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The power of states and business:

Explaining transformative change in the fight against tax evasion and avoidance

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Author(s)	Lukas Hakelberg University of Bamberg Political Science lukas.hakelberg@uni-bamberg.de

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Contents

Executive Summary

Over the past decade, international tax policy has been marked by a string of scandals, revealing the circumvention of tax laws by wealthy individuals and multinational firms. These scandals lead to new policy initiatives against tax evasion and avoidance at the international level. Yet, only when individuals were the main targets of regulation did these initiatives remove the fundamental preconditions for the targeted behaviour. This article shows that the reason for this discrepancy lies in the ability of affected interest groups in major developed economies to exert instrumental, structural and discursive power in the political process. Whereas tax evaders are constrained by the criminal character of their deeds, multinationals routinely point to the legality of tax planning, emphasize the additional job creation and investment a lower tax burden permits, and shift the blame for loopholes to politicians writing the tax laws. This implies that a new policy paradigm can only be established, if it is reconcilable with the interests of powerful economic actors.

1. Introduction

Over the past decade, international tax policy has been marked by a string of scandals revealing the circumvention of national tax laws by wealthy individuals and multinational firms. Some of these scandals, including, for instance, the recent Panama Papers, uncovered how wealthy individuals used banking secrecy and shell corporations to hide assets from national tax authorities (ICIJ 2016; Levin and Coleman 2008). Others – like the Luxembourg Leaks – focused on the accounting practices used by multinational corporations to minimize their tax bills (ICIJ 2014). Irrespective of their focus, both types of scandal created considerable public attention, and put pressure on governments to act against tax practices many perceive as unfair. Following several national and regional initiatives, the Group of 20 (G20) thus tasked the Organisation for Economic Cooperation and Development (OECD) to develop countermeasures to tax evasion and tax avoidance (G20 Leaders 2012). Tax evasion occurs when a household conceals financial wealth and related capital income from the tax office. Its crucial prerequisite is the provision of financial secrecy by tax havens. Tax avoidance refers to accounting schemes enabling multinational corporations to inflate profits in low tax countries while deflating them in high tax countries. These practices are enabled by the arm's length principle in international tax law that obliges tax authorities to treat subsidiaries of a group as separate entities.

Since the G20 launched these initiatives, OECD governments have, indeed, pierced financial secrecy in a steadily increasing number of tax havens. By 2016, all major destinations for hidden capital had signed up to a multilateral agreement on the automatic exchange of account information (AEI) sponsored by the OECD. Instead of abetting tax evasion through the provision of legal constructs such as banking secrecy or anonymous shell corporations, these jurisdictions now regularly report the account balances and capital income of non-residents to their respective home countries (OECD 2014). In contrast, OECD governments have so far failed to move away from the arm's length principle. Whereas their project on base erosion and profit shifting (BEPS) provides technical fixes to some of the tax planning strategies used by multinational firms, and contains some true innovations like country-by-country reporting, the legal principle enabling tax-motivated shifts of assets, investment and profits between related entities remains in place (Picciotto 2015). Given the similar degree of public attention and disenchantment over the unfairness of tax evasion and tax avoidance, *why have OECD governments (so far) failed to reduce the scope for tax avoidance to the extent they have for tax evasion?*

Grinberg (2016) as well as Eccleston and Smith (2016) have recently provided preliminary explanations for this discrepancy. Grinberg stresses different balances of power and distributive dynamics in his account. From his perspective, the United States (US) used its unmatched financial market power to impose AEI on foreign banks. The G20 could then transform this US initiative into a multilateral regime, as all of its members expected additional tax revenue from lifting financial secrecy in tax havens. In contrast, he argues, no country can exert as much power over multinational firms as the US can over international banks. Instead of imposing standards unilaterally, governments thus need to reach consensus on common rules. This was, however, hard to achieve, as abandoning the arm's length principle would redistribute the tax base among major global powers. In addition, Eccleston and Smith argue that BEPS has a more far-reaching impact on the sovereignty of major powers than AEI. According to their view, AEI mainly constrained tax haven governments in upholding financial secrecy, whereas BEPS recommendations also interfere with the tax systems of important G20 members. While these contributions provide a good starting point, they leave much room for further analysis. Most importantly, they neither discuss the formation of government preferences at the domestic level, nor clearly identify the sources and constraints on state power in international tax policy.

Against this background, I argue that the level of change in policies abetting tax evasion and avoidance is determined by domestic factors shaping government preferences over tax policy, and the distribution of power at the international level. At the domestic level, barriers to regressive tax reform determine whether governments respond to tax competition with tax cuts or initiatives for tax cooperation (Genschel and Schwarz 2011). At the same time, it depends on affected interest groups' structural, instrumental and discursive power whether governments can actually pursue a cooperative agenda in tax matters (Fairfield 2010; Fuchs and Lederer 2008). At the international level, the distribution of power determines whether a single hegemon can impose its preferences on the rest of the world, or several great powers have to strike a bargain to establish tax cooperation. In the fight against tax evasion, regulation is directed against international banks managing hidden capital. In this context, the US is the single great power given its dominant financial market and control over central financial infrastructure (Helleiner 2014; Simmons 2001). In the fight against tax avoidance, regulation is directed against multinational firms. Here, both the EU and the US are great powers by virtue of their large consumer markets and importance as destinations for foreign direct investment (FDI). Hence, if the US wants to fight tax evasion, its preferred regulatory model will swiftly be adopted internationally. If either the EU or the US want to fight tax avoidance, however, it depends on the preferences of the other great power whether change is possible (Drezner 2008).

The rest of this working paper is structured as follows: In the next section a theory of power in international tax policy is developed along the lines sketched out in the previous paragraph. Against this background, the subsequent section compares the most recent initiatives against tax evasion and tax avoidance, showing how barriers to regressive tax reform popularized the idea of raising additional tax revenue through the closure of loopholes at the international level. Whereas criminal tax evaders were unable to prevent great powers from imposing AEI on tax havens, law-abiding multinationals used their structural instrumental and discursive power to preserve the arm's length principle in the context of BEPS. The fourth section sums up the study's findings and discusses their relevance for theories of institutional and ideational change. Most importantly, the article finds that transformative change only happens, if it is reconcilable with the economic interests of powerful veto players.

2. Power in International Tax Policy

Welfare economists assume that governments facing international tax competition seek to maximize the sum of tax revenue and production (Chisik and Davies 2004; Keen and Konrad 2014). Yet, how governments weigh these elements and which strategies they apply to attain their goal depends on a range of material and ideational factors. The easiest unilateral strategy in this regard is regressive tax reform. By shifting the tax burden away from internationally mobile capital and towards immobile labour and consumption, this strategy reduces the risk of losing production to international tax competition, and generates additional revenue from increased payroll and value-added taxes (VAT). Accordingly, regressive tax reform has been popular among OECD governments from the 1980s throughout the first decade of the 2000s (Beramendi and Rueda 2007; Genschel and Schwarz 2013; Kentikelenis and Seabrooke 2017). At the same time, however, this strategy also violates a fairness norm underpinning most modern tax systems. According to the ability-to-pay principle, high-income earners should contribute relatively more to the financing of the state than low-income earners, since they find it easier "to bear the sacrifice of material well-being a tax burden entails" (Slemrod and Bakija 2008, 64). Given that the capital share increases while the share devoted to consumption decreases with the level of income, however, regressive tax reform shifts the tax burden from high-income to low-income taxpayers. Hence, high-income earners and their representatives are likely to support, whereas low-income earners and their representatives are likely to resist such a reform.

