead to capital flight from the common market, they were unable to reach consensus on tax cooperation despite several proposals from the European Commission for an automatic exchange of information on financial accounts held by non-residents, or the coordination of withholding taxes on capital income.[32] An initiative binding governments beyond the EU, however, had the potential to alleviate the risk of capital flight to third countries. The interests of France, Germany, Italy, and the United Kingdom were thus largely aligned with those of the US As a result, the 1996 Ministerial Meeting of OECD members requested the organization to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998."[33] Subsequently G7 leaders also issued a joint call on the OECD to "establish a multilateral approach under which countries could operate individually and collectively to limit the extent of [harmful tax] practices."[34]

As requested, the OECD established "Special Sessions on Tax Competition," which were chaired by France and Japan, and tasked with elaborating a report on "Harmful Tax Competition," eventually published in January 1998.[35] In that report, the organization identified tax havens, and PTRs as potentially harmful, that is, susceptible to "erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally."[36] Tax havens were associated with "no or only nominal taxation" of capital income or corporate profits, a lack of

[31] Eccleston 2012, 63; Kudrle 2003, 63; Rixen 2005, 24.
[32] Genschel 2002, 143ff.; Radaelli 1999, 669–670.
[33] cited in OECD 1998, 7.
[34] G7 Leaders 1996, para. 16.
[35] OECD 1998, 7.
[36] Ibid., 8.

transparency and administrative assistance, and an absent link between tax residency and substantial economic activity. From the OECD's perspective these factors were indicative of a jurisdiction "attempting to attract investment or transactions that are purely tax driven."[37] PTRs essentially referred to tax breaks granted only to foreign corporations, ring-fencing the domestic tax base from their impact. Examples cited by the OECD included the exemption of foreign profits from residence taxation, "deductions for deemed expenses that are not actually incurred," and the acceptance of transfer-pricing arrangements that do not reflect the arm's length principle, and thereby overstate a subsidiary's local profits.[38] The OECD made 19 recommendations for fighting these practices, focusing on the collective application by member states of unilateral defense measures, and the toughening of administrative assistance clauses in bilateral tax treaties.[39] In addition, it threatened tax havens with blacklisting and sanctions should they not respond to requests for administrative assistance by foreign tax authorities. In contrast, no such threat was issued towards jurisdictions offering PTRs, most likely because most large OECD members also had such regimes in place.[40]

With the exception of Luxembourg and Switzerland, which abstained from the vote, all OECD member states approved the HTC report at the 1998 Ministerial Council.[41] Accordingly, also the Clinton administration expressed its support, and pledged to transpose OECD recommendations into national law by 2000. To that effect, it announced reporting requirements for all payments going to tax havens identified by the OECD, and the "termination of credits for taxes paid at source in these countries."[42] Subsequently, Treasury also included these measures in its Green Book of Revenue Proposals for fiscal year 2001.[43] In contrast, the 41 jurisdictions identified as tax havens by the OECD tried to attack the HTC project on normative grounds, owing to their lack of material power resources. Their aim was to convince OECD governments to abandon the campaign by stressing its inconsistency with norms they generally promoted. For instance, they argued the project was undermining their fiscal sovereignty, and depriving them of an IMF approved development strategy. Moreover, they claimed that its top-down approach – excluding them from negotiations, while making them subject to its provisions – violated the principle of multilateralism. Last but not least, they also accused the OECD of applying double standards, as it cracked down on non-OECD

[37] Ibid., 22.
[38] Ibid., 30–32.
[39] Eden and Kudrle 2005, 123.
[40] Rixen 2008.
[41] Woodward 2004, 6.
[42] Rixen 2005, 24; Palan, Murphy, and Chavagneux 2010, 217.
[43] US Treasury 2000, 203–204.

tax havens but ignored the practices of Luxembourg and Switzerland as well as the PTRs established by larger member states.[44]

Although these arguments gained traction with the multinational business community and the financial and tax service industries in particular, the OECD still identified 41 jurisdictions as tax havens in June 2000, and threatened them with the collective application of defense measures.[45] Again, the Clinton administration was supportive of OECD efforts with the Secretary of the Treasury, Lawrence Summers, declaring the US "would fully cooperate in preparing sanctions for tax havens that fail to reform."[46] In response, six out of the 41 identified tax havens, including some major players like Bermuda and the Cayman Islands, signed agreements with the OECD "in which they agreed to remove the harmful features of their tax regimes in exchange for being left off the planned list of uncooperative tax havens that could be hit with coordinated sanctions."[47] Accordingly, they were missing from the tax haven blacklist included in the OECD's 2000 progress report, whereas the remaining 35 jurisdictions were threatened with collective defense measures, in case they did not sign a Memorandum of Understanding (MOU) by 31 July 2001, obliging them to abandon their harmful tax practices.[48] Towards the end of 2000 the HTC initiative thus seemed to make good progress towards its goal of eliminating the most harmful features of tax haven business models.

Effectively, however, submission to the OECD came at relatively low cost for the targeted jurisdictions, as multinationals organized in the Business Industry Advisory Council (BIAC) had successfully lobbied for a removal of the substantial economic activity criterion from the OECD's tax haven definition. By removing corporate tax planning from the scope of the HTC project, business gave Bermuda, the Caymans, and other relatively sophisticated OFCs the opportunity to polish their reputations by renouncing to parts of their tax evasion business, while expanding their tax avoidance business with multinationals instead.[49] Tax havens were thus provided an opportunity to avoid blacklisting and the risk of sanctions without making fundamental changes to their business models. Still, they failed to halt the HTC initiative altogether by turning dominant norms against their key proponents. Instead, the following subsections will show that differences in material power resources were decisive in this episode of bargaining over international tax cooperation. Rather than tax

[44] Webb 2004, 806; see also: Sharman 2006a.
[45] Eccleston 2012, 66–67; Webb 2004, 809.
[46] Associated Press 2000c.
[47] Webb 2004, 809.
[48] OECD 2000, 17; Rixen 2008, 136.
[49] Eccleston 2012, 67; Webb 2004, 809.

havens, the domestically defined preferences of the US, which has traditionally dominated tax policymaking in the OECD, owing to its status as the world's leading capital exporter, and the OECD's main financier,[50] largely shaped the content of the HTC initiative at this stage.

4.3. Domestic Bargaining over Tax Evasion and Avoidance

As demonstrated above, the Clinton administration was fully supportive of the OECD's HTC initiative, and prepared to deploy sanctions against non-cooperative tax havens. Its support was based on economic projections of declining revenue from capital taxation in open economies, and a general concern over the relevance of OFCs for organized crime, corruption, and financial instability. Moreover, it was driven by a concern for the publicly perceived fairness of the US income tax system. As Lawrence Summers explained in an interview in 2000, "[the US] tax system is based on voluntary compliance. That compliance depends on people having the sense that others, particularly those who are more fortunate, pay the taxes they are required to pay."[51] However, the Clinton administration faced strong opposition to its international tax agenda whenever it affected the tax planning practices of US multinationals. Therefore, Treasury accepted the dilution of the substantial economic activities criterion in the OECD's 2000 progress report, extended check-the-box rules to US multinationals' foreign subsidiaries despite prior doubts as to their potential exploitation through the setup of hybrid entities, and later backed down from withdrawing corresponding regulations. When neither the interests of US multinationals, nor those of US financial institutions, were adversely affected, however, Treasury was able to pass regulations, for instance, when creating the Qualified Intermediary (QI) program.

4.3.1. Shaping the HTC Initiative

With the approval of the US, the OECD's Committee on Fiscal Affairs (CFA) had adopted an HTC report aiming both at tax evasion by individuals and tax avoidance by multinationals. Yet, dealing with both elements in a single project turned out to be a strategic mistake. One of the elements meant to counter avoidance was the substantial economic activity criterion included in the report's tax haven definition. From the OECD's perspective, granting a corporation tax residence in "the absence of a requirement that [its] activity be substantial […] suggests that a jurisdiction may be attempting to attract investment and transactions that

[50] Avi-Yonah 2005; Eccleston 2012; Farquet and Leimgruber 2014; Graetz 2000; Kudrle 2003.
[51] Associated Press 2000a.

are purely tax driven."[52] This practice was considered harmful, and thus ought to be ended by governments wishing to comply with OECD recommendations. Yet, making a corporation's tax residence conditional on substantial economic activity in the respective country posed a fundamental threat to corporate tax planning strategies, which usually hinge on the ability of multinationals to shift profits to low-tax jurisdictions where no production takes place or no value is added.[53] Accordingly, business lobbies in the US and beyond staged a campaign against the criterion, trying to convince OECD governments of its incompatibility with basic liberal norms.[54]

BIAC's initial response to the HTC report was drafted by Richard Hammer, who also served as chief tax counsel for the United States Council for International Business (USCIB).[55] USCIB, in turn, is the main lobby group for US multinationals from all industry sectors, including many corporations reputed for their tax planning savvy. Following consultations with multinationals and their tax advisors,[56] Hammer criticized the OECD for not having met with business prior to the release of the HTC report. Moreover, he framed tax competition as a means to impose fiscal discipline on governments, forcing them "to make more efficient use of tax revenues,"[57] a variant of the traditional liberal interpretation of tax competition as "the taming of Leviathan."[58] Against this background, he went on to argue "that it was legitimate for businesses to consider tax differentials in planning and structuring their investments."[59] These two arguments subsequently became the basis for corporate criticism of the HTC project, frequently employed by representatives of multinationals and corporate tax advisers.[60]

Yet, corporate critics of the OECD did not object to all forms of international tax cooperation. In fact, they were supportive of efforts to combat tax evasion by means of greater financial transparency, and in favor of removing regulations ring-fencing tax breaks for foreign owned corporations from domestic firms. As Webb suggests, business associations were more conciliatory towards these measures because they either did not directly affect their members, or were conducive to removing discriminatory features from national tax codes.[61] Regarding information exchange, banks from wealth management hubs such as

[52] OECD 1998, 24.
[53] cf.: Genschel and Schwarz 2011; Pinkernell 2012.
[54] Webb 2004, 811.
[55] Ralph 2000.
[56] Ralph 1999.
[57] BIAC 1998, 4 cited in: Webb 2004, 811.
[58] Sinn 1992, 177.
[59] Webb 2004, 811.
[60] cf.: Couzin 2000; Katsushima 1999.
[61] Webb 2004, 811.

Florida or Texas were of course opposed to reporting additional client data. Accordingly, the Clinton administration put corresponding proposals on the back burner.[62] Yet, they were indifferent towards new reporting requirements for FFIs and corresponding sanction threats against tax havens.[63] Hence, they did not back the anti-OECD campaign launched by the Center for Freedom and Prosperity (CFP).[64]

At any rate, the OECD secretariat was swift to accommodate corporate criticism, as it feared opposition from national business associations could cause individual member states to defect from the initiative, thereby endangering the project's survival.[65] In cooperation with BIAC it thus created a liaison group "to ensure that the views of the business community are heard," acknowledging "a need for better communication between business and government, and, in particular, a more inclusive attitude on the part of governments toward the views of the business community."[66] Moreover, Jeffrey Owens, the OECD's head of fiscal affairs, explicitly accepted the legitimacy of corporate tax planning, conceding that "multinational enterprises should be permitted access to certain corporate organizational and structural vehicles, such as co-ordination centres and holding companies."[67] Under the chairmanship of Joseph Guttentag, previously International Tax Counsel in the Clinton treasury, and with the consent of the US, the CFA therefore adopted some subtle changes to the HTC report's substantial economic activity criterion during the second half of 2000.

As Kudrle explains, the CFA first "grafted [ring-fencing] on to insubstantiality as an alternative source of concern" by redrafting the criterion as follows in the 2000 progress report:[68] "the jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having a commercial impact on the economy."[69] On this basis, the CFA then shifted the blame for insubstantiality onto jurisdictions that were denying firms benefitting from preferential tax treatment the opportunity to operate in the domestic market. In the MOU offered to tax havens willing to comply with OECD demands, the requirement for being exonerated from the charge of providing tax residence in the absence of substantial economic activity was thus formulated in a rather twisted way:

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[62] Blum 2004, 582; Freedberg 2002, 1A.
[63] Searches of LexisNexis and HeinOnline using various combinatons of the keywords OECD, harmful tax, bankers, finance, American, Florida, and Texas do not retrieve any documents suggesting that banking associations from Florida or Texas openly opposed the HTC project. In this context, criticism is always directed against new domestic reporting requirements.
[64] Sharman 2006a, 156.
[65] Ibid., 812.
[66] Hammer and Owens 2001, 1305.
[67] Ibid., 1303.
[68] Kudrle 2008, 7.
[69] OECD 2000, 10.

> "For any preferential tax treatment accorded to other service activities, each Party will remove any restrictions that deny the benefits of that preferential tax treatment to resident taxpayers, to entities owned by resident taxpayers, or to income derived from doing the same type of business in the domestic market."[70]

Effectively, this meant that tax havens were allowed to provide tax residence to firms without a substantive presence on their territory, if they stopped ring fencing preferential tax treatment of foreign companies from the domestic economy. By November 2000 the CFA had thus neutralized the fundamental threat to corporations' "legitimate" tax-planning strategies the original formulation of the no-substantial-activities criterion had posed. While Lawrence Summers and Philip West reiterated strong US support for the HTC initiative, and urged tax havens to comply with OECD demands,[71] in their capacities as Secretary of the Treasury and International Tax Counsel they had also allowed the CFA to dilute important terms and definitions where they interfered with the interests of multinationals. As a result, tax havens could enter into MOUs with the OECD to avoid sanctions without risking their stake in corporate tax avoidance schemes. Merely those jurisdictions refusing to make limited adjustments to their administrative assistance practices thus faced a vague risk of sanctions from the US and other OECD members.[72]

4.3.2. Check-the-Box, Hybrids, and Subpart F

The Clinton administration's inability to implement measures limiting the extent of tax avoidance by US multinationals is even better illustrated in the parallel debate over check-the-box regulations. These regulations, proposed by the IRS in 1995, were meant to simplify entity classification for tax purposes. Until then, taxpayers and the Internal Revenue Service (IRS) had used the so-called Kintner test to determine whether an entity was a corporation or a partnership, the latter being disregarded for tax purposes because partners – who also assumed full liability for its debt – were taxed on its profits at the personal level. With the multiplication of corporate legal forms at the state and international levels, however, determining whether or not a certain company passed the criteria of the Kintner test became increasingly cumbersome for tax authorities. At the same time, well-advised taxpayers were increasingly able to tailor their company's legal form so as to obtain their desired classification for tax purposes.[73] Against this background, some IRS officials as well as business associations began to argue for a simplification of entity classification through an

[70] OECD 2000b, 4 cited in: Kudrle 2008, 7.
[71] Associated Press 2000b; Burgess 2000.
[72] In any event, the CFA had first decided to postpone sanctions against uncooperative tax havens to 2001, and later even extended the deadline for full cooperation by tax havens to 2005.
[73] IRS 1995.

elective approach. That is, taxpayers should be allowed to choose their desired classification by simply checking a box in an IRS form. According to the proponents of this approach, this would reduce the administrative burden for the IRS, which no longer had to analyze foreign law to determine entity status, and remove inequities between sophisticated and unsophisticated taxpayers, as the former were de facto already able to choose their desired classification under the Kintner regulations.[74]

After public hearings on the issue had yielded almost unanimous support for check-the-box regulations from the business and tax services community,[75] the IRS adopted the regulations in 1996 despite internal warnings as to their potential abuse through the setup of hybrid entities.[76] Contrary to contemporary wisdom, the proliferation of hybrid entities was not an unintended consequence of check-the-box regulations.[77] In fact, some officials within Treasury and the IRS were fully aware that allowing taxpayers to choose the classification of foreign entities could abet tax avoidance by multinational corporations. Joseph Guttentag, for instance, told tax professionals at a conference in 1996 that "the major concerns with respect to the check the box proposal center on the international area, specifically the problems presented by organizations treated as taxable by one jurisdiction and as transparent by another, the so-called hybrids."[78] Likewise, Robert Culbertson, IRS Associate Chief Counsel (International), told members of the American Bar Association in 1995 he expected an extension of check-the-box regulations to foreign entities to increase the number of hybrids.[79] Yet, proponents from the tax service community managed to allay these fears, arguing that a move from *de facto* electivity to formal electivity would, if at all, merely lead to an incremental increase in the number of hybrids that would be more than made up for by the increase in simplicity, efficiency, and fairness provided by check-the-box regulations.[80]In acknowledgement of internal concerns over hybrids, final regulations still indicated that

> "Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of US tax treaties."[81]

In accordance with expectations from internal critics, a large number of US multinationals subsequently began to bring about inconsistencies between the classification of

[74] Mullis 2011.
[75] Dean 2006, 438.
[76] IRS and Treasury 1996; Mullis 2011.
[77] Interviews on 21 and 23 April 2015, and on 22 June 2015.
[78] Guttentag 1995, 449.
[79] Mullis 2011.
[80] e.g. NYSBA 1995, 86.
[81] IRS 1997, 216.

their foreign subsidiaries in the US and the host country by simply checking the box. This enabled them to circumvent US controlled foreign company (CFC) regulations, as well as taxation at source.[82] CFC regulations, included in the Internal Revenue Code as Subpart F by the Kennedy administration, were intended to curb the ability of US taxpayers to defer tax payments on profits earned by foreign corporations under their control. Until then, such profits were only taxed in the US once they were redistributed as dividends to US shareholders. Profits that were retained abroad remained tax-free. The Kennedy administration considered deferral inequitable and distorting, as it disadvantaged taxpayers without foreign income vis-à-vis taxpayers with foreign income, and therefore created an incentive to invest abroad rather than in the US In its original CFC proposal it therefore suggested that all foreign income of US-controlled foreign corporations be taxed currently. Owing to concerns over the competitiveness of US multinationals, however, Congress eventually reduced the scope of Subpart F to passive income earned by foreign subsidiaries in low-tax jurisdictions.[83] The set-up of hybrid entities simplified by check-the-box regulations does, however, enable deferral even for this income category. A US multinational may, for instance, own a CFC in a high-tax jurisdiction (High-Tax Co). To avoid having High Tax Co's income taxed at source, it could instruct High Tax Co to create a branch in a low-tax jurisdiction (Low Tax Br), and opt for disregarded entity status under check-the-box regulations. Low Tax Br could then offer High Tax Co a loan repayable with interest. As High Tax Co's host country classifies Low Tax Br as a foreign corporation, High Tax Co can deduct interest payments as business expenses from its local tax bill. As the US classifies Low Tax Br as a disregarded entity subsumed under High Tax Co, the loan and interest payments cancel each other out from the US perspective. There is thus no passive income to be taxed currently under Subpart F.[84] As a result of this "earnings stripping with a disregarded loan" strategy the US multinational may thus significantly reduce its tax bill both in the US and abroad.[85]

Based on their monitoring effort, Treasury and the IRS concluded in 1998 "that the use of certain hybrid arrangements […] is contrary to the policies and rules of subpart F," and that "the recent entity classification regulations […] (the 'check-the-box' regulations) have facilitated the creation of the hybrid branches used in these arrangements."[86] Accordingly, the

[82] IRS 1998a; JCT 2005; Office of Tax Policy 2000.
[83] Office of Tax Policy 2000, 13–22.
[84] Ibid., 63.
[85] Mullis 2011; for further tax planning strategies using hybrids to circumvent Subpart F see: Office of Tax Policy 2000; IRS 1998a; West 2005.
[86] IRS 1998a, 18.

IRS released temporary "regulations to address such arrangements, and [requested] public comments with respect to these subpart F issues."[87] The response from the business and tax service communities was devastating. Tax practitioners argued that temporary regulations were equivalent to an extension of Subpart F, for which the IRS lacked the necessary authority.[88] Moreover, they claimed "that much of the planning had the effect of reducing foreign taxes, an objective that historically has been viewed as a good business objective from a US perspective."[89] Accordingly, curbing the abuse of check-the-box rules was interpreted as a blow to the competitiveness of US multinationals.[90] The latter thus formed several lobbying coalitions with their tax advisers and accountants to convince Congress of the above arguments. Eventually, the chairmen of the Senate Finance Committee and the House Ways and Means Committee fell into line, expressing their belief "that Congress, not the Department of the Treasury or the IRS, should determine policy issues relating to the treatment of hybrid transactions under subpart F."[91] Accordingly, they threatened the IRS that they would place a moratorium on its temporary regulations if it did not withdraw them "until a complete analysis of subpart F could be undertaken and laws passed through the proper legislative process."[92] Only six months after the IRS had issued regulations to curb the abuse of check-the-box rules it thus revoked them in June 1998.[93] Hence, the US was unable to prevent abuse of its CFC regime under Subpart F, while the OECD recommended the collective adoption of CFC legislation as a defensive measure against harmful tax competition.[94]

4.3.3. The Qualified Intermediary Program

The Clinton administration's attempts to curb international tax avoidance by US multinationals were defeated by business opposition. However, treasury and the IRS managed to introduce some withholding and reporting requirements for foreign banks that were susceptible to limit tax evasion by US taxpayers with foreign accounts. The QI program and its accompanying regulations were developed from 1997,[95] and finalized in 2000.[96] They

[87] Ibid.
[88] Cooper and Torgersen 1998, 68.
[89] DeCarlo, Granwell, and Suringa 1998, 21.
[90] Carson, Cinnamon, and Kronbergs 1998, 27.
[91] Cooper and Torgersen 1998, 68.
[92] Ibid.
[93] IRS 1998b, Notice 98-35 revokes Notice 98-11 and corresponding temporary regulations. It also presents a new set of regulations. However, these were placed under a moratorium until 2000 when Congress expected to have finished its analysis of Subpart F (Cooper and Torgersen 1998).
[94] OECD 1998, 40–41.
[95] IRS 1999.
[96] IRS 2000.

entered into force on 1 January 2001.[97] The program encourages FFIs to become Qualified Intermediaries (QIs) by signing a contract with the IRS. As QIs they are required to report US-source income beneficially owned by their clients, and "withhold taxes on that income as required by US tax law."[98] In exchange, they are allowed to report income earned by non-US clients on a pooled basis instead of reporting every client individually. This enabled them to shield client data from the IRS, and US banks acting as withholding agents, which were potential competitors. Nonetheless, US-source income earned by US taxpayers still has to be reported on an individual basis.[99]

The QI program was supposed to ensure the efficiency of the US withholding regime against the background of increased investment in US securities by non-institutional investors. In 1913, Congress took the fundamental decision to withhold tax on income from investments in the US before this income leaves the country. This included dividends and certain bond yields that were to be taxed at 30 percent. However, other forms of capital income, including interest from bank deposits, Treasury bonds, and corporate debt obligations, were exempt from withholding to attract foreign investment. In addition, the US offered lower withholding tax rates to foreign partners in bilateral tax treaties. US financial institutions, acting as withholding agents for the IRS, thus had the formal obligation to identify the income source and the beneficial owner's nationality, withhold accordingly, and transfer resulting tax revenue to the IRS. Exempt income still had to be aggregated by source and destination and then reported to the service.[100] Identification of beneficial owners relied exclusively on so-called "statements of eligibility" provided by non-resident aliens to US withholding agents.[101] There was, however, no system in place that would enable the withholding agent to verify the accuracy of obtained information through documentation provided by FFIs actually servicing the beneficial owner.[102] There was thus great uncertainty as to whether US-source income was correctly reported and withheld upon.

The increasing number of small foreign investors in the US exacerbated the problem, and increased the administrative burden for US withholding agents.[103] Through the QI program, the IRS tried to improve the situation by shifting "the burden of investigating beneficial ownership on foreign financial institutions rather than on US custodians, and […]

[97] Government Accountability Office 2007.
[98] Levin and Coleman 2008, 22.
[99] Government Accountability Office 2007, 11.
[100] Government Accountability Office 2007.
[101] Shay, Fleming Jr, and Peroni 2002, 123.
[102] Ibid., 124.
[103] Burke 2007, 403.

providing clear rules requiring withholding in the absence of documentation."[104] Under the new regulations, FFIs had to forward client information obtained through know-your-customer (KYC) due-diligence procedures for every client wishing to be exempt from US withholding tax to the withholding agent managing their correspondent account. By providing this type of data to a US bank, an FFI basically invited a competitor to lure away its wealthy clients. Therefore, the IRS granted FFIs registering as QIs an exemption from individual reporting of their non-US clients. Instead, they were allowed to report pooled income, and obliged to directly withhold and transfer corresponding US tax to the IRS. Income earned by US taxpayers still had to be reported and withheld on an individual basis. But in accordance with general US tax law, IRS regulations did not require FFIs to look-through foreign corporations. As a result, US taxpayers could hide behind interposed entities to evade US income tax, and illegitimately obtain tax exemptions or treaty benefits on their investment in US securities also after the QI program had been established.

The program was very successful with FFIs, as it enabled them to avoid the 30 percent withholding tax on US investments for their clients, while protecting their anonymity from US banks and the IRS. As some well-reputed tax professionals concluded at the time: "[b]ecause of the relative secrecy benefits provided to non-US citizens or residents, the failure of a private bank to qualify as a QI would put that bank in a competitive disadvantage in the marketplace."[105] Inside the US the program received very little commentary during its elaboration phase because it actually shifted responsibility for the identification of beneficial owners to FFIs, thereby reducing the administrative burden for US withholding agents. In fact, in setting up the QI program, the IRS also responded to "years of requests from US banks and brokers to consolidate, clarify, and reduce documentation rules."[106] At the same time, those US persons whose interests were most affected, US investors evading tax by operating through foreign banks, could not publicly defend their position, and were not considered a legitimate lobby group by any influential political force.[107] Although the program had many loopholes, and was thus easy to circumvent by US taxpayers, it still provided "some level of deterrence against tax fraud and evasion."[108] Moreover, the IRS had

[104] Shay, Fleming Jr, and Peroni 2002, 124.
[105] O'Donnell, Marcovici, and Michaels 2000, cited in Grinberg 2012, 17. For further commentary suggesting that FFIs improve their competitive position by becoming QIs see: Hanrehan and Shapiro 1998.
[106] Kentouris 1997, 18.
[107] Interviews on 15 and 17 April 2015.
[108] Shay, Fleming, and Peroni 2002, 128.

"effectively created the first major operational precedent for the concept of a cross-border anonymous withholding regime."[109]

4.4. Theoretical Implications

As have all Democratic administrations since the Second World War,[110] the Clinton administration entered office with the goal of restoring the tax system's progressivity. Owing to internal concerns over the budget deficit, however, a promised tax cut for the middle class was replaced by a more targeted EITC for the working poor, financed by higher taxes on high incomes and fuel consumption. Although this package did not have a meaningful impact on the after tax incomes of the middle class, its regressive element was interpreted as a tax raise for this income group, leading to Democratic defeat in the congressional elections of 1993. Faced with a Republican Congress, the Clinton administration's focus subsequently shifted from legislative projects to international initiatives with the potential to increase growth and tax revenue. Within the area of taxation, it thus consulted with other developed countries organized in the G7 and OECD to set up an international initiative against harmful tax competition.

A corresponding report elaborated by the OECD secretariat concluded that tax havens and PTRs were abetting tax evasion by individuals and tax avoidance by corporations. It made 19 recommendations for ending harmful practices, and threatened tax havens with blacklisting and sanctions should they not comply with OECD demands. Owing to business opposition, however, the tax haven element of the report soon lost much of its corporate dimension, enabling sophisticated tax havens to submit to the OECD while defending their stake in the tax-planning schemes of multinationals. Although it publicly backed the OECD's sanctions threat, the Clinton administration had not leaned against this shift in the HTC project's underlying focus. At the same time, it also failed to defend the US CFC regime against abuse through hybrid entities, the collective adoption of which was one of the defensive measures against harmful tax competition recommended by the OECD. In contrast, some regulatory progress was achieved where multinationals were unaffected, and administrative costs could be shifted from domestic to foreign entities. Through the QI program, the Clinton Administration introduced new reporting and withholding duties for FFIs, which at least deterred some less sophisticated investors from evading US tax on capital income.

[109] Grinberg 2012, 17.
[110] Bartels 2009.

In accordance with *H1* we thus observed a Democratic administration that put tax cooperation on the international agenda as a result of concerns over the perceived fairness of the US tax system, financial stability, and the effectiveness of the US sanctions regime. In accordance with *H2*, however, the multilateral HTC initiative failed to gain momentum, as it also affected the tax-planning schemes of multilateral corporations. Instead of providing US business with a competitive advantage over its foreign competitors, OECD recommendations thus created additional costs, prompting business opposition. In reaction to corporate criticism, the Clinton administration allowed the dilution of the initiative, instead of credibly linking non-compliance with its recommendations to economic sanctions. Therefore, tax havens could enter into virtually costless agreements with the OECD, allowing them to avoid the risk of being sanctioned. In general, the Clinton administration only succeeded in passing international tax regulations when they concerned tax evasion rather than tax avoidance, and thus mainly affected foreign businesses.

The reference to regulative norms indeed played a major role the communication strategy of tax havens. Yet, it did not prevent the OECD or the US from requesting greater administrative assistance, and more financial transparency from them. In late 2000, six major tax havens even formally committed to respect OECD standards for information exchange to be removed from a blacklist. This should not have been necessary, if normative arguments against foreign interference and extraterritoriality had really turned the decision of tax-haven governments to remain non-cooperative into a legitimate policy option. Rather than fending off OECD interference on normative grounds, tax haven governments seized the opportunity to avoid the reputational cost of being included in a blacklist once the OECD had watered down its requests in accordance with demands from domestic business associations in the United States. Likewise, the Clinton administration was not prevented from cracking down on tax avoidance by its electoral defeat. Rather, it bowed to pressure from US multinationals, and thus reduced the HTC initiative's scope even before the Bush administration came into office.

