

**Solving Cooperation Problems over International Taxation:  
Power, Legitimacy and Sovereignty**

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## **Abstract**

Globalization has produced a near borderless economic system that clashes with nationally orientated tax systems. Sovereign states can create preferential tax regimes to compete over internationally mobile capital and poach other states' tax bases. This creates conflict and cooperation problems in the international political economy and the financial crisis raised the salience of solving them. This thesis looks at the nature of these problems, the initiatives being used to solve them, their efficacy and impact. I present four case studies that look at the surprising demise of banking secrecy, extraterritorial application of US law, the bringing of tax havens in line with global tax standards and money laundering regulations, and the EU's attempts to stop states from facilitating tax avoidance by multinationals. I combine existing literature from the fields of political economy, international relations, economics and sociology with hundreds of interviews and exchanges with the experts leading these initiatives whose insights were previously undocumented. I show how dominant states and International Organizations have used various instruments of power, some of debatable legitimacy, to enact change in tax havens that violated their sovereignty. I highlight the important role that coercion has played in solving cooperation problems, how sovereignty has not protected the economic models of tax havens, and how sovereignty has been overridden in favor of newly legitimized norms such as transparency, fairness and equality. This body of work makes many significant contributions to the literature and helps us to understand how and why these cooperation problems exist, how they are being solved, who the actors are, what their roles have been, the instruments of power at their disposal, the legitimacy of their approaches, what the outcomes have been, and the limits of sovereignty in a globalized world. It calls for more research on the social implications of these initiatives and suggests that political scholars need to pay close attention to the motives and incentives of rule-implementing agencies.

## **Zusammenfassung**

Die Globalisierung hat zu einem nahezu grenzenlosen Wirtschaftssystem geführt, das mit national ausgerichteten Steuersystemen kollidiert. Souveräne Staaten können Steuervergünstigungen schaffen, um international mobiles Kapital zu gewinnen. Dies schädigt wiederum die Steuerbemessungsgrundlagen anderer Staaten, was zu Konflikten und Kooperationsproblemen in der internationalen politischen Ökonomie führt. Die Finanzkrise erhöhte die Dringlichkeit, diese Konflikte zu lösen. Diese Dissertation beschäftigt sich mit den Ursachen und Hintergründen des Steuerwettbewerbs. Sie zeigt Lösungsansätze und prüft deren Wirkung. Dazu stelle ich vier Fallstudien vor. Diese befassen sich mit dem überraschenden Niedergang des Bankgeheimnisses, der extraterritorialen Anwendung des US-amerikanischen Rechts, der Angleichung von Steueroasen an globale Standards und Geldwäschebestimmungen sowie den Versuchen der EU, Steuervermeidungspraktiken multinationaler Konzerne einzudämmen. Ich kombiniere vorhandene Literatur aus den Bereichen Wirtschaftswissenschaft, internationale Beziehungen, Volkswirtschaftslehre und Soziologie mit einer Vielzahl von Interviews. Ebenfalls eingeflossen ist der Austausch mit Experten, die diese Initiativen leiten, deren Einsichten aber bisher nicht dokumentiert waren. Ich zeige, wie dominante Staaten und Organisationen verschiedene Machtinstrumente eingesetzt haben – dies zum Teil mit fragwürdiger Legitimität – um Veränderungen in Steueroasen zu bewirken, auch wenn sie deren Souveränität verletzen. Ich unterstreiche welche wichtige Rolle der Zwang bei der Lösung von Kooperationsproblemen gespielt hat und zeige auf, warum die Steueroasen trotz ihrer Souveränität nicht in der Lage waren, ihre ökonomischen Modelle zu schützen und wie die Souveränität zugunsten von neu legitimierten Normen wie Transparenz, Fairness und Gleichheit ausser Kraft gesetzt wurde. Diese Arbeit leistet wichtige Beiträge zur Literatur und hilft uns zu verstehen, warum und in welcher Form es diese Kooperationsprobleme gibt, wie sie gelöst werden, wer die Akteure sind, welche Rollen sie spielen und welche Machtinstrumente sie nutzen. Weiter prüft diese Arbeit die Legitimität der Lösungsansätze, die Ergebnisse und die Grenzen der Souveränität in einer globalisierten Welt. Die Dissertation fordert dazu auf, mehr Nachforschungen zu den sozialen Auswirkungen dieser Initiativen zu betreiben und zeigt, warum Wirtschafts- und Politikwissenschaftler den Motiven und Anreizen der Protagonisten zur Durchsetzung von Vorschriften besondere Aufmerksamkeit schenken sollten.

## 1. Introduction

This thesis looks at various elements of the distributional conflict, discord, and cooperation problems that arise over international taxation. At its core is the fact that globalization has produced a near borderless economic system that is constrained by nationally orientated tax and legal systems. That is, whilst taxation is national in jurisdiction, capital is internationally mobile (Palan et al. 2010). The cooperation problem that links all the papers and contributions of this body of work is that sovereign states can use differences in legislation and regulation to undercut and poach other state's tax bases. According to Rixen (2008), there is an "asymmetrical prisoner's dilemma" in the international tax system whereby strong financial incentives lead individual states to create favourable and preferential tax systems that result in suboptimal competition or a 'race to the bottom' in tax levels and regulatory standards (Stiglitz and Pieth 2016). That is, each state creates and defends its tax strategy, but overall outcomes are worse if they fail to cooperate (Wagner 1983). In this setting, the optimal solution is cooperation between states, yet as sovereign entities they often have competing interests and agendas. The resulting lack of cooperation has produced an uneven playing field of tax winners and losers in the international political economy (Emmenegger 2017; Sharman 2005).

There are two main systems of taxation. The 'territorial' system, although rare, is where only income from a source inside of the state is subject to taxation. The more common 'residential' system is where residents are taxed on their worldwide income, irrespective of where it originates. Residents are expected to declare their offshore assets and income to local tax authorities, and 'double taxation' is avoided through bilateral tax treaties. But the extent to which countries sign tax treaties, and also their contents can vary widely, and so the international tax system is based on a series of inconsistent bilateral agreements that can be exploited for the purposes of tax avoidance and evasion. Such problems have been compounded by the

existence of ‘tax havens’ that adopt preferential tax regimes and secrecy provisions that protect the identity of the beneficial owners of offshore assets. Henry (2012) estimates that \$32tn of global wealth was held offshore in 2010 and Zucman (2014) argues that 8% of household financial wealth is held in tax havens with the United States (US) losing \$36bn of tax revenue annually to international tax evasion.

The global financial crisis and resulting squeeze in public finances has raised the salience of tax issues and solving tax cooperation problems has become an international policy priority (Eccleston 2012). But the attitude of the international community towards offshore financial centres and tax havens has been hardening since the 1990s (Woodward 2016). Various global tax initiatives have evolved over the last couple of decades, both bilaterally between states and multilaterally through International Organizations (IO). These include the Organisation for Economic Co-operation and Development’s (OECD) Harmful Tax Competition (HTC) initiative, the US Foreign Account Tax Compliance Act (FATCA), the Financial Action Task Force’s (FATF) Forty Recommendations on Money Laundering, and more recently the European Union’s (EU) tax haven initiatives. This cumulative thesis is made up of four papers that examine the topologies of cooperation problems over international taxation and the methods used to solve them. From banking secrecy in papers *one* and *two*, to harmful tax practices and money laundering in paper *three*, and tax avoidance in paper *four*.

However, according to Palan and Wigan (2014), the most important change brought about by the crisis was not the creation of new rules and bodies to deal with cooperation problems, but rather the increasing reliance on the extraterritorial application of law and the acceptance of infringements of state sovereignty. Sovereignty implies, inter alia, that it is up to individual states to decide on what tax system they use. According to Frieden et al. (2013) sovereignty is “the expectation that states have legal and political supremacy – or ultimate authority – within their



territorial boundaries”. Violations of sovereignty through forcing states to change tax and legal systems against their will are a recurring theme in this thesis because in all four papers, the sovereignty of a smaller state was infringed by a larger state and/or IO. I argue that contrary to the suggestions of the bulk of the literature on offshore finance, sovereignty and the resulting boundaries of regulatory jurisdiction has not protected the economic models of small states. Other authors have arrived at similar conclusions (Emmenegger 2017; Woodward 2006; Palan 2002; Eden and Kudrle 2005; Sharman 2008; Genschel and Schwarz 2011). The principle of sovereignty is said to have been established in the Peace of Westphalia in 1648 (Lake 2009). My analysis suggests that, in international tax matters, Westphalian sovereignty has indeed been relaxed in favor of newly legitimized norms such as transparency, fairness and equality.

As sovereignty has been overridden, power is thus also a recurring theme in this thesis; as is abuse of power. Power is the production, in and through social relations, of effects that shape the capacities of actors to determine their circumstances and fate. It can be viewed either as an attribute of particular actors or as a product of social processes via certain relationships and interactions and can be exercised directly or diffusely (Barnett and Duvall 2005). Whilst it is frequently acknowledged that power plays a pivotal role in international relations, it is a difficult concept to grasp and complexities in its definition have prevented an elaboration of fully-specified theories about power (Stone 2011). In this thesis, power is simply defined as the ability of one actor to enact change in another.

All four papers look at exercises of power by states and IOs that enacted change, often against the will of smaller states and relative size plays an important role in the various initiatives I analyze. Paper *one* provides an overview of the fight against banking secrecy as well as a comparison of the domestic politics and reaction of the two sovereign tax haven states, Liechtenstein and Switzerland, to chal-

lenges to their banking secrecy regulations. The notion of a ‘small state’ from Katzenstein’s (1985) seminal work is introduced and provides a conceptual framework for thinking about the reactions of all the tax havens considered in the subsequent papers. Paper *two* then analyzes the use of power by the US to coerce Switzerland into enacting change in a unilateral approach via extraterritorial assertion of US jurisdiction. Extraterritoriality has become an increasingly common mechanism by which powerful states attempt to manage problems associated with transnational activities (Putnam 2009). It is understudied relative to other forms of post-war conflict, such as multilateral cooperation through IOs (Raustiala 2009). Paper *three* then looks at how two IOs, the OECD and FATF, used blacklists to coerce tax havens into enacting regulatory change via a multilateral approach, to varying degrees of success. It also introduces the concepts of ‘hard power’ and ‘soft power’ in solving cooperation problems (Nye 2004, 2008). Military force and economic sanctions are the two main types of hard power in international relations, whereas soft power arises from the attractiveness of one’s culture, ideology and policies. Paper *four* looks at an IO exercising power to enact change in a member state, specifically the EU’s state aid ruling over Apple’s tax practices in Ireland.

Through these papers I examine the different mechanisms and instruments power used to solve cooperation problems and their efficacy. For instance, the US and the European Commission (EC) used market power and legal supremacy to enact change in Switzerland and Ireland. The FATF used blacklists and hard power in the form of sanctions to enact global money laundering regulations, whereas the OECD relied more on soft power and the ‘logic of appropriateness’ (March and Olsen 1998; Webb 2004) to promote its tax standards. Even when IOs have access to coercive instruments of power, they have typically been unable to enforce their rules on the most powerful states (Tyler 2006; Zaum 2013). Yet, as I show in all the papers, they have been able to enact change in smaller states using these instruments quite effectively.

In all four papers, because one party is trying to force another to enact change, questions about legitimacy are also central to this thesis. That is, exercises of power left unvarnished are always vulnerable to critique (Weber 1991; Eagleton-Pierce 2013) and an actor's actions must be defensible and justifiable in a wider sense. Suchman (1995) provides one of the most comprehensive definitions: "Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions". Legitimacy has its roots in Weber (1962), who linked legitimate authority to rationally established rules based on enactment, agreement, or imposition (DeJordy and Jones 2008). Yet legitimacy remains one of the more slippery concepts in politics, sociology and organization studies (Blondel 1990; Frost 2013).

In this thesis, legitimacy is viewed as an attribute of an exercise of power in that it serves to justify the use of power and is associated with beneficial authority (Zaum 2013; Buchanan 2002; Hurd 2008b). Finnemore and Sikkink (1998) argue that an important condition for receptiveness to international standards is their legitimation and in this way the quality of the power that a state or IO exercises increases with its level of legitimacy and vice versa (Coicaud 2001). Legitimacy also constrains the exercising of power in that it requires self-restraint by powerful states if they want to maintain the legitimacy of their institutions and ensure continued compliance with them. That is, they must accept being bounded by their own rules (Ikenberry 2001; Krisch 2008; Zaum 2013).

Questions of legitimacy typically arise when people ask whether some social arrangement or institutional practice is valid (Frost 2013), and thus legitimacy can be subjective. Webb (2004) states that "while legitimacy is a normative criterion, it cannot be entirely separated from questions of material self-interest because governments tend to defend their own practices as legitimate while criticizing foreign practices they dislike as illegitimate". For this reason, Tyler (2006) highlights that

perceptions of fairness are central to legitimacy and hence there is a general emphasis on transparency, inclusiveness, and rule-based decision-making in international politics (Tyler 2006; Zaum 2013).

In papers *one*, *two* and *four* it is argued that the financial crisis created demonstration effects (Mattli and Woods 2009) that legitimized various actors' forceful approach to solving cooperation problems. In papers *two* and *four* there are concerns about the legitimacy of the US and EC's approach, who were assertive and seemingly relied on the notion that the ends justified the means; so-called 'outcome legitimacy'. Specifically, paper *two* explains how the US legitimized its actions against Swiss banks and in paper *four* concerns are raised about the EC's procedures in their state aid ruling on Ireland's relationship with Apple. In paper *three*, I look at blacklisting as an instrument of power in international relations and raise concerns about its 'procedural legitimacy' (Keohane 2002; Ba 2013). Whilst the FATF's blacklist and its sanctioning mechanism helped ensure the worldwide adoption of the FATF's money laundering regulations, it raises serious questions about a fundamental element of normative legitimacy: state consent.

In a general sense, multilateral approaches to solving cooperation problems are typically considered more legitimate because the international community deems a collective's direct and indirect actions more normatively appropriate than unilateral approaches (Barnett 1997; Finnemore 2003; Hurd 2007; Thompson 2010). In this way, the first two papers look at exercises of power and legitimacy in bilateral approaches to solving cooperation problems, and the second two papers look at exercises of power and legitimacy in multilateral approaches through IOs. I show how the various actors used different instruments of power, their relative efficacy, and legitimized their approaches in different ways. I consider the G7, G20, EU, OECD and FATF to be IOs in the sense of Young (1980) and Keohane (1984).

That is, institutions defined broadly as “recognized patterns of practice which expectations converge”, not just formal organizations with headquarters and specialized staff.

In analyzing the roles, processes and practices of dominant states and IOs in solving cooperation problems over taxation, this thesis borrows ideas from all three grand theoretical schools of thought in the field of international relations: realism, neoliberal institutionalism and constructivism. Forceful behaviour through economic coercion is a recurring theme in this thesis and is seen to be a viable and effective policy instrument, in line with realism approaches (Keohane and Nye 1977). Hakelberg (2016) also argues that coercion plays an important role in solving cooperation problems in international tax matters. Yet, according to Hurd (2008a), it is wrong to associate a substantive interest in power exclusively with realism, because all three paradigms are interested in power, as their motivation, cause, or effect. Realism is a particular theory about material power in international relations, in contrast with constructivism’s emphasis on the social meaning attached to its objectives or practices, and thus they should not be considered as competing approaches. In line with constructivism, IOs can be seen to be operating autonomously and subject to bureaucratic dysfunction and mission creep in this body of work (Barnett and Finnemore 2004; Stone 2009). I also consider autonomous behavior at the state level to be suboptimal as a starting point for this thesis, where IOs solve cooperation problems by reducing uncertainty and lowering the expected costs of disagreement, in line with neoliberal institutionalism (Drezner 2007; Stein 2008).

The four papers of this thesis use a variety of case study approaches to facilitate a deeper understanding of the approaches used to solve cooperation problems, as well as provide an accurate and detailed historical account of recent events in international taxation (Baxter and Jack 2008). In the framework of Blatter and

Haverland (2012), paper *one* uses a co-variational analysis design to draw inference, whereby two cases are selected according to a high degree of similarity with respect to control variables. That is, comparing Liechtenstein's and Switzerland's differing responses to four challenges to banking secrecy. Paper *two* uses process tracing to look at a sequence of causally connected events to understand an observed outcome, whereby each event was a necessary condition for subsequent events. Specifically, we analyze a sequence of three events that allowed US authorities to force Switzerland to soften its banking secrecy regulations. Paper *three* also makes use of co-variational analysis but by looking at a plurality of comparable cases to draw inference. That is, the roles of stigma, sanctions and legitimacy in the effectiveness of the OECD's and FATF's blacklisting of ten tax havens. Paper *four* uses interpretative analysis to understand an observed phenomenon. That is, the puzzling case of the EC's state aid ruling against Ireland over Apple's tax practices and the fact that Ireland contested the EC's ruling and thus receiving €13bn in back-taxes from Apple.

In writing this thesis, secondary sources from the existing academic literature have been extensively consulted, critiqued and analyzed, particularly from the fields of international political economy and international relations. However, concepts from economics, sociology, organizational and development studies are also drawn on extensively. In addition, reports from the IOs that I analyze were used for many of the historical facts and figures. However, because the events highlighted in this thesis are so recent, there are relatively few detailed studies available on some of the topics I cover and so information from primary sources has also been key to my analysis. To this end, a series of interviews with high profile experts that were closely connected with the events I study were conducted. In this way, I have generated a wealth of primary information that was previously undocumented.

Through first-hand accounts of the events and thought processes of the key people involved, the resulting set of single and comparative case studies that I present provide an in-depth qualitative analysis of the political processes, objectives and outcomes involved in overcoming cooperation problems in international taxation. These individuals furnished a range of letters, official public documents and expert reports from over 100 interviews and exchanges that I conducted. They were chosen due to the important roles that they played, and they have offered unique insights from the differing perspectives of the various actors involved. I have spoken extensively with experts from Liechtenstein, Switzerland, Ireland, the US, the EU, the EC, the OECD, the FATF, academia, business and the media. I also used these interviews to corroborate and verify existing claims in the literature.

To mention some of the most high-profile interviewees, in the case of Liechtenstein, which plays an important role in papers *one* and *three*, I have personally spoken to Hereditary Prince Alois of Liechtenstein, Prince Stefan of Liechtenstein, Liechtenstein's Ambassador Extraordinary and Plenipotentiary to the Holy See and former Ambassador to Germany and Switzerland (2007-2017), and Prince Max of Liechtenstein, Chief Executive Officer of LGT. I also interviewed all five heads of Liechtenstein's government from 1978 to present<sup>1</sup>: Hans Brunhart (1978-1993), Mario Frick (1993-2001), Otmar Hasler (2001-2009), Klaus Tschüscher (2009-2013) and Adrian Hasler (2013-present), as well as several officials, Chairpersons and Chief Executive Officers of banks and industry, the Liechtenstein Bankers Association, Financial Market Authority Liechtenstein and the Liechtenstein Institute of Professional Trustees and Fiduciaries.

In the case of Switzerland which is central to papers *one* and *two*, among others I interviewed ex-Swiss Federal Council member Hans-Rudolf Merz (2003-2010), ex-Swiss Chief Negotiator Michael Ambühl, Renate Schwob of the Swiss Bankers

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<sup>1</sup> Markus Büchel who was in charge for seven months in 1993 was not interviewed as he died 2013.

Association, and ex-partners of Wegelin & Co; the only private bank that was indicted by the US. From the US perspective, I interviewed Kathryn Keneally, who served as the Assistant Attorney General for the Tax Division of the US Department of Justice (DoJ), Alan S. Blinder, who served on President Bill Clinton's Council of Economic Advisers, Aaron L. Friedberg, who served as Deputy Assistant for National Security Affairs in the office of then Vice President Dick Cheney under the Bush Administration, Alan B. Krueger, who served as Chairman of President Barack Obama's Council of Economic Advisers, and Thomas (Tom) P. Bossert, former Homeland Security Advisor to US President Donald Trump. I also spoke with the infamous whistleblower Bradley Birkenfeld.

For paper *three*, I had many discussions about the OECD's initiatives with Angel Gurría, OECD's Secretary-General, Jeffrey Owens, the former Head of the Fiscal Affairs Division and Director of the Center for Tax Policy and Administration at the OECD (1991-2012), and Pascal Saint-Amans, the current Director of the OECD's Centre for Tax Policy and Administration (2012-present), who also created the Global Forum on Transparency and Exchange of Information for Tax Purposes. All three were responsible for the OECD's tax initiatives. I also interviewed Gordon Brown, the former Prime Minister of the United Kingdom (2007-2010), as he was the G20 Summit leader in 2009, which was a turning point in the fight for tax transparency. I also spoke extensively with Rick McDonnell, the former Executive Secretary at the FATF (2007-2015).

To include the EC's perspective in papers *three* and *four*, I interviewed José Manuel Barroso, the former President of the EC (2004-2014) as he played a role in many of the negotiations at that time, as well as Pierre Moscovici, Commissioner for Economic and Financial Affairs, Taxation and Customs of the EC in Brussels. Paper *four* also benefitted significantly from my interview with Timothy (Tim) D. Cook, Chief Executive Officer of Apple, USA. I further interviewed Paschal Donohoe, the current Minister for Finance of Ireland and had personal exchanges



with all four heads of Ireland's government from 1997 to present: Bertie Ahern (1997-2008), Brian Cowen (2008-2011), Enda Kenny (2011-2017) and Leo Varadkar (2017-present). I also talked to Sorcha McKenna, Head of the Dublin McKinsey Office to integrate the voice of the tax advisory industry, and different media representatives, such as Cliff Taylor, the Managing Editor of The Irish Times and Brendan Keenan, the Economics Editor of The Irish Independent.

In sum, this thesis enriches the international political economy literature in a number of ways and shows how tax issues affect political processes, interstate relations, and alter the distribution of power within and across states. It also helps us to understand, as political economists, how and why these cooperation problems exist, how they are being addressed, who the actors are, what their roles have been, the instruments of power at their disposal, the legitimacy of their approaches, what the outcomes have been, and the limits of sovereignty in a globalized world.

## 1.1 Paper One Synopsis

**Paper #1:** Eggenberger, Katrin and Patrick Emmenegger (2015).

**Economic Vulnerability and Political Responses to International Pressure: Liechtenstein, Switzerland and the Struggle for Banking Secrecy.**

*Swiss Political Science Review* 21(4): 491-507.

Paper *one* sets the scene for this thesis and lays out some of its theoretical foundations. It presents a comparative analysis of the differing reactions of Liechtenstein and Switzerland to international pressure over their banking secrecy laws. Banking secrecy allows people to hide assets offshore to avoid taxation and was an important barrier to overcoming cooperation problems over international taxation. Both states historically employed secrecy regulations that protected the identity of their bank's clients from foreign government agencies and regulated domestic public authorities' access to this data (Emmenegger 2014). Secrecy regulations not

only prohibited their banks from disclosing any information about client accounts without their owner's consent, but if they did so they ran the risk of a criminal sanction.

Hence these countries were popular destinations for offshore wealth dating back to the interwar period and were thus considered 'granddaddy' tax havens. Switzerland is one of the world's largest offshore banking hubs and its reputation for trustworthy bankers is legendary among private investors (Finkelstein 1999). According to the latest available information, in 2017, foreign wealth held in Switzerland alone reached \$2.3tn (Alstadsæter et al. 2018). However, before 2009 no amount of international pressure had been sufficient to induce these states to cooperate on tax matters and end banking secrecy (Vogler 2006; Steinlin and Trampusch 2012; Emmenegger 2014). In part, because the international community had collective action problems (Emmeneger 2017; Woodward 2006; Palan 2002; Eden and Kudrle 2005; Sharman 2008; Rixen 2008; Genschel and Schwarz 2011).

Under the premise that the offshore assets held in their banks included the proceeds of tax evasion, tax avoidance and money laundering, these two countries were among the main targets of international pressure from the 1990s onwards; both bilaterally from the US and multilaterally from IOs such as the G7, G20, OECD and FATF. By 2009, they had to protect their banks from criminal investigations from US authorities following a US Senate investigation into their banking secrecy practices as well as demands for increased exchanges of information on tax matters under FATCA and the OECD's HTC initiative. FATCA was passed by US Congress in 2010 and imposes a 30% withholding tax on the US revenue of Foreign Financial Institutions if they do not report the interest, dividend and other capital income of their US clients to the Internal Revenue Service (IRS) (Grinberg 2012). HTC was the first attempt to coordinate international tax policy and laid out a set of standards that states should adopt, including tax, financial and banking reforms to end harmful tax practices (OECD 1998). These standards were later endorsed

by the G20 in 2004 and the United Nations (UN) in 2008 (OECD 2009). Today, 154 states have committed to the Global Forum standards on tax transparency and exchange of information that evolved from this initiative.

Crucially, paper *one* introduces the theory of Katzenstein (1985) and the concept of a ‘small state’, which is used to frame the reactions to international pressure of the various tax havens that I study in this thesis: Liechtenstein, Switzerland, Nauru, Ireland and eight other Caribbean and Pacific island states. Liechtenstein is the focus of papers *one* and *three*, Switzerland is the focus of papers *one* and *two*, Nauru and other Pacific islands states are the focus of paper *three*, Ireland is the focus of paper *four* and Caribbean islands feature in papers *three* and *four*. The premise of Katzenstein’s seminal and award-winning book *Small States in World Markets* is that because small, open economies have limited influence on world markets, they are vulnerable to externalities. The economic and political elite of small countries are typically aware of such vulnerabilities and thus tend to close ranks in times of crisis. That is, because of their limited ability to shape world markets, small states often have little choice but to adapt to changing circumstances. ‘Small’ in the sense of Katzenstein is not solely a function of a country’s size in terms of geography or population, but also its economic dependence on world markets and its self-conception as a small state surrounded by larger ones.

Paper *one* then provides a detailed overview of the key events that led Switzerland and Liechtenstein to give up their staunch defense of banking secrecy and ultimately lead the G20 to decree in 2009 the end of the era of banking secrecy. To the best of our knowledge, this paper is the first to present Liechtenstein’s response to international pressure over its banking secrecy regulations. We further investigate questions such as: What measures were taken against these states to make them compliant? Why did they eventually capitulate? Who and what was the driving force behind this capitulation? And what were the respective roles and outcomes of unilateral pressure from the US and multilateral pressure from IOs?

Paper *one* shows that Liechtenstein behaved as a ‘Katzenstein small state’ whereas Switzerland did not. Because their financial services industry closed ranks and used its privileged access to the government to shape the government’s response decisively, Liechtenstein offered far-reaching bilateral deals to several major economies. Yet the Swiss elite failed to present a united front, which rendered them ineffective at fighting international pressure. Their policy-makers were hopelessly divided on how to confront the challenges presented over banking secrecy and internal disputes often resulted in painful and costly last-minute concessions. One of the key implications of the paper is that Switzerland has become a more normal state in the sense that important decisions are no longer made behind closed doors between powerful representatives of business and politics. Katzenstein (1985) even used Switzerland as his ‘poster child’ of a small state; small and vulnerable yet adaptable and successful. However, in paper *one*, Switzerland did not act like the adaptable and pragmatic small state that Katzenstein (1985) had envisaged.