Indeed, students of comparative tax policy consistently find that conservative parties prefer flat taxes on corporate profits and personal capital income. They usually justify their preference with the larger role of corporations and high-income earners in saving and investment, and the positive correlation between the level of tax and capital flight suggested by the Laffer curve. In contrast, left-of-center governments prefer progressive taxation of corporate profits and personal capital income, which they justify with the ability-to-pay principle (Bartels 2009; Basinger and Hallerberg 2004; Ganghof 2006). Yet, party ideology is not the only determinant of a government's attitude vis-à-vis regressive tax reform. As a result of its redistributive consequences and impact on the perceived fairness of a given tax system, such reform is politically highly salient. Therefore, corresponding voter attitudes and fairness concerns may also impact government positions. Plümper *et al.* (2009) demonstrate, for instance, that conservative governments facing an electorate with predominantly egalitarian convictions are just as unlikely as left-of-center parties to lower taxes on capital in response to tax competition. Accordingly, both party ideology and voter attitudes may create political barriers to regressive tax reform and force governments to search for an alternative strategy to minimize capital flight. In this context, the most likely response is international cooperation against tax evasion and avoidance, which aims to keep capital in the country by replacing the incentive of low tax rates with regulatory constraints on asset mobility. Put more formally, *governments facing countervailing pressures to regressive tax reform should be more likely to seek international tax cooperation than governments not facing such barriers (H1).*

Once a government has developed a preference for international tax cooperation, it needs to defend this agenda against opposition from affected domestic interest groups (Drezner 2008; Frieden 1991). In the case of anti-tax evasion measures, individuals hiding financial wealth and capital income offshore are most affected. In the case of anti-tax avoidance measures, locally headquartered multinationals using accounting schemes to minimize their tax bill face an additional regulatory burden. Both of these groups can exert substantial instrumental power over policymakers. Yet, tax evaders struggle to wield the same structural and discursive power as multinationals. Instrumental power refers to an interest group's ability "to exert direct influence on government decision-makers through campaign contributions and lobbying efforts" (Hacker and

Pierson 2002, 280). Multinationals and wealthy individuals, including those evading taxes, have the necessary resources and access to policymakers to bias tax-related decisions in their favour. In fact, tax experts in finance ministries usually form an epistemic community with tax advisors and chief financial officers of large corporations. They often seek advice or even collaborate with tax law firms in drafting tax legislation, and move back and forth between the public and private sector in some countries (Fairfield 2010; Hakelberg 2016). Likewise, Bartels (2009) shows for the US that elected decision-makers usually adjust their tax policy agendas to the interests of the most wealthy individuals among their constituents. This may be the result of material incentives such as campaign contributions, or more frequent personal interactions with local elites.

Whereas tax evaders, who are often wealthy individuals, thus tend to have similar access to decision-makers as representatives of multinational firms, they do not wield the same structural and discursive power in these relationships. Structural power is based on an interest group's ability to make credible threats of disinvestment (Hacker and Pierson 2002; Lindblom 1977). Multinationals confronting a government that seeks to curb tax avoidance have this ability, as they can respond by relocating headquarters and profit-generating activities to low tax jurisdictions instead of just shifting the profits. Hence, governments can either accept tax avoidance and lose corresponding revenue, or fight it and lose productive activity and related jobs. Given the crucial role of multinationals in job creation, and economic analysis confirming the substitutability of tax avoidance with actual relocations (Hong and Smart 2010), this is a credible threat from the perspective of policymakers. In contrast, tax evaders facing a government that seeks to increase financial transparency struggle to make similar threats. Since their tax liability is linked to their place of residence or citizenship, they would have to move their centre of vital interests to a low tax jurisdiction, or even obtain a new nationality to prevent their (former) home country from taxing their uncovered foreign capital income. Although there are many examples of wealthy individuals changing their primary residence for tax reasons, such a decision also involves leaving home and cutting social ties, which should make physical relocation more difficult for individuals than for corporations. In any case, an individual's decision to change its place of residence should have a negligible impact on employment compared to the relocation of company headquarters or factories. Disinvestment threats from tax evaders should therefore be less credible from the perspective of policymakers.

In addition, tax evaders also have less discursive power than multinational corporations. Discursive power refers to an interest group's ability to shape the interests and perceptions of policymakers and the general public by linking its demands to established norms and ideas (Fuchs and Lederer 2008). In response to criticism, multinationals can justify tax avoidance by invoking the legality of tax planning, thereby shifting the blame to legislators, who fail to remove loopholes. Moreover, they can invoke the public good by stressing their obligation to maximize profits on behalf of shareholders, and by linking a lower tax burden to more investment and jobs. In contrast, tax evaders break the law by concealing foreign capital income from the tax office. Given their status as criminals, their authority in public discourse is severely reduced. Hence, they struggle to plausibly explain why the law should not apply to them. At the same time, the norm of equal treatment obliges policymakers to credibly convey the impression that the law applies equally to all citizens (Scheve and Stasavage 2016). Hence, they need to pursue tax evaders to preserve the perceived legitimacy of the tax system or even the justice system in general. In fact, the norm of legality makes tax evasion a law-and-order as much as a tax policy issue. The number of policymakers considering the demands of tax evaders legitimate should therefore be much lower than the number of policymakers sympathetic to the arguments of multinationals. Against this background, we can thus conclude that *governments should be more likely to act against tax abuse where affected domestic interest groups have limited power (H2)*.

Once domestic bargaining has enabled a government to fight tax evasion and avoidance at the international level, the distribution of state power determines whether it can impose its preferred regulatory model on the rest of the world or needs to build consensus with other or more powerful countries. The relative power of governments relies on a material and an institutional resource: the size of their internal market and their autonomy in regulating in- and outbound economic transactions. A large internal market implies that "a smaller proportion of [a country's] economy [is] engaged in the international economic system" (Krasner 1976, 320). Accordingly, market closure by a large state is less costly for the large state itself 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 (Drezner 2008, 35). For this dynamic to unfold, however, the large state also needs effective control over the regulatory instruments and technical infrastructure enabling market closure. If a government does not have this control – for instance as a result of institutional constraints – it cannot make credible sanction threats against foreign countries or economic actors. As a result, its power may be limited despite a large internal market.

In bargaining over cooperation against tax evasion the control of access to large financial markets should be the decisive source of state power. Regulation in this field essentially targets banks in offshore centers. As custodians of hidden 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. Their business model is based on the attraction of foreign capital, which they need to reinvest to earn competitive yields for their clients. Here, they rely on large financial markets, which by definition account for large shares of worldwide capital demand. Therefore, tax haven banks are vulnerable to the closure of these markets, and their home governments eager to ensure their continued access. A great power should thus be able to coerce these governments into tax cooperation through a threat of market closure. To this effect, it could levy withholding taxes on payments going to foreign financial institutions (FFIs), or withdraw their banking licenses (Emmenegger 2014; Grinberg 2012). Moreover, a great power controlling financial infrastructure for the processing of transactions in its currency could exclude FFIs from the international financial circuit even if they do not operate on its territory (Helleiner 2002; Simmons 2001).

In bargaining over cooperation against tax avoidance general market size should be crucial. In this context, the targets of regulation are multinational corporations. These firms sell their products and services worldwide. Hence, they earn a substantial share of their profits outside their home country (Zucman 2014). Yet, these profits often leave the source country, where sales or production take place, untaxed. Instead, they are artificially shifted to tax havens. Countries with consumer markets negligible to a company's global results risk disinvestment when countering these practices. In contrast, countries accounting for an important fraction of a multinational's global sales have the potential to impose counter measures without risking its presence. Depending on its institutional capabilities, a powerful source country could, for instance, impose a special tax on firms suspected of profit-shifting (Houlder 2015). It could also inquire whether tax rebates granted by low-tax jurisdictions constitute illegal state aid (Oliver, Boland, and Houlder 2014), or target specific profit-shifting strategies by means of transfer pricing or thin capitalization rules (Genschel and Schwarz 2011, 355). Large financial and consumer markets paired with effective control of in- and outbound transactions thus provide governments with enough leverage to counter both tax evasion and avoidance. But which countries can actually wield such power?