5. Bush and the Burial of the HTC Initiative

Students of international tax policy agree that the lack of support from the Bush administration eventually killed the Organisation for Economic Co-operation and Development's (OECD) harmful tax cooperation (HTC) initiative.[1] Accordingly, there is broad acknowledgment of the United States (US) government's ability to determine the direction of the OECD's tax work. Yet, analysts disagree over the reasons for its hostile attitude. Whereas some claim that the Bush administration was indifferent toward the project when it entered office, and only adopted a negative stance after intense lobbying from libertarian activists,[2] others refer to an intrinsic motivation based on the apparent mismatch between its supply-side tax cut agenda and international efforts to increase the effective tax burden on capital, as well as its general skepticism towards multilateral cooperation.[3] This chapter will demonstrate that the Bush administration was critical of the project from the outset of its term, and therefore had an open ear for the anti-OECD narrative proposed by libertarian advocacy groups. Despite recurrent exchanges between senior Bush appointees and these lobbyists, however, the US Treasury did not fully embrace their requests. Much to their chagrin, it merely removed the anti-tax avoidance elements from the project, while still providing nominal support to its anti-tax evasion measures. The Bush administration's policy was thus more in line with the position of US multinationals represented by the United States Council for International Business (USCIB) than with the fundamental libertarian critique of tax cooperation in general. Its ability to transform this position into actual OECD policy despite being isolated within the Group of Seven (G7) is testimony of US power in international bargaining over tax matters.

5.1. The Bush Administration's Tax Policy Agenda

During the 2000 presidential campaign, his electoral platform presented George W. Bush as a "compassionate conservative," who favored both tax cuts, and increased spending on health care and education. This strategy was, of course, only credible against the background of the budget surplus achieved under Clinton.[4] Its cornerstone was the Bush tax plan, which

[1] Eccleston 2012, 71; Palan, Murphy, and Chavagneux 2010, 217; Rixen 2008, 137.
[2] Sharman 2006a, 151.
[3] Eccleston 2012, 71.
[4] Steuerle 2008, 199.

provided for an across-the-board reduction in marginal income tax rates, an expansion of the child tax credit, and the abolition of the estate tax on inheritance.[5] Bush and his advisors claimed that "The Bush tax cuts benefit all Americans, but reserve the greatest percentage reduction for the lowest income families."[6] Moreover, they stated cuts would not lead the budget into deficit, but leave room for debt reduction instead.[7] However, analyses soon revealed the supply-side tax cut agenda behind the plan. According to a widely cited study by Citizens for Tax Justice (CTJ), the Bush proposals actually provided the top one percent of the income distribution with a 13.6 percent tax cut, whereas the bottom 20 percent only received 5.5 percent. Expressed as a share of the proposed tax cut's overall value, the top one percent could expect 43 percent of the benefits, whereas the bottom 20 percent would receive less than one percent. In addition, CTJ found that ceteris paribus this exoneration of the rich would completely eat up the projected budget surplus over the course of the ten-year fiscal period for which they were devised.[8]

Despite the Bush team's political rhetoric, these numbers thus suggested that the plan provided for a strongly regressive outcome, matching the traditional Republican conviction that "in order to be successful, tax cuts had to be directed primarily to the wealthy because of their larger role in saving and investment."[9] In fact, Lawrence Lindsey, the plan's main author and Bush's chief economic advisor, had built his Washington career in the 1980s on "an academic defense of tax cuts as a spur to economic growth [that] endeared him to the Republican Party's supply-side wing."[10] Accordingly, Democrats criticized the Bush tax proposals for their lack of fairness. Vice-President Al Gore, Bush's main electoral opponent, called the plan "a risky scheme to reward the wealthy,"[11] whereas the Party's spokeswoman, Jenny Backus, warned it would "jeopardize the future of Social Security and Medicare."[12] On the conservative side, commentators were split. Grover Norquist, president of Americans For Tax Reform, praised the plan for "[putting] serious reductions in marginal tax rates, Ronald-Reagan style, back on the table."[13] Likewise, a group of reputed economist known for their

[5] Bush Campaign 2000.
[6] CTJ 2000; see also: Bush Campaign 2000.
[7] Ibid.
[8] CTJ 2000. The Bush team's calculations apparently relied on an overly optimistic projection of GDP growth at an average 2.7 percent over the next 10 years.
[9] Tobin and Weidenbaum 1988, 48; cited in: Bartels 2009, chap. 2.
[10] Stevenson 1999.
[11] Stevenson 2000.
[12] Fournier 1999.
[13] Dionne 1999.

neoliberal convictions endorsed the plan in a newspaper ad.[14] Martin Feldstein, a member of the group, also wrote two op-eds for the Wall Street Journal praising the proposals.[15] Skeptical voices from the supply side merely criticized the plan as "too timid," which Bush countered by announcing that he was open for additional tax cuts. "It's the beginning. It's not the end," Bush replied according to the Washington Post.[16] In contrast, several moderate Republicans, including Alan Greenspan and John McCain, considered the extent of the cuts "fiscally irresponsible," given the uncertainty linked to projections of future GDP growth.[17] McCain, Bush's main opponent in Republican primaries, even embraced the CTJ analysis during a TV debate, stating, "Gov. Bush's tax plan has 60 percent of the tax cuts for the wealthiest 10 percent of America."[18]

Despite opposition from Democrats and moderate Republicans in Congress, deep tax cuts remained the Bush administration's top priority after entering office in January 2001. Already on February 8, the President presented his tax package to Congress as part of the annual congressional budget resolution. Including the package in this type of bill had several procedural advantages. Budget resolutions prevent filibusters, and limit the time for debate as well as the number of amendments.[19] As one commentator wrote at the time, "in the evenly split Senate, these advantages will be essential to enact anything like the [proposed] tax package."[20] Despite widespread skepticism as to its chances of adoption, Chairman Chuck Grassley and Ranking Member Max Baucus managed to get the bill past the Senate Finance Committee by extending phase-ins for certain measures, slightly limiting the scope of others, and including some pet projects of skeptical members to secure their support. After similar maneuvering on the Senate floor, the bill eventually passed by a 62-38 margin. That is, 12 Democrats, all of them either involved in drafting the bill in the Finance committee, facing tough re-election battles the same year, or multimillionaires themselves, voted with the Republicans.[21] As a result, President Bush signed one of the biggest tax cuts in history into law on 7 June 2001. Its supply-side orientation was once more underlined in a Treasury companion paper to the bill. Justifying the phase-out of the estate tax, the authors argued that it "impedes economic growth because it levies yet another layer of taxes on capital. More

[14] Coy 2000; The group included Nobel Prize winners Milton Friedman, Robert Lucas, James Buchanan, Gary Becker, and Robert Mundell. For the crucial role these economists have played in the 'Neoliberal Thought Collective' see: Mirowski 2013, chap. 2.
[15] Feldstein 1999; Feldstein 2000.
[16] Dionne 1999.
[17] Steuerle 2008, 200.
[18] Dionne 2000.
[19] Bartels 2009, chap. 2.
[20] Taylor 2000.
[21] Bartels 2009, chap. 6.

capital investment means higher incomes for all workers."[22] While critics still lamented the act's unfairness and its adverse impact on the budget, Republican deputies and corporate lobbyists had just warmed up. The US Chamber of Commerce announced it had a "long list of proposals for business tax breaks omitted from the act." At the same time, Glenn Hubbard, the White House's chief economist, prepared a proposal for a reduction of the dividend tax.[23]

5.2. Domestic Politics

Owing to its supply-side tax cut agenda, the Bush administration was "ideologically predisposed to accept the critiques of the right-wing coalition that had formed in the US to oppose the HTC project."[24] Analysts agree that opponents of the OECD's tax work saw the change of power from Clinton to Bush as a huge opportunity to derail the organization's efforts.[25] Accordingly, associations like the Center for Freedom and Prosperity (CFP), the USCIB, and the US Chamber of Commerce intensified their lobbying activity, swamping Treasury and Congress with letters and e-mails, producing alarmist newspaper op-eds, and rounding up support from congressmen and senators, as well as from the same group of neoliberal economists that publicly backed the Bush tax package.[26] In his publications, Daniel Mitchell, the CFP chief lobbyist, incessantly warned against OECD efforts to establish "a cartel for the benefit of high-tax nations" that would "emasculate financial privacy and undermine fiscal sovereignty […], impoverish less-developed nations and hamstring America's competitive advantage in the world economy."[27] "Fortunately," he reminded his readers, "President Bush can pull the plug on this misguided initiative simply by telling high-tax European nations that America will not impose financial protectionism against low-tax countries."[28] Whereas Mitchell pushed a die-hard libertarian agenda, vilifying any form of international tax cooperation as a socialist plot against flat taxes and small government, Richard Hammer, USCIB's chief tax counsel, chose a more moderate approach. Representing the interests of US multinationals, he continued to argue against the OECD's interference with "legitimate tax-planning opportunities" in his communication to Treasury. Yet, he acknowledged "the need for responsible and legitimate information exchanges," thus

[22] US Treasury 2001, 8.
[23] Bartels 2009, chap. 6.
[24] Webb 2004, 813.
[25] Giridharadas 2001; Shaxson 2012; Sharman 2006a; Webb 2004.
[26] Levin and Lieberman 2001, sec. Permanent Subcommittee on Investigations; Sharman 2006a; Shaxson 2012.
[27] Mitchell 2001c; see also: Mitchell 2000.
[28] Ibid.

"[counseling] Treasury to use its best efforts to change the focus of the [HTC] project to deal solely with transparency."[29]

These lobbying efforts soon bore fruit. The media discovered the issue, with the Washington Post even adopting the CFP characterization of the OECD as "global tax police."[30] Likewise, 86 members of Congress applied CFP rhetoric in a joint letter to Secretary of the Treasury Paul O'Neill, characterizing the HTC initiative as an infringement on fiscal sovereignty, and urging him to withdraw US support. In addition, "Nobel prize-winning economists Milton Friedman and James Buchanan came out in support of the CFP and against the OECD campaign."[31] Most importantly, however, the buzz they had created earned the CFP and US Chamber of Congress a "sympathetic hearing" by virtually every competent political appointee within the Bush administration.[32] In February 2001 Mitchell and several other CFP lobbyists were given the opportunity to "[make] their pitch to a half-dozen Treasury officials in the office of Mark Weinberger, the department's chief tax official and a new Bush appointee."[33] In addition to a score of follow-up appointments with senior Treasury officials, another meeting between Weinberger and the CFP was held in March.[34] Moreover, Mitchell and his colleague Andrew Quinlan met with Lawrence Lindsey, Glenn Hubbard, and Cesar Conda, a senior advisor to Vice-President Dick Cheney.[35] Eventually, these consultations culminated in a meeting in mid-April between Ed Feulner, the president of the Heritage Foundation, which is the CFP's main sponsor, and Secretary O'Neill.[36]

The intensification of the lobbying effort is, indeed, reflected in the evolution of O'Neill's attitude towards the HTC project. Following a meeting of G7 ministers of finance in February, he still announced quite nebulously that certain aspects of the initiative were "under review by the new Administration."[37] He claimed to support "the priority placed on transparency and cooperation to facilitate effective tax information exchange," but underlined it was "critical to clarify that this project [was] not about dictating to any country what should be the appropriate level of tax rates."[38] The Secretary further elaborated this position over the course of the following months, arguing in May that "in its current form, the project [was] too

[29] Hammer 2001, 164–165.
[30] Novak 2001.
[31] Sharman 2006b, 62.
[32] Webb 2004, 813.
[33] Giridharadas 2001.
[34] Ibid.
[35] Sharman 2006b, 62.
[36] Giridharadas 2001.
[37] O'Neill 2001a, 82.
[38] Ibid.

broad and […] not in line with this Administration's tax and economic priorities."[39] Questioned at a Senate hearing in July, he then clarified that the US had argued for a removal of the substantial economic activity criterion from the OECD's tax-haven definition, and against the use of ring fencing as an indicator for PTRs, given that "it [did] not provide an adequate basis to distinguish regimes that facilitate tax evasion from regimes that are designed to encourage foreign investment but that have nothing to do with the evasion of any other country's tax law."[40]

After the OECD had already diluted the substantial economic activities criterion with the acquiescence of the Clinton administration, and in response to lobbying from the Business and Industry Advisory Counil (BIAC) and the USCIB (*see section 4.3.1.*), the Bush administration now further refocused the OECD initiative according to the counseling it had received from US multinationals in the guise of Richard Hammer. Using its weight in the OECD's Committee on Fiscal Affairs (CFA), Treasury removed virtually all elements interfering with corporate tax planning from the HTC project, including conditionality of tax residency on substantial economic activity, and critical reviews of PTRs. As a result, the initiative soon dealt exclusively with increased transparency and information exchange,[41] just like Hammer had requested in his communication with Treasury. The CFP's concerns were most visibly taken into account in O'Neill's rhetoric and the timing of his withdrawal from the HTC project. By refocusing the OECD's tax work on information exchange and the combat of tax evasion, however, Treasury did not comply with the more extreme requests from Mitchell and his colleagues. Accordingly, the CFP showed an ambivalent reaction to O'Neill's turnaround. Although Quinlan and Mitchell celebrated the end of the OECD's tax harmonization agenda, which was their wording for measures against tax avoidance, they complained in June "that it is still not clear whether we have stopped the assault on financial privacy."[42] Still, they assured their sponsors and supporters that "in the coming months, we will be fighting to ensure the correct outcome."[43]

5.3. International Bargaining

As part of its progress report, the OECD had published a blacklist of 35 tax havens in June 2000. With the public backing of the Clinton administration, it threatened these tax havens

[39] O'Neill 2001c, 84.
[40] O'Neill 2001b, 51.
[41] Palan, Murphy, and Chavagneux 2010, 217; Eccleston 2012, 72; Eden and Kudrle 2005, 123.
[42] Quinlan 2001.
[43] Ibid.

with sanctions should they not remove the harmful features of their tax codes by July 2001 (*see chapter 4*). In the following months several of the listed jurisdictions sat down with the OECD to find an agreement, be removed from the blacklist, and avoid sanctions.[44] While the Bahamas announced it would prohibit the anonymous registration of International Business Companies (IBC), and withdrew banking licenses from seven suspicious institutions, Grenada shut down 17 banks in March 2001 to clean up its financial sector.[45] At the same time, the prime minister of St. Vincent complained about a 20 percent reduction in IBC registrations over the course of 2000, while the number of banks registered in Antigua had fallen from 78 in 1998 to 18 by 2001.[46] From the perspective of the OECD, things were developing in the right direction at the beginning of that year. Yet, its optimism soon faded. The Bush administration's foot-dragging along with outreach from the CFP, encouraging tax haven governments to stand firm while they were working Treasury,[47] brought negotiations with the OECD to a halt. Instead of making overhasty commitments, many tax havens now preferred to wait and see, hoping that the US would eventually withdraw its support from the HTC initiative. As a senior OECD official told the Financial Times in April: "There is a hiatus. Nothing is happening because the US position is unclear."[48]

Indeed, the OECD's secretariat and its large European members grew increasingly nervous, sensing that without unambiguous US support the HTC initiative could fail. Accordingly, the OECD sent a delegation to Washington to persuade Treasury of the project's merit, and to make sure it would back its tax work in the conclusions to an upcoming meeting of G7 ministers of finance.[49] But neither the OECD, nor his European counterparts could convince Secretary O'Neill of the initiative. Accordingly, the April communiqué of G7 ministers of finance expressed support for the Financial Action Task Force's (FATF) anti-money-laundering work, but made no mention at all of the OECD's tax initiative.[50] Instead of seeking consensus with European partners, O'Neill announced the withdrawal of US support two weeks later in an official statement. "Following up on the thoughts I shared with my G7 counterparts at recent meetings," he began, "I want to make clear what is important to the United States and what is not."[51] He then explained the US was in favor of tax competition because it forced governments to become more efficient. In fact, it provided his government

[44] Adams, Mallet, and Peel 2001.
[45] Canute 2001a.
[46] Canute 2001b.
[47] Mitchell 2001b.
[48] Adams, Alden, and Peel 2001.
[49] Ibid.
[50] G7 Ministers of Finance 2001.
[51] O'Neill 2001c, 83.

with an additional incentive to reduce the tax burden for all Americans, and simplify the tax system. Nonetheless, tax cheats were breaking the law and had to be caught. But the US would use bilateral information exchange agreements for that. Where the US shared common goals, it would continue to work with G7 partners. "In its current form," however, the HTC project was "too broad and […] not in line with this Administration's tax and economic priorities."[52]

While the USCIB and the CFP were celebrating, European G7 members tried to pick up the pieces. The UK exchequer stated, "Our position is absolutely clear. We support the initiative. The US concerns will be discussed in the OECD." Along the same lines, Bruno Gibert, the French chairman of the harmful tax practices working group, confirmed, "member countries would consider how to respond 'in a constructive way'."[53] However, these diplomatic reactions only masked the major discontent in European capitals that became apparent at the OECD's Ministerial Meeting a week later. In the absence of O'Neill, who was represented by Glenn Hubbard, the White House's chief economic advisor, European ministers tried to put pressure on the US, which was, indeed, isolated on the issue. But Hubbard stuck to his position, reaffirming the US would only participate in a stripped-down version of the project that focused on information exchange.[54] This time, the Europeans responded angrily. Laurent Fabius, then French minister of finance, told his colleagues: "Whether it concerns the struggle against the greenhouse effect, or against money laundering and tax havens, the largest power in the world cannot disengage from the planet's problems."[55] A European OECD official concurred: "How far can it go? Do we scrap all attempts to make people pay taxes?"[56] But it did not help. After several rounds of negotiations in the CFA, OECD ambassadors agreed in July that the HTC's tax avoidance elements should be scrapped, and no sanctions imposed on tax havens at least until 2003.[57] In order to save the initiative, the Europeans had thus agreed to a reform that fully matched US priorities.

Their surrender was eventually enshrined in the OECD's 2001 Progress Report. It defined the fight against "anti-competitive […] practices designed to encourage non-compliance with the tax laws of other countries" as the HTC initiative's new goal,[58] and made clear that the OECD would only rely on "the transparency and effective exchange of information criteria" when identifying non-cooperative jurisdictions included in its

[52] Ibid., 84.
[53] Adams and Peel 2001.
[54] Beattie 2001.
[55] Ibid.
[56] Alden and Peel 2001.
[57] Peel 2001b; Peel 2001a.
[58] OECD 2001, 4.

blacklists.[59] Most importantly, it withdrew the collective sanctions threat by acknowledging that "each OECD member country retains the sovereign right to apply or not to apply any defensive measures as appropriate."[60] "Even though [the Bush administration's anti-tax] ideology found little official support in any other OECD country,"[61] the organization had still minimized the regulatory burden for multinationals, and tax havens accordingly. This outcome thus reveals the US government's ability to make the OECD's tax work reflect its preferences despite opposition from all European G7 members. As Webb observes, "no other country has the power to single-handedly alter the course of the OECD."[62]

5.4. Theoretical Implications

The Bush administration's main goal was to reduce the tax burden on corporate profits and capital income. Owing to this supply-side tax cut agenda, it was skeptical towards the HTC initiative from the outset of its term, and gave libertarian critics of the OECD's tax work a sympathetic hearing. While it bought into their arguments against the removal of PTRs, however, the Bush Treasury could not be convinced to completely abandon the transparency agenda. Hence, it gave priority to removing those elements from the HTC initiative's scope that interfered with the tax planning practices of multinational firms, thereby unraveling the project in its original form. In contrast, it adopted an ambivalent position as to the OECD's work on information exchange. Giving in to the Republican Party's law and order instincts, the Bush administration formally kept the fight against tax evasion and financial opacity on the agenda. Yet, it made sure that the OECD withdrew its sanctions threat against tax havens that refused to become more transparent, thereby reducing the effectiveness of the organization's efforts in this area.

In accordance with *H1*, we have thus observed a Republican administration skeptical towards multilateral attempts at curbing tax evasion and avoidance. From its perspective, international tax competition provided a perfect reason for its preferred domestic tax policy of reducing taxes on capital. Against this background, the reduction of competitive pressures by means of international cooperation seemed counterintuitive. As expected in *H2*, the Bush administration put priority on neutralizing those OECD recommendations that were likely to impose costs on US multinationals. Yet, it also withdrew the sanctions threat against tax havens that refused to become more transparent. The Clinton administration had aimed to

[59] Ibid., 10.
[60] Ibid.
[61] Webb 2004, 815.
[62] Ibid.

reduce both tax evasion and avoidance, but abandoned the latter goal in response to corporate lobbying. In contrast, the Bush administration was not particularly keen to end either tax evasion, or tax avoidance, but kept the fight against tax evasion on the agenda to cater to the Republican Party's law and order instincts. As the next chapter shows, however, it pursued this agenda without conviction. Finally, the Bush administration's ability to transform its priorities into OECD policy despite being isolated in the G7 reflects the US government's sway over the direction of the organization's tax work.

6. Bush and Information Exchange

There is broad agreement in the literature that the Bush administration cherished international tax competition for putting pressure on tax rates, and forcing governments to become more efficient.[1] Tax competition thus provided a perfect justification for its supply-side tax cut agenda. Accordingly, the Bush Treasury was suspicious of OECD efforts to curb tax evasion and avoidance, and withdrew support from the harmful tax competition (HTC) initiative. Despite its skeptical stance, and contrasting requests from libertarian lobby groups, however, it stuck to the OECD's transparency and information exchange agenda. Most analysts attribute the Bush administration's unwillingness to also abandon this part of the OECD's tax work to the September 11 attacks, which created demand for more financial transparency as a means to combat terrorist financing.[2] This chapter will show that the Bush administration was, indeed, dispassionate about increasing financial transparency. But to balance concerns over effective law enforcement with libertarian requests for a complete termination of the OECD's tax work, it chose to provide nominal support to the information exchange agenda, while at the same time revoking the sanctions threat targeted at financially opaque jurisdictions. As a result, tax havens felt no pressure to reform and largely upheld their business models.

6.1. Further Implementation of the Supply-Side Tax Cut Agenda

As mentioned in the previous chapter, the 2001 round of tax cuts did not appease requests for further relief from business groups, influential tycoons, and many congressional Republicans. There were calls for further cuts to personal income tax rates, as well as for reductions in corporation and dividend taxes. Moreover, President Bush and his advisors continued to be sympathetic to these requests, despite projections of a growing deficit. Accordingly, the president announced that his 2001 tax package was only the beginning of a larger project, while his chief economic advisor began working on a proposal for a significant reduction in dividend taxes.[3] In addition, the modest downturn following the September 11 attacks gave the administration another pretext for abandoning fiscal discipline for what it sold as a boost

[1] Van Fossen 2003, 262; Webb 2004, 813; Woodward 2004, 10–11.
[2] Eden and Kudrle 2005, 123; Van Fossen 2003, 264.
[3] Bartels 2009, chap. 6.

to the economy. In accordance with their supply-side convictions, the president and his economic advisors thus tied another tax package giving major relief to capital, while leaving the tax bill of the middle and lower classes virtually unchanged.[4] In addition, September 11 also convinced law enforcement services within the Bush administration of the need to prevent terrorist financing. This gave a boost to international anti-money-laundering activities at the Financial Action Task Force (FATF),[5] and provided a backstop against efforts from the Center for Freedom and Prosperity (CFP) and congressional Republicans to completely unravel the OECD's transparency and information exchange work.[6]

The Bush administration's first post-2001 tax initiative was the Job Creation and Worker Assistance Act of 2002. Among other things, it provided US corporations with more generous depreciation allowances for purchases of certain assets,[7] and tax refunds on business losses incurred as far as five years back.[8] That is, companies were allowed to deduct 50 percent of an asset's value from their tax bill in the year of purchase, instead of deducting only the depreciated value of the asset in every year it is utilized. As Slemrod and Bakija explain, "spreading the deduction out over time is generally less favorable to the firm than allowing a full deduction at the time of purchase because the tax savings from an immediate deduction can be invested and accumulate interest."[9] In general, making depreciation allowances more generous, and extending the period during which past business losses are eligible for tax refunds are ways to reduce the effective tax rate on corporate income. Still, both parties in Congress were in favor of the measures because they did not only provide supply-siders with lower marginal tax rates on capital, but could also be sold to Keynesians as a government stimulus, freeing-up a large sum for additional investment over a relatively short period of time.[10]

In contrast, the Bush administration's second proposal for a major tax package after 2001 was highly contentious. Its main elements were the exemption of dividends from taxation as personal income, and the reduction of capital gains taxes on sales of corporate stock. Moreover, it provided for the acceleration of cuts to marginal tax rates imposed on upper income brackets, which should have been phased-in over a longer time period under the 2001 package. Given that it is usually upper-income people that earn dividends and capital gains, the overall proposal provided for a $700 billion loss in tax revenue almost exclusively

[4] Steuerle 2008, 210–211.
[5] Palan, Murphy, and Chavagneux 2010, 208.
[6] Eden and Kudrle 2005, 123; Sharman 2006b, 80.
[7] Steuerle 2008, 210.
[8] Slemrod and Bakija 2008, 328.
[9] Ibid., 49.
[10] Steuerle 2008, 2011.

to the benefit of the richest members of society.[11] The sheer size of the tax cuts even led several moderate Republican Senators to oppose the package, which made them the subject of aspersive campaigns by the Club for Growth, a conservative lobby group financed by unnamed wealthy individuals.[12] Still, they joined Democratic members of the Senate Finance Committee in requesting a $350 billion ceiling for the proposed cuts. In view of reconciling these concerns with massive pressure from Republicans in the House,[13] the committee leadership decided to tweak the bill through the heavy use of sunsets and phase-ins. By having the most expensive provisions expire after a few years, they reduced the bill's immediate cost below the requested ceiling requested by Senate Finance. However, they provided Congress with the ability to extend the cuts beyond their initial date of expiry, the cost of which was at the time projected to be $736 billion.[14]

Owing to this design, the bill easily passed the Republican-controlled House. In the Senate, however, Vice-President Cheney had to cast his tiebreak vote to enable the adoption of the tax package against opposition from 46 Democrats, three Republicans, and one Independent.[15] Whereas critics outdid each other in the use of pejorative rhetoric in their commentary of the final act, conservative lobby groups and most Republicans rejoiced. As Hacker and Pierson recount,

> "Senate Republican leaders gathered at a press conference to celebrate passage of a cut that was formally far smaller than the one they had originally sought, but anticipated to cost far more. When a reporter skeptically inquired as to whether the tax cut just passed was 'smoke and mirrors' designed to make a large tax cut smaller, Senator George Allen of Virginia said, 'I hope so.' All the senators laughed."[16]

Another observer described general optimism among Republicans as to future tax cuts and extensions as follows:

> "To conservative groups, who have every intention of pushing for an annual tax cut, arguments over the size of each one are hardly worth worrying about in the long run. 'We're going to be negotiating over the size of the tax cut every year for 10 years,' said Grover Norquist, president of Americans for Tax Reform. 'At the end of 10 years, you're going to see how much progress 'not getting everything you want' gets you.' House Majority Leader Tom DeLay called the shrunken […] cuts 'awesome,' adding, 'And it's only the beginning.' Senate Majority Whip Mitch McConnell echoed DeLay's assessment: 'All I can tell you is, we keep on winning, and we expect to win again.'"[17]

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[11] Bartels 2009, chap. 6.
[12] Hacker and Pierson 2005, 40.
[13] Hacker and Pierson argue that Republican Representatives in the House are more vulnerable to campaigns by anti-tax lobby groups such as the Club for Growth or Americans for Tax Reform than incumbent Senators, which is why they almost unanimously accede to requests from these groups.
[14] Hacker and Pierson 2005, 48. In fact, the split Senate extended the cuts by two years in 2010 so they eventually expired on 1 January 2013.
[15] Bartels 2009, chap. 6.
[16] Hacker and Pierson 2005, 48.
[17] Alan K. Ota, 'Tax Cut Package Clears Amid Bicameral Rancor,' CQ Weekly, May 24, 2003, 1245, cited in: Bartels 2009, chap. 6.