Whilst in the end, both countries were forced to enact change and end banking secrecy by agreeing to the automatic exchange of information on tax matters, this paper shows that they reacted in very different ways to international pressure and that Liechtenstein was far more proactive than Switzerland. Liechtenstein even joined the early adopter states of the automatic exchange of information who signed-up to undertake their first exchanges of information in 2017, whereas Switzerland signed up for the second stage and undertook their first exchanges in 2018. The long-awaited automatic exchange of information was of high importance, symbolically and substantively as it was important milestone in the lengthy quest for tax transparency, but also demonstrated that limits could be placed on state sovereignty to overcome cooperation problems over international taxation.

In doing so, the US and OECD exercised power and so paper *one* raises questions about the legitimacy of their methods as the literature has suggested that state sov-

ereignty would protect business models based on secrecy, short of multilateral initiatives that would seriously restrict their sovereignty. According to Palan (1998), these small and conservative states refused to follow suit because as sovereign entities they enjoyed political and legal supremacy within their territorial boundaries and that legal structures such as banking secrecy are made possible by “the gulf between national sovereignty, on the one hand, and the goals of liberalism and the internationalization of capital, on the other”. An effective strategy would thus “require a degree of cooperation among the major industrialized countries and a limit on the sovereign rights of states, which effectively would spell the end of the so-called Westphalian system” (Palan 2002). This theme is continued in papers *two* and *three*. Paper *two* looks at the US’ successful unilateral approach that substantially restricted Switzerland’s sovereignty to eliminate banking secrecy and how the US legitimized its actions. Paper *three* looks at successful multilateral initiatives by the OECD and FATF that substantially restricted the sovereignty of ten other tax havens, including Liechtenstein, as well as examining the legitimacy of their approaches.

## 1.2 Paper Two Synopsis

**Paper #2:** Emmenegger, Patrick and Katrin Eggenberger (2018).

**State sovereignty, economic interdependence and US extraterritoriality: the demise of Swiss banking secrecy and the re-embedding of international finance.**

*Journal of International Relations and Development*, 21(3): 798-823.

Paper *two* looks in depth at exactly how the US penetrated Swiss banking secrecy and the extraterritorial power it exercised to do so. It focusses on the conflict of sovereignty versus market power and explores the rarely studied concept of extraterritoriality. The paper highlights how the US used its dominant market position

to enact change in European states and forced them into tax cooperation (Hakelberg 2015; Helleiner 2002). It also serves to show the extraordinarily wide discretion of prosecutors in the US legal system to extend their jurisdiction extraterritorially. While the academic literature on extraterritoriality is relatively new, it is an important means by which powerful states assert control over economic activity that has escaped their national regulatory regimes. To our knowledge this is the first paper to examine how extraterritoriality was used to force one sovereign state to change its regulations despite staunch opposition, although paper *three* continues this theme.

Specifically, international banks have a structural economic dependence on US markets and the US dollar, which enables US authorities to re-embed international finance by extending the boundaries of US regulatory bodies' jurisdiction and infringe on the sovereignty of other states. In this way, powerful states play a central role in global governance (Krasner 1976; Drezner 2007) and paper *two* highlights that instead of undermining their state capacity as predicted by globalization scholars (Strange 1996), growing economic interdependence may actually endow the most powerful states with additional means of exercising power on less powerful ones.

We show that after several decades of successful Swiss resistance and multiple failed US attempts at influencing its secrecy regulations starting in the 1920s, the US managed to overcome the limitations of sovereignty and forced Switzerland to soften its regulations. We argue that in the conflict over banking secrecy, the key agents of change were US law enforcement authorities who managed to coerce the transformation of Swiss financial practices and regulations against the will of Switzerland's government and financial sector. Specifically, they were forced to comply with FATCA or else lose US market access, which would have had dire consequences.

Under FATCA, banks, even if they have no representation in the US, accept responsibility for their US clients' tax compliance even if these clients do not invest in US markets. FATCA provided a direct regulatory link between the US Internal Revenue Service (IRS) and foreign financial institutions and is thus an example of the extraterritorial application of US law. It applies to foreign banks even if they have no representation on US soil and even if their US clients do not invest in US assets (Raustiala 2009). Switzerland, begrudgingly, agreed to change its regulations under pressure from a foreign state and Swiss banks accepted responsibility for their US clients' tax compliance. Switzerland signed FATCA on 14 February 2013, and Liechtenstein followed on 2 April 2014. Kaczmarek and Newman (2011) also show that extraterritorial interventions by US courts have the capacity to change national regulations in foreign countries and that applying US law extraterritorially on foreign firms increases the likelihood of the firms' home country enforcing their national regulations twentyfold. Before FATCA, Swiss and Liechtenstein banks were only interested in practicing the least stringent form of tax cooperation with foreign governments. Both states were also forced to make similar concessions to multilateral initiatives, which is focus of paper *three*.

There were three key events that allowed US law enforcement authorities to use FATCA to enact change in Switzerland. Firstly, structural economic interdependence allowed the US to introduce the QI program, which required foreign banks to report their client's holdings of US securities directly to US tax authorities (Grinberg 2012). The QI program gave US authorities information on Swiss clients and was the first step towards softening banking secrecy. Secondly, a whistleblower's testimony provided US authorities with the legitimacy that was needed to attack banking secrecy. Former UBS banker Bradley Birkenfeld, whom I interviewed for this paper, accused UBS of violations of the QI program (Garrett 2014). This came in the wake of the financial crisis and its bank bailouts, burgeoning public deficits,

public anger towards banking in general and a large international tax evasion scandal centered on Switzerland that all helped to create a ‘demonstration effect’, or an exogenous event that triggers a regulatory change process (Mattli and Woods 2009). This helped to legitimize the US authorities’ effective but controversial approach to dealing with Switzerland. Lastly, the extraordinarily wide discretion of prosecutors in the US legal system allowed US authorities to extend their jurisdiction extraterritorially as Switzerland’s veil of secrecy weakened.

The US, as a unilateral actor, exercised power to enact change and thus infringed on Switzerland’s sovereignty. US authorities needed to justify their assertive methods and so legitimacy is key to understanding the role of the normative and symbolic resources that they used to do so (Hurd 2007; Zaum 2013). In part, they focused on outcome legitimacy. That is, US authorities are more willing to resort to an assertive and legally questionable approach if the ends justify the means. For instance, the US forces corporations into expensive settlements without proper court trials and this is seen as acceptable to the US public because the outcomes are seen as legitimate (Holder 1999; Garrett 2014). The US also made good use of repeatedly stating that their quest for tax transparency was a legitimate course of action and repeatedly pointed out a ‘bad’ actor to enhance the legitimacy of their approach. This is linked to the concept of productive power of Barnett and Duvall (2005); promoting ‘tax transparency’ as a good thing, ‘banking secrecy’ as a bad thing and Switzerland as a ‘tax haven’. Legitimacy goes hand in hand with productive power because it reinforces the public’s perception of these meanings. That is, tax transparency is good because it is legitimate, tax havens and banking secrecy are bad because they are illegitimate. Eagleton-Pierce (2013) elaborates, if ‘I’ exercise power, I need to express over and over again that what I do is actually legitimate and it is also for an actor who is perceived as legitimate to enact change (Zaum 2013).



Existing accounts also emphasize exercises of power by the US via controlling market access (Hirschman 1969; Krasner 1976; Simmons 2001; Drezner 2007). Kahler and Lake (2009) observe that the US uses control over market access to extend its reach into other jurisdictions and do so when the distributional consequences of the issue at hand are large. Raustiala (2009) notes that extraterritoriality is attractive to US authorities because while it requires some market presence by foreign financial institutions, little assent from other governments is needed. In this way, small states are vulnerable to being closed off from US markets and this enabled the US to wrestle costly concessions from them by linking market access to compliance with its demands. Paper *three* continues this theme of extraterritorial application of US law, but through its embedding in the rules and standards of an IO, specifically via the links between the FATF's money laundering Recommendations and the sanctioning mechanism of the USA PATRIOT Act.

### 1.3 Paper Three Synopsis

**Paper #3:** Eggenberger, Katrin (2018).

**When is blacklisting effective? Stigma, sanctions and legitimacy: the reputational and financial costs of being blacklisted.**

*Review of International Political Economy*, 25(4): 483-504.

Paper *three* looks at how two IOs, the OECD and FATF, exercised power on ten non-member tax havens to enact change in their tax and money laundering standards. The FATF was established in 1989 at the G7's Paris summit to develop, promote and implement legal and regulatory measures aimed at combatting money laundering from the drugs trade (FATF 2014). In 1990 the FATF issued a six-page report entitled *The Forty Recommendations of the Financial Action Task Force on Money Laundering* (FATF 1990) and in 2000, in tandem with the OECD's HTC

initiative, the FATF began blacklisting states that had not adopted them. Blacklisting has also played a prominent role in trying to solve other cooperation problems around non-proliferation and security.

I therefore analyze the usage of blacklists to solve cooperation problems and look to understand what blacklists are, how they work, what gives them power and their legitimacy. In essence, blacklists highlight states for engaging in practices that are inconsistent with international norms and I show that blacklists can be used to impose both reputational and financial costs on a state. I highlight three factors that contribute to a blacklist's effectiveness in gaining state compliance: the stigma attached to the act that led to the blacklisting, the nature of any sanctions that it imposes and the blacklist's legitimacy. I also examine differences in hard and soft power approaches to gaining state compliance through blacklisting and examine the scope and limitations of each.

Specifically, paper *three* compares these two G7 initiatives in the early 2000s as both sought to pressure non-member states into adopting regulations that were neither of their choosing nor design and thus override their sovereignty (Sharman 2006; Kudrle 2008). I explore cross-sectional differences in the responses of the ten (small) states placed on both blacklists, but relative size is not my specific focus as it has already been shown to play a role in the efficacy of the blacklists I study (Payne 2004; Vlcek 2007, 2012). Rather, I contrast and compare the OECD and FATF blacklists to understand how differences in the stigma (Adler-Nissen 2013, 2014) of being associated with money laundering versus tax evasion, blacklists that impose sanctions versus those that do not, and how the legitimacy of the OECD's and FATF's approaches effected the relative efficacy of their initiatives.

Paper *three* is similar to paper *one* in that Liechtenstein's response to international pressure is compared to that of other states. Where paper *one* showed that Liechtenstein reacted faster than Switzerland, paper *three* shows that Liechtenstein reacted faster to the FATF but slower to the OECD than other states including Nauru,

and in doing so gained significant concessions over the automatic exchange of information whilst avoiding the sanctioning mechanism of the FATF over money laundering. The FATF blacklisted Liechtenstein for facilitating money laundering, an act that carries significant stigma and presented the credible threat of severe sanctions from the international banking system. As such, Liechtenstein's government addressed the regulatory demands made of it by the FATF quickly and decisively, although their government protested the violation of their sovereignty throughout. In contrast, when blacklisted by the OECD for its harmful preferential tax practices, acts that carry less stigma, and the OECD blacklisting did not carry the credible threat of sanctions, its government was slower and more combative in its dealing with the OECD. In the case of Nauru, its government was slow and combative in its response to both the OECD and FATF, but it was the FATF blacklist and its resulting sanctions and stigma that ultimately coerced Nauru into reform, including committing to the OECD's tax standards before Liechtenstein.

Paper *three* shows that whilst both the OECD and FATF blacklists suffered from legitimacy problems, such problems hampered the OECD's initiative more given its greater reliance on soft power. For instance, the OECD's first blacklist only contained non-OECD member states (Woodward 2009); Luxembourg and Switzerland were not included and both were major proponents of harmful tax practices. As such, the blacklist was not objective or perceived to be legitimate, which hampered its effectiveness (Sharman 2006; Emmenegger 2017). Switzerland also avoided the FATF blacklist even though it had been identified as a secrecy haven by the UN previously, which also affected the perceived legitimacy of the FATF blacklist (Rose 2015). Where legitimate exercises of power should avoid the need for coercion (Nye 2004; Zaum 2013), the OECD relied on persuasion, deliberation and the 'logic of appropriateness' (March and Olsen 1998; Webb 2004), i.e. soft power, to be effective. By contrast, the FATF's Recommendations are embedded in various UN Conventions and the USA PATRIOT Act which gave the FATF

hard power through related sanctioning mechanisms. As such, the higher reputational and financial costs of the FATF blacklist in many ways superseded its comparable legitimacy problems, and ultimately made it more effective than the OECD blacklist.

According to Mahon and McBride (2009), the OECD lacks coercive instruments and its effectiveness as an institution of global governance rests on its ability to promote policy transfer and conformity with OECD norms through peer review and other reputation-based compliance strategies. However, a few of the OECD's instruments can be said to be 'hard law' such as the Codes of Liberalisation of Capital Movements which obliges member states to remove barriers to the movement of capital. Yet there is no formal sanctioning mechanism for breaches of OECD standards and sometimes no mechanism for determining whether a state has breached them at all (email Angel Gurría, August 2017). Clifton and Díaz-Fuentes (2011) argue that policy makers and scholars alike have acclaimed its pioneering as well as successful implementation of these 'soft governance' tools (Pagan 2002), and for its epistemic influences on policy makers (Carroll and Kellow 2011). The OECD's power rests on its reputation for technical expertise, its trans-governmental structure and linkages to member and non-member states. However, a growing recognition of the role IOs play in knowledge dissemination has been accompanied by an appreciation of the limits of 'soft law' and how this might produce policy transfer failures (Woodward 2006). In fact, FATCA was directly linked to market access because of the OECD's difficulties in gaining state compliance through soft approaches (Eccleston and Gray 2014; Hakelberg 2015).

Paper *three* also revisits the extraterritoriality of US legislation and how it forced Nauru to comply with the OECD's and FATF's initiatives. I highlight how the FATF 'piggybacked' on US law enforcement authorities' capacity to re-embed international finance by extending the boundaries of their jurisdiction extraterritorially to infringe on other states' sovereignty. Although the FATF also makes soft

law, related US sanctioning mechanisms give it hard power in solving international cooperation problems and thus a unique and unusual role in global governance. Paper *three* goes further than paper *two* in that it shows what can happen to a state that fights back against overwhelming US pressure. Through the FATF's Recommendations, Nauru presented an early opportunity for the US to test the extraterritoriality of the USA PATRIOT Act, and its sanctioning mechanisms, which was enacted in the wake of 9/11. This approach made an example of Nauru to the international community and economically isolated the tiny Pacific island from international markets.

Whilst these sanctions have been lifted, the persistent reputational damage inflicted on Nauru through its association with money laundering and international sanctions is one of the most significant issues facing the 'failed state' today (Connell 2006). In this way, paper *three* raises serious questions about the legitimacy of the FATF's approach, concerns shared by the International Monetary Fund (IMF) who argued that it abused norms around legitimacy and state consent. The IMF forced its suspension in November 2002 for a year whilst the IMF piloted a more cooperative approach, that did not succeed (IMF 2002). Vlcek (2012) further argues that the FATF's Recommendations are produced by a limited subset of developed states and their imposition has limited the choices available to developing states.

Also in line with paper *two*, paper *three* complements power-based approaches that emphasize control over market access to solving cooperation problems. Both papers highlight how the threat of legal action against a state's banking system forced the hand of the government to comply with international demands as banks can be prosecuted more easily than states. As such, paper *three* reinforces the role that powerful states play in economic and political governance in a globalized world. Rather than undermining their state capacity, growing economic interdependence endows the most powerful states with additional means to exercise

power. Paper *four* continues this theme by looking at the EC's use of legal action to force member state Ireland into enacting change to its tax laws due to its role in tax avoidance strategies by Multinational Corporations (MNC) such as Apple. Whilst paper *two* and *three* both illustrate that the US is the global trend-setter in international politics via exercises of power that impinge on sovereignty and are of debatable legitimacy, paper *four* shows that other powerful actors such as the EU may be copying the US' assertive and controversial approach.

## 1.4 Paper Four Synopsis

**Paper #4:** Eggenberger, Katrin.

**The Political Economy of Tax Avoidance: Apple, Ireland and the EC's Puzzling State Aid Case.**

Submitted to *International Organization*.

Paper *four* looks at the puzzling case of the EC's state aid ruling with regard to Apple's tax structures in Ireland. It explores a range of issues including the cooperation problems and distributional conflicts of tax competition, political discord over sovereignty in the EU, the political, economic and social implications of tax avoidance, state capture and the rents earned by MNCs, and optimal tax rates. Paper *two* argues that states are transformed from being nation states to competition states through globalization, that resort to poaching each other's tax base, with a focus on personal taxes. Paper *four* focusses on how a competitive state facilitated international tax avoidance by MNCs and caused a major and ongoing dispute over sovereignty in tax matters within the EU.

I provide an overview of the scope, scale and rationale of international corporate tax avoidance by MNCs. Corporate tax is a key component of the tax systems of developed countries because it is one of the primary ways of taxing capital. In the US, about 10% of total tax revenues comes from the corporate income tax (US

Senate 2013) and in Europe it is about 7% (Eurostat 2014). Yet despite its important role, the practicality and enforceability of corporate tax is challenged by globalization and 55% of all the foreign profits of US firms are now kept in tax havens such as Ireland, Luxembourg and Switzerland. In fact, MNCs have amassed \$2.6tn in profits in such states (Zucman 2014). I explain how the international tax system creates opportunities for profit-shifting, how the political economy of small states like Ireland are geared up to facilitate this, and why.

Essentially, Ireland behaves like a typical tax haven in that it undercuts the tax rates of larger states to attract Foreign Direct Investment (FDI) from MNCs like Apple. This relationship helped transform Ireland into one of the richest per-capita economies in the world and Apple into one of the largest companies in the world. I examine how Apple avoided tax, the extent to which they avoided tax, and their financial versus moral motivations for doing so. However, these insights generalize to many MNCs operating out of states like Ireland, and US tech firms in particular. By 2017 Apple had worldwide net sales of \$229bn, net income of \$48bn and held \$285bn in cash and cash equivalents on its balance sheet. This ‘cash mountain’ has been widely publicized, corresponds substantially to the profits of Apple’s foreign subsidiaries, and drew attention from US and European authorities. Following US Senate and EC investigations into Apple’s tax structures in Ireland in 2013, Ireland was accused of having granted special deals to Apple (which both Ireland and Apple strongly refute) that helped Apple avoid corporate tax on almost all profits generated in the EU for nearly a quarter of a century. The EC concluded in 2016 that the deals had breached EU state aid rules and ordered Apple to pay €13bn in back-taxes to Ireland (European Commission 2014); a ruling that both Apple and Ireland contested.

But herein lies the puzzle in paper *four*: Why is Ireland intent on fighting an EC ruling that grants it billions of euros in back-taxes? My analysis shows that it was because Ireland’s government wanted to protect its economic model of attracting

FDI through low taxes and low regulation, had suffered a loss of sovereignty at the hands of the EC, and was concerned about the legitimacy of Ireland's claim to this windfall, as well as the legitimacy of the EC's approach and the retroactivity of its ruling. I further argue that the Irish people are largely quiescent with their government's stance because they also believe in the benefits of defending their economic model and the independence of Irish institutions.

Paper *four* then provides a more holistic analysis of the implications of tax avoidance as a cooperation problem in the international political economy. Due to the possibility of dividing the fiscal subject, individuals and companies can benefit from the public infrastructure of one state while using another state's regulations to avoid paying taxes (Palan 2002). Tax policy can thus be used to directly or indirectly incentivize and reinforce certain kinds of behavior and I look more closely at the morality and redistributive effects of state-enabled corporate tax avoidance. I discuss the relative winners and losers in terms of the various stakeholders involved, i.e. governments, publics, shareholders, employees and consumers. My analysis highlights the difficulties involved in apportioning their respective shares of corporate value generation, but nonetheless shows that corporate tax avoidance is income, wealth and equality distorting, and thus effects power relations.

I argue that the main beneficiaries of corporate tax avoidance are the shareholders, the employees, and in particular the 'management-power-driven' top earners (senior executives) at the companies that avoid tax. The biggest losers are those that pick up the tax burden in society, in particular the individuals and Small and Medium-sized Enterprises (SME) in larger high-tax states that are unable to make use of international tax avoidance strategies, as well as those who depend on tax redistribution the most. The rising share of income going to corporates in the economy, driven by falling tax rates due to the proliferation of neo-liberal economic policy and also as governments try to balance investment versus fiscal revenues due to



international tax avoidance, has fed into executive pay distortions and higher returns to capital than labor.

The conflict of capital versus labor is also a key theme in Katzenstein (1985), and as such my analysis in paper *four* helps to complete the circle of this thesis. My work also builds on early studies from the dependencia literature that looked at the various mechanisms by which MNCs affect political and economic processes, in terms of efficiency, growth, inequality and government effectiveness (Keohane and Ooms 1972, 1975; Moran 1978). I conclude that even though the nature of MNCs has fundamentally changed over the last 50 years, in terms of their scope, scale, areas of activity, and how they produce value (especially via intangible assets), the findings of this literature are largely robust in the modern context. MNCs have a tendency to siphon of economic surplus at the benefit of all of the countries in which they operate when aided by the government of a tax haven. I also agree with Stiglitz and Pieth (2016) in that there is a causal link between corporate tax avoidance and inequality; one of the most pressing issues of our time.

The case of the EC's state aid ruling is a quintessential example of the cooperation problems in international taxation central to this thesis. That is, a preferential tax system was created by Ireland that facilitated tax avoidance on a grand scale by MNCs like Apple, they defended it using the norm of sovereignty, and then a powerful IO in the form of the EU had to enact change using an exercise of power of debatable legitimacy to overcome a cooperation problem. In particular, the EC used the legal supremacy of its Competition Commission to force a retrospective tax ruling on Ireland and forced Ireland to close 'Double Irish' tax loopholes in October 2014 against Ireland's will. However, according to José Manuel Barroso, the EC's actions were deemed necessary to try to level the tax playing field in Europe (author's interview, 9 January 2019), i.e. were legitimate in outcome. In this way, paper *four* shows how state compliance in corporate tax avoidance can

affect power relations in and between states, and like in papers *two* and *three*, suggests that growing economic interdependence endows powerful states with new means of exercising power on smaller states. Where existing accounts tend to emphasize the use of power by the US to overcome cooperation problems (Eccleston 2012; Hakelberg 2015; Steinlin and Trampusch 2012), paper *four* emphasizes the use of power by the EU to a similar end and continues the theme of declining national autonomy in a globalized world (Garrett 1998).

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## **2. Economic Vulnerability and Political Responses to International Pressure: Liechtenstein, Switzerland and the Struggle for Banking Secrecy**

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**Abstract:** After doggedly opposing any increase in exchange of information on tax matters for several decades, both Liechtenstein and Switzerland have made significant concessions over recent years. However, the two countries have reacted rather differently to international pressure: while Liechtenstein has adopted a more proactive approach, offering far-reaching bilateral deals to several major economies, Switzerland has been slow to react to international pressure, despite calls for a more proactive strategy by its financial services industry. We suggest that these differences have a range of causes; in Liechtenstein, in particular, the pressure was more evenly distributed, thus allowing the financial services industry to close ranks and use its privileged access to the government to shape the government's response decisively. By contrast, there was internal division in the Swiss financial services industry and it was soon on the back foot in public debate, eventually losing control over the issue.

### **Introduction**

Roughly thirty years ago, Peter J. Katzenstein (1985) published a seminal book on politics in small European democracies that went on to shape how the economic success of these small states was understood. Being more dependent on foreign markets, small states are more vulnerable to change in the world economy than larger ones but have less political clout; their inability to shape world markets

leaves them little choice but to adapt to changing economic and political circumstances. Katzenstein argues that small states are particularly good at adapting to change because these countries' economic and political elites are typically aware of their countries' vulnerability. In times of crisis in particular, elites in small states close ranks and try to overcome conflicts of interest by finding compromises that protect the country. In this process, small size becomes an asset because short lines of communication and the compactness of the economic and political elite in small states allow for repeated and personal interaction that helps build up trust between decision-makers.<sup>2</sup>

Katzenstein's (1985) analysis uses Switzerland as one of his "poster children" for a small and vulnerable but also adaptable and therefore successful state. However, if Switzerland is a small open economy, Liechtenstein certainly is: encircled by Austria and Switzerland, the Principality has a total surface area smaller than any of the 26 Swiss cantons except Basel-City. In addition, Liechtenstein's economy is highly integrated in the world economy, its main economic sectors being export-oriented manufacturing and offshore financial services. In 2007, Liechtenstein-based financial services providers had assets worth CHF 171 billion under management, approximately 37 times the country's GDP. In comparison, Swiss-based financial services providers had assets worth CHF 7,073 billion under management the same year, corresponding to approximately 13 times Swiss GDP (see Figure 1 for data sources). Based on these figures, Liechtenstein and Switzerland are important players in offshore wealth management and thus highly dependent on foreign markets.

Both Liechtenstein and Switzerland have been subject to considerable international criticism as offshore financial centres. Most importantly, both countries are

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<sup>2</sup> In Katzenstein's account, small size is not solely a function of a country's geography or population size. Rather it is a function of a country's economic dependence on world markets and its self-conception as a "small state" surrounded by larger ones.

considered secrecy jurisdictions that facilitate the creation of structures allowing asset holders to avoid taxation in their country of residence or citizenship (Palan et al. 2010). Their banking secrecy regulations, which determine the exchange of information between tax authorities, are a clear example of this. Both countries have been reluctant to exchange information on tax matters and have been energetic opponents of any system in which information is automatically exchanged. This resistance has crumbled in recent years, however. After their largest banks had been the topic of a hearing in the US Senate, the two countries could no longer resist international pressure and were forced to make a series of political concessions, with both eventually agreeing to the automatic exchange of information (AEI) on tax matters.<sup>3</sup>

While the two countries caved in to international pressure and ultimately accepted AEI, our comparative analysis shows that they reacted to it in very different ways. Strikingly, in its struggle for banking secrecy, Switzerland did not act at all like the pragmatic and adaptable small state that Katzenstein (1985) had described. Swiss policy-makers and the financial services industry were instead hopelessly divided over the question of how to confront the challenge, often resulting in painful last-minute concessions and costly solutions. The Swiss failure to close ranks in the face of international pressure contrasts starkly with Liechtenstein's proactive reaction to the same challenges. Arguably, Liechtenstein's strategy paid off: Unlike Switzerland, Liechtenstein was able to end the bilateral conflict with the USA and avert any criminal indictments of its banks. In a similar vein, it reduced international pressure by joining the group of so-called "early adopters" of AEI, while Switzerland continued to face international criticism for its belated commitment to AEI.