In terms of stock market valuation, interbank transactions, and trade in options and futures, the US has repeatedly been identified as the world's biggest financial market (Simmons 2001; Singer 2007). 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 (World Bank 2013). Between 2009 and 2012, the value of transactions processed by US interbank transfer systems and clearing houses was by far the highest among all reporting countries (BIS 2013). Moreover, 37 percent of worldwide derivatives were traded and/or cleared in North America, compared to 34 percent in Asia-Pacific, and 20 percent in Europe (FIA 2014). The extent of international participation in the American market is reflected in foreign portfolio investment (FPI) statistics. As the IMF reports, 19 percent of worldwide FPI goes to the US, compared to 8 percent going to the runner-up, the United Kingdom (IMF 2015). Hence, the US is also the preferred FPI destination for all but one of the top 5 offshore centers on the financial secrecy index, ranking countries according to the effort they put into concealing account-holder identities (*Table 1*). As FFIs depend on its financial infrastructure, and are heavily invested in the country, the US can thus apply the levers described above to make them and their governments comply with its regulatory demands (Emmenegger 2017; Hakelberg 2016; Palan and Wigan 2014), but what about the EU as a whole?

Table 1: Portfolio Investment of Top 5 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 1* indicates, the common market absorbs even more FPI from three out of the five top secrecy jurisdictions than the US. Moreover, several analysts have recently considered the EU a great power in international economic, and financial affairs (Drezner 2008; Leblond 2011). In 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 able to refuse participation in intra-EU AEI on interest payments, and block mandates for Commission negotiations on that matter with 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 with potential capital flight to Switzerland. Large member states, in turn, were unable to coerce Luxembourg and Austria into participation due to common market legislation providing for non-discrimination, and the free movement of capital (Hakelberg 2015b). Given these institutional constraints, the EU fails to convert market size into actual power.

Table 2: Measures of Countries' Economic Power in 2013

Indicators	US	EU	CN	JP	RU	IN
Population (millions)	316	507	1357	127	144	1252
GDP (current US$, billions)	16800	17352	9240	4902	2097	1877
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
Trade to GDP ratio (2011-2013)	30.1	34.9	51.9	33.6	51.5	54.2
FDI (stock, outbound, % world total)	25.5	38.9	2.5	4.5	1.9	0.5
FDI (stock, inbound, % world total)	19.4	33.7	3.8	0.7	2.3	0.9

Sources: UNCTAD 2015; WTO 2015

To determine great power status in bargaining over cooperation against tax avoidance, Drezner's (2008, 36) approach of considering data on great power candidates' market size, and vulnerability to trade disruptions is applied (*Table 2*). According to these numbers, the EU, US, and China all control sizable consumer markets. Yet, the first two still dominate the latter in inbound as well as outbound FDI. It is thus a lot costlier for a capital exporting country to lose market access in the EU or the US than in China. Likewise, a capital importing country would lose more investment when closing its market to the EU or the US than to China. In addition, the Chinese economy is still more dependent on international trade than the European and US economies. Although this is likely to change in the medium term, the data summarized in *Table* 2 suggests that the EU and the US are currently the only great powers in international bargaining over corporate taxation. Also in this context, the EU is constrained by internal disunity paired with an unanimity requirement in the Council. However, the Commission's exclusive competence in competition policy provides it with an instrument for making credible sanction threats nonetheless.

Large EU members need the consent of Ireland, Luxembourg, and the Netherlands for EU-wide anti-avoidance measures. Yet, these countries serve as gateways through which US firms channel profits out of the common market (Pinkernell 2012, 2014). In return, they profit from an important inflow of US FDI in the form of holding companies. As UNCTAD (2014) reports, 55 percent of US FDI in the EU is located in these three countries. Therefore, they have little interest in joining, but a long history of blocking EU initiatives against profit shifting. As a result, tax competition has been stronger inside the EU than in the rest of the world (Genschel, Kemmerling, and Seils 2011, 591; Wasserfallen 2014, 429). Large member states have a hard time countering this dynamic, as multinationals running their business from Ireland, Luxembourg, or the Netherlands enjoy unconstrained access to the common market under European law. Large member states thus cannot apply countermeasures against firms shifting profits to these destinations, owing to the principle of non-discrimination. As the European Court of Justice (ECJ) made clear in its judgment of the Cadbury Schweppes case, countermeasures can only be applied, if a corporation's presence in another member state is "wholly artificial" (ECJ 2006, para. 51); a narrow definition that applies to letterbox companies only (Pinkernell 2014).

In contrast to large member states, however, the Commission disposes of an instrument to credibly threaten individual multinationals and member states: it can use its exclusive competence in competition law to convict EU governments granting special tax breaks to foreign or domestic companies of illegal state aid. Such decisions by the Commission oblige convicted member states to claw back taxes from privileged companies. Hence, they create monetary costs for multinationals directly involved in investigated schemes and uncertainty for multinationals benefiting from similar schemes in the same member state. Hence, the Commission is able to raise doubts over the legality of preferential tax treatment in a certain member state, which is likely to reduce its attractiveness as a destination for FDI and may increase its readiness to cooperate in the Council of Ministers. Given the Commission's control over an effective sanctions mechanism, the EU should thus be able to convert market size into actual power in the context of bargaining over anti-tax avoidance measures. Whereas international action against tax evasion is dominated by the US, international action against tax avoidance thus depends on consensus between the US and the EU. Put more formally, *the distribution of power between the US and the EU determines whether change can be imposed unilaterally or needs to be negotiated (H3).*

3. Post-Crisis Initiatives Against Tax Evasion and Avoidance

It has become popular among students of international tax policy to trace the current wave of initiatives against tax evasion and avoidance to the financial crisis of 2008. Eccleston (2012) argues, for instance, that the crisis exacerbated governments' budget constraints, and delegitimized the idea of efficiency enhancing (tax) competition. Likewise, Seabrooke and Wigan (2016) suggest that using taxpayer money for bank bailouts increased the political salience of revelations that wealthy individuals and multinational firms were apparently not paying their fair share. While it is certainly true that the financial crisis provided proponents of tax justice with a window of opportunity, my account stresses that it is not at the origin of the process. In fact, the financial crisis merely amplified administrative and political dynamics that had already begun to unsettle the status quo of international tax policy. As the following two sections will show, the decisive impetus for new initiatives against tax evasion and avoidance came from major tax scandals that either preceded or evolved in parallel to the financial crisis. Often these scandals were based on information obtained by national tax authorities, which was then strategically exploited by left-of-center politicians. In combination with the financial crisis these scandals exacerbated the question of who pays for bank bailouts and thus raised barriers to regressive tax reform in the US and the EU. Yet, new tax initiatives only resulted in transformative change when governments in favour were clearly more powerful than the rest of the world, and opposition from affected domestic interest groups was weak.

3.1 The Emergence of Multilateral AEI

3.1.1 Points of Departure: Savings Directive and Qualified Intermediary Program

When the financial crisis hit in 2008, governments on both sides of the Atlantic had already introduced the first (proto-) AEI schemes. In the US, the Clinton administration had created the Qualified Intermediary (QI) program in 2000, partly to shift the onus of administering the US withholding tax regime from US to foreign banks, and partly to address growing concern over the concealment of offshore accounts by US taxpayers (Shay, Fleming, and Peroni 2002). The program encouraged foreign banks to report their clients' US-source income to the Internal Revenue Service (IRS) and withhold the corresponding US taxes. As an incentive, it allowed registered FFIs to report the income of non-US residents on a pooled instead of an individual basis. By becoming a QI, they could thus hide the identities of their non-US clients from the IRS and the US banks acting as intermediaries between them and the service. As a result of these secrecy benefits, the program was very successful with FFIs, despite the fact that the US-source income of US residents still had to be reported on an individual basis (Grinberg 2012). Apparently, FFIs were more concerned with the prospect of losing wealthy non-US clients to their US competitors, than with losing US clients because of individual reporting to the IRS.