Despite projections of a ballooning deficit and the modest economic slowdown after September 11, the Bush administration's supply-side tax cut agenda was thus in full swing. Congressional Republicans were eager to extend sunset provisions built into tax packages, while conservative lobby groups with substantial sway over Republican representatives were even seeking additional cuts. The entire Republican establishment was thus geared towards reducing the tax burden and limiting government. Accordingly, the committed pursuit of international cooperation against tax evasion would have been rather inconsistent. As the next sections make clear, this is why the Bush administration resorted to a "politics without conviction" strategy at the OECD during the following years.[18]

6.2. Domestic Politics

Treasury had acceded to most of the demands from the right-wing lobbying coalition when removing the "tax harmonization" elements from the HTC initiative. Yet, it had stuck to its transparency and information exchange dimension for several reasons. First, information exchange did not interfere with national tax codes, and therefore did not oblige tax havens to remove provisions that enabled multinationals to avoid taxes elsewhere. From the perspective of Secretary O'Neill this meant that it did not affect international tax competition, which he and the libertarian opponents of tax cooperation interpreted as a desirable constraint on government profligacy. Second, tax evasion, the activity to be tackled by information exchange, was a criminal offense. Providing law enforcement agencies with additional information to prosecute such offenses, thus matched the law-and-order instincts of many Republicans.[19] In fact, O'Neill underlined that he had taken an oath obliging him to execute US tax laws as written, which implied going after those "who illegally evade taxes by hiding income in offshore accounts."[20] Third, the September 11 attacks and the ability of Al-Qaida to finance both their perpetrators, and their preparation gave law enforcement agencies another reason for wanting to pierce the veil of secrecy provided by tax havens.[21]

In contrast, the libertarian lobbying coalition and many Republican members of Congress under its influence were still seeing their ultimate goal of minimal taxes and a minimal state endangered by international information exchange. As their wealthy sponsors' desire to reduce their tax burden to zero was difficult to communicate, however, they argued

[18] Eccleston 2012, 60.
[19] Interviews on 15 and 17 April 2015.
[20] O'Neill 2001c, 83. Testifying at a Senate hearing on 'Tax Haven Abuse' O'Neill was eager to dispel allegations that he was turning a blind eye on breaches of US tax law, cf. O'Neill 2001b.
[21] Eccleston 2012, 115; Eden and Kudrle 2005, 123; Shaxson 2012, chap. 8.

instead that information transfers from banks to tax authorities were an infringement of citizens' right to privacy. For instance, Daniel Mitchell of the CFP reminded his followers that "information exchange for tax purposes, even when limited to specific cases, is inconsistent with sound tax policy, respect for privacy, and international comity."[22] Along the same lines, the Prosperity Institute accused Treasury of ignoring "the important balance between due process and privacy concerns on the one hand, and law enforcement or tax administration efficiency on the other."[23] Most importantly, libertarian lobby groups including among others the CFP, the Heritage Foundation, the Cato Institute, the Discovery Institute, and the Prosperity Institute teamed up to form the "Task Force on Information Exchange and Financial Privacy." The task force was chaired by former Republican senator Mack Mattingly, and included former appointees in the Reagan and George H. W. Bush administrations, as well as members of the Mont Pelérin Society, senior figures from George Mason University, and other libertarian lobbyists.[24] In its final report, the task force observed that the US was itself "[allowing] foreigners to invest confidentially in the US," and thus engaged in the same behavior the OECD criticized in tax havens. If the US government thus continued to support the OECD's efforts, it would only motivate high-tax European nations to use the OECD to impose reporting-requirements also on the US This would hurt its attractiveness for foreign investment, lead to massive capital outflows, and sacrifice the privacy of US taxpayers. Accordingly, the US should prevent the OECD from "the total abolition of any financial privacy in the 41 targeted countries."[25]

These arguments were taken up by the business press, and also by senior Republican figures such as House Majority Whip Tom DeLay. In a letter to Secretary O'Neill he criticized information exchange initiatives as "assaults on financial privacy and due process legal protection […] driven by a desire to thwart international tax competition." "But since the United States is the world's biggest beneficiary of tax competition," he added, "it makes no sense for America to participate in an endeavor that will undermine our competitive advantage in the global economy."[26] Interestingly, however, arguments stressing the risk that reporting requirements imposed on tax havens could eventually also be imposed on the US did apparently not gain currency with the potentially affected financial sector. Of course US

[22] Mitchell 2001a, 108.
[23] Mastromarco 2001, 104.
[24] cf. Task Force on Information Exchange and Financial Privacy 2002, 4–12. According to Mirowski (2014), the Mont Pelérin Society and George Mason University are key players in what he describes as the 'neoliberal thought collective.'
[25] Ibid., 35–36.
[26] DeLay 2001, 101.

banks were still opposed to providing additional data on their foreign clients.[27] They were, however, indifferent towards new reporting requirements for foreign banks, and corresponding sanction threats against tax havens (*see chapter 4*). The most likely reason is that US banks – in contrast to libertarian lobbyists – were aware of the established US practice of seeking additional reporting from foreign banks while shielding the US financial sector and its clients from similar requirements.[28] This approach was reflected in the QI program. Moreover, Treasury often negotiated TIEAs providing for unilateral information reporting from the treaty partner,[29] whereas the IRS did not per se respond to requests for administrative assistance from foreign governments. As a former Treasury official explains, especially Latin American countries, which provide the largest client base for wealth managers in Florida and Texas, usually cannot count on cooperation from the US:

> "The truth is, half of Latin America we don't have information exchange agreements with. There are other countries where it is clear that the US would act very slowly. So in theory we should exchange information with Venezuela, but we are not going to, it's not actually going to happen."[30]

Given this configuration of domestic interests, the Bush administration thus wanted to avoid being perceived as lenient on law enforcement issues, while also taking the criticism of die-hard libertarians among its core constituency into account. The result of its strategic deliberations was the pursuit of "politics without conviction."[31] In accordance with demands from libertarian lobby groups, it made sure that the criminal (money-laundering, terrorist financing) and civil (tax evasion) aspects of financial opacity were dealt with separately. The FATF continued to be responsible for the former, and the OECD for the latter. In addition, domestic efforts to combat terrorist financing were linked to the FATF's money-laundering work, instead of the OECD's transparency and information exchange efforts.[32] More importantly, however, the US advocated information exchange upon request at the OECD,[33] instead of automatic information exchange that had just been established within the EU for interest payments to non-residents.[34] The "upon request standard" was, however, known to be ineffective because it conditioned requests for administrative assistance on substantiated

[27] Blum 2004, 582.
[28] Eccleston 2012, 114.
[29] Blum 2004, 631–632.
[30] Interview on 15 April 2015.
[31] Eccleston 2012, 60.
[32] Palan, Murphy, and Chavagneux 2010, 208–209.
[33] Shaxson 2012, chap. 8.
[34] Genschel 2002.

suspicions against particular individuals. That is, tax authorities had to present prior evidence for tax evasion before they could ask their foreign counterparts for information. Yet, prior evidence was hard to come by in the absence of information from their foreign counterparts on a taxpayer's foreign accounts.[35] A potential workaround would have been the permission of group requests. Such requests would have enabled tax authorities to demand information on a particular category of individuals, for instance investors in a particular fund associated with tax evasion, from their foreign counterparts. However, Secretary O'Neill denounced such requests as "fishing expeditions" irreconcilable with citizens' right to financial privacy.[36] As the next sections explain, this is why the OECD's information exchange and transparency work did not have a real impact on tax evaders' investment decisions.

6.3. International Bargaining

The first element of the Bush administration's "politics without conviction" strategy was the endorsement of a toothless standard for international information exchange to address concerns over "financial privacy." Its second element was the deferral of sanctions against uncooperative tax havens until OECD members Switzerland and Luxembourg had also agreed to grant greater administrative assistance in tax matters. This was a direct response to criticism from libertarian lobbyists and tax haven governments concerning the "hypocrisy and double standards between the OECD's treatment of nonmember havens as opposed to abstaining members."[37] By abstaining from the vote on the HTC report and its progeny, Switzerland and Luxembourg had, indeed, made clear from the beginning of the project that they would not consider themselves bound by its recommendations. Of course, this invited other tax havens and their libertarian advisors to question the initiative's fairness, and decry its discriminatory character. Such arguments had not kept the Clinton administration from backing the OECD's sanction threat. For reasons described above, however, the Bush administration endorsed these concerns and distanced itself from countermeasures proposed by the OECD. At a Senate hearing in July 2001 Secretary O'Neill made the following confession:

> "I do not have any trouble with the idea of sanctions properly applied and fairly applied at all, but I did have trouble – now, I must tell you I found it pretty compelling to listen to the finance ministers of people from countries as small as 4,500 people say, 'Well, if you are going to do this to us, is Switzerland going to comply?' I thought that was not a bad argument: 'Well, if you are

[35] Palan, Murphy, and Chavagneux 2010, 34; Rixen 2008, 139; see also: Genschel and Rixen 2015.
[36] O'Neill 2001b, 53.
[37] Sharman 2006b, 91.

> going to do this to us and you are going to use the power of the 30, are you going to do it to yourself or not?' I thought that was a pretty good question."[38]

Of course, the credibility of any sanctions threat from the OECD is greatly reduced without the US on board. Accordingly, the organization reframed its discussion of countermeasures based on the Bush administration's position. In its 2001 progress report released in November, it stated "that a potential framework of coordinated defensive measures would not apply to uncooperative tax havens any earlier than it would apply to OECD member states with harmful preferential regimes."[39] As one tax haven government put it, "the OECD has agreed that its failure to apply rules to our competitors would be grounds for us to break any commitment we may give."[40] At the same time, commitment was far from costly, given that the OECD had removed the anti-tax avoidance elements from its tax haven definition, and was merely asking for respect of a standard that made information exchange conditional on very restrictive requirements. In their watered down version, OECD demands were thus innocuous for the tax havens' business model.[41] As a result, all but seven of the 35 uncooperative tax havens identified by the OECD in June 2000 had pledged to provide greater administrative assistance based on the "upon request standard" by April 2002 when the OECD released an updated blacklist. The only remaining jurisdictions were Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru and Vanuatu.[42] Justifying its continued resistance, the Liechtenstein government argued that it would not loosen banking secrecy provisions unless its bigger neighbor Switzerland did the same.[43]

While tax havens were enjoying their liberation from any meaningful sanctions threat, the OECD also had to change its approach. Instead of using coercion, it now had to revert back to its traditional "method of dialogue and persuasion."[44] In the words of Jeffrey Owens, the OECD's chief tax official, the organization abandoned "the Al Capone approach and replaced it with the Martin Luther King approach."[45] First, this implied rhetorical de-escalation. Gabriel Makhlouf, the chairman of the OECD's Committee on Fiscal Affairs (CFA), as well as Seiicho Kondo, the organization's Deputy Secretary General, expressed their understanding for tax haven's concerns over the establishment of a level playing field. Accordingly, they pledged to pursue common principles applicable to both OECD members

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[38] Levin and Lieberman 2001, sec. Permanent Subcommittee on Investigations 21.
[39] OECD 2001, 10.
[40] Antigua and Barbuda, 18 January 2002, cited in: Webb 2004, 817.
[41] Palan, Murphy, and Chavagneux 2010, 218; Rixen 2008, 138; Webb 2004, 816.
[42] Guerrera and Parker 2002.
[43] Rübartsch and Wolf 2002.
[44] Palan, Murphy, and Chavagneux 2010, 218; see also: Sharman 2006b.
[45] cited by: Easson 2004, 1066; Rixen 2008, 138.

and non-members.[46] Makhlouf also acknowledged that Switzerland and Luxembourg were "permanent abstainers" from the HTC initiative, and that a distinction should be made between compliant and non-compliant countries rather than between OECD members and outsiders.[47] In addition, the OECD changed its terminology for the former from "committed jurisdictions" to "participating partners."[48] More importantly, however, the OECD established the Global Forum on Transparency and Information Exchange. Instead of fixing standards and imposing them on non-members, the Global Forum invited tax havens and other jurisdictions to join OECD members in the elaboration and monitoring of information exchange standards. The first result of this more inclusive approach was the Model Agreement on Information Exchange published in 2002.[49]

In accordance with the Bush administration's general suspicion of multilateral agreements,[50] and Secretary O'Neill's announcement that the US would implement greater information exchange by means of bilateral treaties,[51] the Model Agreement was essentially a template for bilateral Tax Information Exchange Agreements (TIEA). It also provided for a multilateral mechanism, which, however, allowed a country acceding to the agreement to select the other signatories with whom it was willing to exchange information. Otherwise, the Model Agreement effectively made information exchange upon request the international standard for international cooperation in tax matters.[52] It even included some incremental improvements over the pre-HTC period in that it prohibited compliant countries from refusing to transfer information on the grounds that (1) they did not collect requested data domestically, or (2) had banking secrecy provisions in place that outlawed such transfers.[53] Yet, when the CFA also included these provisions in the OECD's Model Tax Convention, the template for double tax agreements, Switzerland and Luxembourg (subsequently joined by Austria and Belgium), upheld reservations against the relevant articles 23 to 26.[54] Previously, they had already vetoed a CFA decision, obliging OECD member states to provide domestic tax authorities access to banking information, which was the first time a veto had been used in that body.[55] Once more, these countries had thus made clear they did not consider themselves bound by OECD recommendations. As their cooperation was the crucial prerequisite for

[46] Sharman 2006b, 91–92.
[47] cited by: Guerrera and Parker 2002.
[48] Rixen 2008, 138.
[49] Ibid.
[50] Pollack 2004.
[51] O'Neill 2001c.
[52] Rixen 2008, 139.
[53] Webb 2004, 818.
[54] Ibid., 820.
[55] Parker and Burton 2003.

countermeasures against non-compliant jurisdictions outside the OECD, their continued opposition took the sanction threat off the table for good.[56]

At this point, what started as a dynamic anti-tax haven initiative had "[slowed] to the speed of the last ship in the convoy."[57] John Snow, O'Neill's successor as Secretary of the Treasury, urged Switzerland, the main instigator, to be more forthcoming in its replies to requests for administrative assistance. Yet, this came in the form of appeals rather than demands backed up by credible sanction threats.[58] At the same time, the Global Forum set out to review the implementation of the "upon request standard" in its 82 member countries. In a report published in 2006, it concluded that most national tax authorities were able to access bank data. However, only 50 countries also exchanged such information for tax purposes.[59] In addition, members of the Global Forum had also begun to sign TIEAs, the situation was, however, far from sufficient for putting a meaningful constraint on tax evasion. The US, for instance, had pledged to strike agreements with 50 percent of the 35 tax havens originally blacklisted by the OECD by 2002.[60] By 2008, however, it had only concluded 11 such agreements.[61] Next to industry champions Switzerland and Luxembourg there were thus plenty of jurisdictions left that did not even grant administrative assistance under the restrictive circumstances of the "upon request standard."

6.4. Theoretical Implications

In accordance with *H1* the Bush administration was dispassionate about the information exchange elements of the HTC initiative it had inherited from the Clinton administration. Like its Republican predecessors, it put emphasis on tax relief for capital, which it justified among other things with international tax competition. Strongly supporting cooperation against tax evasion and avoidance would thus have been inconsistent with its general tax policy agenda. Although the Bush administration continued to participate in the OECD's information exchange work to address law enforcement concerns, it thus revoked the organization's sanctions threat against tax havens that failed to commit to more financial transparency. Moreover, it promoted an information exchange standard that experts expected to be ineffective, and allowed OECD members Switzerland and Luxembourg to place reservations on its more robust provisions. Absent any coercive pressure, tax havens thus stuck to their

[56] Webb 2004, 819.
[57] Parker and Burton 2003.
[58] Ibid.
[59] Rixen 2008, 139.
[60] Levin and Lieberman 2001, sec. Permanent Subcommittee on Investigations 25.
[61] Global Forum 2014b.

business models, implementing cosmetic reforms at best. In accordance with the expected interaction of *H1* and *H2*, the Republican government failed to pursue meaningful tax cooperation despite there being scope for redistributive cooperation. In fact, the costs of effective information exchange, curbing tax evasion via offshore accounts, would have mainly fallen on tax haven banks instead of US financial institutions.

7. Obama, FATCA, and the Emergence of Multilateral AEI

Students of international tax cooperation agree: the Obama Administration's Foreign Account Tax Compliance Act decisively changed bargaining over more financial transparency.[1] Before the act, tax havens usually refused to provide administrative assistance to foreign tax authorities. Soon after its passage they suddenly agreed to automatically provide data on non-resident accounts on a multilateral basis. Yet, analysts still disagree on the factors enabling the act's passage, and the mechanisms through which concessions granted to the US obliged tax havens to also offer greater cooperation to the rest of the world. While some claim that the financial crisis created an important window of opportunity for measures against offshore banking,[2] others point to the UBS scandal as the decisive catalyst for enhanced tax cooperation.[3] As to the transmission mechanism, some approaches stress the importance of normative pressure exerted by the Group of Twenty nations (G20) and the Organisation for Economic Cooperation and Development (OECD).[4] After the passage of FATCA these organizations declared AEI the new global standard for tax cooperation and threatened non-compliant countries with blacklisting. Others interpret concessions to the US as focal points enabling third states to better coordinate their anti-tax haven strategies.[5]

This chapter will demonstrate that FATCA has its origins in the longtime efforts of anti-tax haven activists within the Democratic Party. These activists utilized testimony from a whistleblower and former UBS private banker to prepare a report on the bank's illegal offshore business with US clients. To increase publicity, they held a corresponding Senate hearing, which eventually triggered the UBS scandal. Shortly afterwards Barack Obama entered office. The scandal, his cordial relationship to Democratic anti-tax haven activists, and personal interest in the issue made combatting tax evasion and avoidance a top priority for his administration. In contrast to proposed anti-avoidance measures potentially affecting US multinationals, legislation requesting more transparency from foreign banks serving US clients easily passed Congress. The result was FATCA, a law threatening foreign financial

[1] Eccleston and Gray 2014; Emmenegger 2015; Grinberg 2012.
[2] Eccleston and Gray 2014.
[3] Emmenegger 2015.
[4] Eggenberger and Emmenegger 2015.
[5] Emmenegger 2015.

institutions (FFI) unwilling to report account data of US clients with a 30 percent withholding tax on payments from US sources. The act changed international bargaining over information exchange via two channels. Firstly, by forcing tax havens to enter into AEI agreements with the US, FATCA activated a most-favored-nation clause obliging EU members to grant greater cooperation offered to a third country also to each other. In addition, the principle of AEI contained in FATCA preempted Swiss attempts at promoting anonymity preserving withholding agreements as the international standard. Faced with the prospect of applying AEI to US clients and different withholding regimes to other nationalities, even Swiss banks eventually realized that a single global standard, although it meant more transparency, was less costly for them. Eventually, the US exploited widespread compliance with AEI by refusing to participate itself. Therefore, the country currently enjoys an almost exclusive competitive advantage in the attraction of hidden capital.

7.1. The Obama Administration's (International) Tax Policy Agenda

The Bush tax cuts of 2001 and 2003, and the resulting spike in income inequality made tax justice an important theme for Democratic presidential candidates ahead of the 2008 elections. Hillary Clinton regularly referred to "the President's reckless tax cuts to those at the top" in her campaign speeches.[6] Likewise, John Edwards argued "our tax system has been rewritten by George Bush to favor the wealthy and shift the burden to working families" during Democratic primaries.[7] The candidate putting most emphasis on this issue, however, was Barack Obama, who devoted an entire keynote speech to "tax fairness for the middle class" in September 2007.[8] In that speech, he identified "a successful strategy [by special interests] to ride anti-tax sentiment in this country toward tax cuts that favor wealth, not work," linking that strategy to increasing wealth and income inequality, and pledging to restore a progressive tax system. To that effect, he promised to "end the preferential treatment that's built into our tax code by eliminating corporate loopholes and tax breaks," announced lower taxes on labor and consumption, and declared the US would "lead the international community to new standards of information sharing" in the fight against tax evasion.[9]

This emphasis was certainly politically opportune, as a large majority of respondents polled by Gallup in April 2007 felt corporations and upper-income people were paying too

[6] Clinton 2007b; Clinton 2007a.
[7] Edwards 2007.
[8] Obama 2007.
[9] Ibid.

little tax.[10] Yet, this sentiment is quite constant over time, and Barack Obama had a history of promoting progressive tax reforms. As a an Illinois state senator he had sponsored the state's "earned income tax credit" in 2000, providing low to moderate-income earners with a tax break.[11] As a US senator he had participated in several attempts at making minimum wage earners eligible for a child tax credit on their income tax.[12] Moreover, he had co-sponsored Senator Carl Levin's "Tax Shelter and Tax Haven Reform Act" in 2005, and his "Stop Tax Haven Abuse Act" in February 2007.[13] The 2005 bill *inter alia* proposed penalties for the promoters of tax avoidance schemes qualified as abusive by the Internal Revenue Service (IRS), and the abolition of tax credits for taxes paid to tax haven governments.[14] The 2007 bill reintroduced some of these measures. More importantly, however, the act sought to enable the Treasury Secretary to prohibit the opening of correspondent accounts in the US, and the acceptance of credit cards issued by FFIs from a country seen as impeding US tax enforcement.[15] Barack Obama's interest in tax justice had thus clearly developed ahead of the financial crisis. Rather than just a useful campaign topic for the 2008 elections, it seems to have been part of his more fundamental political convictions as a "loyal Democrat."[16]

Nonetheless, the bank bailouts of 2008 provided a breeding ground for public outrage over the concealment schemes used by United Bank of Switzerland, and Liechtenstein Global Trust to hide their US clients from the IRS. Under the leadership of Carl Levin, the Senate Permanent Subcommittee on Investigations (PSI) had already revealed in a 2006 report that Swiss and Liechtenstein banks helped their US clients to circumvent the Qualified Intermediary (QI) program.[17] The QI program had been set up by the IRS under Clinton mostly to get an overview over who held US securities offshore. Yet, it also obliged FFIs to collect withholding taxes on US-source capital income on behalf of the IRS, and report US clients holding US securities directly to the service. As an incentive for signing up, the IRS exempted participating FFIs from withholding taxes on their US investments. Virtually all FFIs doing business in the US thus registered as QIs. But instead of fulfilling the reporting requirement, they created or purchased interposed legal entities registered in Panama and other secrecy jurisdictions, to hide the true residence of their US beneficial owners. As a result, foreign corporations formally received 70 percent of US-source capital income in

[10] Carroll 2007.
[11] Irvine 2000.
[12] cf. Lincoln 2005; Obama 2006; Snowe 2005.
[13] cf. Levin 2005; Levin 2007.
[14] Levin 2005.
[15] Levin 2007.
[16] Curry 2008; GovTrack 2008.
[17] Levin and Coleman 2006.

2003.[18] Despite the report and a corresponding hearing before the PSI, however, the issue did not attract much public attention throughout 2006 and 2007.[19]

This changed significantly when the PSI released a second report, and held another hearing on the issue in July 2008.[20] The report benefitted greatly from the testimony of Bradley Birkenfeld, a former UBS private banker who had participated in an IRS whistleblower program, following a 2006 reform guaranteeing informant awards.[21] Birkenfeld provided the IRS, PSI, and Department of Justice (DoJ) with documents and e-mails proving the setup of a program by senior UBS private bankers for the systematic circumvention of the QI program's reporting requirement.[22] Based on this evidence the DoJ detained Martin Liechti, head of wealth management for North and South America at UBS, in April 2008,[23] while the IRS obtained a first John Doe Summons from a US federal judge, obliging UBS to surrender 19.000 client files or be subject to civil penalties in the US[24] Under the impression of this concerted action, Mark Branson, the Chief Financial Officer (CFO) of UBS' global wealth management branch, admitted wrongdoing during the PSI hearing in July, and announced UBS would end its offshore business with US clients.[25] Against the background of Treasury's recent bailouts of Bear Stearns, Freddie Mac, and Fannie Mae, the PSI report's estimate that circumvention of the QI program cost Treasury $100 billion in tax revenue, implying a higher tax burden for honest US taxpayers,[26] created what a senior OECD tax official called "the perfect storm."[27]

Carl Levin and his co-sponsor Barack Obama used increased media attention to call for the swift adoption of their anti-tax haven bill. While Levin spread the message in several TV interviews,[28] Obama issued a press statement saying "Washington must take the recommendations of the Subcommittee's report seriously […] and enact the Stop Tax Haven Abuse Act that I introduced with Senators Levin and Coleman to combat tax abuse."[29] Although there was no immediate legislative activity ahead of presidential elections, senior IRS and DoJ officials, who had either already been confirmed by the Democratic Senate

[18] Government Accountability Office 2007.
[19] A Nexis search for "Qualified Intermediary Program" in all English language news retrieved six articles between August 2006, when the PSI report was released, and December 2007.
[20] A Nexis search for "Qualified Intermediary Program" in all English language news retrieved 41 articles between July and December, but only three articles between January and June 2008.
[21] Hässig 2010; IRS 2015.
[22] Hässig 2010.
[23] Simonian 2008.
[24] Schaub 2011, 808.
[25] Senate 2008b, 36ff.
[26] Levin and Coleman 2008.
[27] Interview 6 March 2014.
[28] Levin 2008a; Chung 2008.
[29] States News Service 2008.

majority,[30] or were positioning themselves for promotion under the incoming Democratic administration,[31] heard the message and intensified their efforts. In November 2008 the DoJ indicted Raoul Weil, head of global wealth management at UBS, for "conspiring with other executives, managers, private bankers and clients of the banking firm to defraud the United States."[32] The following month it offered UBS a deferred prosecution agreement (DPA) providing for the suspension of criminal investigations against the bank in exchange for a $780 million fine and the transmission of 250 client files. In parallel, Treasury officials worked with their French and German counterparts to put the issue of financial opacity on the agenda of the G20.[33] Despite its remote connection to the outbreak of the financial crisis heads of state and government thus declared at their first crisis meeting in Washington that "lack of transparency and a failure to exchange tax information should be vigorously addressed."[34] In reaction, the OECD circulated an updated draft black list of countries not complying with its upon-request standard for information exchange, prompting Austria, Luxembourg and Switzerland to drop their reservations against the administrative assistance clause of the OECD's model tax convention in March 2009.[35] This was considered a breakthrough at the time, but proved little effective in curbing tax evasion, owing to the weakness of the upon-request standard.[36] In any event, Treasury officials and congressional staff were already preparing the next step.

7.2. Anti-Tax Haven Legislation

When Barack Obama took office as president of the United States of America in January 2009, he was committed by his own statements, and to his former co-sponsor Carl Levin to push for the adoption of the Stop Tax Haven Abuse Act. However, Treasury officials were skeptical towards the bill, as they perceived the proposed exclusion of tax haven FFIs from correspondent accounts in the US as too disruptive. Instead, they suggested an approach complementary to the QI program, extending its reporting requirements, and using a 30 percent withholding tax on the US-source revenue of non-compliant FFIs as sanctions mechanism. During the following months this proposal was further developed in a drafting process led by the Chief Tax Counsel of the House Ways and Means Committee, and with

[30] Senate 2008a, sec. Senate Finance Committee.
[31] Hässig 2010.
[32] DoJ 2008.
[33] Interviews on 6 March 2014, 14 November 2014 and 28 January 2015.
[34] G20 Leaders 2008.
[35] OECD 2009.
[36] Johannesen and Zucman 2012.

representation from the IRS and Senate Finance Committee. According to several interview partners, the most senior people in the room had already drafted the QI program under Clinton.[37] The final product was then part of a long list of anti-evasion and avoidance measures included in Treasury's Green Book on revenue proposals for 2010,[38] and discussed in the President's budget proposal.[39]

On the occasion of the release of these documents, President Obama, and Secretary of the Treasury, Timothy Geithner, announced a two-pronged strategy for "leveling the playing field" for US taxpayers. Its first element was the "[removal] of tax incentives for shifting jobs overseas" through reforms of deferral, and foreign tax credit rules often exploited by corporations to minimize their tax bill. Its second element, "getting tough on overseas tax havens," involved the closure of loopholes in check-the-box rules, allowing multinationals to set up hybrid entities in offshore centers to avoid taxes, an increase in IRS staff investigating tax evasion, and the extension of the QI program's reporting requirements and sanctions mechanisms discussed above.[40] In a concomitant press conference, President Obama explained, "we're beginning to restore fairness and balance to our tax code. That's what I promised I would do during the campaign, that's what I'm committed to doing as President."[41]

Although Obama threw his full weight behind these measures, and could work with Democratic majorities in both chambers of Congress until 2011, proposals interfering with corporate tax planning did not go far. Just like under Clinton, Treasury faced massive opposition from multinationals and their lobbyists against a reform of check-the-box rules (*see chapter 4*).[42] Again, business argued their amendment would lead primarily to higher taxation of US corporations in EU countries, as a disjunction of their hybrid subsidiaries in Ireland, Luxembourg, or the Netherlands endangered the schemes set up to channel profits out of the common market. According to a tax expert with the congressional staff, many lawmakers were impressed by that argument, thinking, "it was better for US companies to make money than for Europe to make money as a result of US tax reform."[43] So instead of repealing check-the-box rules, in 2010 the Democratic Congress extended the provisions that had turned them from regulation into legislation under George W. Bush. Even Carl Levin

[37] Interviews on 13 and 15 April 2015.
[38] US Treasury 2009, 41.
[39] Office of Management and Budget 2009, 93–94.
[40] Office of the Press Secretary 2009.
[41] Obama 2009.
[42] Rubin and Drucker 2014; Scott 2014.
[43] Interview on 21 April 2015.

voted in favor.[44] As a result, the reform of check-the-box rules disappeared from treasury's Green Book of Revenue Proposals for fiscal year 2011.[45]

Likewise, reforms of deferral and foreign tax credit rules did not make it beyond consultation phase. In its Green Book for fiscal year 2010 Treasury had proposed to disallow the deduction of "expenses from overseas investments while deferring US tax on the income from the investment." Moreover, it sought to end corporations' ability to receive foreign tax credits for expenses that are either artificially separated from foreign profits through a hybrid entity, or based on investments in high-tax countries made only to shelter profits in low tax countries from US taxation through "cross-crediting."[46] The measures were supposed to motivate US multinationals to repatriate their foreign profits, and limit eligible credits against the corresponding tax bill. Unsurprisingly, however, business lobbyists rallied against the measures, arguing the result of repatriation and limited credits, taxation of foreign profits at 35 percent, would put US multinationals at a competitive disadvantage relative to corporations from most other OECD countries, which exempted foreign profits from taxation.[47] Senior Democratic tax writers in Congress heard their arguments. Max Baucus, Chairman of the Senate Finance Committee, commented on the Obama-Geithner initiative, saying "further study is needed to assess the impact of this plan on US business,"[48] whereas Richard Neal, Chairman of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, told reporters he had personally lobbied the president to abandon the characterization of tax deferral on foreign profits as tax avoidance.[49] Owing to the chairmen's lack of interest in implementing measures interfering with tax planning practices, no corresponding legislation made it beyond their committees. The proposals for reforms of deferral and foreign tax credit rules were thus still included in Treasury's Green Book of Revenue Proposals when in 2013 Democrats also lost their Senate majority.[50]

The only items from the Obama-Geithner plan passed by the Democratic Congress before 2011 were those aimed at loopholes in the QI program. As such, they primarily concerned FFIs circumventing their reporting obligations. Following the drafting process discussed above, Senator Max Baucus and Representative Charles Rangel, Chairman of the House Ways and Means Committee, introduced them to Congress as the "Foreign Account

[44] Drawbaugh and Sullivan 2013.
[45] cf. US Treasury 2010, 39–49; US Treasury 2009, 28.
[46] US Treasury 2009, 29–31.
[47] Calmes and Andrews 2009; Javers 2009; Leone 2009; Montgomery and Wilson 2009.
[48] Calmes and Andrews 2009.
[49] Cohn 2009.
[50] US Treasury 2013.