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<sup>3</sup> Unlike previous standards that provided for exchange of information on request, AEI expects jurisdictions to send pre-agreed information each year without having received any specific request.

Why did Liechtenstein turn out to be more adaptable than Switzerland? Adopting a “Katzensteinian” perspective, we argue that the financial services industry’s internal cohesion, a more even distribution of the financial burden and the very close relationship between the financial services industry and the government allowed Liechtenstein to react swiftly and boldly. Meanwhile, the Swiss financial services industry was initially deeply divided over the best way to respond to international pressure. After it had finally reached a somewhat stable consensus on how to face this challenge, its representatives failed to control the issue in public debate; banking secrecy regulations became a topic of intense and partisan debate, resulting in a peculiar situation whereby Swiss banks’ suggestions to make far-reaching concessions in respect of banking secrecy went largely unheeded by political decision-makers.

This paper has the following structure: after a brief discussion of the role of Liechtenstein and Switzerland as offshore financial centres, we present our “Katzensteinian” argument of why Liechtenstein was in a better position to act resolutely. Subsequently, we analyse the political responses of these two countries to four challenges. This section also contains what is to our knowledge the first discussion of how Liechtenstein responded to international pressure on its banking secrecy regulations. The final section summarises our main findings but also argues that it is not necessarily a bad thing that Switzerland is no longer a “small state”.

### **Liechtenstein, Switzerland and banking secrecy**

Liechtenstein and Switzerland are important offshore financial centres specialising in wealth management for so-called high net worth individuals; these are usually understood as individuals with investable assets in excess of one million Swiss francs. Liechtenstein is an important private banking hub, serving Western European countries in particular, while Switzerland is a considerably larger financial



centre (BCG 2013). In addition, Swiss bank UBS is the world's largest bank in terms of assets under management (AuM) (Scorpio 2013).

Both Liechtenstein and Switzerland have been repeatedly accused of facilitating tax evasion (Palan et al. 2010). Although international criticism has also highlighted other aspects of the regulatory environment in Liechtenstein and Switzerland, banking secrecy regulations have played a particularly significant role in the debate over financial secrecy. Two elements form the core of banking secrecy (Emmenegger 2014). First, banking secrecy is a legal requirement that prohibits banks or their employees from disclosing any information about client accounts without the owner's consent, at risk of criminal penalty. This confidentiality requirement also includes bank interactions with foreign authorities. Second, banking secrecy involves rules that regulate who can legally access account information without violating banking secrecy. Swiss authorities can – under certain conditions – access all data and even share information with other states in accordance with international agreements, but Liechtenstein and Switzerland have long been reluctant to provide any international administrative assistance and both countries have been major opponents of the AEI in tax matters.<sup>4</sup>

Given their roles as important offshore financial centres, both countries have also been the targets of multilateral efforts to curb tax evasion. These efforts have redoubled since the early 1980s (Eden and Kudrle 2005), resulting most obviously in the EU Tax Savings Directive and the OECD's Harmful Tax Competition initiative. In both cases, Liechtenstein and Switzerland displayed little willingness to comply with calls for more cooperation and exchange of information (Webb 2004;

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<sup>4</sup> Some definitions of banking secrecy include the clarification of customer identity by self-regulation as enshrined in the agreements on banks' code of conduct (Steinlin and Trampusch 2012).

Holzinger 2005; Sharman 2006a, 2008).<sup>5</sup>

Having historically been roadblocks to increased exchange of information on tax matters, both countries made a series of concessions after 2008 that few, if any, analysts would have anticipated a year previously. Essentially, a major tax evasion scandal, accentuated by the 2007/8 global financial crisis, marked the beginning of an unprecedented debate over banking secrecy (Steinlin and Trampusch 2012; Emmenegger 2017). In February 2008, a spate of media reports revealed that German authorities had searched the home of the chairman of the former state-owned German postal service; he subsequently received a suspended sentence of two years' imprisonment and a one million Euro fine for tax evasion. German authorities had detected evidence of tax evasion while looking through data obtained from a former employee of Liechtenstein's biggest bank, LGT. UBS, Switzerland's biggest bank, came under parallel pressure from across the Atlantic when US authorities detained a US-domiciled UBS client for tax evasion and his client manager turned whistle-blower, allowing the US authorities to prosecute UBS. In April 2008, the US authorities arrested the head of UBS wealth management at a Miami airport.

LGT and UBS' business practices were subsequently addressed in a US Senate hearing in July 2008, which also attracted plenty of international attention. Following the hearing, the US began to take a tougher stance on US clients' offshore wealth, opening criminal investigations against foreign banks for facilitating tax evasion and enacting the Foreign Account Tax Compliance Act (FATCA), which forces foreign banks to provide access to information about their US clients in return for market access. The two tax evasion scandals also triggered further multilateral efforts to curb tax evasion by improving information exchange. In October

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<sup>5</sup> Of course, there have also been earlier attempts to curb tax evasion (cf. Farquet 2013). However, until 2007, both Liechtenstein and Switzerland were strikingly successful in protecting their banking secrecy regulations.

2008, the finance ministers of 17 OECD member states met in Paris to discuss joint strategies to combat tax havens (OECD 2008), while the G20's Washington Declaration of November 2008 called on countries with banking secrecy to commit to international standards in information exchange.

In 2008, Liechtenstein and Switzerland were under pressure from two sides: US criminal investigations were threatening to bankrupt some of their biggest banks, while FATCA was pressuring them to abandon US clients' banking secrecy in return for market access. The OECD simultaneously resumed its efforts to advance the OECD model agreement on exchange of information on tax matters (which, by 2014, included the AEI) and also began to develop blacklists of countries whose regulations did not conform to these new global standards. The first of these OECD blacklists was presented at the April 2009 G20 meeting in London.

At the risk of oversimplification, it could be argued that Liechtenstein and Switzerland faced four main challenges after the US Senate hearing: the two countries had to (i) deal with US demands for increased (bilateral) exchange of information on tax matters, (ii) respond to the new OECD blacklist published in April 2009, (iii) protect their banks from criminal investigations by US authorities and (iv) react to calls for AEI on tax matters.<sup>6</sup> As we demonstrate below, Liechtenstein acted more pragmatically and resolutely than Switzerland to all four challenges. Arguably, Liechtenstein's strategy paid off: not only was it able to end its bilateral conflict with the USA without its banks being the subject of criminal proceedings or massive penalties, it was also able to divert international attention to other off-shore financial centres by making early and targeted concessions to the international community. Given their similar situations in 2008, why did Liechtenstein and Switzerland respond so differently to international pressure?

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<sup>6</sup> Of course, these are not the only challenges the two countries faced. For instance, the EU also demanded more information exchange. However, the EU was not able to exercise the same amount of pressure as the USA, while it channelled most of its activities through the OECD.

## **Economic vulnerability and political decision-making**

Katzenstein (1985) argues that small open economies are vulnerable to change in the world economy. Their inability to shape world markets, however, leaves them little choice but to adapt to changing economic and political circumstances. In an innovative twist on the argument, Katzenstein claims that small Western democracies have turned this disadvantage to their advantage. Because these countries' economic and political elites are typically aware of their countries' vulnerability, small Western democracies have become particularly good at adapting to change. In times of crisis in particular, elites in small states close ranks and try to overcome conflicts of interest by finding compromise solutions that protect the country.

Katzenstein (1984, 1985) strongly relied on Switzerland's political and economic history to demonstrate how a state's vulnerability influences political response to international pressure. However, in the conflict over banking secrecy regulations, Switzerland did not act at all like Katzenstein's pragmatic and adaptable small state, while Liechtenstein did. Switzerland seemed unable to respond to international pressure in a coordinated manner: if anything, political differences escalated even when the country was at its most vulnerable, and the government's hands were tied. Liechtenstein's political landscape, by contrast, showed a general consensus on what direction the country should take and political disagreement was quickly silenced. Liechtenstein not only adapted to change fast, but also achieved an arguably better outcome. Why was this the case?

Working from Katzenstein's findings, we argue that there are two interconnected reasons why Liechtenstein and Switzerland responded so differently to international pressure. In short, we submit that in Liechtenstein, the pressure was more evenly distributed within the financial services industry, which allowed it to close ranks. In addition, in the absence of political polarization, Liechtenstein's financial services industry was able to use its privileged access to the government to decisively shape the government's response.

Katzenstein's (1985) argument is based on the idea that small open economies are more apt to find compromises in two different arenas. First, a compromise must be found among the major economic interests. In his work, Katzenstein primarily referred to the conflict between capital and labour, but in the Swiss context, differences between internationally and domestically oriented businesses are also important (Bonoli and Mach 2000). Notably, the ability to find compromises is a function of the challenges a country faces. The challenges described by Katzenstein typically concerned entire national economies but challenges may also accentuate the conflict of interests between different economic groups. For instance, research shows that as economic internationalization has strengthened some groups *vis-à-vis* others, compromises between these economic groups have become increasingly difficult to find (cf. Sciarini 1994; Mach 2006).

Second, common ground among major economic interests is not sufficient for a "Katzensteinian" response to challenges. Equally important but often neglected in accounts based on Katzenstein (1985) is the role of political parties and the state (Armingeon and Emmenegger 2007). It is generally assumed that political parties and the government underwrite the compromise found between the major economic interests. For instance, Farquet (2013) shows how the Swiss government fiercely defended the interests of its financial services industry in the interwar period. However, economic interests do not always translate easily into public policy. Research shows that in recent years the main focus of decision-making in Switzerland has shifted from the sphere of interests groups to partisan politics (Häusermann et al. 2004). In parallel, Swiss partisan politics has become increasingly polarized and fragmented (Kriesi et al. 2005). In particular, the Swiss People's Party (SVP), currently Switzerland's largest political party, often rejects compromise politics in favour of a principled defence of values such as national self-determi-

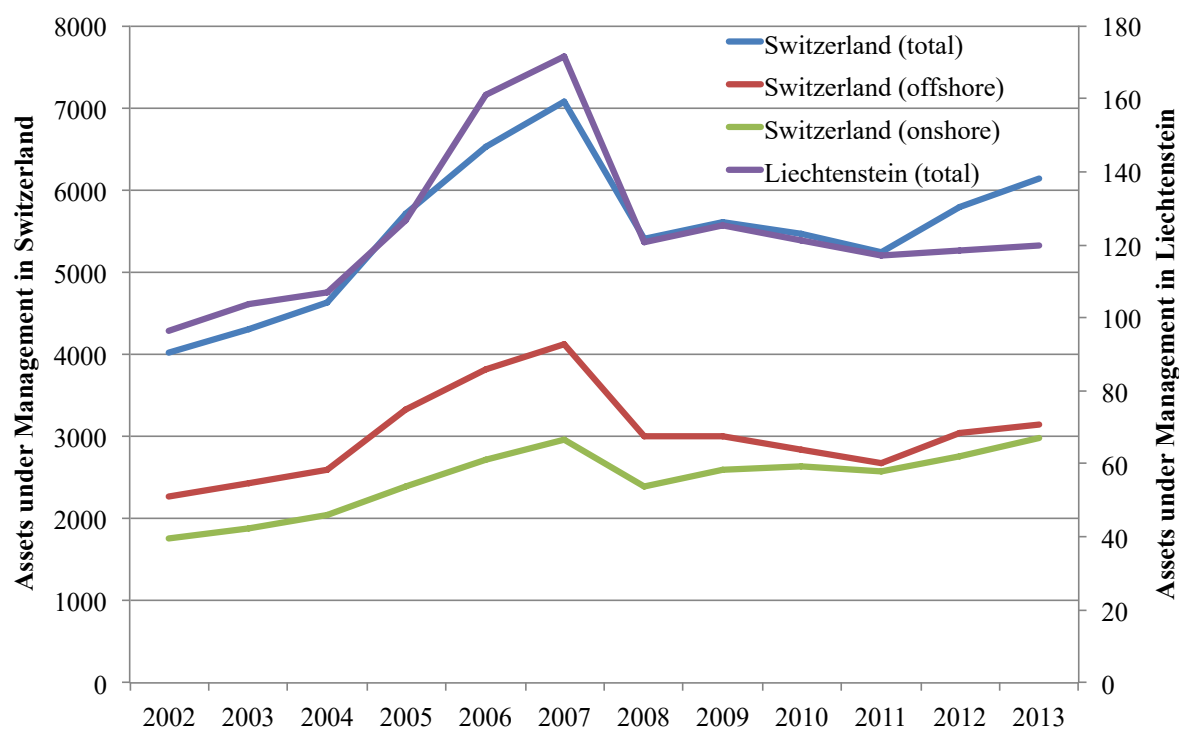
nation and neutrality (cf. Bornschieer 2015; Traber 2015). These days, even if economic actors are able to find a compromise, they can no longer rely on political parties and the government to follow their recommendations blindly.

These developments are reflected in how Liechtenstein and Switzerland responded to international pressure on their banking secrecy regulations. In both countries, AuM declined steeply in the wake of the global financial crisis. AuM in Switzerland dropped by almost 24% between 2007 and 2008, and losses in Liechtenstein amounted to no less than 30% (see Figure 1). This decline in AuM caused more pain to Liechtenstein than Switzerland because the Principality's financial services industry, while more important to the overall economy (in terms of gross value added), is considerably less diversified. Liechtenstein's financial services industry specialises almost exclusively in offshore wealth management; unsurprisingly, it has thus also had to contend with recurrent public deficits since the beginning of the global financial crisis.<sup>7</sup>

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<sup>7</sup> URL: <http://www.llv.li/#/12281> (accessed on September 21, 2014).

**Figure 1: Banking Sector AuM in Liechtenstein and Switzerland**  
between 2002-2013 (billion CHF).



*Source:* Swiss National Bank (2014) and Statistik Liechtenstein (2014)<sup>8</sup>

Another source of pressure on Liechtenstein was the upcoming renewal of the Qualified Intermediary (QI) agreement with the USA. The QI programme requires foreign banks to report investment in US securities directly to US tax authorities (Grinberg 2012b). From 2001 onwards, the QI programme strived to identify US persons that hold beneficial interests in US securities and attempted to ensure the appropriate withholding of US tax from payments of US source income to non-US persons (Hanrehan and Shapiro 1998). However, foreign banks could obviate some of these reporting requirements – or, alternatively, avoid the large withholding tax – by applying for the status of a “qualified intermediary”. As the QI agreement ran

<sup>8</sup> The numbers provided for Switzerland are based on our own calculations using data from the Swiss National Bank (2014). Liechtenstein’s data are based on Statistik Liechtenstein (2014); unfortunately, without allowance to distinguish between offshore and onshore assets.

out in 2008, by making a renewal conditional on increased exchange of information on tax matters, the US was able to increase pressure on Liechtenstein.

Pressure alone, however, cannot explain why Liechtenstein and Switzerland responded so differently. Both countries were facing major economic and political problems in the second half of 2008: while Liechtenstein was hoping to renew the QI agreement, from October 2008, Switzerland was faced with the possibility that its biggest bank, UBS, might be criminally indicted by US authorities, which could have led to the bank's collapse (Emmenegger 2017). From a Swiss perspective, UBS is clearly "too big to fail" – the bank's collapse could have disastrous consequences (Bundesgericht 2011). Both countries were equally under great pressure.

Rather than pressure overall, we argue following Katzenstein (1985) that the greatest difference between the countries was the distribution of the pressure. In Liechtenstein, the legal disputes dogging LGT and Liechtensteinische Landesbank (LLB) were considered to be attacks on the entire financial centre. Moreover, the industry as a whole was more dependent on offshore wealth management than its Swiss counterpart. Thus, the banks were quick to find common ground.

In contrast, Switzerland's more heterogeneous financial services industry was deeply divided. Until at least late 2009, there was a widespread perception that UBS' legal troubles did not concern the Swiss financial services industry as a whole. As a result, the Swiss Banking Association, most banks and all but the left-leaning political parties failed to make more than the minimal concessions required to stem international criticism (Steinlin and Trampusch 2012). With little or no representation outside Switzerland, traditional private banks specializing in offshore wealth management in particular showed little willingness to close ranks to support UBS. This uncompromising position was based largely on the erroneous belief that Swiss banks without representation outside Switzerland were perfectly



safe even if they took advantage of “regulatory arbitrage”.<sup>9</sup> For such banks, any concessions on banking secrecy would compromise their business models. Instead, they saw the UBS scandal as an opportunity to poach clients from a struggling rival.

After 2009, however, it was becoming increasingly clear that the crisis was not restricted to UBS alone. The vulnerability even of traditional private banks with no representation outside Switzerland was forcefully demonstrated by a criminal indictment of Wegelin & Co. in February 2012 that resulted in the bank’s collapse within a few weeks. Representatives of the Swiss financial services industry now demanded decisive and resolute political action to resolve the crisis, including the acceptance of AEI on tax matters. However, their voices went unheard because the mode of political interaction had by that time shifted from informal deliberations between government officials and representatives of the financial services industry to formal disputes between political parties (Culpepper 2011). Put simply, by the time the industry had finally established a common position (about four years after the beginning of the conflict), it had lost control of the issue; political parties were now setting the agenda and they would not help the financial services industry by compromising on banking secrecy regulations because voters seemed against the idea. The international conflict over Swiss banking secrecy had turned into political vote-seeking rather than solution-oriented policy-making.

In Liechtenstein, by contrast, the political reaction to international pressure was coordinated between the government, the Princely House and representatives of

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<sup>9</sup> In addition to a series of newspaper articles (e.g. see the quotations from Patrick Odier, President of the Swiss Banking Association, in NZZ, “Der Bankenverband übt Selbstkritik”, September 4, 2013), this view was also expressed in the criminal proceedings against Wegelin & Co. (see Bruderer 2012).

the financial services industry.<sup>10</sup> The legal hot water in which LGT (and later LLB) found itself affected banks with very close ties to the political establishment: the government provides LLB with a guarantee for the assets it holds, and this provided the government with a strong incentive to protect the bank from legal problems. Similarly, LGT is owned by the Prince of Liechtenstein Foundation, which is controlled by the Princely House, so the interest of Liechtenstein's political elite in the economic welfare of the two banks went beyond tax revenue; the financial fate of the state and of the two banks were aligned. Hence, no relevant group challenged the political consensus.

### **Diverse responses to common challenges**

The following section examines how Liechtenstein and Switzerland have responded to four common challenges: (i) the immediate response to US pressure following the Senate hearing; (ii) the OECD blacklist; (iii) US criminal investigation; and (iv) attempts to instigate AEI on tax matters.

#### *US pressure after the Senate hearing*

In early 2008, both LGT and UBS were confronted with major tax evasion scandals that resulted in a public hearing in front of the US Senate Permanent Subcommittee on Investigations in July 2008, for which the subcommittee had prepared a detailed report based on eight case studies; seven of these concerned Liechtenstein in general and six LGT in particular (Levin and Coleman 2008). While UBS testified, LGT chose not to discuss or defend its practices in public, instead issuing a state-

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<sup>10</sup> The Hereditary Prince must expressly agree to every law passed in Liechtenstein. In addition, there is widespread agreement that no policy can be made against the will of the Princely House of Liechtenstein, which is therefore usually involved in any discussion of political initiatives.

ment in advance of the hearing that its current practices were no longer those described in the report.<sup>11</sup> LGT spokesman Christof Buri stated that the revelations did not describe current practices at LGT because the data on which the Levin-Coleman report was based had been stolen in 2002; the illicitly acquired data was still subject to old, i.e. pre-QI regulations and LGT thus saw no point in participating in proceedings.<sup>12</sup>

The USA, however, was in a position to exercise formidable pressure on Liechtenstein even without the legal case: the Principality was up for a renewal of its QI programme, due to end in 2008. US authorities stipulated that any QI programme renewal be dependent on the conclusion of a tax information exchange agreement (TIEA) between these two countries. Facing exclusion from the US market, Liechtenstein had no choice but to negotiate. As Simon Tribelhorn, Chief Executive Officer of the Liechtenstein Bankers Association, argued, “the QI programme was needed for our business relations so that both the stability of our direct US-investments and the legal certainty with the US would be secured in the future”.<sup>13</sup> Liechtenstein signed the TIEA with the USA on December 8, 2008, making far-reaching regulatory concessions. Given the reputational damage it had suffered as a result of LGT’s prominent role in the Levin-Coleman report and the asset outflow since early 2008 (see Figure 1), Liechtenstein saw no point in continuing to resist US pressure.

Switzerland responded very differently to the US Senate hearing. Despite calls from UBS to show flexibility, the Swiss government, supported by a large political majority, insisted on standard procedures for providing access to client files under banking secrecy regulations. International administrative assistance is a slow and cumbersome process, however, and by early 2009, Switzerland had completed

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<sup>11</sup> NZZ, “LGT nimmt nicht an Hearing teil”, July 17, 2008.

<sup>12</sup> Telephone interview, September 3, 2014.

<sup>13</sup> Telephone interview, August 25, 2014.

preparations for the transfer of information in only 26 cases (Schaub 2011). This was too slow for the USA and on February 17, the Department of Justice publicly threatened to indict UBS if the bank would not enter into a deferred prosecution agreement (DPA), pay a fine of USD 780 million and disclose the names of approximately 250 US clients to the IRS within the next 24 hours (Bondi 2010; GPK 2010). In response, Switzerland complied and authorised the transfer of 255 client files.

US pressure, however, did not relent. The day after UBS had entered into the DPA, US authorities requested further client files. Worried that UBS might buckle under the pressure, the Swiss government threatened to seize all US client files. In August 2009 Switzerland and the USA finally reached an agreement: in return for an additional 4,450 client files and an undertaking to expedite information requests, the USA promised to let UBS off the hook (Emmenegger 2017). These concessions were nonetheless strongly contested within Switzerland, in particular by the political right and large parts of the financial services industry. After the Swiss Federal Administrative Court had come to the conclusion (in January 2010) that some of these data transfers had violated banking secrecy regulations, the bilateral agreement could only be saved by turning it into a state treaty (in June 2010). As stated by Urs Zulauf, then chief legal adviser to the Swiss Financial Market Supervisory Authority, the government was strongly concerned about its ability to get the state treaty through parliament. As a consequence, the government interpreted the agreement in a very restrictive manner and excluded the expedited review of US information requests for banks other than UBS.<sup>14</sup> Clearly, Switzerland was not willing to go any further than ultimately needed.

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<sup>14</sup> Personal interview, April 7, 2014. A few days before the Swiss Parliament accepted the state treaty, the Swiss People's Party launched a parliamentary initiative to give banking secrecy constitutional status, which the Parliament, however, ultimately rejected.

### *The 2009 OECD blacklist*

The public shaming of LGT and UBS in July 2008 in conjunction with the effects of the global financial crisis turned what started out as a bilateral conflict into a multilateral campaign to increase exchange of information on tax matters. In November 2008, the G20 called on countries with banking secrecy to commit to international standards of information exchange, while the OECD promised to produce a new blacklist of uncooperative jurisdictions to be presented at the next G20 summit in April 2009 (Eccleston and Woodward 2014).

These announcements turned into a concrete threat as draft versions of the OECD blacklist began to circulate in early March 2009. Both Liechtenstein and Switzerland were increasingly concerned about the sustained reputational damage to be suffered as a result of these activities and, as more and more countries committed to the so-called OECD standard, the two countries became increasingly isolated. Switzerland in particular, as the home base of several international organisations, feared the prospect of being blacklisted for the first time. Liechtenstein nonetheless managed to pull off a coup by publicly announcing its willingness to accept the OECD model agreement before Switzerland. In a telling display of national unity, the announcement was made at a press conference in the presence of the leaders of the two main parties (which includes the head of government) as well as the Hereditary Prince, who also controls LGT, the bank that precipitated the political crisis.<sup>15</sup> In addition, Liechtenstein announced that it would be seeking bilateral agreements with European countries to find ways to regularise the tax status of the clients of Liechtenstein's banks (this later became the so-called Liechtenstein Disclosure Facility). The Liechtenstein Bankers Association subsequently publicly endorsed the government strategy (Lauber 2009).

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<sup>15</sup> The Hereditary Prince's brother, Prince Maximilian, is the CEO of LGT.

Liechtenstein's surprising move forced Switzerland's hand. With Swiss newspapers full of reports of developments in Liechtenstein and without any prior public discussion and debate, the Swiss Government held a press conference the day after Liechtenstein's announcement stating its willingness to accept the OECD standard on exchange of information on tax matters. According to the then Swiss President Hans-Rudolf Merz, the move would take Switzerland "out of the line of fire" and thereby reduce the risk of being blacklisted by the OECD.<sup>16</sup> Apart from the date, the Swiss announcement differed from Liechtenstein's declaration in two further important ways: while Liechtenstein's announcement had triggered little domestic opposition, the Swiss People's Party strongly criticised the government's decision and announced it would consider a popular referendum to stop the government from making any concessions "as a result of blackmail".<sup>17</sup> Secondly, while Liechtenstein had announced its intentions of resolving the tax status of bank clients by means of bilateral agreements, Switzerland made no mention of any such plans. Only in December 2009 (and thus just a few months before the USA passed FATCA in March 2010) did the Swiss Government embark on a similar (and ultimately unsuccessful) strategy.

### *US criminal investigation of banks*

The bilateral agreements made by Liechtenstein and Switzerland with the US in December 2008 and August 2009 respectively did not conclusively resolve their bilateral conflicts. US attention now turned from LGT and UBS to other banks, including the two second-largest banks in Liechtenstein and Switzerland respectively, LLB and Credit Suisse (CS). By this stage, there could be little doubt that the US authorities desired access to further client files of US persons. However,

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<sup>16</sup> Interview, NZZ, "Wir sind jetzt aus der Schusslinie", March 14, 2009.

<sup>17</sup> Tages-Anzeiger, "Einzig Ueli Maurer wollte beim Bankgeheimnis nicht nachgeben", March 14, 2009. SVP members later launched a popular initiative to give banking secrecy a constitutional status within Switzerland.

the way Liechtenstein and Switzerland reacted to this new reality was starkly different.

There was much relief in Liechtenstein when in July 2013, after several months of negotiations, LLB agreed to a non-prosecution agreement (NPA) in return for a payment of USD 23.8 million to the US authorities. Ultimately, LLB and Liechtenstein had got off lightly. LLB had a state guarantee on savings deposits and medium-term notes so, in the event of a criminal indictment, not only would the bank have been in danger but Liechtenstein's public finances, as well. Thanks to the NPA, however, an indictment could be averted and LLB was to pay only a comparatively small penalty.

Why did the US authorities show so much restraint in their dealings with LLB? The reason may be found in a piece of legislation passed by Liechtenstein's parliament on March 21, 2012. In a cloak-and-dagger operation, Liechtenstein's parliament retroactively permitted so-called group requests by US authorities for tax offences committed after 2001 without "any substantive discussion", as Liechtenstein's newspapers drily reported the day after the vote.<sup>18</sup> A few weeks later, the US Department of Justice directed a request for international assistances to the tax authorities, with which Liechtenstein promptly complied. Once again, this surprising move was welcomed by Adolf Real, then president of the Liechtenstein Bankers Association, who commented that "Liechtenstein has acted quickly and thus maintained its ability to function".<sup>19</sup>

On July 2, 2013, the Liechtenstein State Court came to the conclusion that the transfer of client data concerning US persons as far back as the year 2001 was

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<sup>18</sup> The quotation is from the newspaper Vaterland ("Liechtenstein lockert das Bankgeheimnis für die USA",

March 22, 2012). The other main newspaper of Liechtenstein, Volksblatt, hardly covered this (important)

decision, only printing a short report from a commercial press agency.