In Europe, EU member states had adopted a Savings Directive in 2003, providing for AEI on interest payments to non-residents (European Community 2003). France, Germany, and other large EU countries had promoted this directive to address the loss of deposits to small and secretive member states following the liberalization of capital flows inside the union (Genschel 2002). In contrast, Austria and Luxembourg – the main recipients of non-resident deposits from Eurozone households – were opposed to AEI, and could veto the directive, owing to the unanimity requirement for Council decisions on direct taxation. To win their support, France and Germany thus accepted the inclusion of a transition clause, permitting the two countries and Belgium to levy a withholding tax on non-resident deposits instead of reporting them to EU partners. Transition should end once non-EU secrecy jurisdictions such as Liechtenstein and Switzerland exchanged information with the EU in accordance with OECD standards. Yet, the two countries merely accepted the same withholding option as Austria and Luxembourg in their Savings Agreements with the EU, postponing the end of transition into the indefinite future (Hakelberg 2015b).

In the mid-2000s, official statistics and evidence from individual tax evasion cases suggested that these design failures and other loopholes undermined the effectiveness of both AEI programs. A first senate report on the QI program revealed that the absence of a clause requiring FFIs to look through interposed legal entities, enabled US residents to circumvent individual reporting by hiding behind shell corporations registered in a third state (Levin and Coleman 2006). Likewise, a first study on the Savings Directive suggested that the AEI mechanism's limited geographic coverage undermined its effectiveness in preventing tax evasion (Huizinga and Nicodème 2004). Although tax officials became increasingly aware of these shortcomings, conditions at the political level prohibited swift adjustment of the programs. Following its inauguration in 2001, the Bush administration had moved the focus of US tax policy away from the pursuit of offshore tax evasion (Eccleston 2012), and towards regressive tax relief for capital and top incomes (Bartels 2009). At the same time, the unanimity requirement kept large EU members from extending AEI to uncooperative jurisdictions in- and outside the union (Hakelberg 2015b).

To remedy their inability to obtain accurate information on residents' offshore accounts through official channels, the competent authorities decided to seek data by other means. In 2006, the IRS set up a new whistleblower program, promising informants a stake in tax payments recovered as a result of their cooperation (IRS 2015). In parallel, German tax authorities began to buy stolen account data from employees with Swiss and Liechtenstein banks (Taylor, Inverardi, and Hosenball 2013). These initiatives soon bore fruit. The IRS established contact with Bradley Birkenfeld, a former wealth manager with United Bank of Switzerland (UBS), who provided detailed information on a scheme the bank had developed to shield its US clients from the QI program's reporting requirements (Hässig 2010). Meanwhile, German tax authorities obtained account data on 900 German residents from Heinrich Kieber, a former employee of Liechtenstein Global Trust (LGT) (Brambusch 2013). Based on these data, US and German authorities launched criminal and civil investigations over the course of 2007. Yet, these developments received hardly any media attention at the time (Die Zeit 2008; Hässig 2010).

3.1.2 Setting the Agenda: Left-of-Center Politicians and Major Tax Evasion Scandals

The level of press coverage increased radically in the first half of 2008. In February, the German ministry of finance leaked information on an imminent search of the premises of Klaus Zumwinkel – then CEO of Deutsche Post – to the press. Tax authorities had found his name in the LGT data, and launched criminal proceedings for alleged tax evasion. As a result of the tip off, his arrest was broadcast live on television, and triggered an intense debate in German media (Brambusch 2013; Jäger 2014). Peer Steinbrück, the social-democratic minister of finance, seized the opportunity to convey three messages. First, he disclosed the authorities' possession of foreign account data, urging other tax evaders to submit corrected returns to avoid imprisonment (Faigle 2008). Second, he demanded a swift review of the Savings Directive, stressing the need for a "material and geographic extension" of its AEI mechanism (BMF 2008, 31). Third, he warned elites that the legitimacy of the economic system was at stake, if ordinary citizens got the impression that they were the only ones playing by the rules (Kellner and Strunz 2008; Tuma and Reuter 2008).

In the US, information provided by Bradley Birkenfeld enabled the Department of Justice (DoJ) to launch criminal investigations against the UBS and its senior wealth managers "for conspiring […] to defraud the United States" (DoJ 2008, 1). In parallel, a federal judge obliged the bank to surrender 19.000 client files to the IRS or be subject to civil penalties (Schaub 2011). Most importantly, however, Birkenfeld's testimony informed a second senate report on the circumvention of the QI program (Levin and Coleman 2008). The main author, Democratic Senator Carl Levin, had been a longtime opponent of tax havens. His previous reports and bills on the matter never received much media attention and congressional support (Levin 2005, 2007; Levin and Coleman 2006). The hearing he staged on the 2008 report, however, triggered what we now know as the UBS scandal (Hässig 2010).[1] At the hearing, Senator Levin presented the evidence for illegal activities of UBS and its US clients to the public, and floated an estimate that circumvention of the QI program had cost the US fisc as much as $100 billion (Levin and Coleman 2008, 18). In the presence of several subpoenaed UBS clients, officials and senators expressed their frustration with tax evaders taking advantage of honest American taxpayers. In the words of Douglas Shulman – then chairman of the IRS – "high-net-worth individuals should not be able to short-change their fellow citizens by moving assets or income offshore" (Ibid., 11). Finally, Mark Branson – then chief financial officer of UBS's wealth management branch – apologized for his banks' compliance failures, announced it would end its offshore business with US clients, and cooperate with the authorities (Ibid., 36ff.).

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[1] A Nexis search for "Qualified Intermediary Program" in all English language news retrieved six articles between August 2006, when the PSI released a first report on its circumvention (Levin and Coleman 2006), and December 2007. For the period between July and December 2008 the same search retrieved 41 articles.

The LGT and UBS scandals broke several months before the failure of Lehman brothers, and thus before policymakers could envisage the need for large scale bailout and stimulus packages (Emmenegger 2015). They drew their political force from the accused's high profile, the detailed evidence for their criminal behavior, and the confirmation – emphasized by left-of-center politicians – that wealthy individuals were deceiving their fellow citizens by not paying their fair share of tax. In the LGT case, neither Peer Steinbrück nor the German press linked the Zumwinkel affair to budgetary consequences from the recent difficulties of German banks in the US subprime market. Instead, they integrated the event in an ongoing fairness debate over corporate pay and social responsibility. "The managers already earn so much, and then they don't even play by the rules" was a typical comment these days (Nicolai and Müller 2008). Similarly, the UBS report and hearing protocol do not mention the terms subprime, financial crisis, or bailout. Instead, senators and witnesses denounced the criminal energy of UBS wealth managers and clients, and stressed the unfairness created when "a privileged few believe they are entitled to shirk their obligations and heap their tax liability on the sagging shoulders of other Americans" (Senate 2008, 51).