Tax Compliance Act."[51] The act requires FFIs to report information on accounts held by US individuals, and – to unravel the concealment schemes used to circumvent the QI program – to legal entities beneficially owned by US individuals. For such US accounts, FFIs "must report the account balance […], and the amount of dividends, interest, other income, and gross proceeds from the sale of property."[52] The QI program's reporting requirement was thus expanded from income on US securities to all capital income earned by US residents. Moreover, FATCA does not use incentives like the QI program to make FFIs participate, but relies on coercion. As legislators put it quite explicitly, the act's objective is to "force foreign financial institutions to disclose their US account holders or pay a steep penalty for nondisclosure."[53] This penalty is a 30 percent withholding tax "on the gross amount of certain payments from US sources and the proceeds from disposing of certain US investments." These include the revenue from an FFI's own investments in the US, payments beneficially owned by its clients regardless of their residence, and so-called "pass-through payments" channeled through a participating FFI to a nonparticipating FFI.[54] The latter provision is meant to also force those FFIs into participation that are not investing in the US, but in or through participating FFIs. As one of the act's original authors puts it,

> "FATCA tries to use the combined weight of US financial markets and financial institutions that must, as a practical matter, do business in the US marketplace as leverage with other [FFIs] to ensure near-comprehensive participation in FATCA's cross-border information reporting."[55]

Given the act's focus on reporting requirements for foreign banks, US multinationals were largely unaffected and thus did not submit a position when Chairman Richard Neal held a hearing on FATCA in the Subcommittee on Select Revenue Measures.[56] Similarly, the American Bankers Association (ABA) did not object to any of the act's core provisions, as the reporting requirements and sanctions mechanism did not apply to its members. It did however insist that US banks, which were supposed to act as withholding agents for the IRS under FATCA, were given enough time to build necessary administrative infrastructure, as well as accurate information on the participation status of FFIs to avoid penalties for not fulfilling their withholding duties. Despite the additional compliance burden for US banks, ABA expressed support for "legislation that will ensure that all US citizens and residents pay their fair share of taxes, and thus, prevent loss of millions of dollars by the US because of

[51] Baucus 2009; Rangel 2009.
[52] Grinberg 2012, 23.
[53] Hire Act 2010, cited in: Ibid., 24.
[54] Ibid.
[55] Ibid., 24–25.
[56] cf. GPO 2009, sec. Subcommittee on Select Revenue Measures.

taxpayers that engage in illegal use of offshore accounts."[57] The association's positive attitude was of course grounded in the expectation that FATCA would remove incentives for US clients to hold accounts with Swiss or Liechtenstein banks, and could thus produce net new money for the private wealth management divisions of its members. Owing to FATCA's innocuousness for domestic business, Chairman Neal could thus conclude his opening statement at the FATCA hearing as follows:

> "In terms of the economic confrontation […] America currently is experiencing, […] it makes good sense, before we talk about raising revenue elsewhere, that we begin talking about closing down these tax havens and these loopholes that the American people have justly come to see being patently unfair."[58]

In other words, he was sympathetic to the idea of addressing the fairness concerns of US citizens through a crackdown on tax havens instead of a hike in taxes on domestic business. Accordingly, Patrick Tiberi, the subcommittee's ranking minority member, congratulated him on a bill that "does not blur the issues of tax evasion and legal tax practices, and does not include the most controversial international tax policy changes proposed by the Administration."[59] Owing to general agreement on FATCA's ability to send a signal of fairness to voters at virtually no cost for domestic business, the act passed Congress in March 2010 as a financing mechanism attached to a stimulus package.[60]

7.3. FATCA's Impact on International Tax Policy

7.3.1. FATCA Becomes Intergovernmental

Congress had conceived FATCA as a domestic law with extraterritorial reach, establishing a direct regulatory link between FFIs and the IRS. When it passed in March 2010, no intergovernmental approach was envisaged. In fact, its predecessor, the QI program, had worked in exactly the same way, creating obligations for foreign banks, not foreign governments. As Tanenbaum puts it, FATCA "was steamrolling down on a unilateral basis without any immediate serious attention being given to the pursuit of bilateral or multilateral alternatives."[61] Questioned as to why the US had not tried to tie FATCA into ongoing work on automatic exchange of information at OECD level (TRACE project), a former senior Treasury official replied "once FATCA was enacted, everything that went on with TRACE, well that was important and we had a lot of resources committed to it, but the law enacted in

[57] Ibid., sec. Subcommittee on Select Revenue Measures 80.
[58] Ibid., sec. Subcommittee on Select Revenue Measures 4.
[59] Ibid., sec. Subcommittee on Select Revenue Measures 5.
[60] Mollohan 2010.
[61] Tanenbaum 2012, 623.

the US had to be complied with first. So TRACE was understood as an add-on some time in the future."[62] The focus only shifted to the international level once the IRS had published the first guide to, and a timeline for, FATCA implementation in August 2011.

At this point, many FFIs realized that the act's reporting requirements would collide with data protection and banking secrecy legislation in their home countries, putting them between a rock and a hard place. Either they had to break domestic law to be FATCA compliant, or accept the 30 percent withholding tax due in case of noncompliance.[63] In addition, many FFIs wanted to avoid entering in a privity of contract with the IRS, as this was a very weak basis for changing terms and conditions for their clients, and would have subjected them to direct enforcement action by the US Instead, they preferred to fulfill FATCA reporting requirements under national law, and towards national authorities, which could then pass account information on to the IRS. Accordingly, they lobbied their respective governments for the creation of corresponding intergovernmental agreements.[64] At the same time, the US Treasury grew increasingly concerned over a Swiss campaign to strike new comprehensive withholding tax deals with other OECD members, which it understood as a challenge to the principle of AEI embedded in FATCA.[65]

The Swiss campaign was a reaction to demands from the international community for greater administrative assistance after the UBS and LGT scandals. From 2008, the DoJ had pressed an increasing number of Swiss banks for the transmission of US client files by threatening them with indictment in a US court. In parallel, the IRS had requested such files from the Swiss government through administrative assistance. After some initial resistance, the prospect of losing their US banking licenses prompted several Swiss banks to surrender requested data in violation of Swiss banking secrecy laws. In addition, the Swiss federal court removed the differentiation between tax fraud and tax evasion from Swiss tax law, which the Swiss government had until then used as an excuse for not complying with information requests. As a consequence of that decision, the Swiss government not only responded to the IRS request, it also dropped its reservation against the OECD Model Tax Convention's administrative assistance clause, which had been the basis for the organization's decision to put the country on its G20-backed tax haven blacklist in 2009. [66]

After years of concessions, the Swiss Banking Association (SBA) then tried to regain the upper hand, and preserve banking secrecy through its so-called Rubik concept for bilateral

[62] Interview 13 April 2015.
[63] Eccleston and Gray 2014.
[64] Interviews on 14 March 2014, 28 January, and 3 March 2015.
[65] cf. Grinberg 2012, 3.; Interview 15 April 2015.
[66] Emmenegger 2014; Hässig 2010.

tax treaties. The concept foresaw the collection of withholding taxes on the capital income of the treaty partner's residents, the proceeds of which would then be channeled back to the treaty partner. In addition, Switzerland would collect and transfer a one-time tax on the treaty partner's residents' financial wealth to cover past tax liabilities.[67] In exchange, the identity of nonresident investors in Switzerland should be protected, and the number of information requests from the treaty partner capped at a certain number.[68] The Swiss government, indeed, embraced this concept, and began to offer Rubik agreements to its key trading partners in December 2009.[69] In October of the next year, Swiss minister of finance, Rudolf Merz, could then announce the opening of negotiations on Rubik agreements with Germany and the United Kingdom,[70] which were interested in tapping a new, and quickly available revenue stream.[71] This provided Luxembourg and Austria with another pretext to delay the material and geographic extension of AEI at EU level.[72] More importantly, however, their interpretation of Rubik deals as a viable alternative to AEI,[73] additionally motivated the US Treasury to intercept the Swiss campaign with its own initiative for intergovernmental FATCA implementation.[74]

It was thus shortly after the UK and Germany had signed Rubik deals with Switzerland in August and September 2011,[75] that Emily McMahon, Assistant Secretary of the Treasury, announced the US "was committed to entering into bilateral and multilateral agreements that would allow financial institutions to comply with FATCA without violating local law."[76] To this effect, Treasury opened negotiations on a "common approach to FATCA implementation" with France, Germany, Italy, Spain, and the UK (EU G5).[77] From the US perspective, these countries were crucial trading partners whose tax authorities had the necessary know-how, and were engaged in cordial relationships with the IRS.[78] From the perspective of the EU G5, the US initiative provided a response to the reservations their domestic banks had against entering into direct contractual relationships with an US authority,[79] and to the difficulty they faced in materially and geographically extending AEI

[67] Grinberg 2012, 27.
[68] Interviews 8, and 16 October, and 14 November 2014.
[69] Emmenegger 2014.
[70] Israel 2010.
[71] Interviews on 28 January, and 3 March 2015.
[72] Hakelberg 2015.
[73] Israel 2010.
[74] Interviews on 13 and 15 April 2015.
[75] Warwick-Ching 2011.
[76] Grinberg 2012, 25.
[77] US Treasury 2012a, 2.
[78] Interviews on 13 and 15 April 2015.
[79] Interviews on 28 January, and 3 March 2015.

within the EU. Moreover they hoped for agreements binding the US to reciprocate information reporting.[80] After swift consultations, the US and EU G5 thus issued a joint statement in February 2012. In that statement, the EU G5 committed to implement legislation requiring their banks to collect account information as requested by FATCA, and to transfer the reported information automatically to the IRS. In exchange, the US pledged to eliminate the requirement for banks from the EU G5 to enter into direct contractual relationships with the IRS, and to reciprocate information reporting.[81] Together they committed "to working with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information."[82] In fact, one of the act's authors had already predicted in 2003 that the unilateral imposition of reporting requirements on FFIs "will spur additional multilateral cooperation and coordination."[83] Moreover, Treasury had realized at this point that FATCA treaties would meet less resistance from foreign governments, if they were embedded in a multilateral AEI framework. As a former official in the Department explained:

> "FATCA doesn't really work as a unilateral system. The secret to FATCA is that it needs the multilateral agreement. The level of resistance that you have from foreign institutions and sovereigns just disappears once you have a multilateral process. Because now you can't complain that the US is doing something. Now it's an international standard and the US is just the leading implementer. It makes a huge difference."[84]

Following the joint statement, the US thus lent additional momentum to the emergence of AEI as the new global standard for information reporting. Within the next six months, Treasury drafted a model intergovernmental agreement (IGA) in cooperation with the EU G5. The so-called Model 1 IGA, which later also provided the basis for FATCA treaties with tax havens such as the Cayman Islands or Luxembourg, contains a clause obliging signatories to cooperate with the OECD in the establishment of multilateral AEI. It states:

> "The parties are committed to working with Partner Jurisdictions and the Organisation for Economic Co-operation and Development, on adapting the terms of this Agreement and other agreements between the United States and Partner Jurisdictions to a common model for automatic exchange of information, including the development of reporting and due diligence standards for financial institutions."[85]

Given that the US and EU G5 had committed each other as well as future signatories of FATCA Model 1 agreements to pursuing multilateral AEI, it was only consistent that G20

[80] Interview on 14 March 2014.
[81] US Treasury 2012a, 2–3.
[82] Ibid., 3.
[83] Graetz and Grinberg 2003, 584.
[84] Interview on 15 April 2015.
[85] US Treasury 2012c, art. 6 para. 2. According to an OECD tax official interviewed on 6 March 2014, this wording was understood as obliging signatories to cooperate with the OECD in establishing multilateral AEI.

ministers of finance commissioned the OECD shortly afterwards to deliver a report on AEI. G20 leaders approved this report in June 2012, calling on all countries to adopt the practice.[86] The same month, the US and Switzerland issued a separate joint statement on FATCA implementation, declaring "their intent to negotiate an agreement providing a framework for cooperation to ensure the effective, efficient, and proper implementation of FATCA by financial institutions located in Switzerland."[87] The corresponding treaty was based on an alternative model agreement, providing for the direct reporting of account information from FFIs to the IRS, and finalized in December 2012. Four years after the UBS scandal, and following constant pressure from DoJ and IRS on the Swiss government and financial sector, Switzerland had thus finally lifted banking secrecy for the United States.[88] By not transmitting account information to the IRS itself, however, the Swiss government had initially tried to limit the damage, save its Rubik campaign, and avoid demands from other governments for equivalent cooperation.[89]

To no avail; although the German ministry of finance had tried to play a double strategy, sticking to the Rubik deal to recover past tax liabilities of German tax evaders in Switzerland while promoting AEI as the new global standard through cooperation with the US, and in the G20,[90] the agreement failed in Bundesrat, the German parliament's upper chamber, in November 2012.[91] Social Democrats and Greens, which then held a majority in the chamber, had, in fact, taken issue with several elements of the Swiss-German Rubik deal. At a most fundamental level, they criticized the preservation of anonymity, and the post-hoc legalization of hidden wealth as an undue privilege for German tax evaders in Switzerland, which, after all, had broken the law by underreporting their capital income.[92] Moreover, they argued the agreement would undermine the work of German tax investigators, since it limited the number of information requests to 1500 a year, and banned the active solicitation of stolen account data,[93] which had proven quite an efficient tool at the time to create media attention, waves of voluntary disclosures, and billions in additional tax revenue.[94] In addition to these domestic concerns, however, Greens and Social Democrats also embraced arguments put forward by the EU, OECD, and US, saying a Swiss-German Rubik deal would at least delay

[86] G20 Leaders 2012, 9; G20 Ministers 2012, para. 9.
[87] US Treasury 2012b, 1–2.
[88] Emmenegger 2014.
[89] cf. Barandun, Niederberger, and Valda 2012; Niederberger 2012; Rutishauser 2012a; SDA 2012a.
[90] Interviews on 15 October 2014, 28 January, and 3 March 2015.
[91] Bundesrat 2012.
[92] Ibid., 500.
[93] Interviews on 8, 16 October, and 14 November 2014.
[94] Finanzministerium des Landes Nordrhein-Westfalen 2014; Ministerium für Finanzen und Wirtschaft Baden-Württemberg 2013.

the material and geographic extension of AEI via FATCA.[95] Following a recommendation from the OECD's Centre for Tax Policy, Green members of the Bundestag's Finance Committee had, for instance, invited Itai Grinberg, former Treasury official and one of the authors of FATCA, to explain at a public hearing why a Swiss-German Rubik deal could give other offshore centers a pretext to oppose multilateral AEI.[96] German opposition had thus bought into the strategic considerations of international AEI proponents before rejecting the Rubik deal in Bundesrat.

The almost simultaneous failure of the Swiss-German Rubik deal, and Swiss agreement to a FATCA treaty with the US finally cleared the way for the ascent of AEI as the new global standard for cooperation against tax evasion. While the US sped up its efforts to extend the reach of FATCA worldwide, striking corresponding treaties with 112 jurisdictions, including all major offshore centers,[97] Eveline Widmer-Schlumpf, Swiss minister of finance, announced shortly after agreeing to a FATCA treaty with the US she would also enter into a dialogue on AEI with the EU.[98] Moreover, she created the "Brunetti Group" tasked to develop proposals for the reorientation of Swiss international tax policy.[99] These developments broke deadlock in negotiations among member states on a material and geographic extension of AEI within the EU,[100] made the G20 endorse automatic exchange of information as global standard,[101] and eventually led to the creation by the OECD of a "common reporting standard" based on FATCA,[102] and its adoption by more than 50 governments through the "multilateral competent authority agreement."[103]

7.3.2. FATCA enables agreement on AEI at EU and OECD level

At EU level, Luxembourg and Austria, the biggest recipients of non-resident deposits from within the euro area,[104] were blocking AEI on interest payments to non-residents since the Commission had proposed a Savings Directive in 1998.[105] The Council of Ministers still adopted the Directive in 2003, but to reach consensus its proponents had to concede Luxembourg, Austria, and Belgium the right to levy a withholding tax on interest payments to non-residents instead of collecting account information on behalf of EU partners. This meant

[95] Bundestag 2010, 8472; Bundestag 2012b, 20656; Interviews on 8 October and 14 November 2014.
[96] Bundestag 2012a, 16; Interview on 16 October 2014.
[97] US Treasury 2014a.
[98] Valda 2012a.
[99] Valda 2012b.
[100] Hakelberg 2015.
[101] G20 Leaders 2013.
[102] OECD 2014d.
[103] OECD 2014b.
[104] ECB 2015.
[105] Genschel 2002, 150–152.

some additional tax revenue for the rest of the EU, but account holders in these countries remained anonymous.[106] The opt-out should end once Switzerland and several non-EU microstates started to report information on EU account holders upon-request.[107] Yet, as expected by Luxembourg *et al.*, they merely accepted the same withholding option in their Savings agreements with the EU, postponing EU-wide AEI into the indefinite future.[108]

Following the LGT scandal, Peer Steinbrück, German minister of finance, then put a revision of the Savings Directive on the agenda of the March 2008 Council on Economic and Financial Affairs (ECOFIN).[109] With the support of his French and Italian homologues he encouraged the Commission to speed up the Directive's review, and called for a "material and geographic extension" of its AEI mechanism.[110] The Commission presented a corresponding report in fall 2008,[111] conceding that investors could circumvent the Directive by either hiding behind interposed legal entities, or investing in equity rather than interest producing debt securities.[112] As remedies it advocated a look-through approach, obliging banks to use information obtained through know-your-customer due diligence when determining account ownership, and an extension of the Directive's scope to securities investors may consider equivalent to debt in terms of their risk profile.[113] In contrast, the Commission did not propose changes to the AEI opt out granted to Luxembourg *et al.*

Instead of a swift revision of the Savings Directive, however, Germany, France, and other large EU members received what Luxembourgish Prime Minister Jean-Claude Juncker had already announced at the March 2008 ECOFIN meeting: "many years of fascinating debate."[114] During the next four years, Council presidencies made six attempts at passing a revised draft, and a mandate for Commission negotiations with Switzerland on a corresponding Savings agreement.[115] Every time, Luxembourg and Austria refused to agree, arguing a level international playing field had to be established ahead of their consent. That is, Switzerland had to first signal its willingness to practice AEI with the EU. Otherwise, capital flight from the common market was the likely result.[116] In turn, Switzerland used the non-

[106] Rixen and Schwarz 2012.
[107] European Community 2003, p. art. 10.
[108] Council 2004; Johannesen 2014.
[109] Mussler 2008.
[110] BMF 2008, 31; Commission 2008c.
[111] Commission 2008b.
[112] Research by academics and journalists later revealed that Swiss, and Luxemburgish wealth managers had created, or purchased a massive number of mostly Panamanian corporations on behalf of their clients just after the Savings Directive and Agreement entered into force in 2005 Johannesen 2014; Obermayer and Ott 2015.
[113] Commission 2008a.
[114] Mussler 2008.
[115] Council 2009; Council 2010; Council 2011a; Council 2011b; Council 2012b; Council 2012a.
[116] SDA 2009; SDA 2010a; SDA 2011a; SDA 2011b; SDA 2012b; Council 2012a.

participation of Luxembourg and Austria in intra-EU AEI to justify its unwillingness to do just that.[117] Interestingly, however, it offered to update its Savings Agreement with the EU in accordance with the OECD's upon-request standard.[118] Yet, Swiss politicians knew that the Savings Directive's transition clause made this the crucial condition for a removal of the transitory withholding option,[119] which gave Luxembourg and Austria an additional reason to block any mandate for commission negotiations on a revised Savings Agreement. Owing to the unanimity requirement in tax matters there was little to nothing large EU members could do to break this arrangement.[120]

The only item on intra-EU cooperation in direct taxation that passed during this period was a severely stripped down version of a proposal the Commission had made for an Administrative Cooperation Directive. It foresaw that the Commission, assisted by a committee of national tax experts, should define income types subject to AEI, as well as the conditions under which information should be exchanged.[121] That way, cumbersome Council procedures could have been circumvented in the future. Unsurprisingly, however, Luxembourg and Austria opposed such annulment of their de-facto veto power in tax matters. As a result, the final version of the Directive agreed in December 2010 left everything as it was. AEI became an option for future administrative assistance, but covered income types had to be agreed in subsequent Council decisions.[122] Moreover, the Luxembourgish and Austrian finance ministers could celebrate the codification of the availability principle. That is, even if the Council decided to practice AEI on capital income other than interest, tax authorities only needed to transmit data readily available to them. Data they did not collect domestically was thus excluded from EU-internal exchange in any case.[123] Eventually, the directive only served to transpose the OECD's upon-request standard into EU law, including a customary most-favored-nation (MFN) clause obliging member states to extend any greater cooperation offered to a third country also to each other.[124] This MFN clause seemed benign in December 2010, and thus passed without debate. But the intergovernmental implementation of FATCA should soon turn it into a Trojan horse, breaking Austrian and Luxembourgish opposition to intra-EU AEI.

[117] Naegeli 2010.
[118] Naegeli 2011.
[119] European Community 2003, p. art. 10.
[120] Hakelberg 2015.
[121] Commission 2009.
[122] European Union 2011, p. art. 8.
[123] Ibid., p. art. 3; SDA 2010b.
[124] European Union 2011, p. art. 19.

The same week that Eveline Widmer-Schlumpf announced agreement on a FATCA treaty with the US, Luc Frieden, Luxembourg's minister of finance, declared his country would also enter negotiations on a FATCA deal, and extend equivalent cooperation to EU partners.[125] A few months before, he had still argued in the Council on Economic and Financial Affairs (ECOFIN) that the Swiss-German Rubik deal was the better model for an EU-wide solution than AEI. Yet, its failure in the German Bundesrat had definitively taken that option off the table. Frieden's announcement was thus a major and quite sudden change of tack, the underlying reasoning of which Jean-Claude Juncker, prime minister of Luxembourg, made explicit in his state of the nation speech a few months later:

> "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."[126]

As Germano Mirabile, head of sector for savings taxation at the Commission, explained in May 2013, the reason why Luxembourg could not refuse to grant equivalent cooperation to EU partners was the MFN clause contained in article 19 of the Administrative Cooperation Directive. "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."[127] Other interview partners confirmed the importance of Luxembourgish participation in FATCA for its acceptance of AEI within the EU and beyond, and the crucial role of the MFN clause as transmitter of US pressure to the European level.[128]

The clause was equally important in relations between the EU Group of Five (G5) and the Austrian government, which was less forthcoming than Luxembourg despite the launch of negotiations on a FATCA treaty with the US in January 2013.[129] In fact, the Austrian finance ministry initially argued a direct transmission of account data from Austrian banks to the US, as foreseen by the alternative model IGA agreed between Switzerland and the US, would not create an obligation to accept AEI within the EU, as Austrian authorities were not directly involved in the reporting. From its legal standpoint, Austrian banks were cooperating with the US as a result of the FATCA agreement, not the Austrian government.[130] Yet, this

[125] Valda 2012a.
[126] Juncker 2013, 16-17; cited in Hakelberg 2015, 12.
[127] Interview on 24 May 2013.
[128] Interviews on 5, 7, 14, and 28 March 2014, and 3 March 2015.
[129] Standard 2013.
[130] Bramerdorfer 2015; Szigetvari 2014; Interview on 14 July 2014.

interpretation was far from compelling, as the FATCA Model Agreement on which it was based states in article two that

> "[FATCA Partner] shall direct and enable all Reporting [FATCA Partner] Financial Institutions to […] register on the IRS FATCA registration website with the IRS by July 1, 2014, and comply with the requirements of an FFI Agreement, including with respect to due diligence, reporting, and withholding."[131]

The agreement thus bestows an active role on the Austrian government in facilitating automatic information reporting by its financial institutions to the IRS. Therefore, there may have been a basis for an application of the MFN clause. At any rate, the disputed legal situation enabled the EU G5 to uphold a credible threat of suing Austria before the European Court of Justice for respect of the MFN clause. As a senior tax official from one of the EU G5 explained:

> "We told them explicitly in bilateral conversation: either you participate in AEI, or we will apply the MFN clause. And then you can go ahead and take legal action, à la this isn't even a case for the MFN clause, but that will take three to five years and you won't be able to see through that."[132]

To further increase the pressure on Austria, EU G5 finance ministers also sent a joint letter to Algirdas Semeta, EU Commissioner for Taxation, in April 2013, urging effective application of the MFN clause, and calling "on all EU Member States […] to agree without delay on the amending proposal to the Savings Taxation Directive of 2003."[133] This concerted action against isolated Austria had the desired effect.[134] At the ECOFIN meeting in May 2013 Maria Fekter, Austrian minister of finance, finally agreed to a mandate for Commission negotiations on a revised Savings agreement with Switzerland. In addition, EU finance ministers decided the revised Savings Directive should be passed once Switzerland signaled its willingness to practice AEI with the EU in these negotiations.[135] The latter point was an easy concession to Austrian and Luxembourgish concerns over a level playing field, as Eveline Widmer-Schlumpf had already announced in December 2012 she would discuss AEI with the EU.

In parallel to the US-induced breakthrough at EU level, the intergovernmental implementation of FATCA also put AEI on the agenda of the G20, and the OECD. After G20 leaders had already called on all countries to adopt this practice in June 2012, and the EU G5 had declared their intention to develop a multilateral tax information exchange agreement based on the FATCA Model IGA they had agreed with the US, finance ministers and central bank governors reiterated their support in April 2013, endorsing AEI as "the expected new

[131] US Treasury 2014c, 6.
[132] Interview on 3 March 2015.
[133] EU G5 Finance Ministers 2013, 1–2.
[134] Interview on 7 March 2014.
[135] Council 2013.

standard."[136] Under the impression of this renewed momentum, the Brunetti Group created by the Swiss minister of finance recommended in June 2013 that Switzerland should practice AEI with the EU and other countries to avoid parallel standards, and thus minimize compliance costs for Swiss banks.[137] Beginning with Pierin Vincenz, CEO of Swiss Raiffeisen Group, an increasing number of Swiss bankers had, indeed, come to the conclusion over the course of 2012 that the administration of multiple Rubik agreements was more complex than the automatic reporting of account information based on a single global standard.[138] As Vincenz explained in an interview, "if we agree a withholding tax with all neighboring countries this gets very complex, because every country has a separate method for its calculation. Moreover, there will have to be continuous updates. […] And there will be automatic exchange of information with the US anyway."[139] By June 2013 the CEO of UBS, the Swiss Bankers Association and the Swiss Private Bankers Association had also adopted that position.[140] After publication of the Brunetti Group's report, the Swiss ministry of finance thus acknowledged that AEI would become the new global standard for tax cooperation, and pledged active participation in its development.[141] Moreover, Eveline Widmer-Schlumpf followed up on her December 2012 statement, declaring Switzerland would apply a global AEI standard negotiated at the OECD in its relations with the EU.[142]

In September 2013 G20 leaders eventually endorsed AEI as the new global standard, calling on the OECD to develop a framework for its coherent worldwide application by mid-2014.[143] The OECD modeled this "common reporting standard" on the FATCA IGA agreed between the US and the EU G5 to avoid double regulation and ensure a level international playing field. As an OECD official involved in its drafting explained, "this made sense on a pragmatic level. FATCA is quite broad so it is useful for many countries. And why invent the wheel again, when you have a standard with a lot of bite? In the end, it is better to have a single standard than several."[144] With the Swiss vote, the standard passed the OECD Committee on Financial Affairs in February 2014.[145] Tax Commissioner Semeta could thus report to EU finance ministers shortly afterwards that Switzerland was seeking agreement on

[136] OECD 2014d, 9.
[137] Brunetti 2013.
[138] Flubacher 2012.
[139] Rutishauser 2012b.
[140] cf. Flubacher 2012; SDA 2013a; SDA 2013b.
[141] EFD 2013.
[142] Valda 2013.
[143] G20 Leaders 2013.
[144] Interview on 6 March 2014.
[145] Interviews on 4, and 6 March 2014.