<sup>19</sup> Interview, Vaterland Magazin, "Wir können uns schnell ändern", March 24, 2012.

unconstitutional. However, by this date, almost all client information had already been sent to the US authorities and the NPA for LLB was signed shortly afterwards, on July 24, 2013. In the agreement, the US authorities explicitly thanked Liechtenstein and LLB for its cooperative behaviour, including the new regulations relating to administrative assistance (Department of Justice 2013). Perhaps unsurprisingly, the court ruled that clients were not entitled to claim damages even though the Liechtenstein State Court had decided that the clients' constitutional rights had been violated.<sup>20</sup>

Switzerland was facing the same demands from the US authorities to provide access to client files as far back as 2001 (the year the QI programme had started). Unlike Liechtenstein, however, Switzerland refused to budge, arguing that providing access retroactively would violate the principle of legal certainty. As the Swiss chief negotiator Michael Ambühl argued, violating regular procedures was the line in the sand that the Swiss Government was not willing to cross. There was thus no room for such an overly "pragmatic" agreement between Switzerland and the USA that would allow the USA access to client files in return for more lenient treatment of Swiss banks because, in the words of Ambühl, Switzerland "is not a banana republic".<sup>21</sup>

The US authorities instead continued to increase pressure on Switzerland, including more or less open threats to indict Swiss banks if the Swiss government would not comply with their requests. In January 2012, the Department of Justice made good its threat by indicting Wegelin & Co., which within a month was subsequently forced to sell its non-US business. The Swiss government made several

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<sup>20</sup> URL: <http://www.gerichtsentscheide.li/default.aspx?mode=gerichte&prim=2&value=2013&id=3782&backurl=?mode=gerichte%26prim=2%26value=2013> (accessed on September 11, 2014).

<sup>21</sup> Interview, Tages-Anzeiger, "Die Schweiz ist keine Bananenrepublik", August 24, 2013.



concessions to the USA after this demonstration of power but still refused to provide access to client files going back to 2001; instead, it agreed to an expensive, unilateral amnesty programme with the US authorities that would allow banks to obtain non-prosecution agreements in return for client files as far back as August 2008 in addition to penalties of up to 50% of the maximum aggregate dollar value of US-related, undeclared accounts existing on August 1, 2008 or thereafter. Banks that were already under investigation at the time of the agreement were not entitled to participate but were to be dealt with separately. In May 2014, Credit Suisse agreed to a guilty plea and payment of a penalty of USD 2.6 billion for facilitating tax evasion by some of its US clients.

It should be emphasised that in a stunning display of national disunity, the Swiss parliament rejected the agreement between Switzerland and the USA despite intensive lobbying from the Swiss Banking Association and several prominent representatives of the Swiss financial services industry. The “Lex USA” was rejected by a so-called “unholy alliance” between the political left and the political right against the political centre. The left refused to support the agreement because it did not lead to an AEI on tax matters, while the right considered the agreement an unacceptable submission to foreign power. As a result, the government was forced to conclude a revised agreement with the US authorities that did not need parliament’s approval.

#### *Automatic exchange of information on tax matters (AEI)*

With the USA implementing FATCA, the OECD extending its model agreement and the EU discussing revision of the Tax Savings Directive, it was becoming increasingly apparent that AEI was a foregone conclusion. According to Hereditary Prince Alois, Liechtenstein had begun working towards the implementation of AEI

as early as 2012.<sup>22</sup> In May 2013, the Liechtenstein Bankers Association officially announced its support for AEI. On November 14, 2013, Liechtenstein's Government agreed to implement international standards for administrative assistance and committed to automatic exchange of tax information based on future developments of the OECD standard (Government Declaration 2013). On November 27, 2013, Liechtenstein finally joined the G5's "early adopters" initiative, thereby abandoning virtually any conditions for the implementation of AEI on tax matters (Joint Statement 2013b).

Faced with the inevitable, Liechtenstein was once again quick to act; in Switzerland the process unfolded much more slowly. In a December 2012 press conference on the on-going tax dispute, the Swiss Government presented a strategy that was based on an attempt to conclude bilateral agreements to resolve the tax status of foreign clients of Swiss banks and implement new due diligence regulations. In addition, the government informed the media it had created a new group of experts to develop strategies that would improve the Swiss financial sector's competitiveness in the new regulatory environment. In a subsequent Q&A, Switzerland's Finance Minister first mentioned the need to consider a possible AEI.

The minister's remarks attracted widespread criticism from the political right but the group of experts, which presented its findings in June 2013, went further still, not only recommending the acceptance of AEI as part of a new global standard but even suggesting it should be proactively offered to neighbouring countries to resolve on-going tax disputes (Bericht der Expertengruppe 2013). Bearing in mind the resistance to AEI within the country, the Swiss government did not agree to go this far, however, instead stating that, given domestic opposition to AEI, it would accept automatic exchange of information under the condition that this was introduced as a global standard (Bundesrat 2013). This condition, however, was quietly

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<sup>22</sup> Personal interview, September 5, 2014.

dropped in 2014. In October 2014, the Swiss government announced to introduce AEI by 2018.<sup>23</sup>

### **Alternative explanations?**

If a “Katzensteinian” argument (encompassing smallness, vulnerability and closing ranks) is not appropriate, what else could explain why these two countries reacted so differently to such challenges? Several arguments could be put forward, but none seems convincing. The differential response cannot be explained simply by a change of government, institutional veto points or a shifting balance of power. Unlike in Switzerland, there is no organised group within Liechtenstein that traditionally promotes international tax cooperation. Switzerland’s second-largest political party publicly opposes banking secrecy and has also launched several attempts to abolish it. As in Switzerland, there are multiple institutional veto points in Liechtenstein’s political system: The Hereditary Prince can stymie *any* government decision, for example. However, as the de facto owner of LGT, he had no interest in stopping the government from making concessions that protected the bank. In Liechtenstein, the interests of political decision-makers and the financial services industry are almost perfectly aligned.

Alternatively, it could be argued that Liechtenstein is too weak to resist international pressure or that banking secrecy is not as important to Liechtenstein as it is to Switzerland. Liechtenstein has displayed formidable ability to withstand international pressure in the past, however, best exemplified by its uncompromising stance during the OECD’s Harmful Tax Competition Initiative (Sharman 2006a). In addition, banking secrecy is if anything more important to Liechtenstein, given its (almost exclusive) focus on offshore wealth management. Liechtenstein’s

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<sup>23</sup> By contrast, the Swiss Banking Association’s support for AEI on tax matters is more univocal. See for instance the interview with Patrick Odier, Finanzplatz Schweiz, “Opportunitäten gezielt wahrnehmen”, July 3, 2014.

struggles as an offshore financial centre are also reflected in its inability to attract new assets (see Figure 1).

A potentially more convincing argument might be that Liechtenstein was facing increased international pressure while Switzerland was arguably not even approaching crisis point, so there was thus no vulnerability and no reason to close ranks. However, we would suggest that this explanation, too, is unconvincing; a criminal indictment of UBS and the bank's potential subsequent collapse would have had catastrophic consequences for the Swiss economy. Switzerland is also much more important as an offshore financial centre to both the USA and the OECD, and getting Switzerland to give up its banking secrecy was therefore a much bigger prize, both symbolically and in actual fact. It is telling how German politicians tried to turn the LGT scandal into a Swiss affair before the news broke that UBS, too, was facing a tax evasion scandal. Ultimately, the final consequences of the banking secrecy controversy (including the penalties paid, the reputational damage caused, the criminal investigations undertaken and the eventual reform of banking secrecy structures) clearly show that Switzerland was left facing a crisis the severity of which may have been misjudged by Swiss decision-makers. As we have indicated, however, this misjudgement was primarily the result of the decision-makers' inability to assess the consequences for the country as a whole rather than for their narrow, personal interests.

### **Switzerland disenchanted**

During the banking secrecy crisis, Switzerland behaved nothing like the small state Katzenstein (1985) had so carefully described. Faced with a threat to its very existence, the country failed to close ranks and, riven internally over how to react to international pressure, proved unable to adapt. Liechtenstein, by contrast, immediately acknowledged its vulnerability and this caused all those involved to act in

unison. Liechtenstein's "pragmatism" allowed it to avoid any indictments, blacklists or painful fines and, while it did not welcome change, once it realised that this was inevitable, it adapted quickly, just as Katzenstein would have predicted.

Swiss inability to act cohesively was not least a reflection of the deep divisions in the Swiss financial services industry. In a telling joint interview, Philipp Müller, president of the business-friendly Liberal Party (FDP), remarked that what he was hearing from the industry was a "cacophony" and that it looked as if each bank was simply trying to "save its own skin". In response, Oswald Grübel, the former CS CEO (2003-2007) and UBS chairman (2009-2011), argued that he had stopped listening to the Swiss Banking Association, which he described as a pile of headless chickens ("*Hühnerhaufen*") that had discredited itself through its inability to develop a coherent and consistent position.<sup>24</sup> In a separate interview, Patrick Odier, president of the Swiss Banking Association, used less stark wording to voice his agreement, arguing that "in difficult times, people focus more on their individual than their common interests".<sup>25</sup>

Unlike Liechtenstein, Switzerland proved unable to close ranks and thus had to suffer the consequences. While Switzerland was disenchanted, Liechtenstein's "pragmatism" came at a high cost, however: its credibility as a full-fledged democracy under the rule of law took a considerable knock. In Liechtenstein, the interests of the financial services industry and the state are almost completely aligned; the two banks facing the most international pressure either had the state guaranteeing its assets (LLB) or were controlled by the Princely House (LGT), which can veto any government decision. Tellingly, the announcement of acceptance of the OECD standard in March 2009 was made jointly by the outgoing head of Government, the new head of Government (from the other main party) and

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<sup>24</sup> Interview, Schweizer Monat, "Vor und nach dem grossen Kater", June 2013.

<sup>25</sup> Interview, Finanzplatz Schweiz, "Opportunitäten gezielt wahrnehmen", July 3, 2014.

the Hereditary Prince, who owns LGT and is the brother of the LGT CEO. Similarly, the retroactive 2012 parliament decision to permit group requests by US authorities going back to 2001 (which ultimately ended the bilateral conflict and resulted in a nugatory fine for LLB) was hardly discussed, either in the parliament or Liechtenstein's media. Unsurprisingly, the Liechtenstein State Court later declared the act to be unconstitutional, but by then, the data had already been transferred.

The banking secrecy crisis shows that Switzerland has become a more “normal” country instead of a mere “small state”; important decisions are no longer made behind closed doors, in meetings between powerful representatives of politics and business; no longer are the interests of political decision-makers and the financial services industry almost perfectly aligned (cf. Mach et al. 2011). As this analysis has set out to show, such maturity may have had its price.

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### **3. State Sovereignty, Economic Interdependence and US Extraterritoriality: The Demise of Swiss Banking Secrecy and the Re-Embedding of International Finance**

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**Abstract:** This article explores the tactics of an emergent extraterritoriality in international finance by examining how the US was unilaterally able to pierce Swiss banking secrecy regulations before Switzerland was forced to make similar concessions at the multilateral level. Complementing power-based approaches that emphasize control over market access, we show that for most of the conflict starting in early 2008, the key agents of change were US law enforcement authorities. By relying on legal action against Swiss banks following a large tax evasion scandal rather than engaging in a direct confrontation with the Swiss government, the US was able to avoid a politicization of the conflict, which would have raised questions of legitimacy. The US law enforcement authorities' ability to promote institutional change in Switzerland is based on three factors: the structural economic dependence of banks on access to the US market, corporate liability for legal transgressions of employees and an adversarial legal system characterized by extensive prosecutorial autonomy. More generally, we show that powerful states have the capacity to re-embed international finance by extending the boundaries of their law enforcement authorities' jurisdiction extraterritorially.

## Introduction

The global financial crisis has powerfully demonstrated the necessity of re-embedding international finance. Among others, the crisis has redirected attention to the problem of financial secrecy, which is the result of the gulf between state sovereignty and the internationalization of capital (Palan 2002). If a country facilitates the creation of structures that allow asset holders to avoid taxation, launder money or finance illicit activities, other countries have few means at their disposal to avert the negative consequences. Hence, the literature on offshore finance argues, there is little that can be done against financial secrecy outside of multilateral initiatives that substantially restrict the state's legal sovereignty, but due to collective action problems, such initiatives are unlikely to succeed (Palan 2002; Webb 2004; Eden and Kudrle 2005; Rixen 2008; Sharman 2008; Genschel and Schwarz 2011).

Recently, US law enforcement authorities managed to coerce the transformation of Swiss banking secrecy regulations against the preferences of Switzerland's government and financial sector. Switzerland is considered "the old grand-daddy of tax havens" with impenetrable banking secrecy facilitating tax evasion and its "reputation as trustworthy bankers [a] legend among private investors" (Finkelstein 1999: 6, 44). Since Swiss banks are estimated to manage up to one third of the world's total offshore wealth (Eccleston 2012: 127), Switzerland's agreement to exchange information for tax purposes with US authorities is of great importance.

This article contributes to our understanding of how the US unilaterally pierced Switzerland's allegedly impenetrable veil of secrecy before Switzerland was forced to make similar concessions at the multilateral level. This is an important endeavour because Switzerland's concessions to the US clearly set the pace for subsequent multilateral action in the framework of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes or within the European Union (Palan and Wigan 2014; Emmenegger 2017). With its unilateral action

against Switzerland, the US not only demonstrated the need to tackle tax evasion by means of banking secrecy, it also decisively weakened the possibly most influential opponent of international tax cooperation. In addition, the conflict shaped the US approach to combat tax evasion. For instance, the Foreign Account Tax Compliance Act (FATCA) was created with the deliberate goal to close the regulatory gaps that the conflict had disclosed (Harvey 2012).

Existing explanations of the demise of Swiss banking secrecy emphasize US power, which is typically understood to be a function of market size and the ability to control access to it (Eccleston 2012; Steinlin and Trampusch 2012; Palan and Wigan 2014; Emmenegger 2017; Hakelberg 2016b). While we agree with these accounts, we consider explanations based on market power alone incomplete, because they cannot explain the timing of events. The US has strongly criticized Swiss banking secrecy several times already before the recent conflict but with little effect (IRS 1981; Vogler 2005). Clearly, the global financial crisis has raised the salience of tax evasion (Eccleston 2012), both in the US and globally, but it did not suddenly empower the US to take on Switzerland.

We complement power-based approaches by identifying and theorizing the key agents of change and by tracing the process that led to the sudden demise of Swiss banking secrecy. Our goal is not to explain US support for multilateral initiatives or international tax cooperation (cf. Eccleston 2012; Hakelberg 2016b), but rather to explain how the US unilaterally promoted institutional change in Switzerland. We show that for most of the conflict starting in early 2008, the key agents were US law enforcement authorities. By relying on legal action against Swiss banks rather than engaging in a direct confrontation with the Swiss government, the US managed to do what it had failed to achieve in the past: pressuring the Swiss government into abandoning banking secrecy. When the two countries finally engaged in bilateral negotiations, such as on the implementation of FATCA in late 2012, Swiss banking secrecy for US persons was already hollowed out.

Treating the conflict as a primarily legal matter allowed the US to avoid the conflict's politicization, which would have raised questions of legitimacy, because exercises of power left unvarnished are always vulnerable to critique (Eagleton-Pierce 2013). Given its own tax haven status, a direct attack on Switzerland would have raised questions about power abuse, making it look like one tax haven is simply trying to eliminate a competitor. However, a large tax evasion scandal centred around Switzerland's largest bank allowed US law enforcement authorities to disguise its attack on Swiss banking secrecy as a purely legal matter involving criminal misconduct by Swiss banks. In addition, the scandal in combination with the global financial crisis created a demonstration effect (Mattli and Woods 2009: 22-25), which legitimized the US law enforcement authorities' forceful approach, including the extraterritorial assertion of jurisdiction over actors inside the Swiss territory. As a consequence, US law enforcement authorities ultimately pressured more than 100 Swiss banks into agreeing to pay significant penalties to avoid prosecution for having US clients with undeclared assets although these banks often had no representation on US soil, their clients did not invest in the US market and they were not – in principle at least – responsible for their clients' tax compliance.

Our analysis has important implications. In particular, we demonstrate that powerful states have the capacity to re-embed international finance by extending the boundaries of their law enforcement authorities' jurisdiction extraterritorially. Hence, rather than undermining state capacity, as predicted by globalization scholars (Strange 1996), growing economic interdependence may in fact endow powerful states with new means to exercise pressure on international finance. This is particularly true for the US, which controls access to the world's most important financial system and whose law enforcement authorities have comparatively far-reaching powers. However, in the wake of US efforts to re-embed international finance, other powerful states such as France, Germany and Great Britain have begun to adopt the US approach of pressuring foreign financial institutions into

costly negotiated settlements. The conflict-laden relationship between national states and international capital might thus be in the process of being rebalanced.

### **US Power and Swiss Banking Secrecy**

The transformation of the nation state into a competition state lies at the heart of globalization. As states compete for business activities, individuals or companies try to take advantage of regulatory arbitrage. Taxation is a case in point. Due to the possibility of dividing the fiscal subject, individuals can benefit from the public infrastructure of one state while using another state's regulations to avoid paying taxes (Palan 2002). If regulations are such that they allow what is essentially poaching another state's tax base, international disputes over state sovereignty in tax matters are sure to develop.

Switzerland's banking secrecy regulations are a prominent example of structures that allow holders of internationally mobile assets to avoid taxation in a given country.<sup>26</sup> In the case of banking secrecy, the information necessary to collect taxes is available and could, theoretically, be shared with foreign authorities. However, before 2009, no amount of international pressure had been sufficient to induce Switzerland to exchange information for tax purposes (Vogler 2005; Steinlin and Trampusch 2012; Emmenegger 2014). While this lack of success of unilateral and multilateral initiatives is not to imply that state sovereignty is unchallenged (Krasner 1999), it points to the difficulties states and international organizations face if

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<sup>26</sup> Swiss banking secrecy is based on two pillars (Emmenegger 2014). First, banking secrecy is a legal requirement that prohibits banks from disclosing any information about client accounts without the owner's consent, at risk of a criminal penalty. This requirement of confidentiality also includes bank interactions with foreign authorities. Second, banking secrecy is a set of rules regulating the access of domestic public authorities to financial data and the latitude to share this information with foreign authorities in accordance with international conventions and treaties. According to Swiss law, banks must collect information on all of their clients and, under certain circumstances, transfer this information to Swiss authorities. However, Switzerland is comparatively reluctant to share this information with foreign authorities.

they want to influence the tax laws of other sovereign states. As a consequence, most of the literature on offshore finance shared Palan's (2002: 173) pessimistic conclusion that effective strategies to combat tax havens would "require a degree of cooperation among the major industrialized countries and a limit on the sovereign rights of states, which effectively would spell the end of the so-called Westphalian system."

The US has been highly critical of Swiss banking secrecy for several decades. While US support for multilateral initiatives and international tax cooperation has been unsteady (Hakelberg 2016b), the US was consistent in its criticism of Swiss banking secrecy. For instance, the noted Gordon report (IRS 1981) lists numerous complaints and previous attempts to induce Switzerland to change its policies (see also Vogler 2005). But if the US wanted to eliminate Swiss banking secrecy (for US persons), why did it not simply use its power as gatekeeper to the world's most important financial market to inhibit tax evasion by means of Swiss banking secrecy? The literature in international political economy is rife with arguments that emphasize how economic interdependence and the ability to control access to its market awards the US with the ability to cause others to do something that they otherwise would not do (Hirschman 1969; Krasner 1976; Simmons 2001; Drezner 2007).

Indeed, most accounts of the demise of Swiss banking secrecy forcefully demonstrate that US power was decisive in making Switzerland finally change its policies (Eccleston 2012; Steinlin and Trampusch 2012; Palan and Wigan 2014; Emmenegger 2017; Hakelberg 2016b). We agree with these accounts, but we argue that US power based on control over market access alone was not sufficient to promote institutional change in Switzerland. To show why this is the case, we need to distinguish between two groups of actors that can be subject to US power: states and banks.



The US can use its control over market access to exercise pressure on other states. However, for three reasons, this strategy is challenging. First, it is economically costly (Simmons 2001). For instance, Switzerland is one of the world's largest financial centres and the sixth-largest source of foreign direct investment into the US (Embassy of Switzerland in the US 2014: 7). As we show below, concerns about economic costs were among the reasons why the US had abandoned a previous attempt to eliminate Swiss banking secrecy for US persons. Second, in terms of legitimacy, openly exerting pressure on a respected member of the international community such as Switzerland and infringing its sovereignty would have made the US vulnerable to critique (Eagleton-Pierce 2013). In fact, the powerful norm of state sovereignty is one of the main reasons why previous attempts to combat tax havens had failed (Palan 2002; Sharman 2006a).<sup>27</sup> Third, given its own status as an increasingly important tax haven (Hakelberg 2016b), the US would have to offer convincing arguments to explain on what grounds Switzerland is singled out. Of course, the US could target all countries, as it did with FATCA. However, without the support of several European powers and international organizations (Grinberg 2012b), it is difficult to imagine how the US would have been able to impose FATCA on the world without facing countermeasures.

Most importantly, as we show below, for most of the conflict, the US did not use its control over market access to engage in a direct confrontation with the Swiss government. Instead, the US and in particular its law enforcement authorities always focused their attention on Swiss banks. While it is certainly true that the US pressured Switzerland to implement FATCA, the bilateral agreement was struck only in late 2012. At that time, the conflict over Swiss banking secrecy had been going on for more than four years and banking secrecy for US persons was largely

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<sup>27</sup> Norms can change and subsequent multilateral action indeed redefined the boundaries of legitimate state practice (Webb 2004; Eccleston 2012). However, as we show below, most of the conflict between the US and Switzerland preceded these international developments.

hollowed out. It is no surprise then that Switzerland was among the first countries to implement FATCA. In fact, while Switzerland repeatedly tried to redefine the conflict as one between two sovereign states (which can be solved by diplomatic means), the US was careful to treat the conflict as a purely legal matter between the US law enforcement authorities and Swiss banks (which has to be dealt with in court).

Next to states, the US can use its control over market access to exercise pressure on banks. For instance, banks that violate certain regulations can be excluded from the US market. However, also in this case, the US faces an important challenge. The reason why the US could not simply use its ability to control access to its financial market to enforce change in Switzerland is that business models based on banking secrecy do not depend on market access. Cross-border economic interdependence becomes a source of power only when the boundaries of regulatory jurisdiction and the scope of markets overlap (Newman and Posner 2011). Swiss banking secrecy is an example of what Newman and Posner call “sovereign mismatch,” in which national market size does not determine power. In this situation, the system of state sovereignty protects banks that rely on banking secrecy.

Table 1 uses the boundaries of regulatory jurisdiction (territorial or extraterritorial) and market scope (whether economic activity is constrained by national borders) to differentiate between four ideal-typical scenarios of power dynamics based on economic interdependence. Sovereign congruity describes the most familiar case, in which both markets and regulatory authority are national. In this case, national market size increases power because foreign firms must comply with national regulations to sell their products to consumers. US authorities have considerable power because they control access to the world’s most important market.<sup>28</sup>

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<sup>28</sup> For instance, the Securities Exchange Act regulates the interaction between clients and foreign banks on US territory. Foreign banks’ client managers need to register with the Securities and Exchange Commission in order to be entitled to solicit clients, provide investment advice or

**Table 1:** Banking secrecy and economic interdependence

		<i>Scope of market</i>	
		<i>Territorial</i>	<i>Extraterritorial</i>
Boundaries of regulatory jurisdiction	Territorial	Sovereign congruity <i>National market size determines power</i>	Sovereign mismatch <i>National market size does not determine power</i>
	Extraterritorial	Transnational mismatch <i>The sum of national market sizes under a common jurisdiction determines power</i>	Transnational congruity <i>Market size determines power</i>

*Source:* Adapted from Newman and Posner (2011:597)

Sovereign mismatch denotes a situation in which economic activity is possible outside the boundaries of regulatory jurisdiction. While the US can regulate client-bank interactions on US territory, its regulatory agencies cannot stop US persons from meeting bank representatives abroad. US persons who want to evade taxation at home can simply travel abroad for investment advice or to induce securities transactions. If the bank does not communicate with the clients while they are in the US, all economic activity is extraterritorial and thus – in principle – outside the reach of US authorities. Admittedly, such an arrangement implies certain costs, but if these costs are lower than the tax due, tax evasion is still worthwhile. Hence, in the case of offshore wealth management, national market size does not determine regulatory power.

The most straightforward response to sovereign mismatch is to obtain information about US persons' assets by means of information exchange between national tax authorities, but Swiss authorities were reluctant to provide such information due

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induce securities transactions (including communication with clients in the US through overseas e-mails and phone calls).

to banking secrecy. The alternative to inter-jurisdictional cooperation is the extension of the boundaries of regulatory jurisdiction to create transnational congruity. In this situation, economic activity is not constrained by national borders but a regulatory body with extraterritorial jurisdiction oversees these activities, thus reasserting control over economic activity that has previously escaped from national regulatory regimes (Putnam 2009). As we show below, US law enforcement authorities relied on extraterritoriality to hollow out Swiss banking secrecy. However, if Swiss banking secrecy is an example of sovereign mismatch, how did the US authorities manage to reassert control by extending the boundaries of their jurisdiction extraterritorially?<sup>29</sup>

Extraterritoriality concerns the direct regulation of conduct outside a state's borders and has become an increasingly common mechanism by which powerful states attempt to manage problems associated with transnational activities (Putnam 2009: 459). Unlike other forms of post-war conflict management between sovereign states, though, in particular multilateral cooperation in the framework of international institutions, extraterritoriality has not been the topic of much research (Raustiala 2009: 21). In particular, the political processes that govern the extension of US extraterritorial jurisdiction are not well understood. Nevertheless, the existing literature provides a series of important insights.

Kahler and Lake (2009: 267) observe that the US uses control over market access to extend its reach into other jurisdictions. Moreover, they note that extraterritoriality is deployed when distributional consequences of the issue are large. In a similar vein, Putnam (2009: 482) argues that while US courts primarily use extrater-

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<sup>29</sup> Another example of extraterritoriality is FATCA, which requires foreign financial institutions to report directly to the US Internal Revenue Service (IRS) about accounts held by US clients (Harvey 2012). Crucially, it does not matter whether these clients of foreign financial institutions live in the US or invest in US securities.

itoriality to deal with threats to the domestic regulatory order, extraterritorial capacity derives from the ability to exclude non-complying entities from future transactions. Raustiala (2009: 30) notes that extraterritoriality is attractive to US authorities because – while it requires some market presence by foreign financial institutions – little assent from other governments is needed.