Even with the financial crisis still in the making, the LGT and UBS scandals created enough public attention to set a reform process in motion. Peer Steinbrück used the momentum to gather support from his French and Italian counterparts for putting a revision of the Savings Directive on the agenda of the March 2008 Council on Economic and Financial Affairs (ECOFIN). At the meeting, EU finance ministers requested an accelerated review of the Directive from the European Commission, but Jean-Claude Juncker – then finance and prime minister of Luxembourg – promised "many years of fascinating debate" on the issue (Mussler 2008). In the US, Carl Levin used the UBS scandal to promote anti-tax haven legislation he had introduced with presidential candidate Barack Obama. Countering rich people's movements to untax the one percent (I. W. Martin 2015), Obama had made "tax fairness for the middle class" a crucial campaign topic with a dedicated keynote speech in September 2007 (Obama 2007). In his speech he criticized "secretive offshore centers" and declared the US would "lead the international community to new standards of information sharing" under his presidency (Ibid.). Having co-sponsored legislation against abuses uncovered by the UBS scandal underlined his credibility in the matter. Accordingly, Obama urged that "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" (States News Service 2008).

3.1.3 Towards New Rules: Legislative Initiatives in Europe and the US

While the European Commission was reviewing the Savings Directive, Germany and France, which had just obtained client data stolen from Hongkong & Shanghai Banking Corporation (HSBC) in Geneva (Pelletier 2012), increased pressure on small and secretive European countries via the international level. At a conference on tax evasion in October 2008, they called on the OECD to include Austria, Luxembourg and Switzerland in a blacklist of countries incompliant with its information exchange standard (Bouilhet 2008; Hall 2008). In parallel, they raised support from the US for putting tax transparency on the agenda of the G20's first crisis meeting in November 2008.[2] Soon afterwards, the OECD floated the requested blacklist (Emmenegger 2015), while G20 heads of state and government declared that "lack of transparency and a failure to exchange tax information should be vigorously addressed" (G20 Leaders 2008). To find a common response, the finance ministers of Austria, Luxembourg and Switzerland met at Senningen castle in March 2009. They decided to appease the G20 and OECD by fully adopting the OECD standard (Israel 2009). This came at relatively low cost given the prohibitive conditions the standard foresaw for the actual provision of administrative assistance (Genschel and Rixen 2015). More importantly, the three finance ministers used their meeting to devise a strategy against attempts to expand AEI at EU level (Hakelberg 2015a).

The European Commission presented its review of the Savings Directive in fall 2008. It established that EU households holding deposits in another member state could avoid the reporting of interest payments by hiding behind a shell corporation located in a third state, or by investing in equity instead of debt (European Commission 2008b). In response, the Commission proposed revisions obliging banks to look through interposed legal entities, and extending the Directive's material scope to securities with a risk profile similar to debt (European Commission 2008a). During the next four years, Council presidencies made six attempts at passing these revisions along with a mandate for Commission negotiations over a corresponding Savings agreement with Switzerland. Every time, Austria and Luxembourg argued that Switzerland had to signal its willingness to practice AEI with the EU before they would accept a revised Directive. Switzerland, in turn, declined the request, pointing to Austria and Luxembourg's non-participation in intra-EU AEI

[2] Interviews with OECD tax official on 6 March 2014, and former undersecretary in German ministry of finance on 28 January 2015.

(Hakelberg 2015a). Hence, the only item on direct taxation ECOFIN adopted during this period was an Administrative Cooperation Directive transposing the OECD's information exchange standard into EU law. The Directive contained a customary most-favored-nation (MFN) clause, obliging member states to extend greater cooperation granted to a third state also to each other (European Union 2011). This clause seemed benign when adopted, but soon had unintended consequences, owing to policy developments in the US.

When Barack Obama took office as US president in January 2009, he was committed by his own statements and to his former co-sponsor Carl Levin to act against tax evasion. Treasury officials were sceptical towards the Stop Tax Haven Abuse Act the two Democrats had proposed, as it threatened non-reporting FFIs with exclusion from US clearing systems. Instead, they suggested a complementary approach to the QI program, extending reporting requirements for FFIs to all financial assets held by US clients, and imposing a withholding tax on US-source payments in case of noncompliance. This approach was further developed in cooperation with the house ways and means and the senate finance committees.[3] Along with several other anti-tax evasion and avoidance items (see below) a corresponding draft was included in Treasury's Green Book on Revenue Proposals for 2010 (US Treasury 2009), and eventually proposed to congress as the Foreign Account Tax Compliance Act (FATCA). The act's objective is to "force [FFIs] to disclose their US account holders or pay a steep penalty for nondisclosure" (Hire Act 2010, cited in Grinberg 2012, 24). As penalty, it provides for a 30 percent withholding tax "on the gross amount of certain payments from US sources and the proceeds from disposing from certain US investments" (Ibid.). As one of the act's original authors puts it, the act uses the "weight of US financial markets […] to ensure near-comprehensive participation in FATCA's cross-border information reporting" (Grinberg 2012, 25).

The act easily passed congress for three reasons. First, Democrats held majorities in both chambers between 2009 and mid-2011. Second, the failure of Lehman brothers, several bailouts, and the passage of a first stimulus package in February 2009 made Democrats look for progressive financing mechanisms. Third, the cost of adjustment to FATCA was almost entirely borne by foreign banks without strong political representation in the US. In a first hearing on the act, Richard

[3] Interviews with former US Treasury officials on 13 and 15 April 2015.

Neal, the Democratic chairman of the subcommittee on select revenue measures, concluded his opening statement as follows:

"In terms of the economic confrontation […] America is currently 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 as patently unfair" (GPO 2009, 4).

Comparing FATCA to the Obama administration's anti-avoidance proposals, Patrick Tiberi, the subcommittee's ranking minority member, congratulated Neal on a bill that "does not blur the issues of tax evasion and legal tax practices, and does not include the most controversial tax policy changes proposed by the Administration" (GPO 2009, 5). Likewise, a former Treasury official explained in an interview that the Obama administration refrained from including new reporting requirements for domestic banks in the act so as to not add on to their post-crisis compliance burden:

"We were trying to implement FATCA, starting in March 2009. The entire global financial system nearly collapsed in 2008 – 2009. So these institutions had distractions. They only have so much in their compliance budget, only so many resources to do these things, and to do that in the environment that FATCA actually had to be implemented in was an enormous challenge. The government understood that."[4]

While FATCA was perceived as sending a signal of fairness to voters, it imposed virtually no cost on US banks and multinationals. Hence, the act passed congress in March 2010 as a financing mechanism attached to a second stimulus package (Mollohan 2010).

3.1.4 The Role of Domestic Interest Groups: Tax Evaders and Financial Institutions

The group most affected by EU and US efforts to increase financial transparency includes residents hiding capital income offshore. Since tax evasion is illegal in both jurisdictions, however, these often wealthy and influential individuals cannot openly defend their deeds. The experience of Klaus Zumwinkel is a case in point. Owing to his status as most senior CEO of a German stock corporation, his accumulation of supervisory board seats and selections as manager of the year, the

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[4] Interview with former US Treasury official on 13 April 2015.

Frankfurter Allgemeine Zeitung called Zumwinkel the “grand seigneur of *Deutschland AG*” (Meck 2009). He maintained excellent connections with Germany’s major parties and was involved in many decisions on economic policy. Given that his behavior was illegal, however, he could not exploit these connections when tax authorities obtained data on his Liechtenstein account. For the social democrats his case was useful for the dissuasion of other tax evaders, whereas no conservative politician could afford being perceived as tolerant of criminal activity (Nicolai and Müller 2008). Moreover, Zumwinkel preferred to confess and show remorse instead of defending himself to obtain a weaker sentence and save at least some part of his reputation (Bünder, Jahn, and Steltzner 2009). This rationale has been observed among German tax evaders in general. Instead of mobilizing against the crackdown on tax havens, tens of thousands have filed corrected returns and paid back taxes to avoid imprisonment (Finanzministerium des Landes Nordrhein-Westfalen 2014).