AEI based on the new global standard.[146] After six years of fascinating debate, ECOFIN could thus reach agreement on the revised Savings Directive in March 2014.[147] Moreover, the subsequent European Council ordered finance ministers to adopt a revised Administrative Cooperation Directive by the end of 2014, now intended as a vehicle to transpose the OECD AEI standard into EU law.[148] Owing to newly established consensus, work went ahead quickly, and ECOFIN was in a position to adopt the Directive in October 2014. It codifies comprehensive intra-EU AEI on all types of capital income starting on 1 January 2017, with Austria joining a year later on 1 January 2018.[149] Beyond the EU, 51 countries used the G20's endorsement of the OECD common reporting standard (CRS) in September 2014 as the occasion to sign a multilateral competent authority agreement in Berlin, committing signatories to begin exchanging bank data among each other based on the OECD AEI standard from 1 September 2017, or 2018,[150] including Switzerland, Luxembourg, Austria, and the Cayman Islands.[151] An additional 50 countries subsequently expressed support for the standard, including Hong Kong, and Singapore (*Table 7-1*).[152]

By imposing FATCA on FFIs worldwide, developing an intergovernmental approach to its implementation with the EU G5 and striking bilateral FATCA treaties with 112 jurisdictions, the US had thus enabled agreement on AEI within the EU and at the global level. Within the EU, Luxembourg and Austria would have risked legal action by the G5, if they had not accepted AEI after entering into negotiations on FATCA agreements with the United States. At the global level, the imposition of AEI through FATCA changed the preferences of tax haven banks. Before FATCA, financial institutions from Switzerland and other offshore centers were seeking to apply the least stringent form of tax cooperation with foreign governments. When FATCA forced them to build the infrastructure for automatic reporting of account information, they became interested in practicing a single global standard to minimize compliance costs. As a result, jurisdictions submitting to FATCA generally also pledged to apply the OECD CRS in their relations with other countries (*Table 7-1*). This, in turn, reduced the risk of capital flight from Luxembourg and Austria to third countries linked to the acceptance of AEI at EU level. By facilitating a multilateral AEI regime through FATCA, the US had thus created a level playing field for secrecy jurisdictions in- and outside the EU. However, the AEI regime's architect was itself missing from the list of signatories of

[146] Semeta 2014.
[147] European Union 2014a.
[148] European Council 2014.
[149] Council of Ministers 2014.
[150] OECD 2014b.
[151] OECD 2014c.
[152] SDA 2014.

the Multilateral Competent Authority Agreement (MCAA), as accession to the agreement would have meant adoption of reciprocal AEI.[153] As the next section will show, the US financial sector is fiercely opposed to new domestic reporting requirements that would enable reciprocity. At the same time, the Obama administration is unwilling to pick a fight with finance over this issue. Hence, what politicians and activists alike celebrated as a historic breakthrough for international tax cooperation suffers from a major equity problem: the lack of reciprocal exchange of information from the United States.

Table 7-1: Adoptions of AEI Among Top 25 Secrecy Jurisdictions

		OECD AEI Standard	
Jurisdiction	FATCA Agreement (date of formal signature)	Signed MCAA (agreed AEI start)	Political Endorsement (pledged AEI start)
Switzerland	YES (14 Feb 2013)	YES (September 2018)	
Luxembourg	YES (28 Mar 2014)	YES (September 2017)	
Hong Kong	YES (13 Nov 2014)	NO	YES (September 2018)
Cayman Islands	YES (29 Nov 2013)	YES (September 2017)	
Singapore	YES (12 Sep 2014)	NO	YES (September 2018)
USA	No full reciprocity	NO	NO
Lebanon	NO	NO	NO
Germany	YES (31 May 2013)	YES (September 2017)	
Jersey	YES (13 Dec 2013)	YES (September 2017)	
Japan	YES (11 Nov 2013)	NO	YES (September 2018)
Panama	YES (not yet signed)	NO	NO
Malaysia	YES (not yet signed)	NO	YES (September 2018)
Bahrain	YES (not yet signed)	NO	NO
Bermuda	YES (19 Dec 2013)	YES (September 2017)	
Guernsey	YES (13 Dec 2013)	YES (September 2017)	
UAE	YES (not yet signed)	NO	YES (September 2018)
Canada	YES (5 Feb 2014)	NO	YES (September 2018)
Austria	YES (29 Apr 2014)	YES (September 2018)	
Mauritius	YES (27 Dec 2013)	YES (September 2017)	
British Virgin Islands	YES (30 Jun 2014)	YES (September 2017)	
United Kingdom	YES (12 Sep 2012)	YES (September 2017)	
Macao	YES (not yet signed)	NO	YES (September 2018)
Marshall Islands	NO	NO	YES (September 2018)
Korea	YES (not yet signed)	YES (September 2017)	
Russia	NO	NO	YES (September 2018)

Sources: OECD 2014c.; OECD 2014a.; TJN 2014.

7.4. The Lack of Reciprocity from the United States

Neither FATCA agreements nor the MCAA, which it has not signed, legally bind the United States to reciprocate the information reporting it requests from other countries. The US is thus receiving data on American account holders from most jurisdictions, but is not obliged to disclose equivalent information on non-residents to treaty partners. In fact, the US government only pledges to reciprocate information reporting on non-resident account holders

[153] Vasagar and Houlder 2014.

in one variant of FATCA treaties, the Model 1 IGA agreed with the EU G5. Yet, even this IGA does not provide for full reciprocity, given that the US lacks the domestic regulations to collect all the data from US financial institutions it requests from FFIs, including non-residents' account balances, non-US-source dividends, and beneficial ownership of interposed legal entities.[154] Accordingly, Model 1 IGAs feature the following qualificatory clause:

> "The United States acknowledges the need to achieve equivalent levels of reciprocal automatic information exchange with [FATCA Partner]. The United States is committed to further improve transparency and enhance the exchange relationship with [FATCA Partner] by pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic exchange."[155]

The Obama administration, indeed, included requests for full FATCA reciprocity in its 2013, and 2014 budget proposals.[156] However, these requests did not appear in corresponding Green Books on Revenue Proposals, which are the documents US tax experts consult when in doubt over Treasury's intentions. As a former Treasury official explained:

> "The budget of the United States says a bunch of [stuff] that has to do with the spending side, and occasionally it has some language about tax. But that language is political rhetoric. The real proposals, fledged out at a level of detail that matters, are in the Green Book. Not in the Green Book? There is no proposal for reciprocity! In other words, the document a tax lawyer would read doesn't even have it. […] And that is something you often see in international economic politics, that you send different messages to national and foreign audiences. And this is an example of that. Any uninformed observer would understand that the US government had put out a politically important message. An observer inside the sub-community would see something different."[157]

The Obama administration was thus sending a double message on reciprocity: reassuring its international partners by including corresponding requests in the budgets, while appeasing domestic interests by not retaining them in the Green Books. The underlying rationale for this strategy was apparently that an early focus on reciprocal AEI and corresponding reporting requirements for US banks might have provoked domestic resistance to FATCA, potentially undermining its full implementation. Treasury thus preferred to "take it in steps." As a former senior Treasury official clarified, "in the long term reciprocity will make sense. But at the front edge the logic is different. If we try to make this perfect today, it will probably never happen, and I would say that about FATCA generally."[158]

Hence, Treasury was dragging its foot to avoid the "entrance of [the] US financial industry into the fight" over reciprocity.[159] But even the rather limited regulatory changes it proposed to send a signal of willingness to its treaty partners received a good deal of domestic

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[154] Christians 2013; Christians 2014.
[155] US Treasury 2012c.
[156] Office of Management and Budget 2013; US Treasury 2014b.
[157] Interview on 15 April 2015.
[158] Interview on 13 April 2015.
[159] Garst 2014; see also Newman 2014.

resistance. When the IRS issued a regulation in 2012, extending a requirement for US banks to report interest payments from applying to Canadian account holders only to applying to all non-resident aliens (NRAs), the ABA blasted in response: "these […] regulations will further strain banks' information technology staff and budgets, *for the sole purpose of providing information to the IRS*, especially when there is the risk that many banks will lose billions of dollars in deposit funds due to the resulting loss of many of their NRA customers."[160] Moreover, the banking associations of Florida and Texas, whose members host a lot of Latin American financial wealth, took legal action against the IRS, "claiming the regulation was overly burdensome and could lead to massive capital flight because legitimate customers might fear their information would be disclosed to, and misused by, rogue governments."[161] Although the regulation eventually took effect after the legal challenge was thrown out of court in 2014, US banks can still circumvent the reporting of foreign clients, and their capital income by divesting their portfolios of US and debt securities, or hiding their identities behind shell corporations.

Inter alia this is the case because Treasury has not made progress on regulations meant to bring US know your customer (KYC) rules up to international standards. According to the FATF, the US is noncompliant with its recommendations for the identification of beneficial owners of legal persons and trusts, and only partially compliant with its recommendations for customer due diligence (CDD). US authorities can generally access ownership data available to US financial institutions, however these are under "no obligation in law or regulation to identify beneficial owners except in very specific circumstances."[162] In particular the Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury that combats criminal abuse of the financial system, took issue with lax CDD procedures in the United States. From its perspective, they abetted money laundering, terrorist financing, and tax evasion. Hence, it proposed a rule in 2012, obliging US financial institutions "to categorically obtain beneficial ownership information" from entities holding an account with them.[163] FinCEN's proposal received bipartisan support from Congress,[164] and was included in the "United States G-8 Action Plan for Transparency of Company Ownership and Control."[165] But intense lobbying from the financial sector[166] and resulting differences between FinCEN

[160] Mordi 2011, 2.
[161] Economist 2014.
[162] FATF 2006, 12 and 15.
[163] FinCEN 2012, 13047.
[164] Drug Caucus 2013, 5.
[165] Office of the Press Secretary 2013.
[166] Interview on 15 April 2015.

and banking regulators within Treasury still prevent the rule's finalization at the time of writing.[167]

Whereas FATCA IGAs as well as the OECD CRS embedded in the MCAA thus oblige FFIs to look through shell corporations by applying KYC procedures when identifying account holders,[168] US banks are under no obligation to do so.[169] Hence, their foreign clients only need to put a legal entity between their US account and themselves to avoid having their US-source interest payments reported to their home county. Despite the interest-reporting requirement, the regulatory situation in the US thus continues to prevent full reciprocity. This not only spares US banks the cost of putting new due diligence procedures in place, it provides them with a competitive advantage over FFIs in the attraction of hidden capital[170] while leaving their preexisting tax evasion business, particularly with Latin American clients, largely untouched. Meanwhile, Treasury does not seem overly eager to change this situation. Some in the Department already feel US financial institutions are being stretched very thinly as a result of post-crisis regulation.[171] Hence, the imposition of additional costs without any real benefit for the United States does not have priority.[172]

Similar obstacles stand in the way of complementary initiatives in Congress. Obliging US states to require the disclosure of beneficial owners upon the creation of a legal entity, for instance, would require legislative rather than regulatory action. As a 2006 report from the Government Accountability Office (GAO) revealed, "none of the states collect ownership information in the formation documents […] for corporations," whereas only four states "request some ownership information when a [limited liability company (LLC)] is formed."[173] A field experiment even demonstrated that it was easier to set up an untraceable shell corporation in Delaware or Nevada, than in most other international offshore centers included in the study.[174] Accordingly, reports suggest the US has become an increasingly popular destination for foreign tax evaders, fraudsters, and traffickers of all sorts.[175] To combat such criminal activity, Senator Carl Levin introduced bills to the 110th, 111th, 112th, and 113th Congress requiring states to collect beneficial ownership information by federal law.[176] But

[167] Wolf 2013.
[168] OECD 2014d, 16; US Treasury 2012c, 24.
[169] This shows that any reporting obligation is only as good as the KYC and due diligence procedures financial institutions apply to collect information on their clients. A limitation of this study's theoretical model may thus be the omission of spillover effects between the adjacent policy fields of money laundering and tax arbitrage.
[170] Christians 2013; Eisenring 2014; Newman 2014.
[171] Interview on 13 April 2015.
[172] Interview on 15 April 2015.
[173] GAO 2006, 13–14.
[174] Findley, Nielson, and Sharman 2012, 23–24.
[175] DePillis 2014; Wayne 2012; Findley, Nielson, and Sharman 2012, 7–8.
[176] Levin 2008b; Levin 2009; Levin 2012; Levin 2013.

even during Democratic dominance of the legislature, he was unable to gather sufficient support for his initiatives. Among the roadblocks in his way was Senator Thomas Carper, a Delaware Democrat and Chairman of the competent Committee on Homeland Security and Governmental Affairs, who derailed one of Levin's attempts by introducing an alternative bill, allowing for another entity to be designated as the beneficial owner of a corporation, and let a second die in his committee.[177] In addition, the proposals received consistent opposition from the "National Association of Secretaries of State […] the Chamber of Commerce, American Bar Association, and the state of Delaware, which is the lone state to have hired a lobbyist to work on the matter."[178] According to these critics, ascertaining beneficial ownership would increase the cost of, and time needed for the incorporation process, thereby discouraging business activity and capital formation in the US.[179]

Proponents of financial transparency and reciprocal information reporting under FATCA thus already have a hard time finding support when Democrats hold majorities in Congress. Their prospects seem even dimmer when Republicans take over. Current Speaker of the House of Representatives and 2012 vice-presidential candidate Paul Ryan, for instance, stated in 2011, "we need to have a tax system that makes America a haven for capital formation. Let's make this country a tax shelter for other countries instead of having other countries be a tax shelter for America."[180] Florida Senator Marco Rubio even introduced a bill to kill the IRS' interest-reporting regulation,[181] claiming elsewhere that "forcing banks to report interest paid to nonresident aliens would encourage the flight of capital overseas […], put our financial system at a fundamental competitive disadvantage, and would restrict access to capital when our economy can least afford it."[182] As it seems, there is thus no political actor in the US that wants FATCA reciprocity enough to incur political costs for its implementation. As a former Treasury official put it:

> "no one in either party is really eager to anger the financial institutions in Miami for no reason. They'll do it, but Florida is a swing state. So you will only reach real reciprocity the moment that the political cost of forcing US financial institutions to do something they don't want to do can be weighed against another cost."[183]

Will foreign governments now disadvantaged by the lack of reciprocity from the US be willing and/or able to impose such a cost on the US? They probably won't. In the US, experts familiar with FATCA implementation are confident their government will preserve its

[177] CQ News 2014; Wayne 2012.
[178] Wayne 2012.
[179] GAO 2006, 6; Wayne 2012.
[180] Gabor 2011.
[181] Economist 2014.
[182] Rubio 2011; cited in Christians 2013, 6–7.
[183] Interview on 15 April 2015.

privileges under the current regime. According to one of these experts, "fair is what you can get away with. And the US has the power to defend this outcome."[184] On the other side of the Atlantic senior officials agree. A former undersecretary of state in an EU G5 ministry of finance for instance conceded "we couldn't get more than partial reciprocity from the US For domestic reasons they claimed. So we said ok, this is still better than nothing, and of course these agreements are always give and take."[185] Another senior European tax official explained his government's acceptance of the FATCA IGA in a bit more detail:

> "When the interest in such an agreement is not equally strong on both sides, and the other side has sharper swords – that is, access to the American capital market – then you won't necessarily get what you want. Even if several European countries negotiate with the US there is still a difference in power, since we are more interested in market access for our institutions in the US than the other way around. The Americans don't need the [EU G5 country] capital market to prosper."[186]

The reason why the EU G5 were more interested in an intergovernmental approach to FATCA implementation was of course that their financial institutions did not want to enter into contractual relationships with the IRS. More importantly, however, they also expected this process to provide a crucial impetus for the emergence of AEI as the new global standard for administrative assistance, which would solve their tax evasion problems with traditional tax havens.

Given the financial sector's opposition to new domestic reporting requirements, however, it was consistent for the US administration to enable but not to sign the multilateral AEI agreement, which provides for reciprocal AEI. Moreover, by having all other major economies exchange information on non-residents' capital income, while not participating itself, the US removes two potential competitive disadvantages at the same time. First, it prevents American investors, which have so far profited from offshore arrangements, from being disadvantaged vis-à-vis other investors. Owing to the multilateral agreement, investors in the 51 signatory states are just as likely to be subject to the reporting of their offshore capital income, as American investors under FATCA. Second, the risk of FFIs divesting from the United States to circumvent reporting requirements is minimized, as similar obligations will be in place from 2017 across all major economies. There are thus little alternatives available to recalcitrant FFIs.[187]

[184] Interview on 17 April 2015.
[185] Interview on 28 January 2015.
[186] Interview on 3 March 2015.
[187] OECD 2014b; OECD 2014d; US Treasury 2012c.

7.5. Theoretical Implications

In accordance with *H1* we observed a Democratic administration that put the fight against tax evasion and avoidance high on the legislative agenda. All Democratic candidates had discussed tax fairness during presidential primaries. But the UBS scandal, and Barack Obama's personal affiliation with key anti-tax haven activists within the Democratic party made sure the issue stayed high on the agenda also after the elections. As expected in *H2*, however, the Obama Administration only managed to get anti-evasion measures through Congress. Anti-avoidance proposals affected the tax-planning schemes of US multinationals, thus creating powerful domestic opposition. In contrast, anti-evasion measures put the regulatory burden mainly on foreign banks since the US government does not reciprocate automatic information exchange requested from the rest of the world. As a result, American wealth managers now enjoy a competitive advantage in attracting hidden wealth instead of facing additional regulatory costs.

The US government's ability to maintain such a strongly redistributive outcome points to the importance of coercion for the emergence of the global AEI regime. In fact, the US triggered the process by forcing foreign banks to routinely report information on US clients to the IRS. FATCA credibly linked noncompliance to partial exclusion from the American financial market. Accordingly, virtually all internationally active banks submitted to US demands, while governments across the world entered into FATCA agreements to ensure continued market access for their financial institutions. As tax havens lifted financial secrecy for the US, they also created demand for greater cooperation from third states. After Luxembourg and Austria had entered into FATCA agreements with the US, for instance, large EU member states invoked a most-favored-nation clause to impose intra-EU AEI on them as well. Likewise, the G20 and OECD declared AEI the new global standard for tax cooperation after Switzerland had issued a joint statement on FATCA implementation with the United States. Thus, they quenched the hope of tax havens for an alternative, anonymity preserving solution, and harnessed bank preferences for a single set of global rules.

Regulative norms did neither prevented the US from using coercion against tax havens, nor from taking unilateral advantage of the emerging AEI regime. In fact, tax haven governments and pro-haven activists invoked national sovereignty in tax policymaking as well as the principle of non-intervention to criticize the extraterritorial reach of FATCA. Still, foreign banks registered as reporting institutions with the IRS, accepting the principle of AEI despite not having been involved in the legislative process. Likewise, the Swiss and other tax haven governments strongly criticized the US government's refusal to reciprocate AEI either

under bilateral FATCA treaties or via the multilateral agreement. The argument was reproduced in the media, but failed to have an impact on the eventual shape of the global AEI regime. Despite its obvious unfairness, the US still practices a double standard when it comes to its own reporting standards, and thus maintains a comparative advantage in financial secrecy. Extraterritoriality, interference with foreign sovereignty, and double standards; the normative arguments that halted the harmful tax competition initiative (according to some accounts) thus did not prevent the use of coercion by the United States, or the emergence of the global AEI regime.

8. The Redistributive Impact of Credible Sanction Threats[1]

The previous chapters demonstrated that the United States (US) government issues credible sanction threats in tax matters only under very specific circumstances. This chapter will empirically underpin the study's second major theoretical claim – the absence of joint gains in international tax cooperation – by showing that a credible sanctions threat from the US has a redistributive impact on the distribution of offshore capital between tax havens and non-havens. To this end, a differences-in-differences analysis is applied, comparing the development of foreign-held deposits and debt securities in tax havens and non-havens before and after the passage of the Foreign Account Tax Compliance Act (FATCA) by the US Congress.

8.1. Redistributive Cooperation in Tax Matters

Standard theories of tax competition expect international capital mobility to lead to a downward trend in tax rates that reduces tax revenue and leads to a suboptimal supply of public goods in all affected countries.[2] From this perspective, tax competition appears as a straightforward case of market failure, and international cooperation as a mutually beneficial remedy. When introducing differences in country size to the basic model, smaller countries may overcompensate revenue lost to lower domestic taxes with revenue form incoming foreign tax base, and thus win tax competition against larger countries, which lack this ability.[3] But since they earn less tax revenue from tax competition than large countries lose, owing to their lower rates, in theory scope remains for a mutually beneficial agreement in which large countries compensate small countries for refraining from tax competitive behavior.[4] According to the contractualist reading, such a deal may merely be undermined by the weakest-link problem arising from a stepwise approach to compensation. That is, the longer a tax haven stays out of a cooperating coalition that increases in size, the more it

[1] The formal statistical analysis presented in this chapter is the result of a collaborative effort with Max Schaub.
[2] cf. Zodrow and Mieszkowski 1986; Wilson 1999.
[3] cf. Bucovetsky 1991; Dehejia and Genschel 1999; Kanbur and Keen 1993.
[4] Elsayyad and Konrad 2012.

benefits from reduced competition in the tax-haven market, and the more expensive it becomes for large countries to pay it off.[5]

There are two problems with this contractualist approach to tax competition and cooperation. First, compensating tax havens is a "hard political sell for democratically elected governments."[6] After all, large country governments would spend the money of honest taxpayers to compensate tax havens for not serving the dishonest anymore. It is thus no surprise that compensation has never been seriously debated in negotiations over tax cooperation at the Organisation for Economic Co-operation and Development (OECD).[7] Second, compensatory arguments rely on the implicit assumption that governments compete for tax revenue, which could indeed be replaced by international aid money. It seems, however, closer to reality to assume, as Chisik and Davies do, that governments seek to maximize national income defined as the sum of tax revenue and domestic production,[8] and thus rather compete for tax base. In fact, incoming foreign capital not only increases tax revenue in small countries but also raises economic activity, wages, and employment, which, in turn, increases revenue from the taxation of labor, and reduces spending on out-of-work benefits.[9] These positive spillover effects are most likely more important than increased revenue from the taxation of capital. Yet, they cannot be substituted for by international aid money. While large countries are thus highly unlikely to offer compensation, tax havens are just as unlikely to accept such a solution.

With compensation off the table, bargaining over tax cooperation in practice becomes a zero-sum game, in which small and large countries quarrel over the distribution of a single, globally-mobile tax base. Whereas small countries attract capital and the associated benefits at the expense of large countries when tax competition prevails, large countries win back capital and the associated benefits at the expense of small countries when tax cooperation prevails. There are thus no joint gains from cooperation, and no scope for voluntary agreement by small countries. As a result, large countries need to resort to coercion, if they want to prevent tax havens from poaching their tax base through low tax rates, or the provision of financial secrecy. Coercion needs to be based on a credible threat of economic sanctions. That is, the threatened punishment of non-compliance has to be costlier for the target than for the sender. This is the case when a government controlling a large internal

[5] Genschel and Plumper 1997; Holzinger 2005.
[6] Genschel and Schwarz 2011, 354.
[7] Sharman 2006a, 153–54.
[8] Chisik and Davies 2004, 1123.
[9] Genschel and Seelkopf 2015.

market links access for a small country's firms to its government's good conduct.[10] If such a strategy is applied to enforce tax cooperation, the outcome is necessarily redistributive in that it leaves small countries worse off than the status quo of tax competition. The effective use of coercion should thus be reflected in a loss of foreign-held capital for tax havens relative to non-havens. If, as the previous chapter suggests, tax haven acquiescence to the Multilateral Competent Authority Agreement (MCAA) is indeed a result of coercion by the US enforced via FATCA, we should thus observe a decline in the value of offshore assets in tax havens relative to non-havens during the years following the act's passage.

8.2. FATCA, Multilateral AEI, and Redistributive Cooperation

As the previous chapter shows, the US issued a credible sanctions threat through FATCA. This law, passed by the US Congress in March 2010, provides for a 30 percent withholding tax on US source payments received by foreign financial institutions (FFI) incompliant with the requirement to report the capital income and account balances of US residents among their clients.[11] The threat was credible because it came from the government controlling the world's largest capital market, which is as such indispensable to the investment strategies of international banks. Moreover, it was contained in binding legislation. That is, US banks, acting as withholding agents on behalf of the IRS, would break the law, if they did not impose the tax on payments to FFIs identified as FATCA incompliant by the service. Accordingly, virtually all FFIs doing business in the US registered as reporting institutions with the IRS,[12] whereas all jurisdictions hosting an internationally-active financial sector struck bilateral FATCA intergovernmental agreements (IGA) with the US Treasury,[13] committing their financial institutions to the routine reporting of capital income and account balances of US residents.[14] As a result, FATCA successfully pierced banking secrecy and other provisions protecting investor anonymity in tax havens. The act is thus susceptible to curb tax evasion by US residents using hidden offshore accounts.

In addition, FATCA also changed the dynamic of multilateral negotiations over automatic exchange of information (AEI). Its sanction mechanism forced tax havens around the world to end their fundamental opposition to this form of tax cooperation, making it harder for them to deny third states the same type of information reporting. Recognizing this

[10] cf. Drezner 2008; Krasner 1976.
[11] Baucus 2009; Mollohan 2010.
[12] cf. IRS 2014.
[13] US Treasury 2014a.
[14] cf. US Treasury 2012c.

predicament, the Group of Twenty countries and the OECD declared AEI the new global standard for tax cooperation, and fashioned its formal requirements closely on FATCA and the corresponding IGAs.[15] In Switzerland, for instance, the government's signature of a FATCA deal convinced a majority of banks that it was less costly for them to apply AEI to all of their international clients than to have parallel procedures in place for different nationalities.[16] At the European Union (EU) level, Luxembourg and Austria had to offer AEI also to other member states after entering into FATCA agreements with the US, owing to a most-favored-nation (MFN) clause contained in a Council Directive.[17] Likewise, the UK piggybacked the US in pressuring its Crown Dependencies and Overseas Territories, including important tax havens like the Cayman Islands, Jersey, and Guernsey, to provide itself and other EU member states with account data.[18] Over the course of 2012 and 2013 it thus became increasingly clear to investors that AEI would not only affect US residents, but was likely to be applied across nationalities and by virtually all traditional tax havens in the near future.

During the transition phase from the passage of FATCA until the start of actual information exchanges tax evaders had three options to react to impending regulation. First, they could declare hidden assets to their domestic tax authorities, pay the taxes due, and hope for a fine instead of imprisonment based on the voluntary character of their disclosures. This was indeed what tens of thousands of tax evaders did over the course of the years following FATCA.[19] In the process, they did not necessarily repatriate all of their offshore wealth. But it is likely that they at least used some of it to pay back taxes and fines. Voluntary disclosure by penitent tax evaders should thus depress the value of foreign-held assets in tax havens. Second, tax evaders could either shift hidden assets or just their formal ownership to an entity located in one of the few traditional tax havens that were still dragging their feet in the adoption of AEI. For US residents this was especially hard to do, given the truly global reach of FATCA. But also for other residents this approach became increasingly tough as one tax haven after another pledged to apply AEI multilaterally, thereby increasing pressure on the few remaining non-cooperative jurisdictions, as well as the risk of their eventual acquiescence. Shifting assets between tax havens of course does not reduce the value of overall offshore assets. Yet, the viability of this strategy rapidly decreased with the number of non-cooperative jurisdictions.

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[15] cf. OECD 2014d.
[16] Brunetti 2013; Flubacher 2012; Rutishauser 2012a.
[17] Hakelberg 2015.
[18] Houlder 2013c; Houlder 2013a; Houlder 2013b.
[19] cf. Finanzministerium des Landes Nordrhein-Westfalen 2014.

The third option is similar to the second. Yet, it involves the United States as destination for hidden capital. Despite having forced virtually all other countries to participate in AEI, the US government itself neither signed the MCAA nor provides its FATCA treaty partners with the same data it requests from them. In fact, the country lacks regulations requiring US banks to automatically report the capital income of non-residents to the IRS, and still does not have know-your-customer rules in place that satisfy Financial Action Task Force (FATF) standards.[20] Most importantly, however, several US states like Delaware, Nevada, and South Dakota allow investors to open shell corporations without providing any identification.[21] As a result, the US has become more secretive than most traditional tax havens, and has thus increased its attractiveness for hidden capital through FATCA. In fact, tax advisors have begun to recommend the US as a safe haven to committed tax evaders holding assets in Switzerland, Austria, or Luxembourg,[22] while international private banks have recently opened new branches in secretive US states, which, in turn, have registered solid growth in their financial sectors.[23] FATCA is thus likely to reduce the stock of foreign-held assets in traditional tax havens, while increasing it in the United States. Post-FATCA divergence between tax havens and non-havens should thus be larger when the US is included among non-havens than when it is excluded.

8.3. Analytical Strategy

To ascertain FATCA's redistributive impact, a differences-in-differences analysis is applied, comparing the stock of offshore capital in tax havens and non-havens before and after the act's passage. The diff-in-diff method has been conceived for the identification of a treatment's causal effect on a treatment group relative to a control group not exposed to the treatment. In the basic setup, outcomes are observed for the two groups before and after the treatment. The average difference in the outcome values of the control group is then subtracted from the average difference in the treatment group. This removes biases in after-treatment comparisons of the treatment and control groups that could be due to other factors permanently distinguishing the two groups from each other. It also removes "biases from comparisons over time in the treatment group that could be the result of trends" distinct from the actual treatment.[24] The crucial assumption underpinning this reasoning is that the

[20] Christians 2013; Eisenring 2014; FATF 2006.
[21] Findley, Nielson, and Sharman 2014.
[22] Interview on 7 July 2014.
[23] Drucker 2016; Scannell and Houlder 2016.
[24] Wooldridge 2007, 2–3.

outcomes in the treatment and control groups would have shared a common time trend had it not been for the treatment.[25] In lab experiments, where the method was originally applied, this assumption holds as a result of the randomized selection of treatment and control groups. In econometrics, where diff-in-diff has been widely used to study the impact of government policies and programs on economic actors in different geographic locations, the assumption is confirmed via the observation of common trends in the outcome variable before the introduction of the respective policy.[26]

8.4. Context and Data

The diff-in-diff analysis implemented in this chapter will thus compare the value of assets held by foreigners (outcome) in tax havens (treatment group) and non-havens (control group) before and after the passage of FATCA (treatment). Accordingly, it relies on two main data sources: Data on foreign-held assets is obtained from locational banking statistics provided by the Bank for International Settlements (BIS), while the classification of countries into tax havens and non-havens is based on their readiness to practice AEI ahead of FATCA. The plausibility of this selection procedure is confirmed through a comparison of the resulting groups' average scores on the financial secrecy index (FSI), and population size.