Kaczmarek and Newman (2011) show that extraterritorial interventions by US courts have the capacity to change national regulations in foreign countries. Analyzing the regulatory effects of the enforcement of foreign bribery legislation by US courts, which concerns cases of bribery committed by foreign firms outside the US territory, they show that extraterritorial application of US legislation against foreign firms increases the likelihood of the firms' home countries enforcing their national regulations twentyfold. However, it is worth noting that, in their analysis, it is foreign companies dependent on market access who commit the illegal acts, while in the case of banking secrecy, tax compliance is primarily the taxpayers' responsibility. Hence, the literature demonstrates the effectiveness of extraterritoriality once jurisdiction has been asserted but not how that jurisdiction was extended in the first place.

### **From Sovereign Mismatch to Extraterritoriality**

In the following, building on historical institutionalist scholarship (Farrell and Newman 2010; Fioretos 2011), we develop a causal sequential argument to explain how US law enforcement authorities managed to overcome the sovereign mismatch problem and force Swiss banks into costly settlements. Sequential arguments maintain that events set into motion have an inherent logic, in which event A is causally linked to event B, which is causally linked to event C and so on (Pierson 2004: 68).<sup>30</sup> Hence, the order in which things happen plays a crucial role

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<sup>30</sup> This inherent logic does not rule out the possibility that earlier events have unanticipated consequences.

because, according to Hay (2011: 68), “strategic choices made at a particular moment eliminate whole ranges of possibilities from later choices while serving as the very condition of existence of others.”

More concretely, we argue that the demise of Swiss banking secrecy was the result of a sequence of three causally connected key events. First, the US used its power to control market access to force Swiss banks to sign up to a programme that – although compatible with banking secrecy – made Swiss banks for the first time co-responsible for the tax compliance of some of their US clients in specific circumstances. Second, a tax evasion scandal linked to this particular group of US clients involving Switzerland’s largest bank allowed US law enforcement authorities to enforce access to some confidential client data. Third, the resulting inaugural piercing of Switzerland’s veil of secrecy enabled US law enforcement authorities to extend their jurisdiction extraterritorially and to dispose of Swiss banking secrecy for US clients altogether.

The first key event in the causal sequence was the introduction of the little-known Qualified Intermediary Programme (QIP), discussed in greater detail in the next section, which allowed the US to create a link between US power and Swiss banking secrecy. Two factors would seem to sever this link. A business model based on banking secrecy is not dependent on market access and banks are not responsible for the tax compliance of their clients. We demonstrate below that the QIP allowed US law enforcement authorities to negate those two factors and forge just such a link between US power and Swiss banking secrecy.

In the late 1990s, the US took advantage of asymmetrical economic interdependence to require foreign banks to participate in the QIP in return for market access. Given Swiss resistance and US concerns about economic costs, the QIP was created in a way to be compatible with banking secrecy and did therefore not solve the sovereign mismatch problem. However, as we show below, it nevertheless provided US law enforcement authorities with a gateway to attack banking secrecy

because the authorities' prosecutorial autonomy allowed them to extend their investigations beyond violations of the QIP to include transgressions normally protected by sovereign mismatch. Hence, when in 2008, US law enforcement authorities, based on a whistleblower's testimony, accused the Swiss bank UBS of violations of the QIP, the conditions necessary for an attack on Swiss banking secrecy were at last ripe at the same time (the second key event): The US had the legal right, the power, but also the legitimacy to pounce on Switzerland.

First, in terms of legal rights, US law enforcement authorities have exceptionally wide discretion and "the adversarial system in the United States creates an unusually prosecution-friendly dynamic" (Garrett 2014: 224). Among other characteristics, companies are required to submit all requested documentation to the authorities, while the authorities can extend their investigations to include transgressions that are only loosely connected to the initial ones. As a result, in the case of Swiss banking secrecy, US law enforcement authorities could based on the whistleblower's testimony for the first time legally request access to the files of all US clients of Swiss banks, despite Swiss law explicitly forbidding providing such information and the QIP not anticipating such an exchange of information.

In addition, corporate liability makes companies relatively easy targets for prosecution. Compared to most other countries, US law enforcement authorities are relatively quick to hold responsible companies for transgressions committed by employees even if the management did not know of or benefit from them. What is more, once investigations have started, companies are expected to fully cooperate with the authorities (Holder 1999). Hence, companies cannot prevent investigations by simply pointing to the inappropriate behaviour of some rogue employee.

Second, with regard to power, US law enforcement authorities can exercise considerable pressure on companies. For instance, they can restrict banks' access to the US market in punishment for lack of cooperation. At the most extreme, they

can use “the corporate death penalty” (Garrett 2014: 14). Given the history of criminal indictments of banks, US law enforcement authorities know that banks do not economically survive criminal indictments (Holder 1999).<sup>31</sup> In the case of Swiss banking secrecy, facing US demands to provide access to client files while being legally bound to keep them secret, Swiss banks had little choice but to hope for some agreement between the two involved jurisdictions.

However, US law enforcement authorities were in a great bargaining position because they could anticipate that Switzerland is structurally dependent on its largest bank’s survival. At the beginning of the conflict in 2008, the Swiss bank at the centre of the tax evasion scandal, UBS, held assets worth approximately three times Switzerland’s GDP (by comparison, all US banks together held assets worth approximately the US GDP). The economic risks of a criminal indictment were further aggravated by the consequences of the global financial crisis, during which UBS was forced to request state help. As a result, a credible threat to indict UBS was likely to trigger a response by the Swiss government that would satisfy US demands.<sup>32</sup>

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<sup>31</sup> An indictment indicates that a competent body has come to the conclusion that there is sufficient probability that the accused company has committed the crime. After an indictment has been served, the public prosecutor can continue to collect evidence against the accused company before the case is possibly subject to trial in court. Nevertheless, criminal indictments typically bankrupt banks because of the reputational damage and resulting bank runs, the possible revocation of banking licenses or the exclusion of indicted banks from over-the-counter transactions between banks (Garrett 2014). It is often argued that very large financial institutions are “too big to fail” and thus off-limits for criminal prosecution because criminal convictions might lead to the institutions’ collapse, which in turn could endanger the viability of the global financial system. However, while their ability to enforce criminal convictions of very large financial institutions is indeed limited, US authorities still have an unparalleled ability to coerce large financial institutions to accept huge penalties in the framework of negotiated settlements (for a detailed discussion of the argument see Emmenegger 2015).

<sup>32</sup> It is not known whether US authorities would have really taken this risk, given the fragile state of the US financial market. It is, however, clear that a UBS collapse would have been more harmful for Switzerland.



Finally, in terms of legitimacy, openly exerting pressure on a respected member of the international community such as Switzerland and infringing its sovereignty by requesting institutional change would have made the US vulnerable to critique (Eagleton-Pierce 2013). In the UBS case, that critique was not forthcoming because the tax evasion scandal allowed the US to treat the conflict as a purely legal matter. Thereby, the US could avoid a politicization of the conflict, which would have raised questions of legitimacy. Hence, what was, from a Swiss point of view, a bilateral conflict and thus in the realm of international law, the US considered to be a purely legal matter that just happened to involve, at the end, more than one hundred Swiss banks. As such, the US did not directly infringe Swiss sovereignty but still forced Switzerland's hand because Switzerland had no choice but to come to its banks' aid.

Of course, the issue of legitimacy is also important for US law enforcement authorities because their greater autonomy and ability to exercise pressure on companies could raise questions about abuse of power. While the legitimacy of European law enforcement authorities is primarily based on their commitment to a clear set of rules (procedural legitimacy), US authorities are more willing to resort to an assertive approach if the ends justify the means (outcome legitimacy). Hence, the US approach to pressure companies into expensive settlements without proper court trials is acceptable to the public only because it seems legitimate (Holder 1999). Crucially, the whistleblower's detailed account of illegal practices in combination with a shifting public mood following the global financial crisis legitimized the US authorities' assertive approach by demonstrating the economic and social cost of the regulatory status quo (Mattli and Woods 2009: 22-25).

Importantly, the first encounter between US law enforcement authorities and Switzerland was primarily concerned with UBS' violations of the QIP. In addition, while the resulting Swiss concessions gave US authorities access to some client

files, these concessions were still a far cry from the automatic exchange of information that ultimately resulted. To truly put an end to Swiss banking secrecy, US authorities had to continue to exert pressure on Swiss banks and induce the Swiss government to make further concessions. In the absence of new violations of the QIP, what could the banks be accused of?

The answer, as we show below, was a new interpretation of the QIP. In the absence of any regulatory change, the US law enforcement authorities used their prosecutorial autonomy in late 2010 to make Swiss banks responsible for having any US clients with undeclared bank accounts on their books (the third key event). Legitimized by the successful investigation against UBS that revealed widespread abuse and based on client data obtained from multiple offshore voluntary disclosure programmes, US law enforcement authorities now issued new threats to criminally indict banks unless they provided full access to their client files. Worried about its banks' survival and struggling to undermine the US investigations' legitimacy despite their questionable legal basis, the Swiss government ultimately agreed to dismantle banking secrecy for US clients of Swiss banks.

In what follows, we use process tracing to analyze, based on primary sources, specialized secondary literature and twelve interviews, how US law enforcement authorities took advantage of asymmetrical economic interdependence and their prosecutorial autonomy to extend their jurisdiction extraterritorially. We are primarily interested in understanding why Switzerland was not able to block these developments.<sup>33</sup> We have therefore talked to senior officials of Swiss banks and their interest associations as well as senior officials from the responsible regulatory agencies. However, we have also talked to senior officials of US regulatory agencies. For both legal and practical reasons, it is difficult to obtain interviews with

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<sup>33</sup> See Eccleston (2012) and Hakelberg (2016b) for an analysis of US preferences and strategic considerations in recent attempts to combat tax evasion and Eggenberger and Emmenegger (2015) for a discussion of Swiss domestic politics during the conflict.

the actors involved in these developments. We have therefore pledged to protect the interviewees' anonymity. A list of interviews is provided in the appendix. In the analysis below, we cite additional primary sources wherever possible.

### **Conditions for Market Access: The Qualified Intermediary Programme**

US extraterritorial power is based on its central position in the dollar-based financial system. For most activities in finance (offshore wealth management being a notable exception), there is virtually no possibility for banks to be globally active without repeatedly trading with US-based institutions or in US dollars. The Federal Reserve controls the clearing of transactions in US dollars, the Internal Revenue Service (IRS) taxes all income from a source inside the country and several agencies regulate banking activities within the US territory. The US can use this structural dependence on access to the dollar-based financial system to impose conditions for market access.

A prominent example is the QIP, which required foreign banks to directly report information to US tax authorities in case of investments in US securities. The QIP strove to identify US persons who held beneficial interests in US securities, but also to ensure the appropriate withholding of US tax from payments of US-source income to non-US persons. Foreign banks could eliminate some of these reporting requirements by applying for the status of "qualified intermediaries." As such, foreign banks themselves were responsible for information collection by determining which of their customers were US persons subject to information sharing and which were non-US persons entitled to reduced rates of withholding tax under a treaty or statute, thereby keeping client names confidential (Hanrehan and Shapiro 1998).

Foreign banks had a strong interest in participating in the QIP. If banks did not participate, their payments were subject to withholding at a rate of approximately

30%. For Swiss banks specifically, there were two issues that complicated participation. First, the QIP conflicted with Swiss banking secrecy if banks were engaged in offshore wealth management for US clients. As originally conceived, the QIP had left Swiss banks with two possibilities: either stay out of the QIP and pay the punitive withholding tax, or participate in the QIP and do away with secrecy in the case of US clients. Second, the US had a strong interest in maximizing foreign direct investment. If the Swiss government barred its banks from participating in the QIP (through an act of law), the programme might have resulted in negative economic consequences for the US because the large withholding tax would have made the US financial market unattractive for Swiss investors.

In negotiations this dilemma was quickly solved.<sup>34</sup> The QIP allowed foreign banks to keep the names of non-US clients confidential. Instead, the implementation of the QIP by foreign banks was subject to two external audits within a six-year period (Sec. 10.03 QIP). In practice, this meant that where bilateral double taxation treaties (DTT) were in place, the US financial market remained a lucrative destination for foreign investors with undeclared assets. Additionally, the QIP did not require foreign banks to share information with the IRS on their US clients if they refrained from investing in US securities on behalf of their US clients (Sec. 6.04 QIP). This exemption from reporting requirements – a concession to Switzerland – was the reason the Swiss government did not consider the QIP to be in violation of banking secrecy regulations. The QIP left individual US clients of Swiss banks the choice between giving up banking secrecy or forgoing the right to invest in US securities (Bundesrat 2012).

These US concessions were certainly a success for the defenders of banking secrecy. However, the QIP, even in this revised form, created problems for Swiss banks. The fact that some US clients did not want their identity reported could

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<sup>34</sup> Interview 8, senior Swiss bank official (phone), May 13, 2014; interview 9, senior official of Swiss banking association (phone), May 27, 2014.

have been interpreted as a sign that they had something to hide. Banks were thus obliged to investigate these clients' tax status for reasons of due diligence. Also, some clients with undeclared assets might still insist on investing in US securities, given the US financial market's relative attractiveness. In this situation, banks would have had to resort to highly problematic obfuscatory techniques to avoid attracting the attention of US authorities.

Most importantly of all, the QIP made foreign banks responsible for collecting information if there was income from a US source, by determining which of their clients were US persons subject to information-sharing and which were non-US persons but entitled to reduced rates of withholding tax under a DTT. While this responsibility was the cost for the right to keep client names confidential, it had one crucial consequence. It suddenly made foreign banks to some extent liable for the tax compliance of US clients if there was any US-source income (Grinberg 2012b). In this way, the QIP created a link between US power and Swiss banking secrecy, although the involved actors were not able to recognize this at the time.

### **Piercing Switzerland's Veil of Secrecy: The UBS Tax Evasion Scandal**

The QIP did not make a business model based on banking secrecy impossible, but it did circumscribe it. Those US clients of Swiss banks who wanted to participate in the highly attractive US securities market, particularly in the years before the subprime mortgage crisis, found what at first sight seemed a loophole in the QIP. Consistent with US law, the QIP defined the beneficial owner of an account to include (foreign) corporations (Morse 2012: 533). This allowed banks to continue to serve US clients that were interested in trading US securities while respecting both the QIP as well as the confidentiality requirements of Swiss banking secrecy. In this scenario, US clients of Swiss banks appeared as foreign corporations and were thus not subject to information sharing. Importantly, using such intermediary

structures was perfectly legal, according to US law, as long as their sole purpose was not tax evasion (GAO 2007: 14).<sup>35</sup>

Such possibilities of circumventing the QIP did not escape Swiss banks' attention. In the years around 2000, delegations of the Swiss Federal Tax Administration and the Swiss Banking Association met repeatedly with the IRS to discuss the two nations' different interpretations of an account's beneficial owners.<sup>36</sup> According to the tougher Swiss regulations, banks are obliged to identify the persons who control intermediary structures and these structures' bank accounts. The IRS, however, insisted on its understanding of beneficial owners (Müller 2008; FINMA 2009). An analysis by the law firm Baker & McKenzie (2000: 3, emphasis in the original) confirmed this interpretation: "The fact that a non-US company is 'passive' and wholly or partially owned by a US person should not prevent the non-US company from being treated as a non-US person for US withholding tax and information reporting purposes."<sup>37</sup>

Not everybody was willing to trust this interpretation. Some client managers specializing in the US market left big, internationally active banks to become independent asset managers, create new private banks or join existing small banks such as Wegelin & Co., bringing along their US clients. These client managers were relying on another strategy to circumvent reporting requirements. By creating or joining small banks with no representation in the US, they were assuming the small

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<sup>35</sup> This inconvenient fact was largely ignored in the conflict over Swiss banking secrecy. For instance, while quoting from the GAO report, Levin and Coleman (2008: 25) simply omitted the word "legal."

<sup>36</sup> Interview 8, senior Swiss bank official (phone), May 13, 2014; interview 9, senior official of Swiss banking association (phone), May 27, 2014.

<sup>37</sup> During the first years of the QIP, this interpretation was not challenged. In the QIP a term lasts six years, during which two external audits are required (Sec. 10.03 QIP). None of the external audits in the cases of UBS, Credit Suisse or Wegelin revealed any relevant violations of the QIP.

size of their new employers would not attract US attention and the system of state sovereignty would continue to protect their business activities.<sup>38</sup>

At first, it seemed as if these more risk-averse voices were right, as the QIP's interpretation began to change at some point in the mid-2000s. In 2006, the US Senate's Permanent Subcommittee on Investigations released a report that highlighted tax haven abuses, including the use of foreign corporations owned by US persons, although without explicitly discussing the QIP's loopholes (Coleman and Levin 2006). In contrast, the loopholes were the topic of a hearing before the US Senate's Committee on Finance and a report of the Government Accountability Office in 2007 (Committee on Finance 2007; GAO 2007). Hence, at the latest towards the end of 2007, the writing was on the wall that the US would no longer accept the circumventing of QIP reporting requirements by means of intermediary structures.

In parallel, another string of events was unfolding that turned a reinterpretation of existing regulations into a serious bilateral conflict. In May 2005 the US police searched the house of a US-domiciled UBS client. In response, the UBS client manager transferred all the client's assets to a Liechtenstein-based bank (in June 2005) because he believed that "Liechtenstein had better bank secrecy laws than Switzerland" and ended his employment at UBS in spring 2006 (Court of Southern District of Florida 2008: 12). Before he left, the client manager alerted UBS' management of possible transgressions, such as using intermediary structures to obfuscate the identity of beneficial owners, becoming an internal whistleblower at UBS. As the situation escalated, the client manager decided to talk to US authorities. In June 2007, he met representatives of the Department of Justice (DoJ) for the first time. What he did not know, however, was that by then, his US-domiciled client

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<sup>38</sup> Interview 1, senior Swiss bank official, Zurich, March 7, 2014; interview 3, senior Swiss bank official, Zurich, March 24, 2014; interview 10, senior US bank official, New York, February 7, 2015; interview 12, senior official of US regulatory agency, New York, December 18, 2015.

had already admitted to tax evasion. As a result, in June 2008 the whistleblower was sentenced to 40 months in prison for his role in assisting tax evasion.

US attention now turned to his former employer, UBS, which is the world's largest bank measured by assets under management and also has a sizeable presence in the US market since its merger with Paine Webber in 2000 (Scorpio 2013). Based on the whistleblower's information, US law enforcement authorities arrested the head of UBS wealth management in the US at a Miami airport in April 2008. UBS was also the topic of a public hearing and a report of the US Senate's Permanent Subcommittee on Investigations in July 2008, which highlighted the violations of the reporting requirements under the QIP (Levin and Coleman 2008). In the hearing, UBS representatives admitted wrongdoing. However, they insisted that the use of intermediary structures to obfuscate beneficiary ownership was legal according to US law, that the problem was primarily a case of compliance failure and that the main fault lay with rogue client managers, not the bank itself (Branson 2008).

Following the hearing, US law enforcement authorities requested information on Swiss banks' US clients, but given Swiss banking secrecy regulations, such information would only have been accessible by means of a process called international administrative assistance. The Swiss Financial Market Supervisory Authority (FINMA) advised US representatives on how to file such requests in a meeting in June 2008.<sup>39</sup> In this meeting, Swiss representatives were also informed that the IRS would issue a John Doe summons, requesting 19,000 client files, in July 2008, but would not request its enforcement. Its main purpose was instead to interrupt the statute of limitations that sets the maximum time after an event that legal proceedings based on this event could be initiated (Bundesrat 2009: 45). Nevertheless, if enforced, the John Doe summons would create a major problem, as it would force

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<sup>39</sup> Interview 4, senior official of Swiss regulatory agency, Zurich, April 7, 2014; interview 6, senior official of Swiss regulatory agency, St.Gallen, April 16, 2014.



UBS to disclose information on unknown taxpayers, which banking secrecy prohibits.

International administrative assistance is a cumbersome process. By February 2009, Switzerland had completed preparations for the transfer of information in only 26 cases (Schaub 2011: 214-215). For the US law enforcement authorities, this process was too slow. In late 2008, the DoJ offered UBS a deferred prosecution agreement (DPA) in exchange for admitting to having helped US clients evade taxation, paying a fine of USD 780 million and disclosing the names of approximately 250 US clients to the IRS (Bondi 2010: 9). To increase pressure on UBS, the DoJ also indicted the head of the bank's wealth management division in November 2008. The Swiss government now signalled its willingness to support the DPA but it still had the problem of how to allow UBS to send client files without violating banking secrecy laws.

The conflict finally escalated in February 2009. In a letter to UBS dated February 17, the DoJ openly threatened to indict the bank: "If UBS fails to enter into this deferred prosecution agreement with the Department of Justice by February 18, 2009, the trial team will immediately seek authorization to obtain a criminal indictment against the bank" (cited in GPK 2010: 3361). Unwilling to risk an indictment, FINMA immediately complied and authorized the transfer of 255 UBS client files to the DoJ on February 18, 2009. In a creative move, FINMA redefined the use of intermediary structures to circumvent the QIP as a case of tax fraud rather than tax evasion. In cases of tax fraud, Swiss banking secrecy does not bar authorities from engaging in international administrative assistance. Pointing to the real danger of an indictment and using this creative strategy, FINMA could send the UBS client files without violating banking secrecy.<sup>40</sup>

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<sup>40</sup> Interview 2, Swiss investigative journalist, Zurich, March 10, 2014; interview 11, senior official of Swiss regulatory agency, Zurich, December 7, 2015.

The decisive questions are of course whether an indictment would have jeopardized UBS' survival and – if yes – whether US law enforcement authorities would have taken this risk, given the fragile state of its own financial markets in spring 2009. Be that as it may, it is clear that Swiss authorities were convinced that UBS would not survive an indictment.<sup>41</sup> In July 2011, the Swiss Federal Court also decided that transferring the client files was legal because FINMA had sufficient reason to assume that an indictment would have led to the bankruptcy of the bank, which in turn would have caused serious and virtually uncontrollable economic repercussions for Switzerland (Bundesgericht 2011).

The UBS DPA addressed the criminal investigations against UBS. It did not, however, address the request for information about US clients issued by the IRS. In a surprise move, the day after UBS had entered the DPA with the DoJ, the IRS requested the relevant district court to enforce the John Doe summons and now demanded 52,000 client files (Bondi 2010: 2). The Swiss government immediately made clear that UBS would not be allowed to send further client files. Moreover, on April 30, it sent an Amicus brief to the court, presenting its view of the legal conflict. Emphasizing its interest in preserving the integrity of Swiss law and sovereignty and pointing to US obligations to respect international treaties with Switzerland, it observed that “if the Court were to order UBS to produce evidence from Switzerland, and backed that order with coercive powers, the Court would be substituting its own authority for that of the competent Swiss authorities, and therefore would violate Swiss sovereignty and international law” (Bundesrat 2009: 13). In July 2009, the Swiss government noted that it would, if necessary, seize the requested files from UBS, so UBS could not transfer them to the US authorities.

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<sup>41</sup> Interview 4, senior official of Swiss regulatory agency, Zurich, April 7, 2014; interview 5, senior official of Swiss banking association, Zurich, April 10, 2014; interview 6, senior official of Swiss regulatory agency, St.Gallen, April 16, 2014.

On August 19, 2009, the two sides finally reached a settlement. Switzerland agreed to give the IRS access to 4,450 client files as well as to provide administrative assistance in case of tax evasion in the future (in the form of a revised DTT). The settlement allowed Swiss authorities to screen and select the client files to ensure that only files of clients who had committed tax fraud as per Swiss law were sent to the IRS. Notably, the Swiss Federal Administrative Court rejected that agreement in 2010 for violating banking secrecy regulations. This court decision, however, was subsequently overruled by a parliamentary decision in June 2010 that turned the settlement into a state treaty.

In sum, after having obtained the legal right and the legitimacy to do so, US law enforcement authorities used the power that is theirs based on others' economic dependence to bring UBS, and by extension the Swiss government, to their knees. US law enforcement authorities continuously increased pressure on UBS until they finally threatened to impose "the corporate death penalty." At this point, because it could not risk the collapse of its biggest bank, Switzerland finally complied with US demands. For the first time ever, Switzerland's veil of secrecy was decisively pierced.

### **Shifting Boundaries: Prosecutorial Autonomy and Extraterritoriality**

In November 2010, all charges against UBS were dropped. However, the settlement did not put an end to the bilateral conflict. Rather, US law enforcement authorities announced that they would now start investigations against other Swiss banks for conspiracy to aid US taxpayers in filing false income tax returns. These new investigations were no longer about violations of the QIP. In the framework of the QIP, foreign banks were not responsible for the tax compliance of their US clients, as long as these US clients' assets were not invested in US securities. In

contrast, these new investigations, made possible by the prosecutors' wide discretion and contra the QIP, now suddenly extended the banks' responsibilities to include all US clients with undisclosed assets.<sup>42</sup>

The UBS tax evasion scandal proved crucial in this process. In its wake, US clients were looking for ways to get their assets out of reach of the US authorities. Some decided to transfer their assets to other offshore financial centres, while others transferred their assets to small banks that had no representation outside Switzerland. These banks still welcomed US clients and, in accordance with Swiss regulations, did not monitor the tax status of their new clients' assets because they believed, incorrectly, that the UBS case did not affect them.<sup>43</sup> For instance, court documents reveal that the small Swiss private bank Wegelin was accepting US clients without proper documentation at least until late 2009 (Court of Southern District of New York 2012: 7-8; Court of Southern District of New York 2013: 2). As late as March 2010, the bank rejected the notion that it was running an operational risk due to the ongoing conflict and its US clients. Rather, Wegelin believed that by keeping a low profile and banking on Swiss state sovereignty, it would draw no attention from US law enforcement authorities (Hummler 2010; Bruderer 2012).

Those who believed only the giant bank UBS was a US target were soon to be proved wrong. Thanks to the UBS client files that the US authorities had received, two special offshore voluntary disclosure programmes and their own investigations, US authorities now had considerable information on tax non-compliance by

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<sup>42</sup> Interview 4, senior official of Swiss regulatory agency, Zurich, April 7, 2014. In March 2010, the US Congress passed FATCA, which was to replace the QIP. Unlike the QIP, FATCA makes foreign banks responsible for the tax compliance of all their US clients. In late 2010, however, Switzerland had not yet agreed to implement FATCA.

<sup>43</sup> Interview 1, senior Swiss bank official, Zurich, March 7, 2014; interview 3, senior Swiss bank official, Zurich, March 24, 2014; interview 12, senior official of US regulatory agency, New York, December 18, 2015.