The criminal character of their offshore activities also kept US tax evaders from openly defending themselves. At the UBS hearing, all subpoenaed UBS clients invoked their right not to incriminate themselves and remained silent (Senate 2008). They were subsequently engaged in prolonged legal battles with the IRS, some of which ended with guilty pleas while others are still ongoing (Novack 2016; Schreiber 2016). Similar to the German experience, however, the IRS reported in 2016 that 54,000 US taxpayers had participated in its offshore disclosure program since 2009, generating $8 billion in additional tax revenue (IRS 2016). Whereas many of those directly affected by the US crackdown on tax havens were thus seeking arrangements with the authorities, a libertarian lobby group financed by billionaire tycoons tried to mobilize against efforts to increase financial transparency. In its letters to legislators and the administration, the Center for Freedom and Prosperity (CFP) argued that FATCA was infringing upon the privacy of law-abiding citizens, lead FFIs to disinvest from the US, and interfered with the sovereignty of foreign countries (CFP 2010, 2013). Yet, the group’s arguments did not gain any currency with Democrats, and had already been unsuccessful in keeping the previous Republican administration from signing tax information exchange agreements with foreign governments. At the time, Paul O’Neill – the Bush administration’s first Treasury Secretary – explained that he was in favor of tax competition, but had sworn an oath obliging him to purse those “who illegally evade taxes by hiding income in offshore accounts” (O’Neill 2001, 83).

Tax evaders and libertarian lobbyists were thus unable to influence the tax haven debate given the simultaneous infringement of fairness and legal norms the underreporting of foreign assets involves.

In addition, the financial sectors in large EU countries and the US tended to support greater financial transparency in tax havens. From their point of view, secrecy provided tax haven banks with a competitive advantage in wealth management. They were thus in favor of raising international standards to the level they already complied with. Commenting on the revision of the Savings Directive, the research department of *Deutsche Bank* concluded, for instance, that its material and geographic extension entailed "a considerably higher compliance burden, but also more transparency. In view of fairer tax competition, this should be welcomed" (Zipfel 2009, 9). More drastically, the French Banking Federation (FBF) advocated common industry standards for financial transparency, insisted that its members were strictly applying the law, and underlined that to be effective measures against tax evasion had to be enforced at the European and global levels (FBF 2009, 2013). Likewise, the American Bankers Association (ABA) welcomed "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 taxpayers that engage in illegal use of offshore accounts" (GPO 2009, 80). Yet, the association insisted that its members were given enough time to build the necessary infrastructure for FATCA implementation, and opposed any new reporting requirements for US banks (Mordi 2011).

In contrast, financial sectors in countries still providing secrecy benefits were strongly opposed to AEI. Whereas the Luxembourg Bankers Association insisted that account holders had to agree to the reporting of their capital income under Luxembourgish law (ABBL 2012), the Austrian Bankers Association stressed that its members' participation in AEI was currently prevented by Austrian law (Bankenverband 2012). In Switzerland, private banks whose business model depended on secrecy kept the Swiss Banking Association (SBA) from making concessions on AEI to aid UBS (Eggenberger and Emmenegger 2015). Instead, the SBA tried to undermine the emergence of AEI as the new global information exchange standard by developing the so-called Rubik model for bilateral tax treaties (Hässig 2010). The model foresaw the imposition of withholding taxes on the capital income of the treaty partner's residents, the proceeds of which would then be channelled 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. The identities of nonresident investors in Switzerland would, however, be protected (Grinberg 2012). The Swiss government began to offer Rubik agreements to its key trading partners in 2009. Yet, its efforts merely provoked the US to speed up the internationalization of FATCA (Emmenegger 2015; Grinberg 2012).

3.1.5 Reaching International Agreement: From Bilateral FATCA Deals to Multilateral AEI

Congress had conceived FATCA as a domestic law with extraterritorial reach, following the approach already applied in the implementation of the QI program. The US Treasury's focus eventually shifted to the international level for two reasons. First, after the publication of a first guide- and timeline for FATCA implementation in August 2011, many FFIs realized that the act's reporting requirements would collide with data protection and banking secrecy legislation in their home countries. This forced them to choose between breaking domestic law to be FATCA compliant, and accepting the 30 percent withholding tax due in case of noncompliance (Eccleston and Gray 2014). In addition, many FFIs wanted to avoid entering in a privity of contract with the IRS, as this was a weak basis for changing terms and conditions, 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.[5] Second, the US Treasury wanted to stop the spread of Swiss Rubik agreements, which it understood as a challenge to the principle of AEI embedded in FATCA.[6] As a result of these considerations, Emily McMahon, Assistant Secretary of the Treasury, announced in September 2011 that the US "was committed to entering into bilateral and multilateral agreements that would allow financial institutions to comply with FATCA without violating local law" (Grinberg 2012, 25).

To this effect, Treasury opened negotiations on a "common approach to FATCA implementation" with France, Germany, Italy, Spain, and the UK (EU G5) (US Treasury 2012b, 2). 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.[7] From the perspective of the EU G5, the US initiative provided a response to the concerns of their domestic banking industries, a means to further the expansion of AEI at EU level, and a chance to obtain reciprocal information exchange from the US.[8] Accordingly, the parties agreed on a joint statement in February 2012.

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[5] Interviews with French tax official on 14 March 2014, former undersecretary in German ministry of finance on 28 January 2015, and German tax official on 3 March 2015.

[6] Interview with former US Treasury official on 15 April 2015.

[7] Interview with former US Treasury official on 13 April 2015.

[8] Interview with French tax official on 14 March 2014, and German tax official on 3 March 2015.

Whereas the EU G5 pledged to legally require banks to collect account information as requested by FATCA, and to transfer the reported data automatically to the IRS, the US agreed to exempt banks from the EU G5 from entering into direct contractual relationships with the IRS, and to reciprocate information reporting. 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 for information" (US Treasury 2012b, 2–3). Based on the joint statement, the US Treasury drafted a so-called model 1 intergovernmental agreement (IGA) as a template for FATCA treaties with jurisdictions around the world. Its article 6 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" (US Treasury 2012a, Art. 6).[9]

Given that the US had committed future signatories of model 1 IGAs to pursue multilateral AEI in cooperation with the OECD, G20 ministers of finance asked the organization to deliver a corresponding report (G20 Ministers 2012, para. 9). G20 leaders approved this report in June 2012, calling on all countries to adopt AEI (G20 Leaders 2012, 9). Following the first indictment in the US of a Swiss private bank for assisting US clients to evade tax, prompting the bank's dissolution, these developments finally convinced the Swiss government to abandon the principled defense of banking secrecy (Emmenegger 2015). The same month, it issued a joint statement with the US, declaring its 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" (US Treasury 2012c, 1–2). In an attempt to improve its position in subsequent bargaining with the EU, however, it negotiated a so-called model 2 agreement with the US, providing for the direct reporting of account information from Swiss banks to the IRS (Niederberger 2012; Rutishauser 2012). Still, Eveline Widmer-Schlumpf, then Swiss minister of finance, announced shortly after signing the FATCA treaty that she would also enter into a dialogue on AEI with the EU (Valda 2012).

[9] 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.