8.4.1. Foreign Deposits and Debt-Security Holdings

The BIS provides information on cross-border deposits and debt-security holdings for 44 countries in its locational banking statistics.[27] Deposits reflect the cash value of bank accounts, whereas debt securities refer to "negotiable instrument[s] serving as evidence of a debt."[28] In BIS statistics these include "bills, bonds, notes, negotiable certificates of deposit, commercial paper, debentures, asset-backed securities, money market instruments and similar instruments normally traded in financial markets."[29] The data underlying these statistics is reported on a quarterly basis from commercial banks to central banks, where it is compiled, aggregated, and then transmitted to the BIS.[30] The BIS, in turn, publishes this data as country-level aggregates; for instance, total deposits and debt securities held by foreigners in Swiss banks, or total deposits and debt securities held by German residents in foreign banks. In contrast, the BIS keeps bilateral data revealing deposits and debt-security holdings of German

[25] Waldinger 2014, 24.
[26] cf. Taber 2012.
[27] BIS 2016c.
[28] BIS 2016a, 290.
[29] Ibid.
[30] Johannesen 2014, 49.

residents in Swiss banks confidential.[31] For the purposes of this study, however, limited access to bilateral data is secondary, as it centers on a comparison of overall foreign deposits and debt-security holdings in tax havens relative to non-havens.

The BIS data are heavily relied upon in international economics, as they are a crucial component of balance of payments statistics. Moreover, they have been very popular for studying the impact of regulatory measures on tax havens, as all important offshore centers report to the BIS (*see Table 8-1*). In fact, the BIS systematically includes new offshore centers in its statistics "when their cross-border banking business becomes substantial,"[32] which implies that those not included can be considered negligible as destinations for hidden capital. In addition, coverage rates within tax havens (and all other reporting countries) are close to universal as all deposit-taking financial institutions with cross-border positions are required to report.[33] Accordingly, the data has been used to study the impact of withholding tax rates and information exchange on cross-border depositing,[34] the effect of the Swiss-EU Savings Agreement on the composition of counterparties owning deposits in Switzerland,[35] and the impact of bilateral Tax Information Exchange Agreements (TIEA) on cross-border deposits held by the treaty partners' residents.[36] Although the data is thus suitable for general inferences on the determinants of cross-border depositing in tax havens, and other countries, it still has several limitations relevant to this study.

First, the BIS does not disclose the share of deposits and debt securities owned by households. Counterparties are merely separated into banks and non-banks. Yet, next to households non-banks also include multinational corporations and institutional investors. In contrast to households, however, these do not rely on financial secrecy to evade personal income taxes on capital income. They should thus be unaffected by a tax haven's participation in AEI. On the one hand, this implies that BIS data does not allow for the direct observation of the reaction of tax evaders to the introduction of AEI. It merely allows for inferences based on variance in foreign deposits and debt-security holdings of non-banks. On the other hand, this does not undermine the validity of the study's results precisely because non-banks other than households evading taxes should be unaffected by FATCA and the introduction of AEI it precipitated. Accordingly, any observed effect of FATCA on deposits and debt-security holdings of foreign non-banks should be attributable to the reaction of households with

[31] Johannesen and Zucman 2012, 9.
[32] BIS 2012, 6.
[33] Ibid.
[34] Huizinga and Nicodème 2004.
[35] Johannesen 2014.
[36] Johannesen and Zucman 2012.

undeclared capital income. The inclusion of non-banks other than households should, however, reduce the elasticity of reported liabilities to the treatment compared to an ideal dataset including households only.[37]

To provide the above assumption with some empirical backing, this paragraph presents several estimates of the share of households among non-banks that the size of the observed effect can be assessed against. Based on data on assets under management in Swiss banks provided by the Swiss National Bank (SNB), and anomalies in balance of payments statistics, Zucman estimates that households held $1.4 trillion in tax-haven bank accounts in 2011. This figure is commensurate to 50 percent of all foreign non-bank deposits in tax havens reported by the BIS for the same year.[38] Shares for individual jurisdictions may even lie above this figure. As Zucman and Johannesen report, in 2007 households owned 70 to 75 percent of deposits in the Channel Islands and the Isle of Man, whereas 80 to 90 percent of Swiss accounts held by non-residents between 1987 and 2011 were fiduciary deposits.[39] "These accounts enable clients to invest in money markets if they don't have sufficient volumes of assets to do so directly."[40] As non-financial firms usually have direct access to money markets, fiduciary accounts are almost exclusively held by households.[41] Likewise, the Luxembourgish statistics office attributes 53 percent of all foreign-held assets managed by the country's banks in 2012, including debt securities, to households,[42] whereas the SNB attributes a third of debt securities held by foreigners in Swiss banks in 2010 to households, however, without taking private foundations and trusts into account.[43] Based on these numbers the assumption of a household share of 50 percent in deposits and debt securities held by foreign non-banks seems fair, given that BIS data for individual countries suggests that deposits and debt securities each account for about 50 percent of the combined total.[44]

The second limitation in the BIS data concerns its focus on deposits and debt-security holdings. This implies that they do not take foreign equity holdings that could form an important part of an investor's asset portfolio into account. The SNB reports, for instance, that

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[37] cf. Johannesen 2014; Johannesen and Zucman 2012.
[38] cf. Zucman 2013b.
[39] Johannesen and Zucman 2012, 11.
[40] Brown, Döbeli, and Sauré 2011, 7.
[41] Ibid., 11.
[42] Adam 2014, 8.
[43] SNB 2014, A130. In 2004 the SNB shifted trusts and foundations out of the household category and into the category of commercial clients other than institutional investors. When combining households and commercial clients, their joint share in total debt securities rises from 29 to 38 percent. Institutional investors hold the remaining 62 percent.
[44] Unfortunately, we cannot determine the fraction of deposits and debt securities that is declared to tax authorities by foreign households. A report on UBS from the US Senate suggests, however, that this fraction is very small given that only 1000 out of 20000 UBS accounts owned by US customers had been declared to the IRS (Levin and Lieberman 2008, 84).

65 percent of all assets managed in Swiss banks on behalf of foreign households are company or mutual fund shares.[45] Therefore, the present analysis does not enable direct conclusions on the impact of FATCA on the distribution of households' overall offshore financial wealth. Given that the act's reporting requirements extend to all asset classes, however, investing in equity instead of debt does not protect a tax evader from detection by her domestic tax authority. Therefore, the impact of FATCA on deposits and debt securities is a good proxy for the reaction of households' overall offshore financial wealth to the introduction of AEI. Still, it reflects only a fraction of the total capital outflow precipitated by FATCA, and thus only a fraction of the costs imposed on tax havens.

8.4.2. Tax Havens and Non-Havens

In accordance with this study's theoretical expectations, FATCA only targets those tax havens that abet tax evasion by individuals through the provision of secrecy. By imposing a comprehensive reporting requirement on foreign banks, the act pierces banking secrecy and other forms of financial opacity outside the United States. Yet, it does not interfere with tax avoidance strategies deployed by multinational corporations, which are usually based on the legal exploitation of loopholes in tax codes and treaties rather than criminal underreporting of foreign capital income. Therefore, only jurisdictions providing secrecy to private investors are classified as tax havens for the purposes of the present analysis. In contrast, tax havens enabling the tax avoidance schemes of multinationals (but not providing financial secrecy) are classified as non-havens as they are not targeted, and should thus be unaffected by the provisions of FATCA.

Even when focusing on secrecy, however, a consensual tax haven definition is hard to come by.[46] As the Tax Justice Network (TJN) reveals by means of its financial secrecy index, there are many possibilities for providing foreign investors with anonymity from their home countries, and at least some of these possibilities prevail in every country.[47] Of course, the Cayman Islands, Panama, and Switzerland put a lot more effort into concealing investor identities than the average member of the Nordic Council. Yet, the difference may be interpreted as gradual rather than categorical when comparing secrecy scores for different countries. In contrast, tax-haven blacklists published by international organizations such as the OECD or the International Monetary Fund (IMF) are supposed to provide a categorical distinction between countries compliant and non-compliant with a certain transparency or tax

[45] SNB 2014, A130.
[46] cf. Palan, Murphy, and Chavagneux 2010, 17ff.
[47] TJN 2015.

standard. Yet, these blacklists are often politically biased in that they exclude member states, or third states having politically committed to reforms but not yet implemented them.[48] Sometimes they also confound jurisdictions providing financial secrecy with other jurisdictions focusing exclusively on the abatement of tax avoidance.[49] In order to select those BIS reporting countries into the treatment group (tax havens) that are also most likely to be affected by the treatment (the introduction of AEI via FATCA) a new list geared towards the requirements of this study thus needs to be established.

Conveniently, FATCA was not the first attempt at convincing tax havens to participate in AEI. In fact, the EU had already passed the Savings Directive in 2003, providing for AEI on interest payments to non-residents among its member states.[50] To avoid capital flight from the common market as a result of increased cooperation, the EU Commission also tried to include those third states in the directive's AEI mechanism that were hosting the largest stocks of offshore wealth beneficially owned by EU residents.[51] Yet, by 2009 EU member states Austria and Luxembourg still refused to participate in intra-EU AEI, providing third states with the perfect excuse to decline the Commission's overture.[52] For the purposes of this study, those countries will thus be defined as tax havens that had been approached by the Commission, but were still refusing to participate in the EU's AEI scheme when the US Congress passed FATCA in 2010. These countries accounted for significant shares in EU-owned offshore wealth, and they obviously associated participation in AEI with competitive disadvantages for their financial sectors. They should thus be most affected by the subsequent enforcement of AEI through FATCA. In addition, the Bahamas, Bahrain, and Panama are included in the tax haven group. They were not approached by the Commission concerning the signature of a Savings Agreement, but are defined as offshore centers by the BIS for "dealing primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy."[53] Moreover, they have also been identified as important

[48] Sharman 2006b; Webb 2004.
[49] Dharmapala and Hines 2009; Palan, Murphy, and Chavagneux 2010, 41–44.
[50] European Community 2003.
[51] In addition to EU member states subject to the Savings Directive, the Commission aimed to strike analogous Savings Agreements with dependent or associated territories of EU member states and other third states. Among BIS reporting countries these include: Bermuda (NA), Cayman Islands (IE), Guernsey (WT), Hong Kong (NA), Jersey (WT), Isle of Man (WT), Netherlands Antilles (WT), Macao (NA), Singapore (NA), and Switzerland (WT). NA = no agreement reached; WT = country agreed to apply an anonymous withholding tax; IE = country formally agreed to information exchange, but devised implementing legislation prohibiting actual reporting (Hemmelgarn and Nicodème 2009, 8; Rixen and Schwarz 2012, 156; TJN 2008, 1).
[52] Hakelberg 2015.
[53] BIS 2016b, 59.

destinations for hidden capital that fled jurisdictions, which had entered into Savings Agreements.[54]

The tax haven and non-haven groups obtained as a result of the above procedure are presented in *Table 8-1*. Tax havens include all countries defined as offshore centers by the BIS plus Austria, Luxembourg, and Switzerland. In 2009, Luxembourg and Austria were the last remaining opponents of intra-EU AEI, and the largest recipients of cross-border deposits from within the euro area. The same year, Switzerland was the world's biggest offshore center in terms of foreign assets under management, and still refused to discuss AEI with the EU.[55] Accordingly, non-havens include all remaining countries providing data to the BIS, minus Cyprus, Indonesia, Malaysia, and South Africa, which only started reporting in or shortly before 2010, and thus do not provide enough data for the pre-treatment comparison of group trends beginning in 2005.[56] The United States is a special case among non-havens since it is not merely affected or unaffected by FATCA, but the act's originator and main profiteer, owing to its refusal to reciprocate AEI. To show that FATCA's redistributive impact benefits the US in particular, two models will be estimated: the first excluding, and the second including the country among non-havens. Obviously, FATCA's redistributive impact on tax havens relative to non-havens should be stronger when including the United States in the second group.

In general, the plausibility of the applied selection procedure is confirmed when comparing the groups' average secrecy scores, as well as their population size. The secrecy score is a component of the TJN's financial secrecy index, and measures the effort a given jurisdiction puts into concealing the identities of non-resident account-holders. It takes values between 0 and 100, and is made up of 15 components that indicate: (1) whether information on the beneficial owner of a bank account, trust, foundation, or corporation is readily available to local tax authorities and the public; (2) whether tax administration is efficient in the sense that information actually flows from financial institutions to the services; (3) and whether the given jurisdiction respects international standards for tax cooperation, and actually provides administrative assistance to foreign authorities.[57] The index has been released every two years since 2009. Yet, the 2009 index does not provide scores for many countries included in the selected groups.[58] Therefore, the intergroup comparison is based on

[54] Johannesen 2014.
[55] Hakelberg 2015.
[56] BIS 2016c.
[57] cf. TJN 2013; TJN 2015.
[58] cf. TJN 2009.

scores released in 2011, but based on research carried out in 2010.[59] Accordingly, the 2011 scores reflect the regulatory situation at the time when FATCA was passed. As *Table 8-1* shows the average secrecy score for tax havens lies 27 percentage points above the average score for non-havens. Also according to this measure, tax havens were thus financially far more opaque than non-havens before FATCA. In addition, they were also a lot smaller in terms of population, and thus far more likely to benefit from the small-country advantage in tax competition. This data thus provides additional reason to expect strongly diverging reactions to the introduction of AEI between the two groups.

Table 8-1: Classification of BIS Reporting Countries into Tax Havens and Non-Havens

Tax Havens			**Non-Havens**		
Country	*Secrecy Score (2011)*	*Population (millions)*	*Country*	*Secrecy Score (2011)*	*Population (millions)*
Austria	66	8.7	Australia	(51)	24.1
Bahamas	83	0.4	Belgium	59	11.3
Bahrain	78	1.4	Brazil	(57)	206.1
Bermuda	85	0.1	Canada	56	36.0
Cayman Islands	77	0.1	Chile	(65)	18.2
Guernsey	65	0.1	Denmark	40	5.7
Hong Kong	73	7.3	Finland	(37)	5.5
Isle of Man	65	0.1	France	(45)	66.7
Jersey	78	0.1	Germany	57	81.7
Luxembourg	68	0.6	Greece	(43)	10.8
Macao	83	0.6	India	53	1288.9
Curaçao	83	0.2	Ireland	44	4.6
Panama	77	0.4	Italy	49	60.7
Singapore	71	5.5	Japan	64	127.0
Switzerland	78	8.3	Mexico	(54)	122.3
			Netherlands	49	17.0
			Norway	(46)	5.2
			Portugal	51	10.4
			South Korea	54	50.8
			Spain	34	46.4
			Sweden	(35)	9.9
			Taiwan	n.a.	23.5
			Turkey	(77)	78.7
			United Kingdom	45	65.0
			United States*	58	323.5
Mean	75.3	2.3	Mean	48.1	108

Notes: Scores in parentheses are estimates for countries not ranked in 2011, owing to the small size of their financial sectors. They reflect the respective country's score in a subsequent edition of the FSI multiplied by the FSI's average rate of decline between editions. *Data sources:* TJN 2011, 2013, 2015; World Bank 2016.

[59] Meinzer and Eichenberger 2011, 7; TJN 2011.

8.5. Graphical Evidence

8.5.1. The Parallel Trends Assumption

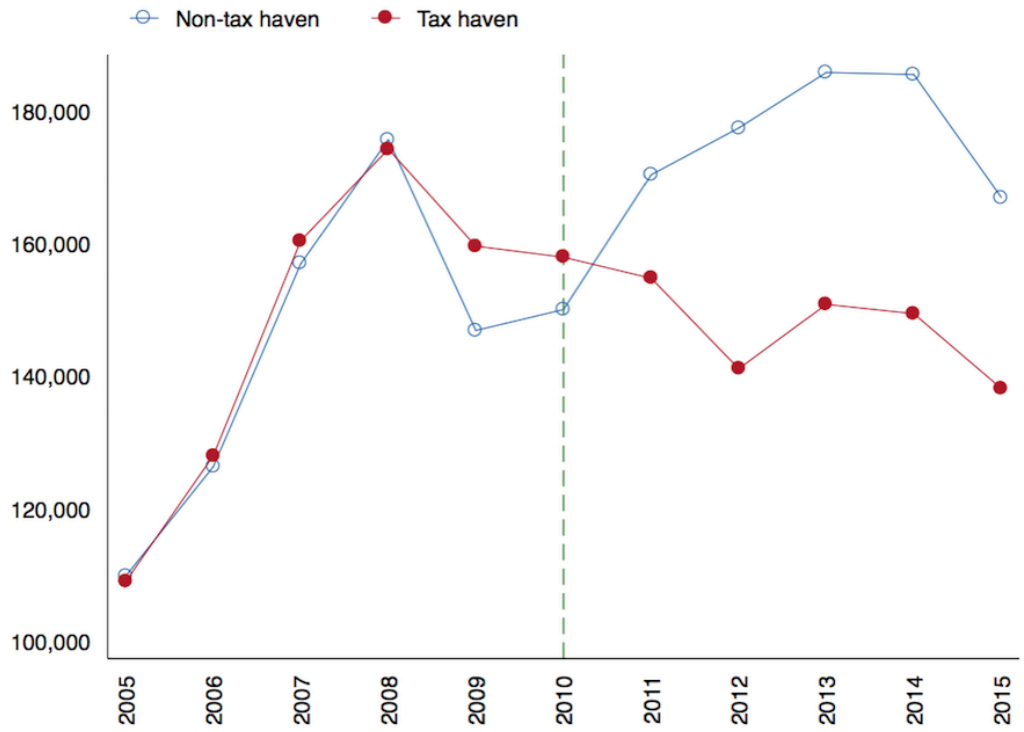
As discussed above, diff-and-diff analyses rely on the assumption that the outcomes in the treatment and control group would have followed the same time trend had it not been for the treatment. To validate this assumption for the present study, *Figure 8-1* displays the evolution of the average value of deposits and debt securities held by foreign non-banks with banks in tax havens and non-havens for the five years preceding, and the five years following the introduction of FATCA. In fact, group trends evolved perfectly in parallel between 2005 and 2008. After the outbreak of the financial crisis they continued to move in the same direction, sharply declining between 2008 and 2009, and then stabilizing between 2009 and 2010. Including the United States in the non-haven group does not alter the general picture. As *Figure 8-2* shows, both non-havens and tax havens continue to experience strong growth ahead of the financial crisis, followed by a sharp decline and subsequent stabilization in the value of cross-border deposits and debt-security holdings. The graphical evidence thus suggests that the common trend assumption holds. Slightly faster pre-crisis growth in non-havens, observed when including the US, as well as steeper post-crisis decline also observed when excluding the US do not challenge this conclusion, but still merit an explanation.

According to Bernanke *et al.*, emerging economies, including most notably China and the oil exporters, began to run large current account surpluses at the beginning of the 2000s. Instead of investing these surpluses in their domestic economies, however, they "sought safe, high-quality financial assets that their own governments and financial systems could not provide but were being produced in the advanced economies."[60] Accordingly, their sovereign wealth funds invested heavily in US Treasury bonds and other highly rated debt securities issued in major advanced economies.[61] As institutional investors acting on behalf of governments, these funds had no incentive to hold their securities via tax-haven banks, and thus invested directly in advanced economies. While increasing the volume of debt securities held by foreign non-banks in non-havens, their investment also created downward pressure on bond yields, and created demand for supposedly safe debt securities producing higher returns. The US financial sector met this demand with the issuance of mortgage-backed securities, the default of which eventually triggered the financial crisis.[62] Their subsequent debasement may thus also be reflected in a steeper decline of non-havens' deposit and debt-security liabilities.

[60] Bernanke et al. 2011, 5.
[61] Ibid.
[62] Ibid.

After this correction, however, group trends again evolved roughly in parallel between 2009 and 2010, that is, just before the introduction of FATCA. It is indeed only in 2011 that truly diverging group trends can be observed for the first time during the observation period.

Figure 8-1: Banks' Deposit and Debt-Security Liabilities to Foreign Non-Banks, $ Billions (excl. US)



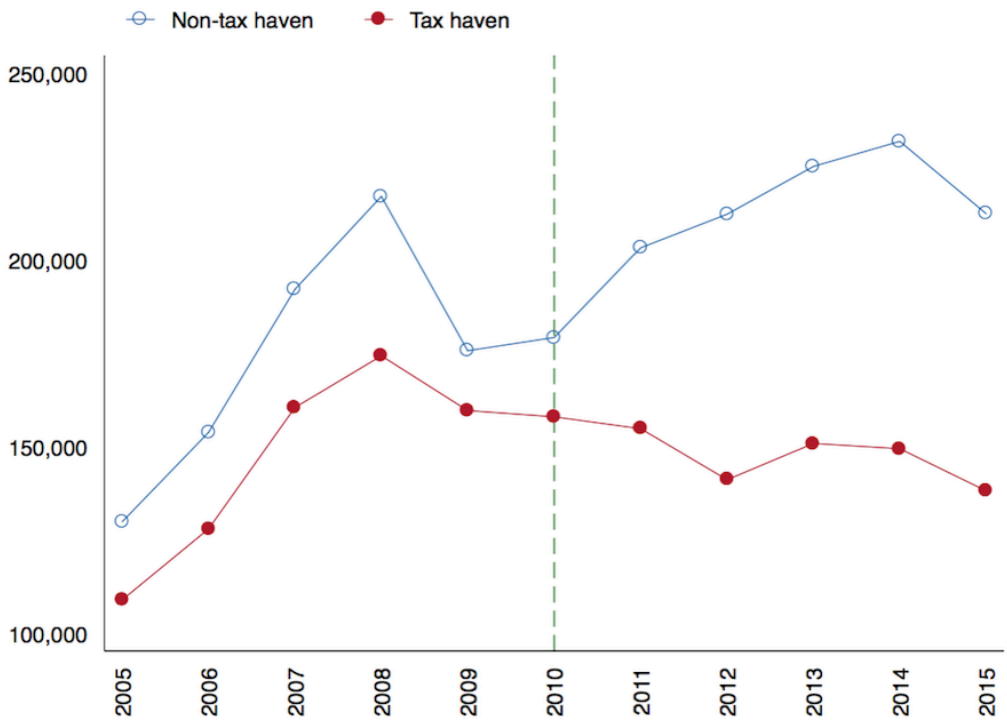
Data Source: BIS 2016

8.5.2.The Impact of FATCA and its Progeny

The country sample excluding the US among non-havens as well as the one including it feature large breaks in the trends of tax haven and non-haven means after 2010, the year when Congress passed FATCA (*see Figures 8-1 & 8-2*). Whereas the tax-haven mean drops by $17 billion, or 11 percent between 2010 and 2012, the non-haven mean grows by $27 billion, or 18 percent over the same period when the US is excluded. The result is a difference in differences of $44 billion, which is almost five times the amount of $9 billion observed for the preceding two-year period. Most strikingly, the $17 billion decline in the tax-haven mean exceeds the $16 billion loss incurred between 2008 and 2010. On average, FATCA thus seems to have affected tax havens even more than the financial crisis. In contrast, foreign deposits and debt-security holdings in non-havens already grew half as fast between 2010 and

2012 as between 2006 and 2008, the two boom years preceding the crisis. The data thus points to a strongly redistributive outcome to the detriment of tax havens.

Figure 8-2: Banks' Deposit and Debt-Security Liabilities to Foreign Non-Banks, $ Billions (incl. US)



Data Source: BIS 2016

The picture does not change much for the two-year period directly following the introduction of FATCA when including the US among non-havens. Between 2010 and 2012 the non-haven mean grows by 18 percent just like before. During the four-year period following the introduction of FATCA, however, greater divergence can be observed. Whereas the non-haven mean grows by 24 percent between 2010 and 2014 when excluding the US, it grows by 29 percent when the country is included. The five-percentage point increase shows that foreign deposits and debt-security holdings grew faster in the United States than in the average non-haven during the four years following the introduction of FATCA. As it seems, the country thus benefitted more from the act's redistributive impact than others, not immediately, but over time. In fact, an instant benefit for the US would have been surprising given FATCA's implementation history. As discussed in chapter 7, the first joint statements on FATCA implementation with Switzerland and the EU G5 were not finalized before mid-

2012.[63] Accordingly, it only became clear that year that the US would not reciprocate AEI under FATCA, and was thus unlikely to join a multilateral AEI mechanism. It is therefore quite likely that committed tax evaders only began to shift their hidden assets to the US over the course of the subsequent years.

As expected, the data's graphical representation thus suggests that FATCA had a substantial impact on the distribution of foreign deposits and debt-security holdings between tax havens and non-havens. Whereas group trends had evolved largely in parallel before the act's passage, tax havens experienced huge losses afterwards, exceeding even those incurred during the financial crisis, while non-havens benefitted from solid growth. Moreover, above average growth in the US during the four years following FATCA suggests that the country benefitted more from the act than other non-havens, most likely due to its refusal to reciprocate AEI.

8.6. Regression-Based Evidence

8.6.1. The Causal Effect of FATCA and its Progeny

The previous graphical analysis revealed parallel group trends before the introduction of FATCA as well as substantial divergence beginning just after its passage. This section provides a more formal analysis of these trends, based on the estimation of the regression below:

$$y_{ct} = \gamma_c + \lambda_t + \beta TaxHaven_{ct} + \epsilon_{ct}$$

Whereby γ_c are fixed effects for the different countries, λ_t are indicators for the year of observation, $TaxHaven_{ct}$ captures the effect of being a tax haven for a country *c* at time *t* and ϵ_{ct} is an error term. In order to account for potential year-to-year serial correlation in the values of the dependent variable within countries, in all calculations standard errors are bootstrapped (1000 repetitions), blocking at the country level. This is the procedure recommended by Bertrand, Duflo and Mullainathan for samples with a relatively large number of clusters like the one under study (there are 40 countries in the dataset).[64] Regression results are reported in *Table 8-2*.

The reported diff-in-diffs relate to the reference point t=2010, the year of FATCA adoption. The coefficient β for $TaxHaven_{ct}$ captures the difference in the evolution of

[63] US Treasury 2012b; US Treasury 2012a.
[64] Bertrand, Duflo, and Mullainathan 2004, 265–66.

deposit and debt-security liabilities in tax havens relative to non-havens. In model (1), excluding the US from non-havens, this coefficient is substantially large and statistically significant at the .10 level for the three years following the passage of FATCA. Tax havens' liabilities to foreign non-banks decreased on average by $3.2 billion between 2010 and 2011, whereas they increased by $20.3 billion in non-havens, resulting in a difference in differences of about $23.5 billion. The coefficients for the remaining years are the 'leads' and 'lags' of this main diff-in-diff effect (the change in changes between 2010 and 2011).[65] The coefficient for $TaxHaven_{c2009}$ captures for instance to what extent the diff-in-diffs changed between 2009 and 2010. Its small size and statistical insignificance demonstrate that time trends traced each other before the treatment period. Similarly, the coefficient for $TaxHaven_{c2012}$ captures the diff-in-diff between 2010 and 2012. The effect is substantially large and, in contrast to the effects for the pre-treatment period, statistically significant at the .10 level. Hence, the coefficient is testimony to the fact that the effect of FATCA continued to grow over the course of 2011, which is consistent with the act's implementation history discussed above.