US clients of Swiss banks. This information provided for the first time hard evidence that several Swiss banks had systematically used banking secrecy to facilitate tax evasion by US persons. In addition, this information clearly demonstrated that some Swiss banks, despite the UBS case, still relied on business models based on banking secrecy. Hence, this new information in combination with a shifting public mood following the financial crisis legitimized the US authorities' assertive approach that allowed it to extend their jurisdiction extraterritorially.

In October 2010, US law enforcement authorities arrested a senior Wegelin client manager at a Miami airport, who was on his way to a conference in the Bahamas. In the past, this banker had worked with a US-based lawyer who had been arrested by US authorities in autumn 2009. The Wegelin client manager subsequently cooperated with the US authorities, thereby giving them sufficient material to indict Wegelin. In January 2012 the Southern District Court of New York (2012) indicted three further Wegelin employees and ultimately, in February 2012, the bank itself. The bank immediately withdrew from business, as did two other small Swiss banks whose senior managers had been indicted by US authorities around the same time.

Why did the conflict escalate so suddenly? Following the UBS agreement and in light of the new information, US law enforcement authorities kept requesting client files, but the Swiss government insisted on the system of international administrative assistance, including the new DTT. As already noted, this system is slow and cumbersome. In addition, the US government struggled to get the new DTT through Congress. As a result, US law enforcement authorities resorted to indicting the small but well-known bank Wegelin (Emmenegger 2015), which was clearly an attempt to increase pressure on the Swiss government.<sup>44</sup>

The Swiss government immediately reacted to the new situation. Based on a new interpretation of the still-active 1996 DTT, the Swiss government now allowed

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<sup>44</sup> Interview 5, senior official of Swiss banking association, Zurich, April 10, 2014.

group requests in cases of international administrative assistance. In addition, it allowed Swiss banks to send files to US law enforcement authorities that did not blacken out their employees' names. Finally, in a joint statement in June 2012, the US and Switzerland informed that they would start negotiating the implementation of FATCA. An agreement on FATCA implementation was reached in December 2012, which Switzerland subsequently ratified in September 2013 (Joint Statement 2013a).

These concessions still did not satisfy US law enforcement authorities. While they created automatic exchange of information for the future and simplified the procedure for accessing information through the international administrative assistance system with a view to identifying past transgressions, US authorities still insisted on access to client files outside the regular administrative procedures, in contravention of Swiss banking secrecy laws. Across the table, as the Swiss negotiators argued, violating regular procedures was the line in the sand that the Swiss government was not willing to cross again.<sup>45</sup> Both sides seemed stuck.

Faced with the threat of indicting even more banks, including Switzerland's second-largest bank Credit Suisse, the Swiss government tried to negotiate a new state treaty from spring 2011 onwards that would put an end to the conflict once and for all. Yet, the US had little interest in resolving the conflict by diplomatic means.<sup>46</sup> The result was therefore not a state treaty but a unilateral "amnesty" programme for Swiss banks created by the US law enforcement authorities, which the Swiss government agreed to support (Joint Statement 2013a). The programme allows banks that are not already under investigation to obtain non-prosecution agreements (NPA) or non-target letters from the DoJ. Banks requesting non-target letters must prove that all of their US clients paid their taxes. If they fail to do so,

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<sup>45</sup> Interview 11, senior official of Swiss regulatory agency, Zurich, December 7, 2015.

<sup>46</sup> Interview 11, senior official of Swiss regulatory agency, Zurich, December 7, 2015.

they are excluded from the programme and may be subject to criminal investigations.

If banks worry about having US clients with undeclared assets, they can request an NPA.<sup>47</sup> In order to obtain an NPA they must provide detailed information on internal procedures, including employee names and client accounts. That information would, in turn, allow US authorities to get access to client files through the system of international administrative assistance. In addition, these banks must agree to pay as a penalty an amount equal to 20% of the maximum aggregate dollar value of US-related accounts that existed on August 1, 2008, an amount equal to 30% of the maximum aggregate dollar value of all such accounts that were opened between August 1, 2008 and February 28, 2009, and an amount equal to 50% of the maximum aggregate value of all such accounts that were opened after February 28, 2009 (Joint Statement 2013). Banks may benefit from rebates if the bank can prove that the assets of US persons were properly declared or if it successfully encouraged US clients to participate in the voluntary offshore disclosure programmes.

Crucially, this amnesty programme criminalizes banks for activities that were, in the framework of the QIP, legal at the time they were committed (i.e. unless banks actively supported their US clients in evading taxation). The odd choice of the dates of the programme reflects that banks were supposed to follow the changing interpretation of tax laws by US authorities (rather than regulatory reforms). Although there is no official justification for the choice of these dates, the August 1, 2008 date is likely to refer to the July 17, 2008 Senate hearing on UBS, while the February 28, 2009 date is likely to refer to the UBS DPA from February 18, 2009.

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<sup>47</sup> Given the vague definition of US persons (cf. IRS 2014), many banks often do not know whether their clients are in fact US persons and thus subject to information sharing. Hence, many banks have opted to request an NPA (and pay a penalty) even though they are not engaged in offshore wealth management.

Put differently, higher penalties are linked to developments in the UBS case and not to regulatory changes.

The fifteen banks already under investigation cannot participate in this programme and have to find bilateral solutions to their tax conflict with US authorities. In May 2014, Credit Suisse agreed to a penalty of USD 2.6 billion and a guilty plea to avoid a court trial.

From a Swiss point of view, the amnesty programme has the advantage of giving banks the opportunity to resolve the conflict with US law enforcement authorities. However, the compromise also has disadvantages. Clearly, it is very expensive. In addition, because the US amnesty programme shifts the burden of proof onto the banks, it imposes significant administrative costs on banks that have never played a relevant role in international wealth management because these banks – in order to obtain a non-target letter like any other Swiss bank – need to document to the IRS that they did not violate US laws.

In sum, US law enforcement authorities deliberately took advantage of their prosecutorial autonomy as well as economic interdependence to put pressure on Swiss banks,<sup>48</sup> while the banks – worried about the consequences of criminal indictments – basically accepted any agreement offered by the US law enforcement authorities.<sup>49</sup> In a similar vein, the Swiss government agreed to scrap banking secrecy regulations for US persons in order to reduce the pressure on Swiss banks. Whether the accusations of the US law enforcement authorities had any legal basis is a completely different matter. So far, not a single bank has dared to challenge the agreement in court.<sup>50</sup>

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<sup>48</sup> Interview 12, senior official of US regulatory agency, New York, December 18, 2015.

<sup>49</sup> Interview 4, senior official of Swiss regulatory agency, Zurich, April 7, 2014; interview 5, senior official of Swiss banking association, Zurich, April 10, 2014; interview 7, senior Swiss bank official, Zurich, April 30, 2014.

<sup>50</sup> In addition, in November 2014, the head of the UBS wealth management division was found *not* guilty of conspiring to defraud the US government.



## Conclusion

Referring to the bilateral conflict between Switzerland and the US over banking secrecy, the then-President of Switzerland argued that “no state has more value than another. No state should rule over another one. (...) All states are sovereign and have equal rights. Their relationships are based on law and not power” (Maurer 2013). His view reflects the prevalent understanding of sovereignty in international law. However, in practical terms, as this case study has demonstrated, he is wrong. National law can force another state’s hand.

In today’s world, powerful states’ law enforcement authorities can extend their jurisdiction extraterritorially to infringe on other states’ sovereignty. Extraterritoriality does not require assent from other governments. All that is needed is economic dependence on market access. Given the US’ financial pre-eminence, virtually all financial institutions are in some way dependent on access to the its financial system, which gives US law enforcement authorities the power to regulate their behaviour and to prosecute them in case of violations – even if the acts are legal in the country where they were committed.

More specifically, we argue that US law enforcement authorities managed to coerce the transformation of Swiss financial regulations by relying on their unparalleled ability to extend their jurisdiction extraterritorially. For this a sequence of three causally connected key events was needed. First, economic interdependence allowed the US to introduce the QIP, which created the necessary link between US power and Swiss banking secrecy. Second, a whistleblower’s testimony and the financial crisis provided US law enforcement authorities with both the legal right as well as the legitimacy to prosecute Swiss banks and by extension attack banking secrecy. Third, the resulting first piercing of Switzerland’s veil of secrecy, combined with the wide discretion of prosecutors in the US legal system, finally allowed US law enforcement authorities to extend their jurisdiction extraterritorially and to dispose of Swiss banking secrecy for US persons altogether.

Our analysis therefore shows that even in times of globalization, powerful states play central roles in global economic governance. Rather than undermining their state capacity, growing economic interdependence may even endow the most powerful states and in particular their law enforcement authorities with additional means to exercise pressure on other states as well as on multinational companies. From this point of view, globalization scholars may be right in highlighting how globalization leads to a decline of state autonomy but their prediction is not true for all states. As long as economic actors are dependent on market access, great powers have the potential to regulate their activities. This conclusion is particularly true for the US, which controls access to the most important financial system in the world and whose legal system carries global credibility.

However, in the wake of US efforts to re-embed international finance, other powerful states such as France, Germany and Great Britain have begun to adopt the US approach of pressuring large multinational companies into costly negotiated settlements. Legitimized by the global financial crisis, they impose significant penalties on foreign financial institutions without proper court trials, although the penalties reflect the smaller size of the markets they control. As a result, the most important regulatory change brought about by the global financial crisis might thus not be the creation of new multilateral rules or bodies but rather the increasing reliance on the extraterritorial application of national law (Palan and Wigan 2014) and the acceptance of the resulting infringements of state sovereignty in cases such as tax evasion, money laundering, violation of sanctions or financing of illicit activities.

Extraterritoriality, like any exercise of power, can be used for good. As economic activities, in particular in finance, increasingly cross borders, the world is confronted with a situation in which a borderless economic system faces a still-bordered legal system. The resulting tensions create opportunities for regulatory arbitrage and increase the risk of a regulatory race to the bottom. If the global financial

crisis has taught the world anything, it is that a re-embedding of international finance is imperative. A critical test case of this necessity to re-embed international finance is the struggle against tax havens. Extraterritoriality is a promising strategy powerful states can use to deal with these challenges.

However, there is also a darker side to extraterritoriality. The power to extend its jurisdiction extraterritorially allows powerful states to obtain competitive advantages and to force rules upon others, while at the same time avoiding following those rules themselves (Raustiala 2009). It should therefore come as no surprise that the US has so far played a contradictory role in the fight against tax evasion. In some ways, the US has been leading the way, not least with its attack on Swiss banking secrecy and the unilateral imposition of FATCA. In other ways, the US is considerably less dependent on multilateral cooperation to enforce tax compliance because it has sufficient means to exercise pressure on other states. In addition, by relying on extraterritoriality, rather than on multilateral cooperation, the US retains considerably more autonomy. We therefore conclude that, while FATCA is likely here to stay, continued US support for the OECD's Global Forum is not set in stone.

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## **Appendix**

List of interviews:

- Interview 1: Senior Swiss bank official, Zurich, March 7, 2014
- Interview 2: Swiss investigative journalist, Zurich, March 10, 2014
- Interview 3: Senior Swiss bank official, Zurich, March 24, 2014
- Interview 4: Senior official of Swiss regulatory agency, Zurich, April 7, 2014
- Interview 5: Senior official of Swiss banking association, Zurich, April 10, 2014
- Interview 6: Senior official of Swiss regulatory agency, St.Gallen, April 16, 2014
- Interview 7: Senior Swiss bank official, Zurich, April 30, 2014
- Interview 8: Senior Swiss bank official (phone), May 13, 2014
- Interview 9: Senior official of Swiss banking association (phone), May 27, 2014
- Interview 10: Senior U.S. bank official, New York, February 7, 2015
- Interview 11: Senior official of Swiss regulatory agency, Zurich, December 7, 2015
- Interview 12: Senior official of U.S. regulatory agency, New York, December 18, 2015

## 4. When is Blacklisting Effective? Stigma, Sanctions and Legitimacy: The Reputational and Financial Costs of Being Blacklisted

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**Abstract:** Blacklisting is a policy tool that is used extensively in the international political economy, and blacklists have been invoked following the Panama Papers scandal, Russia's annexation of Crimea and the Democratic Republic of North Korea's proliferation activities. To analyze the principal mechanisms at work in what is an understudied tool of global governance, this paper compares the Organisation for Economic Co-operation and Development's and the Financial Action Task Force's blacklisting of secrecy havens in the years 2000-2009. We show that blacklisting can be used to impose both reputational and financial costs on a state and highlight three factors that contribute to a blacklist's effectiveness: the stigma attached to the act that led to the blacklisting, the nature of any sanctions that it imposes and the blacklist's legitimacy. The blacklisting of Liechtenstein and Nauru highlight the interplay between these factors, but they also raise questions about the legitimacy of blacklisting itself.

### 1. Introduction

In a general sense, a 'blacklist' is a public register of entities that are viewed negatively and they are widely used in the international political economy to highlight actions or practices that are inconsistent with international norms. Some of the most prominent uses of blacklisting have been in the fights against banking secrecy and non-proliferation. Yet, despite their significant role in critical issues of global

governance and security, relatively few studies focus on what blacklists are and how they work (Sharman 2006, 2009). In this comparative analysis we focus on the G7's initiatives to bring Offshore Financial Centers (OFCs) under global governance in the early 2000s through the Organisation for Economic Co-operation and Development (OECD) and the Financial Action Task Force (FATF). Through their usage of blacklisting, this episode allows us to explore the principal mechanisms at work and highlight the conditions under which blacklisting can be effective in gaining state compliance.

In essence, blacklists impose reputational costs on a state via stigmatization and/or financial costs via sanctions and restrictions. We study the concurrent blacklisting of 10 banking secrecy havens in June 2000 that did not meet the OECD's and FATF's international tax and money laundering standards. The OECD's blacklist was an exercise in 'naming and shaming' in that it highlighted states for their harmful tax practices. Yet, despite the OECD's threats of 'defense measures' such as imposing withhold taxes on transactions with tax havens, their blacklist did not actually impose sanctions. The idea was to create spill-over costs for blacklisted states that replicate sanctions through damaging reputation. By contrast, the FATF's blacklist was an exercise in 'naming, shaming and punishing' in that it highlighted states for facilitating money laundering, which is a criminal offense under international law, but also came with the likelihood of FATF 'counter-measures'. These ranged from enhanced due diligence from the international banking system of transactions with a blacklisted state's entities up to their complete prohibition from participating in it.

The credibility and severity of the financial costs imposed by the FATF blacklist were higher than those of the OECD blacklist and so too were the reputational costs; being branded a 'money laundering state' carries more stigma than being branded a 'tax haven'. These differences in stigmatization and sanctions played a crucial role in the FATF blacklist's effectiveness. It took five years for the FATF

to gain the compliance of all 10 secrecy havens with money laundering standards, despite the need for significant regulatory and legal reforms. By contrast, it took the OECD nine years to gain a (softer) commitment to their attenuated tax information exchange standards. Whilst both blacklists suffered from legitimacy problems that hindered their effectiveness, a lack of legitimacy hindered the OECD's blacklist more than the FATF's. Where power is the ability to shape the capacities of actors to determine their own circumstances or fate (Barnett and Duvall 2005), the OECD relied on persuasion and deliberation or 'soft power' (Nye 2004, 2008) and the 'logic of appropriateness' (March and Olsen 1998; Webb 2004) to be effective. Legitimacy is crucial for the success of such exercises of soft power (Suchman 1995). By contrast, the FATF's recommendations are embedded in various UN Conventions and the USA PATRIOT Act which gave the FATF 'hard power' through sanctions and economic coercion that superseded the need for deliberation and legitimacy.

Of the 10 secrecy havens that were blacklisted by both the OECD and the FATF, Liechtenstein and Nauru are the most interesting when it comes to charting their reactions; Liechtenstein displayed the greatest variance of reaction to the two blacklists and Nauru, being the least compliant, was the only state that was ultimately sanctioned. Liechtenstein was the world's oldest banking secrecy haven, which had made it one of world's richest countries by GDP per capita when it was blacklisted. Liechtenstein responded quickly and assertively to the FATF by making significant regulatory reforms in record time but responded slowly and combatively to the OECD. Liechtenstein argued that the OECD blacklist was illegitimate and undermined Liechtenstein's economic strategy and sovereignty. Also, that the OECD had no right under international law to impose its tax standards. It took 9 years, three increasingly combative blacklists, a watering down of the OECD's demands, evolving social norms around tax evasion and ultimately the credible threat of sanctions from the G20 to gain Liechtenstein's commitment to

international tax standards. By comparison, Nauru, along similar lines of reasoning to Liechtenstein, responded slowly and combatively to both the FATF and OECD. Resistance to the FATF resulted in Nauru being sanctioned under the USA PATRIOT Act, which imposed significant financial costs. The stigma attached to money laundering also imposed significant reputational costs. These costs forced Nauru to comply with not only the FATF but also the OECD six years before Liechtenstein. Whilst both case studies show the additional hard power of the FATF blacklist, the case of Nauru also highlights the power of stigmatization through association with an iniquitous act. It has been suggested that Nauru was made an example of for purposes of an Anti-Money Laundering (AML) demonstration effect (Reuter and Truman 2004). Today, the impoverished Nauru is struggling to re-establish an onshore banking sector due to perceived AML risks.

This paper forms part of the literature that studies modern tools of power, control and governance<sup>51</sup>. Other scholars that focus on blacklisting include Sharman (2006, 2009) who provides insight into the power of blacklisting given that it cracked banking secrecy. We further explore the various sources of power of these blacklists as well as their relative efficacy and limitations. Masciandaro (2005, 2008) seeks to explain compliance with international standards through a policy-maker payoff maximization problem. We argue that financial sanctions strongly influence such an analysis. Traditional thinking is that economic and trade sanctions are generally ineffective<sup>52</sup>, however our study adds to the growing body of evidence that modern ‘smart’ sanctions can be effective<sup>53</sup>. Where relative size and market power are known to have played a role in the efficacy of the blacklists we study (Payne 2004; Vlcek 2007, 2012), we add that stigmatization, sanctions and

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<sup>51</sup> See also Adler-Nissen (2013, 2014), Kelley and Simmons (2015), Heng and McDonagh (2008), Fougner (2008), Löwenheim (2008), Larner and Le Heron (2004).

<sup>52</sup> Peksen and Drury (2009), Galtung (1967), Wallensteen (1968), Barber (1979), Baldwin (1985), Haass (1997), Pape (1997).

<sup>53</sup> Drezner (2000, 2015), Arnold (2016), Loeffler (2009), Torbat (2005), Zarate (2013).

legitimacy also played important roles. Kelley and Simmons (2015) argue that easy-to-understand rankings can be powerful policy tools and cite blacklisting as a prominent example that carries considerable soft power. We add that blacklists can exert hard power through sanctions. We also add to the growing list of papers that highlight concerns about such exercises of power by international organizations. Swedlund (2017) argues that political scholars need to pay close attention to the institutional incentives of sanction-implementing agencies, as well as their political motives. Ban et al. (2016) argue that the global regulatory regime is being extensively shaped by international organizations that exhibit very particular institutional agendas and biases. Pauly (1999) casts doubt on the wisdom of extending international organizations' mandates as they are prone to becoming conduits for their powerful members.

This paper's primary sources include interviews with some of key players involved: José Manuel Barroso, the former President of the European Commission (2004-2014); Gordon Brown, the former Prime Minister of the United Kingdom (2007-2010); Hans Brunhart, Mario Frick, Otmar Hasler, Klaus Tschüscher and Adrian Hasler, Liechtenstein's Prime Ministers between 1993-present; Pascal Saint-Amans, Director of the Center for Tax Policy and Administration at the OECD (2012-present); Jeffrey Owens, the former Head of the Fiscal Affairs Division and Director of the Center for Tax Policy and Administration at the OECD (1991-2012) and Rick McDonnell, the former Executive Secretary at the FATF (2007-2015). It also draws on extensive fieldwork conducted in Liechtenstein as well as at the OECD, the FATF and the G20.

## 2. Blacklisting

### 2.1. Background

The word ‘blacklist’ entered the lexicon of international relations during World War I through the Trading with the Enemy Act of 1914, when the British government issued a list of companies aiding their enemies and prohibited its subjects and neutral states from trading with them (Brockman-Hawe 2012). Blacklisting has since evolved into a widely-used policy tool and there are currently more than 400 blacklists in use globally (Liss and Sharman 2015). Perhaps the most prominent are the Consolidated United Nations Security Council Sanctions List of individuals and entities subject to UN sanctions and the US Office of Foreign Asset Control’s Specially Designated Nationals and Blocked Persons List of entities subject to US sanctions. Other examples include the EU Air Safety List of airlines banned from operating in Europe and the recent EU Blacklist of Non-Cooperative Tax Jurisdictions<sup>54</sup> published in December 2017 following the Panama and Paradise Papers scandals.

The logic of blacklisting is that ‘bad’ people or entities are registered and categorized as such, and the list is published to highlight undesirable actions and prevent them from causing harm (Espeland and Stevens 1998; Löwenheim 2008). In a rational sense, the goal of blacklisting is to generate costs that are higher than the benefits being gained from the behaviour that led to the blacklisting. Blacklisting draws its power in part from its simplicity: a list can be scanned and disseminated quickly, is attention-grabbing and exploits negative social information (Kelley and Simmons 2015; Pratto and John 1991). Concise and comparable rankings also allow their authors to wield considerable power (Büthe 2012; Hansen 2012) and blacklists can be used to try to establish norms and standards (Weisband 2000).

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<sup>54</sup> The inaugural EU blacklist contains 17 countries that fail to meet good governance tax standards. A further 47 countries, including Liechtenstein and Switzerland, have been put on a ‘grey-list’ (European Commission 2017).



When a list carries normative significance that conveys acceptable versus unacceptable behaviour, it may change power relations and have regulatory-like effects (Büthe 2012; Davis et al. 2012).

However, some authors have challenged the legitimacy of blacklisting. Legitimacy is the perception that actions are desirable, proper or appropriate within some socially constructed system of norms and beliefs (Suchman 1995). For instance, the legal literature takes a dim view of the quasi-legal powers that blacklists can imbue in their authors and blacklisting challenges existing logics of evidence, criminal culpability and proportionality (De Goede 2011; Cameron 2003; Eckes 2009; Watson Institute 2006). Cooley (2015) argues that blacklisting has had ill effects on political rights<sup>55</sup> and Sullivan and Hayes (2010) find that blacklisting can entail human rights breaches. The Tax Justice Network believes that blacklisting is politically charged, biased and open to lobbying (Edwards 2015).

## **2.2. The Reputational and Financial Costs of Blacklisting**

To highlight the principle mechanisms at work in blacklisting, we compare two different types of blacklist. On the one hand, the US, the UN and the EU have the power to impose sanctions on blacklisted entities and their blacklists prohibit a range of activities with their persons. There will be reputational costs for the entities on these blacklists, but generally they impose financial costs directly rather than through damaging reputation. On the other hand, Greenpeace publishes a blacklist of fishing operations it deems irresponsible. The idea is to generate bad publicity and create indirect costs for a blacklisted company as consumers and distributors boycott their products. That is, Greenpeace cannot impose sanctions and so their blacklist tries to replicate one. Whilst the reputational and financial costs of being blacklisted are not mutually exclusive, the sovereign debt literature

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<sup>55</sup> See also Hansen (2012), O’Callaghan (2007), Power et al. (2009), Sharman (2009), Gillies (2010).

has explored both (Borensztein and Panizza 2008). Bulow and Rogoff (1989) argue that financial costs via sanctions are the only reliable mechanism to make governments repay their debts but Tomz (2007) argues that reputation also plays an important role.

Reputational costs are those that serve to undermine the credibility, legitimacy and integrity of actors and scholars have long understood that reputation is important (Claude 1966). Blacklisting imposes reputational costs through a process of stigmatization: by labelling, stereotyping, separating and discriminating the blacklisted entity (Adler-Nissen 2013, 2014). Labelling involves the creation of social categories of normality and deviance. These labels are then linked to stereotypes that serve as indicators of social identification, separating normal from deviant. Deviants lose status and are discriminated against with both material and social consequences<sup>56</sup>. Reputational costs are intangible but can include difficulty operating effectively, weak negotiating terms and exclusion. They can be significant (Sharman 2009) and their magnitude is a function of the stigma of the act that led to the blacklisting; the worse that the public and governments find the act, the higher the reputational costs (Martin 1993; Finnemore and Sikkink 1998). They are also a function of the legitimacy of the blacklist and blacklisting entity (Sharman 2006).

The financial costs of a blacklist are primarily a function of the restrictions or sanctions that it imposes, including market closure, revoking banking licenses, limiting access to settlement systems and clearing houses and imposing withholding taxes (Emmenegger 2017; Grinberg 2012). There is a significant body of literature on material punishments and rewards in international relations (Downs et al. 1996) and sanctions are intended to serve political ends via economic means (Barber 1979). Sanctions can range from trade bans and economic embargoes on entire

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<sup>56</sup> Other authors who study stigma include: Tannenwald, (2005), Zarakol, (2011), Chwieroth (2015).

states to ‘smart’ sanctions such as travel bans and financial restrictions on specific entities and individuals. The literature has traditionally argued that trade bans and economic sanctions are ineffective at gaining state compliance (Wallensteen 1968; Hufbauer et al. 1990) and disproportionately affect the human rights of the weakest members of targeted regimes whilst being prone to circumvention by their elites (Shagabudinova and Berejikian 2007). However, Haass (1997) argued that under the right circumstances economic sanctions can be effective, just less so if their scope is large or time is short. Morgan (1995) and Morgan and Schwebach (1996) argue that the costlier sanctions are to the target, the more likely it will be to comply. Drury (1998) argues that sanctions should be as costly as possible to be effective and Hufbauer et al. (1990) assert that distressed targets are the most likely to comply<sup>57</sup>.

More recently, ‘smart sanctions’ have been found to be effective, especially financial sanctions in the post 9/11 era<sup>58</sup>. This is because banks, companies and individuals can be coerced under the threat of criminal prosecution more easily than states. Generally, smart sanctions rely on the same mechanisms as traditional trade bans and economic sanctions in that they generate both financial and reputational costs, but due to their discriminatory approach aim to minimize their humanitarian impacts. Smart sanctions can also include restrictions such as travel bans that impede the physical movement of individuals, but as there is no analogy at the state level, the resulting class of ‘movement costs’ are beyond the scope of this paper. Shagabudinova and Berejikian (2007) examine the effectiveness of smart sanctions and find that they improve the humanitarian versus effectiveness trade-off. Cortright and Lopez (2002) argue that smart sanctions are effective when placed

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<sup>57</sup> Other authors include: Pape (1997), Baldwin (2000), Drezner (2003), Bapat and Kwon (2015), Peterson (2013), Swedlund (2017).

<sup>58</sup> See Arnold (2016), Loeffler (2009), Torbat (2005), Zarate (2013), Masciandaro (2005).

on ruling decision-makers. Portela (2016) studies the emergence of targeted sanctions since the mid-1990s and finds that EU sanctions have become less targeted over time.