The internationalization of FATCA completely changed the dynamic of bargaining over AEI at EU level. As the US now used its financial market power to impose bilateral FATCA treaties on the rest of the world, Austria and Luxembourg had no chance but to comply. By signing a FATCA agreement with the US, however, they activated the Administrative Cooperation Directive's MFN clause, obliging them to extent equivalent cooperation to EU partners. Against this background, Luxembourg swiftly gave in. As Jean-Claude Juncker, then the country's prime minister, explained:

"If we now modify our position, we do it because the Americans do not leave us a choice. They restrict their financial operations to countries, which accept automatic exchange of information. If we do not comply with this condition, there won't be any financial operations with the USA. Yet, an international financial center cannot cut itself from the American financial circuit. […] We cannot refuse to also extend to the Europeans the concessions that we have to make to the Americans within the context of a bilateral treaty" (Juncker 2013, 16-17 cited in Hakelberg 2015b)

In contrast, Austria initially tried to circumvent the MFN clause by signing a model 2 agreement with the US, providing for the direct transmission of account data from banks to the IRS.[10] Nonetheless, the EU G5 threatened to sue Austria before the European Court of Justice for disrespect of the MFN clause. As a senior German tax official 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."[11]

In addition, the Swiss government's willingness to enter into negotiations on AEI with the EU implied the establishment of the level playing field requested by the Austrian and Luxembourgish governments, as well as the end of the Savings Directive's transition period. As a result, Austria and Luxembourg first agreed to a Commission mandate for formal negotiations with Switzerland. Following Swiss confirmation of its willingness to practice AEI with the EU, the two governments also agreed to revised Savings and Administrative Cooperation Directives, extending intra-EU AEI to all member states and asset types (Hakelberg 2015b).

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[10] Interview with Austrian tax official on 14 July 2014.

[11] Interview with German tax official on 3 March 2015.

The US had thus enabled the material and geographic extension on AEI at the European level by imposing bilateral FATCA agreements on Austria and Luxembourg. Yet, its efforts were not limited to Europe. Between 2012 and 2014, the US Treasury signed FATCA agreements with 112 jurisdictions including all major offshore centers (US Treasury 2014). As a result of US coercion the principle of AEI was thus rapidly adopted around the globe. The OECD used this opportunity to create a global reporting standard based on the model 1 IGA as well as a multilateral agreement for its implementation. 51 governments signed this agreement in October 2014, and another 30 jurisdictions have joined since, including again all major offshore centers. Financially opaque jurisdictions had usually justified their refusal to exchange account information with domestic legal provisions protecting this data. After they agreed to AEI with the US and made the corresponding domestic reforms, this argument disappeared. Once it became clear that their governments had to extend greater cooperation also to third states, financial industries in these countries preferred a single global standard to individual arrangements with each treaty partner. Hence, the large majority of governments that entered into FATCA agreements with the US also signed the OECD sponsored multilateral agreement. Whereas financial secrecy has thus been lifted almost everywhere, the US corresponded to demands from its financial industry and did not follow up on its pledges to reciprocate AEI. As the Obama administration did not enforce new domestic reporting requirements against opposition from finance, the US cannot provide FATCA partners with the same information in collects from them. Accordingly, the country is still among the few jurisdictions that have not signed the multilateral agreement (Hakelberg 2016). In terms of secrecy, it now enjoys a competitive advantage over the rest of the world, which has recently led to a redistribution of financial assets towards the US (Hakelberg and Schaub 2017).

3.2 Incremental Change in the Fight against Base Erosion and Profit Shifting

3.2.1 Points of Departure: Limiting Taxation at Source Through Transfer Pricing

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, developed countries 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 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 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 (Avi-Yonah 2000; Dharmapala 2014).[12]

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.[13] 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 allowing 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 (Pinkernell 2012). The same schemes also enabled US multinationals to avoid being taxed on their foreign profits in the United States.

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[12] Interview with tax advisor to the German finance ministry on 22 June 2015.

[13] Interview with German tax official on 3 March 2015.

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. EU G5 governments could not counter these practices because of 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 Controlled Foreign Company (CFC) rules against subsidiaries incorporated within the EU. As a result, tax competition has been more intense inside the European Union than in the rest of the world (Genschel, Kemmerling, and Seils 2011).

3.2.2 Setting the Agenda: Starbuck's and the Inclusion of Emerging Economies

Against this background, tax experts and administrators in the EU have been looking for legislative remedies at least since the early 2000s. In 2001 the European Commission first presented its idea for a common consolidated corporate tax base (CCCTB) to the Council of Ministers. The concept foresees the consolidation of a group's EU subsidiaries into a single entity for tax purposes. Instead of having each member state tax the profit reported by a group's local subsidiary, the group's consolidated EU wide profit should be taxed centrally and the revenue apportioned to member states following a certain formula. This application of unitary taxation at EU level shall prevent multinationals from shifting profits from high tax to low tax member states, for instance, through license fee payments between sister subsidiaries (European Commission 2001). In parallel, corporate tax lawyers and officials engaged in an intense debate over the definition of Internet servers as permanent establishments (PE). The contentious issue was whether transactions processed via a given server – for instance in the context of online shopping – could be taxed by the country in which it is located (Pinkernell 2014). Given the redistributive consequences of these proposals, however, member states have since failed to agree on the CCCTB, whereas the US – home to virtually all Internet giants – insisted on limiting source countries' right to tax Internet transactions at the OECD.[14] As a result of this deadlock, expert officials in the EU G5 had a hard

[14] Interviews with tax advisor to the German finance ministry on 22 June 2015, and partner in US tax law firm on 17 April 2015.

time raising interest for the issue of tax avoidance with their political masters. As a German tax official explained in 2015:

"All these issues have been discussed in the OECD's tax committee for at least 15 years. They never became more than printed paper. Not because they didn't make sense, but because there was no political backing. There was no tailwind. So how did it reach the agenda? I believe that politics is not really projectable, but there are opportunities and time slots. When I first told the minister about what we had been discussing among experts, he replied that was a nice topic but he wouldn't fight a lonely battle against Google, Apple, or whoever. And that was it for the time being. That must have been around March/April 2012. And then – I still remember like it was today – just before the G20 summit in Los Cabos, in November 2012, George Osborne [then the UK's minister of finance] expressed his outrage over tax avoidance by Starbuck's. Suddenly our minister had this catchy example and my colleagues mailed me from Los Cabos, asking how one could integrate the tax avoidance issue into the final communiqué."[15]

Hence, the UK and Germany responded to public outrage over Starbuck's tax avoidance in the common market by involving the G20 with the issue. This resonated with the Obama administration, which was less concerned with US multinationals avoiding taxes in Europe, but took issue with the fact that these US corporations were hoarding their foreign profits in tax havens to defer corresponding tax payments in the US. Although the US and EU G5 were thus looking at the issue from quite different angles, tax avoidance was a problem for both. Accordingly, the G20 leaders declared in Los Cabos, "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" (G20 Leaders 2012). 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. 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

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[15] Interview with German tax official on 3 March 2015.

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" (Fehling 2015, 822).

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" (Kreienbaum 2014, 637). Next to the US government, which did not want to block the process, but aimed to prevent moves towards more source taxation (Piltz 2015), 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 (Ibid.).

3.2.3 Towards New Rules: The BEPS Report's Ambiguous Recommendations

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 length as the international tax system's underlying principle (Picciotto 2015, 7). 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 (OECD 2015a, 15). 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]" (Picciotto 2015, 7). 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," he added (Sheppard and Johnston 2015).

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 (OECD 2015b, 9–10). 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 (Picciotto 2015, 9). 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, "the proposal tilts in favor of source country tax administrations because the lack of clarity allows administrations to interpret the provisions however they wish" (J. Martin 2015). Owing to US opposition, recommendations related to action 8 were still considered provisional and subject to debate at the time of writing (OECD 2016). 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 (J. Martin 2015). Its adoption of these measures is thus highly unlikely.

3.2.4 The Role of Interest Groups: In Defense of the Arm's Length Principle

The US has thus prevented meaningful shifts towards source country taxation in the context of BEPS, while the EU G5 were looking for an uneasy compromise between solving some of their problems in the common market and not fundamentally questioning the arm's length principle. Accordingly, transformative change in the sense of a substitution of separate entity accounting with unitary taxation has so far not taken place. At a more fundamental level, this is due to the preference for arm's length by multinationals on both sides of the Atlantic, and the ability of this interest group to exert instrumental, structural and discursive power on decision makers.