Table 8-2: Differences in Differences to Reference Year 2010

	(1) excl. United States (mean) liabilities		(2) incl. United States (mean) liabilities	
2005	-8,733	(33,333)	325	(34,700)
2006	-6,238	(25,634)	-4,604	(25,702)
2007	-4,413	(15,527)	-10,400	(16,378)
2008	-9,336	(15,595)	-21,446	(19,392)
2009	4,833	(7,828)	5,210	(7,559)
2011	-23,542*	(12,029)	-27,197**	(13,004)
2012	-44,286*	(23,404)	-49,856**	(24,370)
2013	-42,947*	(25,128)	-52,938**	(26,991)
2014	-44,048	(27,257)	-61,052*	(32,059)
2015	-36,771	(33,476)	-52,963	(36,947)
Constant	153,074***	(43,450)	171,218***	(46,537)
Country fixed effects	Yes		Yes	
Time fixed effects	Yes		Yes	
Obs.	429		440	
R^2	0.13		0.15	

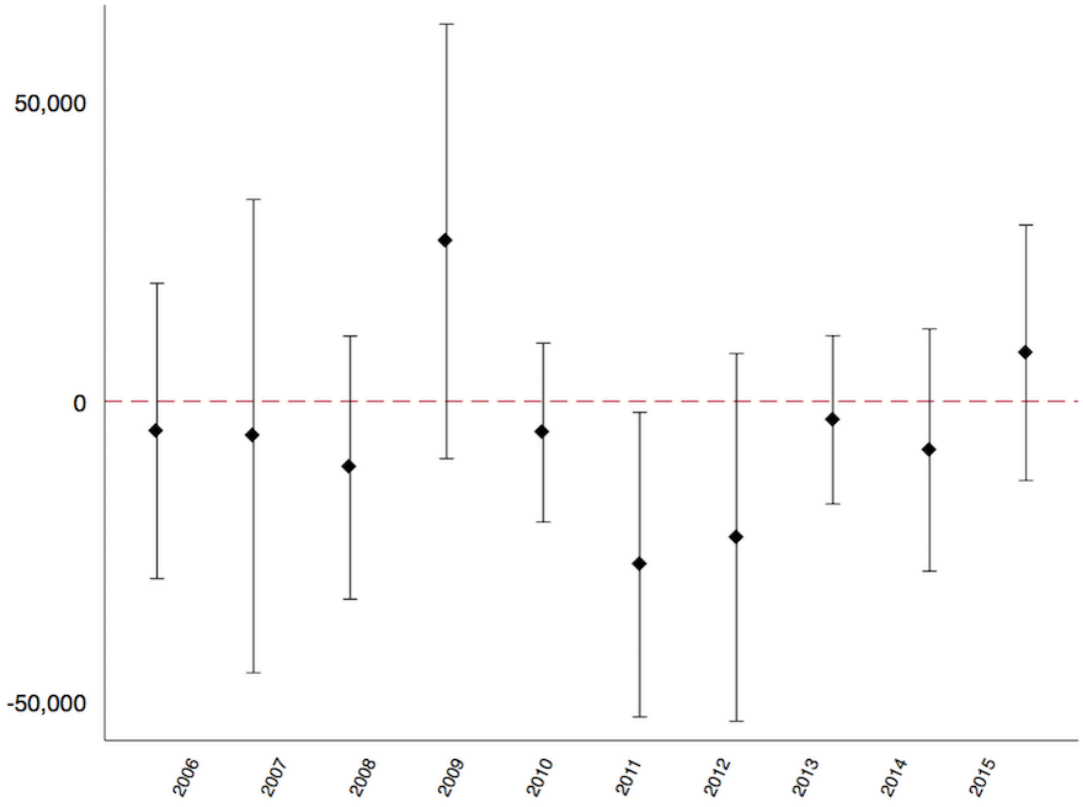
Standard errors in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Model (2) capturing the effect of FATCA on the country sample including the US among non-havens, shows the same general pattern as model (1). Diff-in-diffs relative to 2010 are substantially small and statistically insignificant just before the reference year and

[65] The concept of leads and lags was introduced by Autor 2003.

become large and statistically significant for the four years following the adoption of FATCA. The larger coefficients for model (2) are the result of including the second largest destination for cross-border deposits and debt-security holdings behind the UK among non-havens, which increases the group mean for non-havens. Moreover, the US also grew more than twice as fast as the average group member during the post-treatment period (52 vs. 24 percent between 2010 and 2014). As a result, the coefficients for the years 2011 to 2013 become statistically significant at the .05 level, whereas the coefficient for 2014 becomes statistically significant at the .10 level. This implies that FATCA's redistributive impact increases when including the United States among non-havens, and strongly suggests that the country's refusal to reciprocate AEI increases its attractiveness for capital formally hidden in jurisdictions making up the tax-haven group.[66]

Figure 8-3: Year-to-Year Diff-in-Diffs, Change in Tax Havens Relative to Change in Non-Havens (incl. US), $Billions



As an additional test demonstrating the impact of FATCA, *Figure 8-3* displays the year-to-year differences between changes in the liability levels of tax havens and non-havens

[66] Given the lack of bilateral data on cross-border deposits and debt-security holdings, it is impossible to prove that capital flowing into the US after FATCA actually came from countries included in the tax haven group. Still, the simultaneity of strong growth in the US and deep losses in the haven group makes this the most likely scenario.

when including the United States. The figure can be read in terms of mock experiments, taking place each year since 2006. The plotted coefficients for the subsequent year then show the treatment effect of these hypothetical interventions. Of course, an actual intervention in the form of a credible sanctions threat from the US did not take place in any of the years except 2010. As the figure shows, diff-in-diffs are relatively small for all years except 2009, 2011, and 2012, reflecting that trends evolved largely in parallel ahead of FATCA. What is more, out of the three substantially large coefficients only the one for 2011 is statistically significant at the .05 level, reflecting group trends' opposite directions between 2010 and 2011. Whereas non-haven liabilities had fallen steeper than tax-haven liabilities during the financial crisis, liabilities grew in non-havens and declined in tax havens after the adoption of FATCA, leading to an overall diff-in-diff effect of similar size. Accordingly, the act's redistributive impact is confirmed also when looking at year-to-year diff-in-diffs instead of diff-in-diffs relative to 2010.

8.6.2. A Counterfactual Test

To exclude that the above results are produced by a simultaneous trend or intervention other than FATCA, the analysis above is applied to a tax-haven activity that is closely related to the management of non-bank deposits and debt securities but unaffected by FATCA: the receipt of deposits and debt securities from foreign banks.[67] The interbank trade has an even larger volume than transactions between banks and non-banks and is unaffected by levels of financial secrecy given that banks are obliged to disclose their full balance sheet to shareholders, and have many legal means available to avoid profit taxes. Their activities should thus be unaffected by increased financial transparency. In contrast, the interbank trade is sensitive to changes in the global business cycle, turmoil in financial markets, domestic conditions in tax- and non-havens, and any other trend potentially overlapping with the impact of FATCA. Therefore, *Table 8-3* reports results for interbank liabilities produced by exactly the same regression ran for liabilities towards non-banks.

As the substantially small and statistically insignificant coefficients for $TaxHaven_{c2011}$ and $TaxHaven_{c2012}$ demonstrate, FATCA – or a potential parallel intervention – had no effect on the interbank trade. Instead, trends for the tax haven and non-haven group evolved in striking parallelism during the entire observation period, including the years that show the largest effects for liabilities towards non-banks. Moreover, adding the US to the non-haven group merely increases the size of the coefficient, owing to the importance

[67] This counterfactual test was originally proposed by Johannesen and Zucman 2012.

of the US financial market, but does not alter the non-haven trend. In fact, for all but one year during the observation period the reported coefficient is simply enlarged by an almost constant value of between $4 and 5 billion. Common time trends for both country constellations, and the entire observation period are also reflected in *Figures 8-4* and *8-5*, plotting group means. The absence of any reaction in the interbank trade suggests that there was no parallel shock affecting financial markets in general. Tax havens did not lose relative to non-havens, nor did non-havens gain relative to tax havens. Accordingly, the effect observed for non-bank liabilities must, indeed, be driven by households' reaction to increased financial transparency.

Table 8-3: Differences in Differences to Reference Year 2010 (Interbank Trade)

	(3) Interbank (excl. US) (mean) liabilities		(4) Interbank (incl. US) (mean) liabilities	
2005	81,177**	(37,504)	119,470**	(53,186)
2006	67,540**	(32,543)	89,976**	(38,748)
2007	16,741	(65,271)	23,097	(63,989)
2008	-34,018	(63,234)	-28,342	(62,388)
2009	12,416	(22,326)	18,759	(22,438)
2011	4,672	(16,962)	-8,964	(22,014)
2012	-10,706	(23,414)	-8,432	(23,705)
2013	18,008	(33,427)	13,417	(33,856)
2014	12,338	(40,071)	-3,908	(43,817)
2015	39,422	(52,477)	31,799	(53,119)
Constant	341,689***	(98,582)	410,760***	(120,700)
Country fixed effects	Yes		Yes	
Time fixed effects	Yes		Yes	
Observations	352		363	
R^2	0.12		0.13	

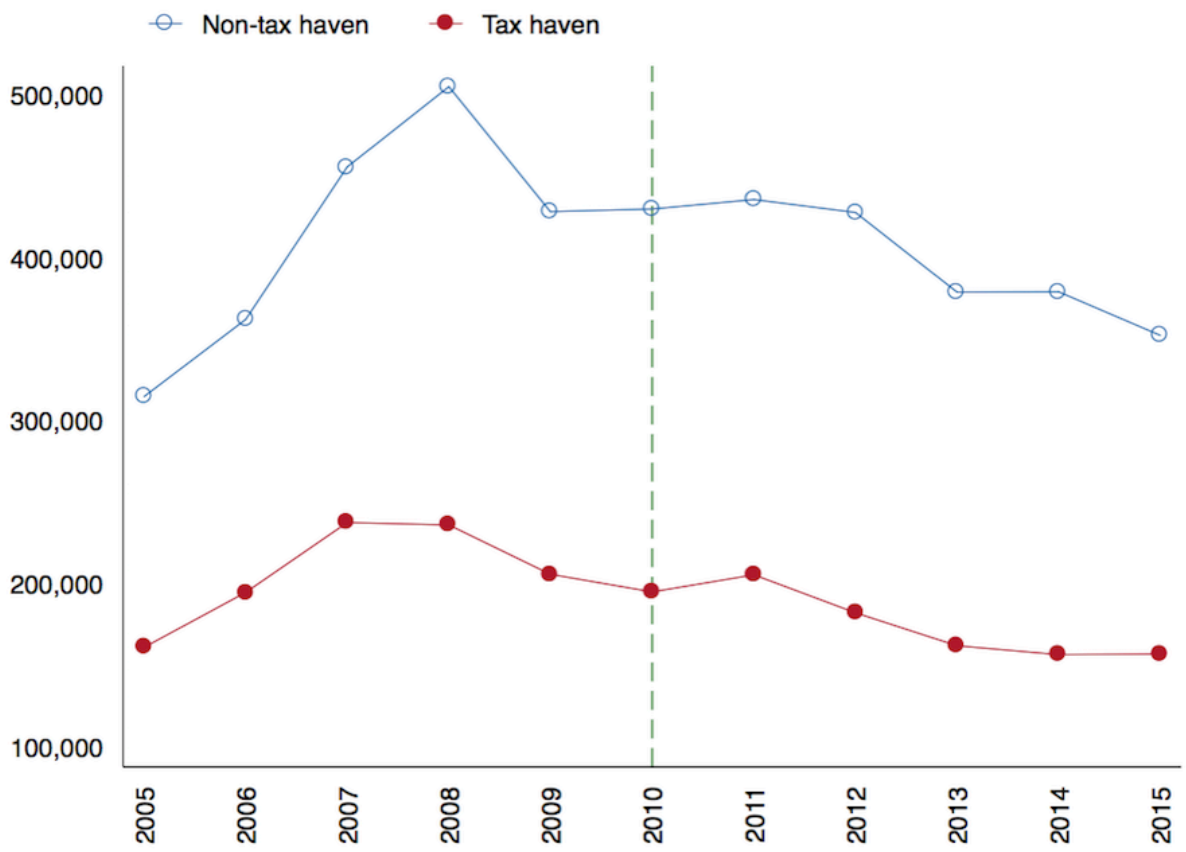
Standard errors in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

8.7. Discussion

As expected, the credible sanctions threat contained in FATCA had a causal effect on the international distribution of deposit and debt-security liabilities to foreign non-banks. By forcing tax havens to report account data bilaterally to the US, and providing third states with an opportunity to request equivalent multilateral cooperation, the act reduced the average value of such liabilities in this county group during the three years following its adoption, while not affecting growth in non-havens. Moreover, FATCA's redistributive impact grows substantially, and in terms of statistical significance when including the United States among non-havens, while the counterfactual test confirms that the act's effect is entirely attributable

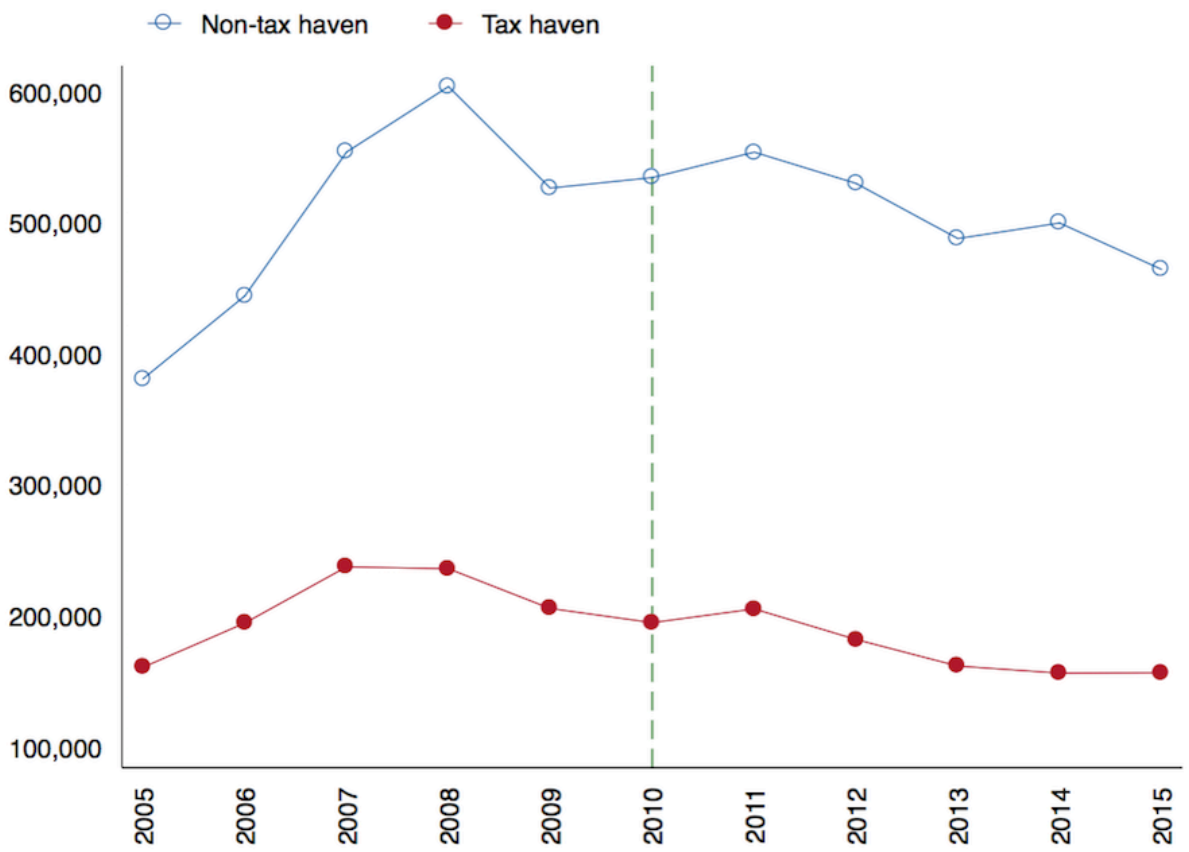
to the investment decisions of households hiding capital in tax havens. This strongly suggests that the act was not only effective in curbing the evasion of taxes on capital income through the exploitation of financial secrecy in traditional tax havens. At the same time, it also increased the attractiveness of the United States as a destination for hidden capital, owing to the country's refusal to reciprocate AEI. Whereas the intended and achieved outflow of capital from tax havens thus implies that tax cooperation does not produce joint gains for all parties involved, above average inflows of foreign capital into the US suggest that governments powerful enough to use coercion will exploit tax cooperation to their own benefit. The result is thus consistent with an interpretation of international bargaining in tax matters as a zero-sum game. Whereas tax havens benefit at the expense of non-havens under conditions of tax competition, non-havens, and great powers in particular, benefit at the expense of tax havens under conditions of tax cooperation.

Figure 8-4: Banks' Deposit and Debt-Security Liabilities to Foreign Banks (excl. US), $Billions



Data source: BIS 2016

Figure 8-5: Banks' Deposit and Debt-Security Liabilities to Foreign Banks (incl. US), $Billions



Data source: BIS 2016

9. Conclusion and Outlook

Tax evasion and avoidance are massive phenomena. We know this from scientific estimates of the sums routed through tax havens, and large datasets on the offshore holdings of individuals and corporations that whistleblowers have leaked to tax authorities and the media. Investment in tax havens does not happen by chance. The available evidence confirms instead that households and multinationals investing offshore are sensitive to the local rate of tax and the level of secrecy. In other words, the goal of investing in tax havens is to minimize the tax bill at home. Absent any international cooperation, tax arbitrage by individuals and corporations forces governments into tax competition. Either they reduce the tax burden on capital, or it moves to a different (paper) location. In any case, equal tax treatment of labor and capital becomes increasingly hard to implement. For small countries this is less of a problem, as they can substitute revenue lost to a tax cut with revenue gained from attracting additional tax base. They can thus compensate labor on the spending side for its discrimination on the revenue side. In contrast, large countries are unable to attract enough foreign capital with a tax cut to balance revenue lost to lower taxes on their domestic tax base. Accordingly, they are less likely to compensate labor through additional spending. The result is a major problem of equity.

This thesis does not develop an ideal regulatory instrument to counter tax arbitrage and competition. By explaining why the Group of Twenty nations (G20) and the Organisation for Economic Co-operation and Development (OECD) succeeded in establishing multilateral automatic exchange of information (AEI), it reveals, rather, how such instruments can actually be enforced at the international level. In contrast to previous accounts emphasizing structural and normative constraints on the use of coercion, it shows that governments controlling large internal markets are indeed powerful enough to force tax havens into cooperation. Their lever is a threat of economic sanctions that credibly links market access to compliance. As tax-haven banks depend on investment in large financial markets, which by definition account for significant shares in global capital demand, their governments have no choice but to ensure their continued access. Accordingly, they have to give in to regulatory demands from great powers. Hence, cooperation from tax havens depends on the willingness of governments controlling large internal markets to make use of their power through coercion. As the long absence of such cooperation suggests, this willingness is only given under specific circumstances. Domestic political constraints have to prevent a shift of the tax

burden to labor, while tax cooperation needs to produce a competitive advantage for domestic business.

9.1. Coercion as the Mainspring of International Tax Cooperation

Why have tax havens along with over a hundred governments agreed to automatically exchange information on accounts held by non-residents? From a contractualist perspective, tax havens benefitting from tax competition have no incentive to lift financial secrecy in such a way. For their financial centers, secrecy is a major selling point in the attraction of foreign capital. A larger capital stock provides banks with higher returns from management fees, the government with a larger tax base, and society with higher wages and less unemployment. Accordingly, they will only agree to increase transparency, if they are somehow compensated for the outflow of foreign capital such a decision is likely to precipitate. As chapter 7 shows, however, neither the G20 nor the OECD offered tax havens compensation for foregone profits from the management of hidden capital in return for participation in AEI. Instead, tax-haven governments expected losses for their financial sectors and in employment as a result of their consent. In fact, data presented in chapter 8 suggests they were right. The stock of foreign-held assets in tax havens declined substantially relative to the stock in non-havens once investors anticipated the multilateral adoption of AEI. Still, tax-haven governments complied with G20 and OECD demands.

In the absence of joint gains, proponents of tax cooperation must use coercion against dissenting governments to bring about their preferred outcome. According to constructivist accounts of international bargaining in tax matters, however, shared regulative norms including non-intervention, national sovereignty, and multilateralism may prevent powerful states from employing this means. From this perspective, tax havens have usually undermined tax cooperation by stressing the right of sovereign governments to maintain the level of tax and financial secrecy they consider appropriate. Against this background, any international obligation to deviate from the preferred policy mix constitutes an undue interference with one of the core competences of national governments. Such actions are considered even less legitimate, if tax havens are merely the targets of international efforts instead of being involved in the decision-making process.

As chapters 4, 5, and 6 show, interest groups in large countries have indeed taken up such normative claims to influence domestic policy debates. Yet, they did so to defend the underlying material interests of their sponsors, not the norms per se. The Center for Freedom and Prosperity (CFP), for instance, was the most outspoken lobby group against tax

cooperation under Clinton and Bush, and made heavy use of the normative claims described above. However, it is mainly the Koch brothers – two billionaires who have demonstrably made heavy use of offshore structures – who provide the group's financing. It is thus quite likely that normative claims were employed to protect their economic interests.

In addition, a comparison of chapters 5 and 7 reveals that the salience of normative claims depends on the ideological predisposition of the government in power. The Bush administration partly bought into the CFP's arguments, as it was per se sympathetic to the idea of tax competition. From its perspective, the concept provided a useful justification for its supply-side tax cut agenda. In contrast, the Obama administration, which aimed to restore the tax system's effective progressivity, paid little attention to the CFP when developing the Foreign Account Tax Compliance Act (FATCA). Instead, it created a law with a massive extraterritorial impact on foreign financial sectors. In fact, the act not only forced countries such as Switzerland to abandon banking secrecy – a sacrosanct provision it had defended for almost a hundred years – the underlying process was also completely unilateral. That is, affected foreign governments were not involved in the decision-making. Accordingly, the Obama administration violated every norm the opponents of tax cooperation were usually appealing to. Still, the act made it through Congress, and fundamentally changed bargaining over financial transparency at the international level.

The case studies thus suggest that neither the diverging interests of tax-haven governments nor the exploitation of shared norms could prevent the emergence of multilateral AEI. Despite these challenges – and in contrast to the Bush administration, which also had the opportunity – the Obama administration drew lessons from the circumvention of the QI program, and effectively used the market power of the United States to impose the routine reporting of account data on United States (US) clients on foreign financial institutions. In an almost ideal typical fashion, it used FATCA to credibly threaten non-compliant foreign banks with partial exclusion from the American financial market. As a result, virtually all internationally active banks registered as reporting institutions to protect their revenue and that of their clients from a prohibitive withholding tax. In many countries such reporting would have happened in violation of existing law. To escape this catch-22 situation, financial institutions across the world began to request legislative reforms from their home governments. Moreover, they urged them to enter into bilateral FATCA agreements with the United States to remove any potential conflict of laws. As a result, tax havens relaxed banking secrecy and other legal provisions that create financial opacity. Many of these had previously been national sacred cows that were supposedly non-negotiable, and had been defended for

almost a century in some cases. In addition, bilateral deals struck with the United States created legal precedents for subsequent AEI agreements with third states.

Owing to concessions granted to the United States, tax havens could no longer argue that domestic legislation prohibited them from providing account data to other governments. In the cases of Austria and Luxembourg, FATCA agreements also activated a most-favored-nation (MFN) clause, obliging the two countries to extend greater cooperation to European Union (EU) partners as well. Hence, they had to end their opposition against intra-EU AEI, which finally enabled the Commission to also request automatic information reporting from Switzerland. The G20 and OECD recognized these predicaments, and declared AEI the new global standard for tax cooperation shortly after the US had struck the first FATCA agreements. In order to ensure compatibility, the OECD fashioned its AEI standard closely onto the US model, while EU Group of Five (G5) governments prepared a multilateral agreement for its implementation. These developments convinced many tax haven banks that their governments would eventually have to make concessions to third states as well. Against this background, they soon realized that it was less costly for them to practice a single standard for all clients then to maintain parallel procedures for US citizens and other nationalities. Accordingly, the Swiss Bankers Association abandoned its withholding tax model, which it had originally conceived to preempt the emergence of AEI as the new global standard. Instead, Switzerland and most other offshore centers signed up to the multilateral AEI agreement soon after they had bowed to coercive pressure in bilateral relations with the United States. We can thus conclude that a great power can effectively coerce tax havens into tax cooperation.[1]

9.2. The Conditions Under Which Great Powers Use Coercion

If great powers are indeed able to use coercion against recalcitrant tax havens, why have they so seldom applied this means? As discussed in chapter 3, the two jurisdictions with great power potential in international tax matters are the US and the EU. They control the largest financial and consumer markets, and are less dependent on foreign trade and investment than the third great power candidate China. Yet, the EU has been unable to convert its material power resources into actual sway over international tax policy during the observation period. This is due to the unanimity requirement for Council decisions in tax matters, which enables

[1] Although impending sanctions from the United States, and the codification of AEI in EU law suggest that mock compliance with AEI will be difficult in bilateral relations with the US and inside the EU, it remains a possibility in the context of the multilateral agreement.

intra-EU tax havens to block legislation against tax evasion and avoidance as well as sanction threats towards tax havens outside the EU. The EU G5 were unable to overcome the veto power of countries like Austria or Luxembourg, as EU law and European Court of Justice (ECJ) jurisprudence prevent them from limiting market access to firms from other EU member states, and from applying controlled foreign company (CFC) legislation to highly profitable subsidiaries in intra-EU tax havens. For these reasons, Luxembourg and Austria were able to refrain from AEI on interest payments within the EU, and to block powerful mandates for Commission negotiations with Switzerland. This only changed once the United States had imposed AEI on these countries. From that moment, Luxembourg and Austria were obliged to practice AEI within the EU as well, and thus interested in imposing the same standard on Switzerland to avoid competitive disadvantages.

Before the establishment of multilateral AEI, however, the only great power in international tax matters was the United States. In accordance with *H1*, the US government's activism in international tax matters systematically varied with the party in power. Democratic administrations put high priority on initiatives against tax evasion and avoidance, whereas Republican administrations pursued such projects without conviction. As chapter 4 shows, concerns over an erosion of the tax base, and the perceived fairness of the US tax system led the Clinton administration to promote a multilateral initiative against tax havens in the Group of Seven nations (G7), which then tasked the OECD with developing the harmful tax competition (HTC) project. The Clinton Treasury gave strong support to the organization's recommendations, and publicly backed its threat of collective defense measures against noncompliant jurisdictions. Likewise, chapter 7 demonstrates that the Obama administration aimed to level the playing field for US taxpayers by removing incentives for shifting capital overseas. Accordingly, it developed the comprehensive Obama-Geithner plan against the abuse of tax havens by individuals and corporations, and included a long list of anti-evasion and avoidance measures in its Green Book of Revenue Proposals for fiscal year 2010. Most importantly, it issued a credible threat of economic sanctions against foreign banks unwilling to regularly report account data on US account holders through FATCA.

In contrast, the Bush administration discussed in chapters 5 and 6 aimed to reduce the tax burden on capital. Hence, it cut taxes on top personal income brackets, corporate profits, dividends, and inheritance, thus creating a major budgetary shortfall. An important justification for this supply-side tax cut agenda was international tax competition. From the perspective of the Bush Treasury, this was a positive phenomenon, forcing governments to

become more efficient, and protecting taxpayers from public overreach. In an act that underlines the US government's sway over the OECD's tax work, it thus removed all elements from the HTC project that aimed at the removal of special tax breaks, or linked tax residence to actual economic activity. Following the rhetoric of libertarian lobbyists, the Bush administration interpreted these measures as a first step towards the international harmonization of tax rates, and the abolition of beneficial tax competition. It thus considered them contrary to its general tax policy agenda. In contrast, it stuck to the HTC project's transparency and information exchange provisions, but made sure the sanction threat against noncompliant jurisdictions was effectively removed. In sum, the Bush administration pursued international tax policy without conviction, superficially positioning itself against criminal tax evasion, but preventing the OECD from implementing effective countermeasures.

As expected in *H2*, however, an administration's political orientation is not the only factor determining the use of coercion by the United States. Instead, a comparison of the Clinton and Obama administrations, as well as the comparisons of their actions against tax evasion and tax avoidance in chapters 4 and 7, suggests that the US uses credible sanction threats to curb tax evasion, but not to curb tax avoidance. In the case of tax evasion, the targeted organized interests are mainly foreign banks managing the hidden financial wealth of US residents. The regulatory costs can thus be shifted to businesses outside the United States. In the case of tax avoidance, a removal of tax planning opportunities in tax havens also affects organized interests inside the United States. Namely, American multinationals that make use of tax havens to minimize their tax bill. Therefore, anti-avoidance measures proposed by the administration receive strong opposition from US business. Using its instrumental and material power, this interest group makes sure that corresponding measures are either blocked in Congress, no matter which party controls its two chambers, or directly withdrawn by the administration in case of regulations. Owing to business opposition, the Clinton administration agreed to weaken the OECD's definition of substantial economic activity, and withdrew regulations against the abuse of check-the-box rules through hybrid entities. Likewise, the Obama administration failed to pass proposed reforms of check-the-box rules and the tax deferral system, as these would have endangered the tax planning strategies of US multinationals, and despite Democratic control of both chambers of Congress for some time after the publication of the Obama-Geithner plan.

For the US to enforce tax cooperation, a Democratic administration needs to be able to shift the regulatory burden to foreign actors. This was the case for the Qualified Intermediary (QI) program under Clinton, and for its successor, the Foreign Account Tax Compliance Act,

under Obama. In both cases, new reporting requirements were created for foreign banks only, sparing financial institutions in the US from regulatory adjustments. The QI program worked with incentives, and was focused on the reporting of US assets held by US investors. It therefore passed largely unnoticed. In contrast, FATCA was based on a credible sanctions threat against foreign banks, which it obliged to report all capital income and the account balances of US residents. Although the US pledges reciprocal information exchange in bilateral FATCA agreements, it has failed to pass regulations ensuring that domestic financial institutions collect and report the required information on their foreign clients. Moreover, the Obama administration did not sign the multilateral AEI agreement that more than a hundred jurisdictions currently participate in. As a result, it has not only shifted adjustment costs to foreign banks, but also created an important competitive advantage for US banks in the attraction of hidden capital. This is not only evident from the legal set up of the current AEI regime. As chapter 8 shows, it is confirmed by strong growth in the value of assets held by foreigners in the United States after the passage of FATCA, and the simultaneous decline in the value of assets held by foreigners in traditional tax havens. Given that the US government needs to provide domestic business with a competitive advantage to successfully pursue international tax cooperation, the eventual outcome is thus necessarily redistributive. Accordingly, bargaining in international tax matters resembles a zero sum game in practice. Whereas tax havens benefit from tax competition at the expense of large countries, great powers tailor tax cooperation to their own benefit at the expense of tax havens and everyone else. Instead of capitulating because of the weakest-link problem, they use their power to become the weakest-link themselves, thereby furthering the economic interests of domestic financial sectors and potentially some small constituent states, seeking to become – or defend their status as – global wealth management hubs.

9.3. The Future of International Tax Cooperation

The US government has been the only great power in international tax matters. But for domestic reasons it has only enforced cooperation against tax evasion when a Democratic administration could bias the ensuing regime to the benefit of US business. For proponents of international action against tax abuse these conclusions must seem discouraging. Yet, when applying this thesis' theoretical framework to current developments in international tax matters, it becomes clear that two possibilities for further progress exist. Either the EU must emerge as a second great power in international tax matters, or progressive interest groups in the US need to increase the political salience of tax fairness through clever use of

compensatory arguments. In current debates over reciprocal information exchange from the US, and the containment of tax avoidance by multinationals in the context of the OECD's base erosion and profit shifting (BEPS) project, these tendencies already exist. The following subsections will thus discuss the most recent developments in light of the theoretical insights at hand.