### **3. The Blacklists**

In order to bring OFCs under global governance, the G7 tasked the OECD and the FATF to guide and inform international tax and money laundering policy, and to persuade states to adopt their standards. Both initiatives revolved around challenging financial secrecy which is useful to both tax evaders and money launderers. In June 2000, they blacklisted states that did not meet their standards.

#### **3.1. The OECD Blacklist**

The OECD was established in 1961 to focus on global economic development and today has 35 member states that account for 80% of world trade and investment. Its Secretariat is in Paris and is made up of some 2,500 staff who support its 250 committees. The OECD's standard- and rule-setting can be described as 'soft law' that member states and non-member signatories commit to abide by<sup>59</sup>. The OECD was accorded the role of tackling international tax policy in 1996 at the G7's Lyon summit<sup>60</sup>. Two years later, they published a landmark report entitled *Harmful Tax Competition: An Emerging Global Issue*. As the first attempt to coordinate international tax policy, it laid out a set of standards that states should adopt, including tax, financial and banking reforms (OECD 1998). These standards were later endorsed by the G20 in 2004 and the UN in 2008 (OECD 2009a). Today, 146 states

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<sup>59</sup> A few of the OECD's instruments can be described as 'hard law', such as the Codes of Liberalisation of Capital Movements. It obliges member states to remove barriers to the movement of capital, yet there is no formal sanctioning mechanism for breaches of it and sometimes no mechanism for even determining breaches (email Angel Gurría, August 2017).

<sup>60</sup> The OECD's 1961 Convention does not mention tax.

have committed to the Global Forum standards on tax transparency and exchange of information that evolved from this initiative.

The report was split into two sections: the first identified 47 mostly small and island states that offer zero or low rates of taxation to non-resident individuals and businesses. They were subsequently investigated by the OECD and in June 2000, 35 were blacklisted as tax havens<sup>61</sup>. This was primarily an exercise in naming and shaming, although the OECD recognised early on the potential need for its members to apply sanctions to ensure commitment to their standards. These were referred to as ‘defensive measures’ and possibilities included: imposing withholding taxes and disallowing deductions and exemptions on transactions conducted with tax havens. The second section of the report was aimed at harmful tax practices among OECD members, particularly Luxembourg and Switzerland who then abstained from approving the report (OECD 2001). However, the OECD recognised that defensive measures could not legitimately be applied to only non-OECD member states.

The Clinton administration welcomed the report and the US Treasury put forward legislative and regulatory initiatives in its Greenbooks for 1998-2001 aimed at transposing OECD standards into law (US Department of the Treasury 1998-2001). However, pressure from US corporations, tax advisors, the tax havens and latterly the Bush administration forced the OECD to soften its initiative and ended the prospect of sanctions on blacklisted states by 2002 (Hakelberg 2016). It has been argued that the OECD had to then ‘piggy-back’ on the FATF’s campaign having been side-lined by the Bush administration (Eccleston 2012). There was little further mention from the OECD of defensive measures until 2008-2009

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<sup>61</sup> Six were found not to qualify and another six committed just before the blacklist was published.

when the G20<sup>62</sup> stepped in to increase pressure on non-compliant states (OECD 2009b). G20 sanctions included implementing withholding taxes, a ban on the use of interest paid in blacklisted states to offset tax, reviewing tax treaty policies, putting political pressure on global companies to withhold investment and even a reduction in aid (G20 2009b).

### **3.2. The FATF Blacklist**

The FATF was established in 1989 at the G7's Paris summit as a 16-state task force focused on developing, promoting and implementing legal and regulatory measures aimed at combatting money laundering from the drugs trade (FATF 2014). Today, the FATF is comprised of 37 member states, shares its headquarters and secretariat with the OECD, and is funded by OECD member contributions. In 1990 the FATF issued a six-page report entitled *The Forty Recommendations of the Financial Action Task Force on Money Laundering* (FATF 1990). These Recommendations have since evolved to include other money laundering typologies such as combatting terrorist financing in the wake of 9/11, combatting corruption in 2010, maritime piracy in 2011 and non-proliferation in 2012. In the mid-90s the FATF successfully pressured member states Turkey and Austria to improve their AML frameworks, before turning their attention to non-member states. In February 2000, the FATF defined criteria for 'Non-Cooperative Countries and Territories' and in June 2000 published a blacklist of 15 of them.

'To encourage compliance' from non-cooperative states, the FATF suggested conditioning, restricting, targeting and even prohibiting transactions with them. Recommendation 21 (which later became Recommendation 19) requires signatories to apply "enhanced due diligence to business relationships and transactions with natural and legal persons, and financial institutions in blacklisted jurisdictions" and

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<sup>62</sup> The G20 called on Angel Gurría, Secretary-General of the OECD, to step up the fight against banking secrecy (author's interview José Manuel Barroso, November and December 2015).

to “apply counter-measures when called upon to do so by the FATF”<sup>63</sup>. Where there was no legal basis to take such action, the FATF encouraged adopting the relevant legislation to do so (FATF 2000a). Essentially, the FATF blacklist labels transactions with a state’s entities as potentially criminal and at a minimum will impose higher administrative and trading costs due to enhanced due diligence. At a maximum, they can be fully cut off from cross-border banking and investment activity. Even if there is no actual risk of money laundering, the increased costs of engaging in such transactions make most business unviable.

Today, over 190 states have adopted the FATF’s recommendations (FATF 2014). They have also been adopted by the IMF and the World Bank and are tied to various UN treaties and conventions that oblige ratifying states to use them (Hayes 2012). For instance, FATF Recommendation 3 is based on the criminalization of money laundering under the 1988 Vienna Convention and Recommendation 5 is based on the criminalization of terrorist financing (2178 UN Treaty Series 197). Violating these parts of the FATF’s recommendations is a criminal offense under international law. Currently only Iran and the Democratic Republic of North Korea (DPRK) are blacklisted by the FATF and in Resolution 2094, the UN urges “Member States to apply FATF’s Interpretative Note to Recommendation 7” or the implementation of targeted financial sanctions. The FATF’s recommendations are also embedded in the USA PATRIOT Act. With regards to Iran and DPRK, the Financial Crimes Enforcement Network (FinCEN), the US Treasury’s AML bureau, states: “In concurrence with the FATF’s decision, FinCEN is advising US financial institutions of their increased obligations under Section 312 of the USA PATRIOT Act, 31 USC § 5318(i)” (FinCEN 2016). In sum, the FATF blacklist is

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<sup>63</sup> The interpretive note to Recommendation 19 provides examples, including refusing the establishment of subsidiaries, branches or offices of financial institutions from the state concerned and limiting business relationships and transactions with the state and its persons (FATF 2012).

broadly linked to banking activity, development funding and aid (Southworth 2012).

### **3.3. The Financial and Reputational Costs of These Blacklists**

In terms of financial costs, the FATF blacklist threatens ‘counter-measures’ ranging from enhanced due diligence from the international banking system up to complete prohibition from it. The OECD blacklist threatened ‘defensive-measures’ which were essentially the imposition of higher taxes on transactions with tax havens. Yet, initially, it was not clear who had agreed to impose them, at least until the G20 stepped in in 2009. By contrast, FATF members had agreed to impose financial sanctions if called upon to do so, as proven by successful actions against FATF members Austria and Turkey. In fact, Rose (2015) argues that the FATF’s recommendations are functionally equivalent to binding transnational criminal law treaty and that the FATF’s use of the expression ‘counter-measure’ is imprecisely drafted. The possible counter-measures listed by the FATF constitute sanctions and are ‘retorsions’ in a legal sense, which are measures taken in response to an objectionable act by another state.

Retorsions are controversial when viewed in terms of public international law and their use raises questions about the acceptability of and limits to ‘name, shame and punish’ strategies (Gilmore 2001). As stated in Masciandaro (2005), the FATF blacklist was not merely the publication of a list of states considered ‘non-cooperative’, but also an explicit call for FATF members to apply Recommendation 19 or else run the risk of facilitating money laundering; a criminal offense under UN treaty. The FATF recommendations are unusual in that a formal sanctioning procedure accompanies a non-binding instrument and whilst the FATF does not impose sanctions itself, its signatories do when called on. The IMF even challenged the FATF’s initiative, arguing that it abused norms around legitimacy and state consent and forced its suspension in November 2002 for a year whilst the IMF



piloted a more cooperative approach (IMF 2002). As Baldwin (1985) and Fearon (1999) show, the two key factors in a state complying with demands in international relations are (i) their credibility and (ii) their severity. The credibility and severity of the financial costs imposed on states by the FATF blacklist were higher than those of the OECD blacklist.

In terms of reputational costs, FATF blacklisted states were being highlighted publicly by a reputable international organization for facilitating money laundering, i.e. the proceeds of crime. This was politically damaging and all of the blacklisted states expressed a desire not to be tainted with anything criminal (Sharman 2006). By comparison, the OECD, another reputable international organization, was highlighting these states for their harmful preferential tax practices. Whilst the OECD blacklist imposed reputational costs, being branded a ‘tax haven’ does not carry as much stigma as being branded a ‘money laundering state’ because facilitating money laundering is a more iniquitous act. Also, even OECD member states had different opinions on correct taxation practises, but there was little difference in opinion about the legitimacy of money laundering and there is no defence for facilitating it. In part, this is why it was easier to pass international money laundering regulations than tax standards. In sum, the FATF blacklist imposed higher reputational costs on a state than the OECD blacklist, and given a lack of supporting sanctions, the OECD’s blacklist relied primarily on damaging reputation. The OECD hoped that by putting off investors, an attack on reputation would replicate a sanction by creating spill-over economic costs for tax havens (author’s interview Jeffrey Owens, October 2016)<sup>64</sup>. However, Kudrle (2008) looks at the effects of the OECD blacklist on the ex-post financial activity of blacklisted states and suggests that these costs were likely small.

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<sup>64</sup> For instance, Singapore forbade some Liechtensteinian banks from opening branches due to the OECD’s blacklist (Sharman 2006).

#### 4. The Blacklisted States

Table 1 shows the 10 states that were blacklisted by both the FATF and the OECD and the date they were removed from the blacklist.

**Table 1:** The 10 states on both blacklists in June 2000.

FATF	Date of removal	OECD	Date of removal
Liechtenstein	22 June 2001	St Vincent and the Grenadines	27 February 2002
Bahamas	22 June 2001	St Kitts and Nevis	6 March 2002
Panama	22 June 2001	Dominica	6 March 2002
St Kitts and Nevis	21 June 2002	Bahamas	18 March 2002
Dominica	11 October 2002	Cook Islands	27 March 2002
Niue	11 October 2002	Niue	15 April 2002
Marshall Islands	11 October 2002	Panama	17 April 2002
St Vincent and the Grenadines	20 June 2003	Nauru**	12 December 2003
Cook Islands	11 February 2005	Marshall Islands**	7 August 2007
Nauru*	13 October 2005	Liechtenstein**	27 May 2009

Colours: the Pacific (white), the Caribbean (light grey), Europe (dark grey)

\* Counter measures applied in December 2001

\*\* Blacklisted by the OECD as unco-operative tax havens on 18 April 2002

*Source:* OECD (2009a) and Kudrle (2009)

It is apparent that all of these blacklisted states are small and it has been shown that the relative size and market power of the OECD and FATF played a role in the efficacy of their blacklists (Payne 2004; Vlcek 2007, 2012). Both blacklists were met by hostility from the governments of the blacklisted states who felt that their economic strategies and sovereignty were being undermined and that they were not included in decision-making processes. Neither Luxembourg nor Switzerland was blacklisted, even though both had been identified as secrecy havens by the UN (Rose 2015), and as such both initiatives were considered biased towards the agendas of larger, more powerful states (Sharman 2006). Masciandaro and Portolano (2002) argue that the FATF process may not have been uniformly

applied as it is much more challenging both politically and technically to sanction larger states.

Table 1 also shows that the FATF gained these states' compliance by 2005 whereas it took the OECD until 2009 to gain commitments, which suggests that the FATF blacklist was more effective. The first three states to be removed from the FATF blacklist were Liechtenstein, the Bahamas and Panama. They are the most significant OFCs on the lists and they moved to address deficiencies in their AML frameworks by June 2001 in order to be removed from the FATF blacklist at the earliest possible date; one year after its publication. All three acted quickly and decisively having seemingly appreciated the costs of the FATF blacklist (Johnson 2001). Reputation and high standards of financial probity are key to the functioning of large OFCs (Vlcek 2010) and as they had significant numbers of institutional businesses, it was too costly to bare economic losses before agreeing to reform (Sharma 2009).

The Caribbean islands of Dominica, St Kitts and Nevis and St Vincent and the Grenadines have much smaller OFCs and unified their responses to the FATF and OECD by stating publicly that they would cooperate in the fight against money laundering but would protect their no-tax or low-tax status (Johnson 2001). Having satisfied the FATF, Dominica and St Kitts and Nevis were removed from its blacklist in 2002. St Vincent and the Grenadines took a year longer as they had to repeal the stringent secrecy laws afforded by the Confidentiality Act of 1996 in order to satisfy the FATF (Drayton 2003). There was a general sentiment among black-listed states that AML regulations were being used as cover by OECD member states to eliminate competitive tax regimes through 'fiscal colonialism', enforcing protectionism via sanctions that would violate international trade law's non-discrimination provisions if they did not apply to OECD member states that had similar tax features (Vlcek 2007). They argued that as sovereign states they had the right to determine their own tax systems and that because the OECD had no right

under international law to impose tax rules on them, the blacklist was not legitimate (author's interview Jeffrey Owens, Geneva, October 2016). Whilst the FATF blacklist suffered similar legitimacy problems, states were more compliant in their dealings with the FATF; money laundering is a criminal offense that carries significant stigma and the FATF could readily sanction states for non-compliance.

To be removed from it, OECD blacklisted states had to commit to exchange of information by July 2001, set out a two-year timetable for dismantling their most harmful tax practices and fully implement exchange of information by 2005. However, after George W. Bush became President, an unusual combination of Republican Congressmen and the Congressional Black Caucus allied with Caribbean OFCs and successfully pressured Treasury Secretary Paul O'Neill to withdraw US support for the OECD initiative (Van Fossen 2003). Faced with faltering political support and significant resistance, over time the OECD was forced to postpone its deadlines and scale back its requirements to simply a commitment to exchange of information and transparency. They also dropped their focus on eliminating discriminatory and preferential tax regimes (Webb 2004). By February 2002, only 11 of the original 35 blacklisted states had committed and so the OECD engaged in intensive negotiations with the remaining 24 before issuing a new blacklist of 'unco-operative tax havens'. During this period, they produced a model exchange of information agreement that was published in April 2002 that was developed jointly with tax havens (OECD 2006). In turn, most of the blacklisted states decided to commit to the OECD as their conditions were no longer so onerous; they could continue to offer tax breaks to foreign investors if they did so in a transparent way (Webb 2004). However, all of the states that committed to the OECD in 2002 specified that their commitments were non-binding unless all OECD member states committed as well.

Compared with the Caribbean states, the Pacific states had smaller OFCs that were more marginal, had less institutional business and focused more on lower-margin

and lower skilled ‘booking center’ and ‘brass-plate’ activities (Sharman 2005). Still, despite protestations the FATF blacklist generated political willpower in the Cook Islands, the Marshall Islands and Niue to rectify their AML deficiencies and their governments set about passing regulations to placate the FATF (Van Fossen 2003). Having satisfied their concerns, the Marshall Islands and Niue were removed from the FATF blacklist in 2002. There were no significant benefits to either economy of the shell banking businesses that the FATF took issue with and both subsequently closed down their OFCs following their blacklisting (Hampton and Christensen 2011). For the Cook Islands, revisions to the 2003 FATF Recommendations meant that their legislation had to be reviewed, which delayed their removal from the FATF blacklist until February 2005 (Lowtax 2017). Nauru, which was synonymous with financial crime in the late 1990s, initially took a non-compliant stance with the FATF and, as documented below, this resulted in Nauru being the first state sanctioned under the USA PATRIOT Act.

Like the Caribbean states, the Pacific states were more defiant toward the OECD than the FATF. The Cook Islands shaped the region’s response by urging solidarity and in May 2001 the Pacific Islands Forum Secretariat agreed to a unified front. They demanded the removal of the threat of sanctions over tax matters, and refused to meet the July 2001 deadline as the OECD had failed to show evidence that OFCs caused harm. They managed to gain a series of concessions and deadline extensions from the OECD, but a change of government in the Cook Islands in March 2002 led to a significant weakening of anti-OECD sentiment, which also had an effect on Niue’s stance (Van Fossen 2003). Both reached agreement with and committed to the OECD just before the publication of the second blacklist. By 18 April 2002, seven states including Liechtenstein, the Marshall Islands and Nauru still refused to commit to the OECD and were thus placed on the new blacklist. Nauru finally committed to the OECD in December 2003 having already been sanctioned

by the FATF. The Marshall Islands depended more heavily on its flag of convenience industry and thought they could beat the OECD by relying on their Compact of Free Association with the US with whom they had signed a Tax Information Exchange Agreement in 1991. However, they declared their commitment to the OECD in 2007 under US pressure (author's interview Jeffrey Owens, October 2016). Liechtenstein, one of the first states to comply with the FATF, was one of three final European holdouts (with Monaco and Andorra) that only committed to the OECD in 2009.

#### **4.1. The Blacklisting of Liechtenstein**

Covering 160 km<sup>2</sup>, the Principality of Liechtenstein's population was 38,000 in 2017. It shares a border, the German language and a currency with Switzerland and since World War II has experienced sustained economic development that transformed it into one of the world's wealthiest countries per capita<sup>65</sup>. Its OFC managed 137 billion Swiss Francs in 2016; 26 times Liechtenstein's GDP or 4 million Francs per capita. Liechtenstein's popularity as an OFC came from its low and predictable taxes (IMF 2008) and its banking secrecy laws (Steinlin and Tramusch 2012), which predate Switzerland's by 12 years<sup>66</sup>. These laws had long been the target of international efforts aimed at curbing banking secrecy (Eggenberger and Emmenegger 2015), yet its government resisted pressure for nearly a century using the norm of state sovereignty. They behaved exactly as would be expected from a small state in the seminal work of Katzenstein (1985) and it had been argued that multilateral initiatives that would restrict state sovereignty were needed to curb such practices (Eden and Kudrle 2005; Woodward 2006; Rixen 2008; Genschel and Schwarz 2011).

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<sup>65</sup> GDP per capita adjusted to purchasing power parity (Central Intelligence Agency 2017).

<sup>66</sup> Liechtenstein's banking secrecy laws date from January 1923 and evolved from the distrust of national authorities that came from the atrocities, rights failures and expropriations of the inter-war period (Landesverwaltung Fürstentum Liechtenstein 1923).

Liechtenstein was blacklisted by the FATF because their system for reporting suspicious transactions was inadequate and because there were no proper laws in place for exchanging information or co-operating with foreign authorities (FATF 2000b). To comply with the FATF, within one year Liechtenstein revised its criminal code, its due diligence laws, created a police unit for economic and organized crime, set-up an independent financial intelligence unit and a department under the Ministry of Justice to assist with international AML initiatives. Following these changes, the FATF concluded that Liechtenstein implemented in record time a substantial package of legal and institutional reform and was to be removed from the blacklist (Moneyval 2003). Then-Prime Minister Mario Frick said publicly that Liechtenstein had been ‘falsely judged’ by the FATF and coerced into regulatory reform under the threat of sanctions (author’s interview Mario Frick, Prime Minister from 1993-2001, August 2017).

Liechtenstein was blacklisted by the OECD because of its banking secrecy laws and lack of information exchange. Their blacklisting was met by accusations of bullying and interference with Liechtenstein’s sovereignty (Eggenberger and Emmenegger 2015). The norm in Liechtenstein was that low taxes were good and Liechtenstein’s government was less concerned about being blacklisted by the OECD. Heinz Frommelt, then Minister of Justice, said “the FATF blacklist was about money laundering; the OECD blacklist was only about tax issues. Liechtenstein’s government felt the FATF blacklist was far more harmful” (author’s interview, August 2017). Also, Liechtenstein’s government felt that it had a number of strengths that would allow it to withstand pressure from the OECD. For instance, a variety of popular bespoke optimization products, the rule of law, a AAA credit rating and a strong client base in Switzerland (author’s interview Mario Frick, August 2017). Initially, Liechtenstein only had one employee coordinating with the OECD as implementing their standards was considered a low priority task (author’s interview Philip Schädler, October 2015). By contrast, their government was

acutely aware of the sanctioning mechanism of the FATF (author's interview Mario Frick, August 2017) and in Adler-Nissen's (2013, 2014) terms they recognized the stigma of the FATF blacklist but initially rejected the stigma of the OECD blacklist. The reputational costs of being highlighted as a tax haven were far lower than for facilitating crime. Masciandaro (2008) argues that the OECD blacklist could have even been beneficial in the sense that it may have acted as publicity for tax havens.

However, nowadays, Mario Frick thinks that his government's initial stance towards the OECD was naïve and slow to adapt to changing international norms (author's interview, August 2017). In particular, norms around banking secrecy evolved significantly following the financial crisis of 2007-2008 and the resulting squeezes on public finances as well as a series of tax evasion scandals centered on Switzerland's and Liechtenstein's banks that began in 2008 (Sharman 2017). It has been shown that political elites are susceptible to social pressure and are more likely to endorse new norms during periods of turmoil (Finnemore and Sikkink 1998; Ikenberry and Kupchan 1990; Ron 1997). In particular, a scandal at LGT bank (controlled by Liechtenstein's Princely House) where a whistleblower sold sensitive client data to foreign tax authorities resulted in a US Senate hearing in July 2008 that attracted international attention. Following the hearing, the US began to take a tougher stance on US clients' offshore wealth, opening criminal investigations into foreign banks that facilitated tax evasion. These events created demonstration effects<sup>67</sup> that changed societal views and gave renewed impetus to the regulation of tax havens and banking secrecy.

By November 2008 public and media pressure was so high that the G20 instructed the OECD to produce a third blacklist of uncooperative tax havens to be presented at their London Summit in April 2009. Opinion within the G20 was divided on the

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<sup>67</sup> An exogenous event that can trigger a regulatory change process (Mattli and Woods 2009).



issue<sup>68</sup>, but it announced that it would sanction states on this blacklist (author's interview Gordon Brown, September 2016): “[W]e agree [...] to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems” (G20 2009a). A draft of this blacklist began to circulate in March 2009 (Eccleston and Woodward 2014) and Liechtenstein, who was on it, declared their commitment to the OECD shortly afterwards, having been blacklisted for nine years<sup>69</sup>. Liechtenstein finally capitulated to the OECD's demands because the costs of maintaining banking secrecy now outweighed the benefits (Eggenberger and Emmenegger 2015). This marked the death knell of banking secrecy and a concrete timeline was then set out for the Automatic Exchange of Information<sup>70</sup>. Shortly after, President Obama enacted the Foreign Account Tax Compliance Act (FATCA) in March 2010, which is the US' unilateral initiative to enact international tax policy. However, in light of the OECD's problems in gaining commitments, FATCA was linked to market access directly (Emmenegger and Eggenberger 2017; Eccleston and Gray 2014; Hakelberg 2015). This shift towards punishing banks as the main instrument for gaining compliance is more aligned with the FATF's strategy. It is easier to prosecute banks than states and a loss of market access is very costly, particularly for states that are highly integrated.

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<sup>68</sup> G20 Summit Chair and Prime Minister Gordon Brown said that Nicholas Sarkozy threatened to storm out of a tense meeting over differences within the G20 over tax issues. France wanted sanctions to be imposed on non-compliant states but the People's Republic of China was highly resistant (author's interview Gordon Brown, September 2016).

<sup>69</sup> Whilst Liechtenstein avoided being on this third blacklist, they were placed on a 'graylist' of 38 jurisdictions that had committed to, but not substantially implemented the OECD's standards (Lawrence 2009).

<sup>70</sup> Previous standards provided information on request, but the Automatic Exchange of Information requires information to be sent yearly without a specific request (Eggenberger and Emmenegger 2015).

What the case of Liechtenstein highlights is that when Liechtenstein was blacklisted for an act that carried significant stigma and faced the credible threat of severe sanctions, its government quickly and decisively addressed the demands made of it. By contrast, when blacklisted for an act that carries less stigma, and there were no sanctions, the blacklist was less effective. Whilst both blacklists suffered from legitimacy problems that hindered their effectiveness, legitimacy is key to exercises of soft power. The OECD lacked the hard power of the FATF, whose legitimacy problems were in many ways superseded by the higher reputational and financial costs of its blacklist. Over time, the legitimacy and thus effectiveness of the OECD blacklist improved through changing some of its provisions and as social norms evolved. But the credible threat of sanctions from the G20 still played an important role in getting the most resistant states like Liechtenstein to commit to the OECD.

#### **4.2. The Blacklisting of Nauru**

Nauru is an island of 13,000 inhabitants covering 21 km<sup>2</sup> in the western Pacific. Its economy was traditionally based on phosphate mining, which by the 1980s had given it one of the highest incomes-per-capita in the world (Connell 2006). By the 1990s the phosphate was depleting and so was Nauru's wealth through a combination of mismanagement, fraud and poor investment of its trust funds (US Department of the Treasury 2003). To shore up its economy, Nauru turned to selling 'economic citizenship' through passports as well as offshore banking licenses with secrecy provisions. In the late 1990s, these activities landed Nauru at the centre of one of the largest money laundering scandals of all time when tens of billions of dollars from the Russian Federation were found to have been laundered through Nauru. International scrutiny ensued and in June 2000 the FATF and OECD blacklisted Nauru.

The OECD blacklisted Nauru for the same reasons as Liechtenstein and like Liechtenstein, Nauru's government rejected their blacklisting on the grounds that their sovereignty was being impinged (Harris 2002). The FATF blacklisted Nauru because money laundering was not a criminal offense and strong banking secrecy laws were in place. The FATF drew particular attention to some 400 shell banks that were prohibited from taking deposits from the public and had links to Russia (FATF 2000b). These banks had no physical or legal residence anywhere else in the world and were all registered to a single wooden hut (US Department of the Treasury 2003). Whilst initially non-compliant, the threat of sanctions affected the willingness of Nauru's government to cooperate with the FATF (author's interview Rick McDonnell, former Executive Secretary at the FATF, 31 January 2018). In August 2001, they passed AML legislations, but these changes failed to placate the FATF and then, following the September 11 attacks, Nauru was subject to even greater scrutiny on the grounds that it might have been a conduit for terrorist money transfers (Connell 2006). In December 2001, the FATF called on its members to break financial links with Nauru.