According to a tax lobbyist for US multinationals, "companies care about earnings per share. Taxes go directly to earnings per share. Other costs and expenses do not have such a direct impact on the bottom line. So reducing taxes has a bigger effect than reducing other costs."[16] Hence, US multinationals preferred the status quo, which allowed them to minimize taxes in the EU and the US at the same time. From their perspective, the BEPS initiative created uncertainty over the prerogatives of source countries, which was likely to lead to double taxation. In fact, the United States Council for International Business (USCIB), the key lobby group for US multinationals at the OECD, warned against BEPS recommendations encouraging corporations to produce additional data on their local profits, assets, and staff, or the procedures used to establish transfer prices. From the lobby group's perspective, this additional information violated the spirit of the arm's length principle by inviting source countries to unilaterally apply a form of formulary apportionment (Sample 2014). Therefore, US multinationals emphasized in their communication to the Obama administration and congress that BEPS recommendations would increase tax revenue for EU governments instead of the US. According to a tax expert with the Congressional Research Service, this was a compelling argument for many policymakers.[17]

In general, US multinationals found it much easier to counter criticism of their tax minimization strategies than tax evaders. When Carl Levin staged a hearing on the tax planning strategies of Apple Inc., the company's senior managers were free to speak, given the legality of the schemes they had set up (Seabrooke and Wigan 2017). In fact, Tim Cook, the CEO of Apple, insisted in his testimony, "we pay all the taxes we owe, every single dollar. We not only comply with the laws, but we comply with the spirit of the laws" (Cook 2013, 38). Following a typical defense strategy of multinationals, he then emphasized his company's enormous job creation and investment across the country, his duty to serve the interests of his shareholders, and the responsibility of lawmakers for overly complex tax laws enabling tax planning (Ibid.). In contrast to the UBS hearing when no senator sided with tax evaders, committee members from both parties shared Cook's perspective. Democrat Claire McCaskill, for instance, began her opening statement as follows: "First is I love Apple. I love Apple. I am Apple. My family – I made all my family – I harassed my husband until he converted to a MacBook. […] I have questions about this, not because I think Apple is a villain

[16] Interview with senior tax lobbyist for US multinationals on 23 April 2015.

[17] Interview with tax expert from the congressional research service on 21 April 2015.

but, rather, Apple is utilizing the tax code we have given them" (McCaskill 2013, 34). Likewise, Republican Rand Paul insisted, "This Committee will admit that Apple has not broken any laws […] I would say that what we really need to do is apologize to Apple, compliment them for the job creation they are doing, and get about doing our job. […] Let us make the tax code better, fairer, and more competitive" (Paul 2013, 12). Owing to the legality of tax planning, employment in their home states, and potential campaign contributions from multinationals, many senators were thus much more conciliatory towards tax avoiding companies than towards criminal tax evaders. From the perspective of a former US Treasury official this is unsurprising:

"I think tax evasion is a law and order issue. It can be described as not being about evading taxes but just as people acting criminally. […] You know, the law and order instinct of the right kicks in. It is different when it is about tax planning. You want to make tax planning illegal. For them that is just a tax increase. That is very different than saying you are behaving illegally, you should stop."[18]

In Europe, business is split between export oriented multinationals in favor of sticking to the arm's length principle at the international level, and local companies deploring unfair competition from US multinationals in the common market. Similar to US multinationals, the first group fears BEPS recommendations could provide emerging economy governments with additional leeway in taxing their activities at source. The Federation of German Industries (BDI), for instance, expressed concern that "the BEPS project involves concessions from developed to emerging economies, compromising the competitiveness of domestic companies" (Kampermann 2015). Adapting the argument used by US multinationals as to the effect of BEPS on the US fisc, the BDI reminded the German government, "Germany in particular risks to lose the fiscal tug-of-war with emerging economies" (Ibid.). In contrast, representatives of the German digital economy called for a level playing field in the common market, arguing that the non-taxation of their US competitors provided them with a decisive competitive advantage. According to a senior corporate tax lawyer advising the German finance ministry, this situation put the German and other European governments between a rock and a hard place:

"If Germany is the world's export champion and also fairly well positioned in the digital area that is a tax policy dilemma. On the one hand, I want to limit the international diffusion of source taxation,

[18] Interview with former US Treasury official on 15 April 2015.

because that is bad for my car manufacturers and pharmaceutical companies. On the other hand, I also know that my digital economy that is competing with the Americans will continue to be at a competitive disadvantage, because we do not tax these foreign competitors at source. They are also neither taxed at home nor in the interposed low tax countries. That is a real dilemma."[19]

Against this background, the EU's ambiguous position in BEPS negotiations discussed above becomes intelligible. Somewhat surprisingly, however, the European Commission may have recently found a way out of the dilemma faced by individual EU governments.

3.2.5 Reaching International Agreement? Ongoing EU-US Bargaining over BEPS

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 (UNCTAD 2014; Pinkernell 2014). 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 (European Commission 2015d; Hirst 2015). 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, now president of the Commission, and Margarete Vestager, commissioner for competition, Treasury secretary Jack Lew wrote, "while we recognize that state aid is a longstanding concept, pursuing civil investigations – predominantly against U.S. companies – under this new interpretation creates disturbing international tax policy precedents" (Chee 2016). 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" (Lynch 2016) . As this angry reaction suggests, the

[19] Interview with corporate tax lawyer advising the German finance ministry on 22 June 2015.

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.

Such 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 (Vestager 2016, 2), and opened new a new investigation into a tax deal granted to McDonald's in Luxembourg (European Commission 2015a). In parallel, and in accordance with a joint request from finance ministers of France, Germany, and Italy (European Commission 2015b, 2), 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 (European Commission 2015c).

With the consent of Ireland, Luxembourg, and the Netherlands, the Council of Ministers has indeed adopted corresponding directives since then. From 1 January 2017 national tax authorities will be obliged to inform their EU counterparts about transfer-pricing agreements reached with multinationals (Council of Ministers 2015). 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 their profits, tax payments, employees, and tangible assets in country-by-country reports (Council of Ministers 2016a). 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 US (Sheppard 2016). 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. 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 (Council of Ministers 2016b).

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.

4. Conclusion

Tax evasion and avoidance scandals – sometimes engineered by left-of-center politicians – have increased countervailing pressure to regressive tax reform in powerful developed economies. As further shifts of the tax burden to labour and consumption became politically hard to defend, tax policymakers in these countries tried to tax previously forfeited offshore capital instead. To this end, they launched international initiatives against tax evasion by wealthy individuals and tax avoidance by multinational corporations. Yet, these initiatives only resulted in transformative change where affected domestic interest groups were weak. In fact, even politically well-connected tax evaders were unable to defend themselves against criticism given that their method of tax minimization is illegal. In contrast, multinationals could partially repel criticism by insisting that they were complying with the law, creating jobs and investing in the domestic economy. More specifically, multinationals could plausibly explain to policymakers that measures to curb tax planning would increase the tax revenue of source countries rather than their own.

At a more theoretical level these findings have several implications. First, they show that major public scandals provide policy entrepreneurs with a window of opportunity to advance their political agendas. These events enable them to contest established orders. Second, the above findings imply that a new policy paradigm can only be established, if it is reconcilable with the interests of powerful economic actors. Otherwise, these actors will use their instrumental, structural and discursive power to bring corresponding initiatives to a halt. Therefore, the diffusion of ideas also depends on their material consequences. Third, the above findings confirm that governments can convert market size into power at the international level. By linking their regulatory demands to market access, they coerce foreign governments into compliance. Only when several great powers enter the bargaining arena does international cooperation have to be negotiated. Accordingly, the current US-EU row over corporate taxation provides an exciting area for future research.

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