9.3.1. Preconditions for Reciprocal Information Exchange from the US

From the outset of negotiations on AEI the US government refused to provide other countries with the same type of account data it requests from them. Accordingly, neither the bilateral FATCA agreements, nor the Multilateral Competent Authority Agreement (MCAA), which it has not signed, oblige the United States to reciprocate the routine reporting of account information. The result of this unbalanced distribution of regulatory obligations is a major competitive advantage for US banks in the attraction of hidden capital. For European governments, for instance, persistent financial opacity in the United States could imply that the tax evaders among their citizens transfer assets previously hidden in traditional tax havens such as Switzerland to Delaware or Nevada instead of declaring them, and paying the corresponding back taxes and fines. Still, the EU G5 and OECD remained silent about the non-reciprocity of bilateral FATCA agreements, and the US government's non-participation in multilateral AEI. Instead, they acknowledged the importance of FATCA for the multilateral process, and expressed their understanding for domestic resistance in the United States.[2] In an exemplary statement on the occasion of the MCAA's signature, German minister of finance Wolfgang Schäuble told reporters:

> "Without FATCA we would not have seen the same progress on automatic exchange of information in Europe, which underlines the importance of the United States for global economic stability. Congress will have to draw its own conclusions on the progress achieved at the international level, and it will not necessarily appreciate counsel from foreign governments."[3]

In fact, the EU G5 and the OECD had several reasons not to stress non-reciprocity from the United States. First, there was little they could do about it. Given the United States' great power status, EU governments faced a 'take it or leave it' decision when negotiating FATCA agreements with the Obama administration. Whereas their financial institutions faced sanctions without the agreements, disunity in the Council of Ministers prevented EU governments from linking non-reciprocity to the imposition of similar costs on US banks. As a senior European tax official explained, "Even if several European countries negotiate with

[2] Brown and Martin 2014.
[3] BMF 2014.

the US there is still a difference in power. Because we are more interested in market access for our institutions in the US than the other way around."[4] Second, it was far more important for the EU G5 to lift financial opacity in traditional tax havens such as Switzerland and Luxembourg. At the time, the largest share of European offshore wealth was indeed managed in these countries,[5] and tax officials from the EU G5 still believed they did not have a tax evasion problem with the United States.[6] Accordingly, they did not want to delegitimize the political process that was getting them closer than ever to their main goal by criticizing FATCA on fairness grounds. As the head of the OECD's tax department recently confessed in an interview: "[Ignoring non-reciprocity from the US] was extremely embarrassing, but no one wanted to crash the party."[7]

However, things may be subject to change after all major tax havens have committed to multilateral AEI, including those within the European Union. As described in chapter 7, FATCA deals struck with the US in combination with the Administrative Cooperation Directive's MFN clause, obliged Luxembourg and Austria to also practice AEI with other EU member states. Accordingly, they agreed to the full transposition of the OECD's AEI standard into EU law,[8] and signed the MCAA.[9] As a result of coercive pressure from the United States, there is thus for the first time unanimity on financial transparency in the Council of Ministers. In fact, after consenting to AEI, Luxembourg and Austria are now just as eager as France or Germany to avoid competitive disadvantages by imposing the standard on third states. This was evident in their eventual support of a mandate for negotiations on AEI between the Commission and Switzerland,[10] and the wording of European Council conclusions on the adoption of a revised Savings Directive. In these conclusions, EU heads of state and government called on the Commission to conclude negotiations on AEI with third states and report back by the end of 2014. "If sufficient progress is not made," they requested, "the Commission's report should explore possible options to ensure compliance with the new global standard."[11]

Although the Commission has managed to strike AEI agreements with Switzerland, Liechtenstein, San Marino, Andorra, and Monaco since then,[12] it still developed an "external strategy for effective taxation" in response to the Council request. The purpose of this strategy

[4] Interview on 3 March 2015.
[5] Zucman 2014a.
[6] Interviews on 14 March 2014 and 3 March 2015.
[7] Besson 2016.
[8] European Union 2014b.
[9] OECD 2014c.
[10] Höltschi 2014.
[11] European Council 2014, 3.
[12] Commission 2016b.

is to project transparency and other standards for good tax governance practiced in the EU onto third states.[13] In the area of information exchange tools include a consolidated EU blacklist of noncooperative tax havens, and collective countermeasures against jurisdictions that fail to reform despite being listed. As to countermeasures, the Commission proposes "withholding taxes and non-deductibility of costs for transactions done through listed jurisdictions."[14] Moreover, it urges member states "to decide the exact nature of the counter-measures that should apply towards listed jurisdictions. They should do this before the end of 2016, so that third countries are fully aware of the repercussions once the EU screening process is underway."[15] As it stands, there is thus consensus in the Council on the need for sanctions against third countries not practicing AEI, and a concrete strategy for their coordination and implementation by the Commission. Of course, recent developments are not per se directed against the United States, but they certainly improve the EU's ability to make credible sanction threats in response to continued non-reciprocity in AEI.

Meanwhile, the lack of cooperation from the US has received increased attention in the period since most traditional tax havens committed to AEI. Recent academic studies and media reports suggest that the offshore business in US states such as Nevada or South Dakota is rapidly expanding, owing to very low regulatory hurdles for the anonymous incorporation of shell companies.[16] According to data reported by the Financial Times, for instance, the value of assets held in trusts registered in South Dakota doubled from $100 billion in 2012 to $200 billion in 2015.[17] This is consistent with results from difference-in-differences analysis reported in chapter 8, and with projections from the Boston Consulting Group according to which offshore wealth will only grow faster in Hong Kong and Singapore than in the United States.[18] Against this background, also the OECD has also recently broken its silence, and explicitly criticized the US government's lack of cooperation. As Pascal Saint-Amans, the organization's head of tax policy, declared in an interview, "for us the lack of complete reciprocity from the United States is a concern. The United States is not Panama. But it is not as good as it could be."[19] Likewise, at least some EU member states have recently debated the benefits of coordinated action against "a big powerful jurisdiction" that remains noncooperative.[20]

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[13] Commission 2016a, 2.
[14] Ibid., 12.
[15] Ibid.
[16] cf. BCG 2016; Drucker 2016; Findley, Nielson, and Sharman 2014; Scannell and Houlder 2016.
[17] Scannell and Houlder 2016.
[18] BCG 2016.
[19] Besson 2016.
[20] Commission 2015c, 8.

In sum, the US-induced consensus on AEI in the Council of Ministers, the Commission's willingness "to coordinate possible counter-measures towards non-cooperative tax jurisdictions,"[21] and increased awareness of the cost of non-reciprocity from the United States, may enable the EU to finally harness its great power potential in international tax matters. According to a former US Treasury official "you will only reach real reciprocity the moment that the political cost of forcing US financial institutions to do something they don't want to do, can be weighed against another cost."[22] In the present situation, EU member states could indeed create such a cost for US financial institutions, and thereby change the dynamic of US domestic politics to their benefit. They would simply have to translate their common preference for a level playing field in global tax matters into the adoption of withholding taxes on transactions from the common market to non-AEI-complaint jurisdictions as proposed by the Commission. By assuming its great power status and checking the US with its own means, the EU could make sure that tax evasion becomes extremely complicated no matter where shell companies or accounts are formally registered. At the same time, it could avoid competitive disadvantages for European wealth managers.[23]

9.3.2. The Prospects for Tackling Tax Avoidance by Multinationals

Whereas the US government has enforced international cooperation against tax evasion, it has not followed through with proposed domestic and international measures against tax avoidance. The reason is opposition from US multinationals defending their tax planning practices, and an underlying dilemma faced by developed countries organized in the OECD. In general, these countries host the headquarters and intellectual property (IP) of multinational corporations. They are thus interested in an international tax system that emphasizes residence taxation, and allows 'their' multinationals to repatriate profits from emerging and developing countries where production and sales take place. To this end, they have created OECD transfer-pricing guidelines that link taxable profits to added value, and added value to the location of IP. Based on these rules, the Chinese subsidiary producing and selling cars on behalf of a German manufacturer pays license fees to the parent company for the use of its IP. This reduces the taxable profit in China, and increases it in Germany, as license fees are deemed passive income, and, as such, are taxable at residence. If the manufacturer manages to locate its IP in a tax haven, however, the same rules also enable it to shift profits there instead of repatriating them. Developed countries can thus either choose to curb profit shifting and

[21] Commission 2015b, 13.
[22] Interview on 15 April 2015.
[23] The impact of Brexit on the EU's market power depends on the exact terms of the exit agreement and the relocation decisions of international banks. At the time of writing these were unforeseeable.

risk more source-based taxation, or they insist on residence-based taxation and risk more tax avoidance. In any case, they lose part of their tax base to foreign governments. In contrast to more tax avoidance, however, more source-based taxation would not only reduce the tax revenue of residence countries, it would also increase the effective tax burden on multinationals headquartered there. In order to reduce the foreign tax burden for their multinationals, OECD governments have thus generally given priority to limiting source-based taxation.[24]

With the advent of a digital economy dominated by US corporations, and the consolidation of the common market, however, this OECD consensus dissolved. In fact, EU G5 governments grew increasingly concerned at the ability of US multinationals to channel profits out of the common market untaxed.[25] With the complicity of several small EU member states, these companies set up tax-planning schemes like the "Double Irish with a Dutch Sandwich" to minimize the taxable profits of their subsidiaries in large EU member states. They achieved this through cost-sharing arrangements that allowed them to transfer the rights to the foreign use of their IP from the US to subsidiaries in Ireland, Luxembourg, or the Netherlands. These subsidiaries were granted special deals minimizing tax payments to the respective government, and then started collecting license fees for the use of their parent company's IP from their sister subsidiaries in the rest of the EU. These payments reduced taxable profits in large and high-tax member states, and increased them in small and low-tax member states.[26] Moreover, as described in chapter 2, the same schemes also enabled US multinationals to avoid being taxed on their foreign profits in the United States. As a result, US-owned coffee chains, book retailers, or computer firms enjoy a massive competitive advantage in the common market relative to their local competitors, which lack access to these tax-planning techniques. At the same time, EU G5 governments could not counter these practices, as their hands were tied by common market legislation, and ECJ jurisprudence. Owing to the unanimity requirement in tax matters, they could not get meaningful anti-tax avoidance directives through the Council of Ministers. Moreover, they were also unable to issue credible sanction threats, as the EU treaties prevent them from limiting market access for other member states. This is also why the ECJ in its *Cadbury Schweppes* ruling prevented large member states from using CFC rules against subsidiaries incorporated within the EU. As

[24] Avi-Yonah 2000; Dharmapala 2014. Interview with senior corporate tax advisor on 22 June 2015.
[25] Interview with senior EU G5 tax official, 3 March 2015.
[26] Pinkernell 2012.

a result, tax competition has been more intense inside the European Union than in the rest of the world.[27]

Against this background, the UK and Germany used public outrage over tax avoidance by Starbucks as a window of opportunity for bypassing the EU, and involving the G20 with the issue of tax avoidance at its 2012 summit in Los Cabos.[28] With the Obama administration's consent, the group declared, "we reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area."[29] In response, the organization opened its tax policy committees to observers from non-OECD G20 members, and began work on a BEPS report eventually released in October 2015. From the perspective of the OECD, opening deliberations to emerging economies should prevent the emergence of an alternative venue, and thus secure its position as the central forum for decisions on international tax policy.[30] As a German tax official explained in an article:

> "The BEPS project has strengthened the OECD's leading role in international tax policy. From the German perspective, this is a strategic success, since principles developed by the OECD tend to reflect the interests of an industrialized country like Germany. These standards will evolve to take the interests of emerging and developing countries into account. But at the same time, they provide a chance for continued unification of international tax standards, which is in the particular interest of Germany with its globally connected economy."[31]

Indeed, in the words of the German representative in the OECD's fiscal affairs committee, it soon became clear that "the inclusion of all G20 members in the discussion as opposed to a pure OECD discussion leads to a stronger regard for the interests of source countries."[32] Next to the US government, which did not want to block the process, but aimed to prevent moves towards more source taxation,[33] bargaining over BEPS thus involved two country groups with at least partial preferences for increased source taxation. The EU G5 wanted to prevent US multinationals from channeling profits out of the common market untaxed, but still defended arm's length as the international tax system's underlying principle. In contrast, emerging economies participating as observers without voting rights aimed at a more fundamental redistribution of taxing rights towards source countries.

The final report reflected this political constellation. Owing "to the stubborn insistence of the US and some other states," its actions 8 to 10 stress the continued relevance of arm's

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[27] Genschel, Kemmerling, and Seils 2011.
[28] Interview with senior EU G5 tax official on 3 March 2015.
[29] G20 Leaders 2012.
[30] Interviews with senior corporate tax advisor and senior EU G5 tax official on 3 March and 22 June 2015.
[31] Fehling 2015, 822.
[32] Kreienbaum 2014, 637.
[33] Piltz 2015.

length as the international tax system's underlying principle.[34] In a somewhat contradictory manner, they uphold the legal fiction that branches of a multinational are separate entities, and that transfer-pricing agreements between them should therefore be respected. To prevent abuse, however, they allow tax authorities to challenge these agreements, and reclassify the resulting transactions. For this purpose, a "facts and circumstances analysis" has to be implemented, determining where control over an intangible asset and related risks is actually exercised.[35] Its results then enable tax authorities to attribute profits resulting from the use of an intangible to the place of effective control. Yet, according to critics of the BEPS project, this analysis is extremely burdensome "even for OECD tax authorities," and depends on so-called comparables (comparable transactions between unrelated entities) that in practice do not exist. As a result, they expect the attribution of tax base related to intangibles to "remain largely a matter of negotiation between tax authorities and [multinationals]."[36] Still, Robert Stack, the US representative in the OECD's Committee on Fiscal Affairs, claimed to be "shocked and appalled" by the discretion the facts and circumstances analysis granted to tax examiners. Instead of questioning the place of effective control over an intangible, some governments should simply "accept that there [might] not be much value added in their territory."[37]

Next to the inconsistent overhaul of the arm's length principle, the BEPS report also includes recommendations to strengthen the position of source countries in a more straightforward manner. Its action 7 broadens the definition of "permanent establishment," the presence of which is the precondition for taxation at source. It now includes warehouses and commissionaires to prevent multinationals from artificially separating the delivery of a product from its purchase.[38] If implemented, this would make it harder for e-commerce platforms such as Amazon to pay taxes only in Luxembourg where online purchases from the entire common market are formally registered. Yet, it is likely not to capture purchases of digital products such as apps, e-books, mp3s, or video streaming, as no local warehouses are required for the delivery of these products.[39] Still, the US Treasury interpreted action 7 as an assault on 'its' multinationals, with several senior officials announcing the US would enter a reservation, if recommended changes to the PE definition were added to the OECD Model Tax Convention. According to Danielle Rolfes, the US Treasury's international tax counsel,

[34] Picciotto 2015, 7.
[35] Ibid.; OECD 2015b, 15.
[36] Picciotto 2015, 7.
[37] Sheppard and Johnston 2015.
[38] OECD 2015c, 9–10.
[39] Picciotto 2015, 9.

"the proposal tilts in favor of source country tax administrations because the lack of clarity allows administrations to interpret the provisions however they wish."[40] Owing to US opposition, recommendations related to action 7 were still considered provisional and subject to debate at the time of writing.[41] Moreover, the US withdrew from the working group elaborating a multilateral agreement for the implementation of action 7, and other tax treaty related BEPS recommendations.[42] Its adoption of these measures is thus highly unlikely.

Despite the EU G5 and non-OECD G20 members being in favor, the US has thus prevented meaningful shifts towards source-country taxation in the context of BEPS. Moreover, it is highly unlikely to adopt recommendations it does not support, which is consistent with its great power status in international tax matters. Yet, if the US does not participate, other governments may also abandon the project to avoid competitive disadvantages.[43] To rescue the project, the proponents of BEPS thus need to ensure implementation of its recommendations by the United States. In this context, it is again the EU that, if it can overcome its internal divisions, may have an opportunity to impose costs on an incompliant US government.

As described above, meaningful EU measures against tax avoidance have so far been prevented by small member states such as Ireland, Luxembourg, and the Netherlands, which have enabled subsidiaries of US multinationals to channel profits out of the common market. In return, they account for 55 percent of overall US foreign direct investment in the EU, mostly in the form of holding companies.[44] However, the EU Commission has recently begun to use EU competition law against these countries by investigating whether the sweetheart deals they grant to individual multinationals constitute illegal state aid. Since July 2014, cases have been opened against Starbucks in the Netherlands, Fiat and Amazon in Luxembourg, and Apple in Ireland. In October 2015, the Commission then set an important precedent by ruling that the Netherlands and Luxembourg had granted selective tax advantages to Starbucks and Fiat, and thus need to claw back €30 million in taxes from these companies.[45] Meanwhile, investigations of Apple and Amazon are ongoing, and subject to major diplomatic quarrels between the Commission and US Treasury. In a letter to Jean-Claude Juncker, President of the Commission, and Margarete Vestager, Commissioner for Competition, Treasury Secretary Jack Lew wrote, "while we recognize that state aid is a

[40] Martin 2015.
[41] cf. OECD 2016b.
[42] Martin 2015.
[43] cf. Piltz 2015.
[44] UNCTAD 2014; Pinkernell 2014.
[45] Commission 2015a; Hirst 2015.

longstanding concept, pursuing civil investigations – predominantly against U.S. companies – under this new interpretation creates disturbing international tax policy precedents."[46] In addition, he threatened to resort to "a rarely used provision in the Internal Revenue Code that permits the president to double U.S. taxes on countries and individuals in countries that have subjected US firms to discriminatory taxes."[47]

As this angry reaction suggests, the Commission may have found an effective lever to undermine the tax planning schemes of US multinationals in the common market. By ordering member states to claw back taxes lost to sweetheart deals, it not only imposes a direct monetary cost on investigated firms but also – if its novel use of state aid rules is systematically implemented – could create general uncertainty as to the viability of tax planning schemes set up in Ireland, Luxembourg, and the Netherlands. This may force these governments, as well as the United States, to make concessions to the rest of the EU in return for legal certainty. Concessions may include agreement to a common consolidated corporate tax base (CCCTB) within the EU, or participation in the multilateral implementation of BEPS recommendations by the US government. This is indeed what the Commission seems to have in mind. Commissioner Vestager underlined that "the Commission's reasoning in its investigations into tax rulings is based on firm legal ground" in her response letter to Jack Lew,[48] and opened new a new investigation into a tax deal granted to McDonald's in Luxembourg.[49] In parallel, and in accordance with a joint request from the finance ministers of France, Germany, and Italy,[50] the Commission launched an "Action Plan for Fair and Efficient Corporate Taxation in the EU," providing among other things for a re-launch of negotiations on the CCCTB, the transposition of BEPS recommendations into EU law, and the exchange of information on tax rulings (the sweetheart deals discussed above) among national tax authorities.[51]

At the time of writing, and with the consent of Ireland, Luxembourg, and the Netherlands, the Council of Ministers had indeed adopted corresponding directives. From 1 January 2017 national tax authorities will be obliged to inform their EU counterparts about transfer-pricing agreements reached with multinationals.[52] This makes it harder for corporations to tell different stories to different tax examiners, but critics find fault with the information not being public. Starting in fiscal year 2016, corporations need to break down

[46] Chee 2016.
[47] Lynch 2016.
[48] Vestager 2016, 2.
[49] Commission 2015d.
[50] cf. Commission 2015e, 2.
[51] Commission 2015b.
[52] Council of Ministers 2015.

their profits, tax payments, employees, and tangible assets in country-by-country reports.[53] As a result, inconsistencies between economic activity and tax payments are easier to detect, but information again isn't public, and the underlying OECD standard excludes intangible assets at the insistence of the United States.[54] In contrast, the Commission's more far reaching re-launch of the CCCTB, the original aim of which was to establish the unitary taxation of multinationals at EU level and the subsequent formulary apportionment of tax revenue among member states, was once more postponed in the Council. Whereas France and Germany were in favor, the UK and Ireland voiced concern.[55] Hence, member states eventually decided to focus on the proposal's BEPS related elements, and pass a separate anti-tax avoidance Directive (ATAD) to this effect.[56]

The Commission formally proposed the ATAD in January 2016. Its draft provided for "limitations to the deductibility of interest, exit taxation, a switchover clause, a general anti-abuse rule, controlled foreign company rules and a framework to tackle hybrid mismatches."[57] Accordingly, its aim was to tackle tax avoidance through thin capitalization, inversions, profit shifting to low-tax jurisdictions, and the setup of hybrid entities. Yet, the Dutch Council Presidency proved an open ear for complaints from member states such as Austria, Belgium, Ireland, and Malta,[58] eventually tabling a compromise version of the directive that watered down many of the Commission's proposals.[59] Although interest deductions were limited at a 30 percent ratio of interest payments to pre-tax earnings, the effective date of this provision was postponed to 1 January 2019, and loans granted before that date are excluded from its scope. The provisions on hybrid mismatches, according to which the classification of an entity chosen by the member state where a "payment, expense, or loss originates shall be followed by the other Member State which is involved in the mismatch,"[60] now exclude inconsistencies involving third countries. Most importantly, however, the directive fails to enable the application of CFC rules to intra-EU subsidiaries. In accordance with the ECJ's *Cadbury Schweppes* ruling, member states are prevented from applying CFC rules, if the EU subsidiary of a resident corporation can demonstrate substantial economic activity. Yet, in practice this means any activity that is not "wholly artificial."[61] Given that a desk and a handful of employees are usually enough to fulfill this requirement, and the burden of proof

[53] Council of Ministers 2016a.
[54] Sheppard 2016.
[55] Houlder 2015a; Oliver and Houlder 2015.
[56] Commission 2015e.
[57] Commission 2016c, 11.
[58] Finley 2016; Giegold 2016.
[59] Council of Ministers 2016b.
[60] Commission 2016c, 9.
[61] ECJ 2006, para 51.

stays with tax authorities, multinationals will still be able to hoard passive income in low-tax jurisdictions within the EU, while large member states continue to be prevented from applying pressure on intra-EU tax havens through CFC legislation.

With the backing of Germany, France and Italy the Commission is thus applying more pressure than ever on intra-EU tax havens abetting tax avoidance by US and other multinationals. Through its state aid investigations it has forced these governments to the negotiating table, where some progress on the exchange of information on tax rulings, country-by-country reporting, and exit taxation has been achieved. Yet, important loopholes remain, and fundamental improvements such as the CCCTB or the EU-internal application of CFC rules have been postponed or abandoned. It thus remains to be seen whether the proponents of meaningful anti-avoidance legislation in the EU manage to bring intra-EU tax havens into line, and thus prevent profit shifting out of the common market. If they succeed, the US is likely to make concessions at the OECD level, as the competitive advantage of its multinationals in the common market would have disappeared. Hence, BEPS implementation would not create additional costs. If they fail, however, the present system is likely to prevail for several decades unless domestic tax politics in the US undergo a fundamental change.

So far, Democratic administrations have not been able to overcome the opposition of multinationals to meaningful anti-avoidance legislation. Owing to their material and instrumental power, the latter have instead even been able to block regulations, which are not debated and approved by Congress. This is understandable. Democrats, including Barack Obama himself, have received large campaign contributions from companies like Amazon, Apple, and Google. Also, it is in the interest of the US government to provide these companies with competitive advantages at the international level by helping them to minimize the tax burden of their foreign subsidiaries. Ideally, this increases the profitability of resident parent companies, allows them to create well-paid jobs, and thus increases the US government's revenue from labor taxation. As long as voters pay little attention to international tax matters, Democrats thus do not have an incentive beyond their party ideology to impose additional costs on US multinationals. Although such a constellation has not been observed yet, it is nevertheless conceivable that tax justice advocates may increase the salience of corporate tax avoidance through the clever use of compensatory arguments. Increased voter attention could then provide administrations, and legislators of all political orientations with an electoral incentive to impose costs on multinationals.

As Scheve and Stasavage have recently shown, societies have generally succeeded in increasing the effective tax burden on capital when compensatory arguments based on the

equal treatment paradigm could be used as justification. This has usually been the case after episodes of mass mobilization for war, during which young and less affluent citizens have made sacrifices to the benefit of old and more affluent citizens. Harnessing the paradigm according to which all citizens should be treated as equals, proponents of capital taxation were then able to construct arguments according to which those having fought the war should be compensated for their sacrifice through more redistribution financed by those who had not sacrificed.[62] But compensatory arguments can also be constructed in the absence of war. Their originators simply need to demonstrate that government has created systematic inequities to the benefit of a certain social group, and should therefore compensate the rest of society to ensure the equal treatment of citizens.[63] In the context of corporate tax avoidance, such arguments are possible. After all, the US has over decades upheld an international tax system that allows multinational corporations to avoid paying the taxes they owe under the US tax code. In contrast, most ordinary citizens have no choice but to pay the taxes they owe on their labor income, as these are directly deducted from their salaries. The state is thus responsible for the unequal treatment of taxpayers, and should therefore compensate the large majority of taxpayers for this discrimination. Otherwise, sustained unfairness could undermine the legitimacy of the domestic tax system and challenge the voluntary disclosure procedure. That said, compensatory arguments may be possible, but their impact on the political process also depends on the ability of tax justice activists to make themselves heard against the opposition of well-financed and staffed corporate lobbyists. For the moment, NGO representatives in the US still emphasize their inferiority. As a senior campaigner put it, "voters in the US have a very short memory, tax avoidance scandals are in the headlines for a couple of days, but they quickly disappear."[64]

Whatever the ability of the EU to harness its great power potential, or the ability of tax justice activists to change the political debate evolve in the future, this thesis has shown that the key to understanding international cooperation against tax evasion and avoidance lies in the domestic political economy of the United States. The United States is the only great power in international tax matters, owing to the size of its internal market, and can therefore shape the rules governing the taxation of cross-border transactions. This will usually result in redistributive arrangements benefitting US business at the expense of foreign firms. In fact, US business will prevent any legislative or regulatory initiative that removes the competitive advantages it currently enjoys, owing to its instrumental and material power in US domestic

[62] Scheve and Stasavage 2016, chap. 6.
[63] Ibid., chap. 9.
[64] Interview on 22 June 2015.

politics. The predominant influence of business could, however, be checked if tax justice activists managed to increase the salience of corporate tax avoidance through the use of compensatory arguments. Alternatively, the EU could change the incentives for US multinationals by imposing costs on them unilaterally that can only be avoided through international cooperation by the United States. Some progress has been made in this direction but important challenges remain. Most importantly, Brexit creates major uncertainties as to the EU's material power resources, and its ability to project its preferences onto third states. Yet, its impact on international tax policy provides an exciting topic for future research.

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Appendix

A.1. List of Interviews

#	Interviewee Identifier	Interviewee Place of Work	Date of Interview	Type of Interview
1	Tax Policy Advisor to Green Member of EU Parliament	Brussels	5 May 2013	Phone
2	Senior EU Commission Tax Official	Brussels	24 May 2013	Phone
3	OECD Diplomat for Small Member State	Paris	4 March 2014	Face-to-face
4	OECD Ambassador for Small Member State	Paris	4 March 2014	Face-to-face
5	OECD Diplomat for Small Member State	Paris	5 March 2014	Face-to-face
6	OECD Tax Official	Paris	6 March 2014	Face-to-face
7	Senior OECD Tax Official	Paris	6 March 2014	Face-to-face
8	OECD Diplomat for Large Member State	Paris	6 March 2014	Face-to-face
9	OECD Diplomat for Small Member State	Paris	7 March 2014	Face-to-face
10	Global Forum Official	Paris	14 March 2014	Face-to-face
11	Senior French Tax Official	Paris	14 March 2014	Face-to-face
12	EU Commission Tax Official	Brussels	28 March 2014	Phone
13	Partner at Tax Law Firm	Vienna	7 July 2014	Face-to-face
14	Manager at Tax Law Firm	Vienna	7 July	Face-to-face
15	Member of Austrian Parliament (SPÖ)	Vienna	8 July 2014	Face-to-face
16	Tax Policy Advisor to Austrian Greens	Vienna	9 July 2014	Face-to-face
17	Former Austrian Minister of Finance	Vienna	10 July 2014	Face-to-face
18	Senior Austrian Tax Official	Vienna	14 July 2014	Face-to-face
19	Austrian Tax Official	Vienna	16 July 2014	Written Replies
20	Tax Policy Advisor to Austrian Chancellor	Vienna	16 July 2014	Face-to-face
21	Member of German Parliament (SPD)	Berlin	8 October 2014	Face-to-face
22	Member of German Parliament (CSU)	Berlin	15 October 2014	Face-to-face
23	Member of German Parliament (Greens)	Berlin	16 October 2014	Face-to-face
24	Member of German Parliament (SPD)	Berlin	14 November 2014	Face-to-face
25	Former Undersecretary in German Finance Ministry	Berlin	28 January 2015	Face-to-face
26	Senior EU G5 Tax Official	Berlin	3 March 2015	Face-to-face
27	Former Senior US Tax Official	Washington	13 April 2015	Face-to-face
28	Former US Tax Official	Washington	15 April 2015	Face-to-face

29	Partner at Tax Law Firm	Washington	17 April 2015	Face-to-face
30	Senior Tax Advisor to US Congress	Washington	21 April 2015	Face-to-face
31	Senior Lobbyist for US Multinationals	Washington	23 April 2015	Face-to-face
32	Partner at Tax Law Firm	Bonn	22 June 2015	Face-to-face
33	Senior Tax Justice Activist	Washington	23 June 2015	Face-to-face
34	OECD Tax Official	Paris	23 June 2015	Face-to-face
35	Senior Tax Justice Activist	Brussels	24 June 2015	Face-to-face