As Nauru had become synonymous with financial crime and was appearing on increasing numbers of blacklists it aroused the wrath of the US government. In December 2002, Nauru was designated a "primary money laundering concern" by the US Treasury under Section 311 of the USA PATRIOT Act based on guidance from the FATF (US Department of the Treasury 2003). Nauru's problems were further compounded when in February 2003 two suspected Al-Qaeda agents were captured holding Nauruan passports and then when former President Dowiyogo died of a heart attack during a visit to the US to end the sanctions shortly after (Van Fossen 2017). He signed an executive order agreeing to US demands to end offshore banking and passport sales on his death bed in a Washington hospital (Herr and Potter 2006). Upon his delegation's return, the Nauruan parliament honoured his agreement and passed the required laws in March 2003. Yet, the FATF wanted

Nauru to ensure that previously licensed offshore banks were no longer in existence or conducting banking activity as a condition for removing counter-measures. Finally, in April 2003, FinCEN imposed its fifth and highest level of ‘special measures’ on Nauru, i.e. complete financial prohibition between US financial institutions and any Nauru-licensed institution.

Having been sanctioned by the FATF, Nauru capitulated to the OECD on 3 December 2003. In a letter to the Secretary-General of the OECD, Nauru agreed to commit to the OECD standards on the basis that they would not be subject to “any framework of coordinated defensive measures by OECD member states”<sup>71</sup>. In October 2004, the FATF withdrew counter-measures against Nauru due to its efforts to reform its banking system and in October 2005, once the shell banks had been abolished, the FATF removed Nauru from its blacklist. The US Treasury only withdrew its designation of Nauru as a primary money laundering concern in April 2008, in light of actions taken by the FATF (US Department of the Treasury 2008).

The path of slow and inadequate compliance with the FATF was particularly costly for Nauru. Blacklisting and sanctions helped to undermine its already faltering economy and have subsequently served to undermine the re-establishment of its onshore banking sector, which was non-existent for a decade after the central bank collapsed under the country’s debt burden. Because there was no functioning onshore banking system, and because the government did not collect data, quantifying the financial costs of the FATF’s sanctions is difficult (Sharman 2012). However, the most significant issue facing Nauru today is the reputational damage inflicted by its prior association with money laundering and blacklisting (FATF 2012). Several banks still refuse to do transactions with Nauru and/or have withdrawn corresponding banking relationships. For instance, citing AML concerns,

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<sup>71</sup> Letter from President Harris to Secretary-General Johnston, 3 December 2003, Re: OECD Harmful Tax Initiative.

the Australian bank Westpac announced in April 2016 that it will no longer conduct business with the Government of Nauru or a handful of business entities on the island (Fox 2016). Bendigo Bank, which opened an Agency in Nauru in 2015, has reported that it struggles to do transaction with countries other than Australia due to AML risks (IMF 2017).

There were reputational costs of being on the OECD blacklist but Nauru's story was primarily about money-laundering and these costs were likely superseded by the reputational and financial costs of being on the FATF blacklist. In fact, the FATF blacklist and resulting sanctions likely played a significant role in getting Nauru to commit to the OECD's standards (author's interview Rick McDonell, 31 January 2018). The OECD and the FATF are said to create 'soft law' (Terry 2010), but the FATF's soft law exerts hard power and is highly coercive. The case of Nauru also highlights the power of damaging reputation through stigmatization. It has been suggested that Nauru was made an example of for purposes of an AML demonstration effect (Reuter and Truman 2004) and that Nauru presented an early opportunity to test the USA PATRIOT Act's sanctioning mechanisms (Herr and Potter 2006). These are the same mechanisms that have subsequently been used on Iran and DPRK, making Nauru's sanctions some of the harshest imposed on any state. The precipitous decline in both its phosphate and offshore banking industries have seen Nauru become impoverished. Many functions of the state have collapsed, it depends on foreign aid, has turned to maintaining detentions camps for Australian immigrants for revenue, and has most of the characteristics of a failed state (Connell 2006).

## **5. Conclusion**

Blacklisting is a modern tool of global governance that is used in the international political economy to support policy objectives based on changing behaviour. By

comparing the OECD's and FATF's blacklisting of secrecy havens in the early 2000s, this study asks the question: When is blacklisting effective?

We show that blacklisting can be used to impose both reputational and financial costs on a state and highlight three factors that contribute to a blacklist's effectiveness: the stigma attached to the act that led to the blacklisting, the nature of any sanctions that it imposes and the blacklist's legitimacy. Under certain conditions, the sum of these costs can be very high and in turn blacklisting can be effective. For instance, when the FATF blacklisted Liechtenstein for facilitating money laundering, an act that carried significant stigma. Faced with the credible threat of severe sanctions, Liechtenstein's government quickly and decisively addressed the legal and regulatory demands made by the FATF. By contrast, when blacklisted by the OECD for its harmful preferential tax practices, acts that carry less stigma, and did not face sanctions, its government was slower to respond and more combative with the OECD. This highlights how the additional financial and reputational costs imposed by the FATF blacklist made it more effective than the OECD blacklist. Similarly, in the case of Nauru, its government was slow to respond and combative with both FATF and OECD, but it was the FATF blacklist and its resulting sanctions and stigma that coerced Nauru into reform. These factors likely played a significant role in getting Nauru to commit to the OECD's standards as well. Nauru presented an early opportunity to test the USA PATRIOT Act's sanctioning mechanisms and was made an example of to the international community. Whilst these financial sanctions have been lifted, the persistent reputational damage inflicted through its association with money laundering and blacklisting is one of the most significant issues facing Nauru today and it is struggling to revive its onshore banking sector. Whilst both the OECD and FATF blacklists suffered from legitimacy problems that hindered their effectiveness, legitimacy was more essential to the OECD's initiative given its greater reliance on soft power. The OECD

lacked the hard power of the FATF in the form of sanctions, and the higher reputational and financial costs of the FATF blacklist in many ways superseded its legitimacy problems.

Our analysis is not to imply that a legitimate blacklist that generates stigma and comes with sanctions will ensure that an iniquitous entity complies with the blacklist's author. Rather, that these seem to be the optimal conditions for effectiveness. Further work remains to be done on understanding the factors that contribute to unsuccessful blacklistings in the presence of these conditions. For instance, whilst Lee and Gray (2017) argue that the FATF's process has been ineffective in gaining the DPRK's compliance in non-proliferation, we show that it was highly successful in gaining the compliance of OFCs with AML initiatives. Our analysis would suggest that their result may in part be explained by the DPRK's lack of dependence on international markets.

The FATF's blacklist is particularly interesting because whilst the FATF does not impose sanctions directly on a state, they can call on the many banks, regulators and international organizations who endorse their recommendations to do so. Whilst the FATF makes soft law, the USA PATRIOT Act and various UN conventions give the FATF hard power, their usage of which has raised questions about state consent and sovereignty. It has been argued that economic coercion can lead to a reduction in quality of life and security, lead to human rights abuses, and widen the income gap (Gibbons and Garfield 1999; Weiss 1999; Cortright et al. 2001). Surprisingly few studies look at the social effects of such practices (Woodward 2009; Martens and Jakobi 2010). We call for further research in this direction.

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## 5. The Political Economy of Tax Avoidance: Apple, Ireland and the EC's Puzzling State Aid Case.

*Submitted to International Organization*

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**Abstract:** Both cash-strapped governments and populist movements are looking towards the billions of dollars that multinational corporations hold offshore to avoid tax. In this paper we examine Apple's tax structures in the Republic of Ireland and the resulting US Senate investigation and subsequent prosecution under EU state aid rules in 2016. Our analysis of this case gives insight into a range of pressing issues in political economy including the distributional conflicts of tax competition, sovereignty and political discord in the EU, the rents earned by multinational corporations, state capture and compliance in corporate manipulations, optimal tax rates and policy design. More generally, we look at the rationale behind tax avoidance, the means and complexities involved, and its political, economic and social implications. It can affect interstate relations, alter the distribution of income and power, increase the returns to capital versus labor, increase inequality and is arguably immoral. Our analysis calls for further theoretical work on the correct apportionment of corporate value generation between the various stakeholders in society. Practically, we call for a better alignment of international taxation with relevant underlying economic substance.

### **Introduction**

In the post-crisis austerity era, cash-strapped governments and publics suffering from spending cutbacks have placed tax avoidance high on the political agenda. The Institute on Taxation and Economic Policy suggests that US Fortune 500 companies alone hold \$2.6 trillion in profits overseas to avoid US taxes (Philips et al.

2017). As a result of profit-shifting to low-tax jurisdictions, the effective corporate tax rate of US companies has declined from 30% to 20% over the last 15 years (Zucman 2014). We begin this study with an overview of the scope and scale of international tax avoidance by Multi-National Corporations (MNCs) and look at their rationale, their means, the complexities involved, and its social, economic and political implications.

We then turn to the case of the European Commission's (EC) state aid ruling with regard to Apple's tax structures in Ireland. We first examine the political economy of Ireland and how it has evolved through Ireland's accession to the European Union (EU). That is, Ireland's political economy is geared towards undercutting the tax rates of larger states to attract Foreign Direct Investment (FDI). Such policies attracted companies like Apple and its relationship with Ireland was symbiotic; over time Apple became one of the largest companies, and Ireland one of the richest economies, in the world. Apple embodies the spirit of entrepreneurial capitalism and the rise in power of the MNC. Headed by its 'cult-of-genius' leader Steve Jobs, it developed iconic and revolutionary technologies that changed the way people work, share information, study and communicate. Apple's 'value creation', or Research and Development (R&D), was in the US, its products were built in China, and then they were distributed and sold globally from US and Irish headquarters to create gigantic revenue streams and cash reserves.

However, in May 2013 the US Senate held hearings on how Apple had avoided tens of billions of dollars of US taxes. They concluded that Apple's actions increased the federal deficit, forced other taxpayers to shoulder the tax burden and undermined the fairness of the US tax code. Their evidence also suggested that Apple was avoiding tax in many European states as well. One month later the EC launched an investigation into the historical Irish tax rulings that facilitated Apple's tax avoidance. Strategies such as the 'Double Irish Dutch Sandwich' created what the EC deemed 'stateless' subsidiaries through which Apple had shifted a



significant component of its worldwide sales. It has been argued that Apple used the inherent mobility and jurisdictional ambiguity of intangible assets to arbitrage loopholes in fiscal systems (Fernandez and Hendrikse 2015). Apple was accused of avoiding corporate tax on almost all profits generated in the EU for nearly a quarter of a century and the EC concluded in 2016 that the deals with Ireland had breached EU state aid rules. They ordered Apple to pay €13bn in back-taxes to Ireland (European Commission 2014); a ruling that both Apple and Ireland contested. Joseph Stiglitz goes as far as to argue that this amounts to the largest tax fraud in history (Smialek and Webb 2016).

But why did Ireland fight the ruling? It is puzzling that the Irish government sided with Apple to argue against receiving a tax redistribution that amounted to €2,700 per capita in cash. Our analysis shows that it was because Ireland's government wanted to protect its economic model of attracting FDI through low taxes and low regulation, had suffered a loss of sovereignty, and was concerned about the legitimacy of Ireland's claim to this windfall. Also puzzling is the fact that the Irish government had popular support for this policy. We argue that the Irish people are largely quiescent because they believe that the benefits of defending their economic model outweigh the benefits of receiving a short-term payoff. Concerns about defending the independence of Irish institutions also played a role. To what extent they are correctly informed as to the merits and risks of their government's approach, and whether it is really in the popular interest, is a moot point.

So, in a more holistic sense, we then discuss the relative winners and losers from corporate tax avoidance in terms of the various stakeholders involved, i.e. governments, publics, shareholders, employees and consumers. Our analysis highlights the difficulties involved in apportioning their respective shares of corporate value generation and that whilst its effects are complex and nuanced, corporate tax avoidance is income and wealth distribution distorting. The most direct losers are the governments of large high tax jurisdictions, where SMEs and individuals not

able to replicate international tax avoidance strategies tend to pick up the tax burden. Those who depend on government redistribution the most are among the biggest losers. The rising share of income going to corporates in the economy has fed into executive pay distortions, higher returns to capital than labor, and tax avoidance can be considered a special case of regressive tax cut (Alvaredo et al. 2013; Piketty 2014). All of these dynamics can be related in increases in wealth and income inequality. According to Stiglitz and Pieth (2016) there is a growing consensus that inequality is one of the most pressing issues of our time.

Our analysis of the EC's state aid case against Apple and Ireland shows how corporate tax avoidance effects political process, can affect interstate relations, and alters the distribution of income and power within states. The overriding of Ireland's sovereignty by the EC also shows how MNCs that evade government policies can be linked to declining national autonomy (Garrett 1998). It serves to highlight some of the structural fault lines in the EU, where in addition to fiscal concerns, tensions are high on a number of other issues ranging from sovereignty, to immigration and exit. Early studies from the dependencia literature looked at the various mechanisms by which MNCs affect political and economic processes, in terms of efficiency, growth, inequality and government effectiveness (Keohane and Ooms 1972, 1975; Moran 1978). We view the state aid case through the lens of this literature, but with a view that the nature of MNCs has fundamentally changed over the last 50 years; in terms of their scope and scale, areas of activity, and how they produce value; especially via intangible assets. Our study refreshes this seminal work in a modern context and concludes that its findings are largely robust.

This paper's primary sources include interviews with some of key players involved: Timothy (Tim) D. Cook, Chief Executive Officer of Apple, USA; Paschal Donohoe, Minister for Finance of Ireland; Bertie Ahern, Brian Cowen, Enda Kenny, and Leo Varadkar, Ireland's Prime Ministers from 1997 to present; Pierre

Moscovici, Commissioner for Economic and Financial Affairs, Taxation and Customs of the EC; José Manuel Barroso, the former President of the EC (2004-2014); Sorcha McKenna, Head of Dublin McKinsey Office. It also draws on extensive fieldwork conducted in Ireland and the US, as well as at the EC.

### **Tax Avoidance by Multi-National Corporations**

One of the primary goals of the senior management of an MNC is to maximise firm value for shareholders, ideally through higher revenues and profits. However, the same can be achieved by lowering a company's effective tax rate (Modigliani and Miller 1958). Avoiding tax is one way to do so and unlike tax evasion, it is legal<sup>72</sup>. The international tax system is based on a series of inconsistent bilateral agreements that MNCs can exploit to engage in so-called 'treaty shopping' (Zucman 2014). That is, by carefully choosing the location of their affiliates, they can artificially shift profits to low tax jurisdictions. A US Treasury Department study by the Joint Committee on Taxation (2010) found that the potential for profit shifting was highest in licensing and cost sharing arrangements involving Intellectual Property (IP) and Intangible Assets. Essentially, when parents and subsidiaries contribute combined resources toward the joint development of a new product. US tech firms make extensive use of such profit shifting strategies (Kadet 2016), although more generally financially distressed firms are the most likely to engage in tax avoidance (Lee 2017).

US companies are incentivized to shift profits offshore because the US has some of the highest tax rates in the Organisation for Economic Co-operation and Development (OECD) and its MNCs can defer taxes on their foreign subsidiaries until

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<sup>72</sup> The tax evasion literature is surveyed by Cowell (1990a; 1990b). More recent surveys include Andreoni et al. (1998), Slemrod and Yitzhaki (2002), Chen and Chu (2005), and Crocker and Slemrod (2005).

profits are repatriated through dividends (PwC 2009). These tax features have created a ‘trapped income’ phenomena<sup>73</sup> where US MNCs keep at least 60% of their cash overseas (US Senate 2013). The Tax Justice Network estimates that the offshore wealth generated from offshore activities is as much as \$20-30 trillion globally (Henry 2012). 83 of the 100 largest US public companies have subsidiaries in tax havens (US Government Accountability Office 2008) and combined, MNCs have accumulated \$2.6 trillion in profits outside of the US. Also, US multinationals report 43% of their overseas profits in either Bermuda, Ireland, Luxembourg, the Netherlands, or Switzerland whilst only 4% of their foreign employees and 7% of their foreign investments are located there. By comparison Germany, United Kingdom, Canada, Australia and Mexico only account for 14% of their overseas profits although 40% of foreign employees and 34% of investments are located there (Keightley 2013). This proliferation in overseas tax structures has been a causal factor in the decline in the US government’s corporate tax revenue as a percentage of total tax from 30% during the 1950’s to nearer 10% by the 2010’s (Levin and Coburn 2012). Similarly, US corporate tax rates as a percentage of corporate profits have declined from an average of 26% between 1987 and 2008 to 12% by 2012 (Bank 2013).

Varying degrees of state sophistication in transfer pricing and other corporate manipulations have played a role. Not all countries are equally able to deal effectively with MNCs who extract large rents from tax manipulations (Keohane and Ooms 1975). Even if they are highly sophisticated, there are severe limitations in the extent to which tax authorities can ensure that intragroup IP transactions are conducted at market price as if affiliates were independent because intangible assets are typically unique and lack comparable market prices. In a discussion on the

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<sup>73</sup> See the Independent Commission for the Reform of International Corporate Taxation (2015) for a broader discussion.

possible remedies to corporate tax avoidance, Zucman (2014) argues that the concept of ‘arms-length’ is flawed because MNCs are by definition synergistic entities. Even if governments could monitor transfer prices, MNCs spend billions of dollars on treaty shopping and transfer pricing and when authorities try to curb them, their legal and accounting expenditures simply rises to defend such practises. This can lead to a wasteful expenditure of resources. Sikka (2015) goes as far as to argue that staff at the big four accountancy firms in the UK can even be seconded to the Treasury to design tax laws that they advise their clients how to exploit, earning up to £1bn in fees from doing so. Even if governments do successfully pursue and penalize tax avoidance, MNCs can choose to relocate to a more accommodating tax jurisdiction and thus take with them any direct and indirect benefits they generate. Such exit risk following unilateral action is a recurring theme in the literature on the cooperation problems in international taxation (Emmenegger 2017).

In their defense, MNCs tend to pay all *legally* owed taxes and make significant tax contributions through sales, payroll, income and dividend taxes. Some argue that corporate taxes are too high or that the return to paying them are too low; the foundation of fairness-based empirical and theoretical models of tax avoidance and evasion (Bordignon 1993). In an expected utility setting, theoretical models can suggest that even tax evasion could be optimal from the perspective of a taxpayer if either the probability of detection or resulting penalties are low (Sandmo 2005). Another factor in the extent to which taxpayers avoid tax is their perception of the behavior of others; it is costlier to be honest when dishonesty is common (Andvig and Moene 1990) and the more widespread avoidance is, the more socially acceptable it becomes (Sandmo 2005).

Questions about the fairness of corporate tax go back to its introduction (Hoogstra et al. 2014). Governments provide collective goods to society that are undersupplied by the market (Garrett 1995) and MNCs make extensive use of public goods

and services that one could argue they have a moral, if not legal obligation to pay for. They need healthy educated workers, roads, police, courts and prisons among other public utilities. Tax avoidance alters the flow of funds between governments, firms and households in such a way that can lower government spending and lead to overall welfare losses (Slemrod and Wilson 2009). When mobile firms are unwilling to pay taxes, the tax burden is shifted onto immobile labor which undermines the redistributive effects of the welfare state (Rodrik 1997). From a theoretical perspective, calculating optimal tax rates consists of choosing a set of tax instruments that maximize social welfare subject to a required tax-revenue budget-constraint; this is the so-called ‘equity-efficiency trade-off’. Given its importance, there is a significant literature on ‘optimal’ taxes back to Ramsey (1927). Diamond and Mirrlees (1971), Atkinson and Stiglitz (1976), Mankiw et al. (2009) and Saez (2001, 2002a and 2002b) also make important contributions.

Yet if MNCs avoid tax in order to create jobs with good wages and innovate, particularly if a host government is corrupt, this could actually be welfare increasing. The dependencia literature explored these themes and the various other ways in which MNCs affect political and economic processes in and between countries (Keohane and Ooms 1972, 1975; Moran 1978). It finds that MNCs siphon off economic surplus and that host countries tend to receive too few benefits, or pay too high a price, for the services they receive. MNCs can even profit at the expense of all of the countries in which they operate, particularly if aided by the government of a tax haven (Keohane and Ooms 1975). Tax policy is vital to governments as they need funds before they can do anything else, who wins and who loses from tax policy effects the democratic process, and it can be used to directly or indirectly incentivize and reinforce certain kinds of behavior (Hansen 1990).

## **Ireland and Apple**

The Republic of Ireland is the western most state of the European Union and is about the size of the US State of South Carolina. It covers 84,431 km<sup>2</sup> and in 2016 its population was 4.7 million. Ireland was historically one of Europe's poorest countries and by the mid-80's nearly one in four people were unemployed. Ireland was struggling with double-digit inflation and a brain drain through emigration (Gupta and Halpin 2013). Its second largest city Cork had suffered particularly badly from the closure of its shipyards and a Ford car plant. Yet Ireland's political economy has long been geared towards attracting FDI through tax breaks. From as far back as 1956, Ireland offered a zero corporate tax rate to create jobs in the manufacturing sector. However, as part of Ireland's accession to the European Economic Community in 1973, Ireland was forced to stop offering unfair tax competition in 1980. From 1981 onwards, companies arriving in Ireland had to pay corporate tax, but at a relatively low rate of 10% providing they qualified for manufacturing status. Since 2006 Ireland's corporate tax rate has been 12.5% and Ireland has the 5<sup>th</sup> lowest Total Tax Rate in Europe at 26% (PwC, the World Bank and International Finance Corporation 2016).

By the early 2000's, Ireland had become the fastest-growing economy in Europe driven by the exports of about 1,000 MNCs based there. They were attracted to Ireland due to a combination of its low taxes, political stability, pro-business government policies and regulations, a transparent judicial system, a flexible English-speaking workforce, good transportation links and proximity to both US and European markets (US Department of State 2015). Nowadays it has the second highest GDP per capita in the Euro Zone, after Luxemburg and according to José Manuel Barroso, the former President of the EC (2004-2014): "99% of the world would like to be where Ireland is and even after the financial crisis this is still the case. Ireland's is run by two center/right parties who effectively make the case for

Ireland and for Irish competitiveness, including better deals for MNCs than its European peers” (author’s interview, 9 January 2019). Today, these MNCs employ 5% of its workforce and generate nearly a quarter of Ireland’s economic output (Bowers 2016). They include one of the world’s largest companies, Apple Inc, which reached a record market capitalisation of \$1 trillion in 2018.

Apple was founded on the 1<sup>st</sup> of April 1976 in California by Steve Jobs, Steve Wozniak and Ron Wayne and is headquartered in Cupertino today. It has approximately 80,000 employees worldwide and focusses on manufacturing high-end personal computers, mobile devices and developing software. The company has pioneered iconic and transformative consumer products such as the iMac, iPod, iPhone and iPad. Apple was the first technology company to establish a manufacturing operation in Ireland in 1980; the year the Irish tax system changed under EU rules. It invested \$7m in a manufacturing plant in Holyhill near Cork. Today, although a very different entity, Apple is Ireland’s largest company and is Cork’s biggest private sector employer. It employs 5,000 people and economists estimate it generates €19bn annually in direct benefits for the Irish economy through salaries, tax and investment (Reddan 2018). According to John Sculley, Apple’s Chief Executive Officer from 1983 to 1993, the tax subsidies gained for creating 700 jobs played a key role in Apple’s decision to invest in Ireland. In 1989, the first year that detailed accounts were filed, Apple’s Irish subsidiary – then known as Apple Computer Inc. Ltd – paid \$500,000 in corporate tax on profits of \$317m; a tax rate of 0.2% (Gupta and Halpin 2013).

However, following billions of dollars of losses in 1996-1997 Apple underwent a major restructuring. Manufacturing was outsourced from Colorado, California and Cork to third-party manufacturers in China and Taiwan. Apple’s treasury operations were based in Ireland and the low-regulation states of Delaware and Nevada in the US (Duhigg and Kocieniewski 2012). Nowadays, Apple’s R&D is conducted in the US, its components are sourced globally, and its final products are



assembled in China. Sales and distribution of these products are then organised from Apple's US (Americas) and Irish (rest of world) headquarters. Essentially, Apple capitalizes on outsourced manufacturing in low-waged countries and then sales, distribution and treasury services in low-tax states. Apple's Irish subsidiaries held the rights to Apple's IP for goods sold outside of the Americas, but the legal ownership of this IP remained with Apple Inc in the US, its largest market. In return for the rights, the Irish subsidiaries shared the cost of funding Apple's R&D in the US with Apple Inc. This structure was favourable to Apple's Irish subsidiaries because, in effect, they paid much less for these rights than they made from selling Apple's goods. But it also enabled Apple to transfer patent-related income, such as the proceeds of sales of iPhones in the US, to its subsidiaries in Ireland. In the process it generated and accumulated record profits and cash reserves (Bryan et al. 2017). By 2017, Apple had worldwide net sales of \$229bn, net income of \$48bn and held \$285bn in cash and cash equivalents on its balance sheet. This 'cash mountain' has been widely publicized and corresponds substantially to the profits of Apple's foreign subsidiaries (European Commission 2016).

### **Apple's Tax Structures**

Apple is said to have pioneered tax avoidance strategies such as the 'Double Irish Dutch Sandwich'. Before it was closed down in the wake of the Apple investigations, it involved a US company licensing its IP to a subsidiary in Ireland that had its tax residency in a Caribbean tax haven. The Irish subsidiary then sublicensed the IP to a Dutch company with tax residency in Holland, which then sublicensed the IP back to a second company in Ireland with a tax residency in Ireland. The second Irish company, a wholly owned subsidiary of the first Irish company, could then sublicense the IP to other jurisdictions outside of the US for which it received royalties. It would keep a small amount of these royalties (5-10%) and forward the

rest to the Dutch company, which kept a small amount and forwarded the remainder to the first Irish company. The second Irish company only paid taxes on the royalties it kept. The royalties forwarded to the Dutch company were permitted deductions against the royalty income they received and so were not liable for tax. Then, under existing tax treaties, there was no Irish withholding tax on the royalties forwarded to the Dutch company, nor Dutch withholding tax on the royalties paid to the first Irish company. The first Irish company would have low or no tax rates in the Caribbean (Holtzblatt et al. 2016). Many other companies including Google and Microsoft have used Double Irish strategies (Kleinbard 2011a, 2011b, 2013).

Under Irish law, a company that is incorporated or centrally managed and/or controlled in Ireland is normally considered a tax resident of Ireland and liable for Irish corporate tax on its worldwide profits. However, prior to the Finance Act 2013 and 2014<sup>74</sup>, which phased out Double Irish strategies<sup>75</sup> under EU demands, Ireland's Taxes Consolidation Act 1997 (TCA 97) provided two exceptions to Ireland's tax residency<sup>76</sup>. In particular, under exemption (ii), companies incorporated in Ireland with a trading activity in Ireland that were controlled outside of Ireland were not considered a tax resident of Ireland. However, there was no requirement that they had a tax residence elsewhere. The Irish subsidiaries that were not tax resident in Ireland at the center of Apple's tax investigations included: **Apple Operations International (AOI)**, formerly known as Apple Computer Inc Ltd, was

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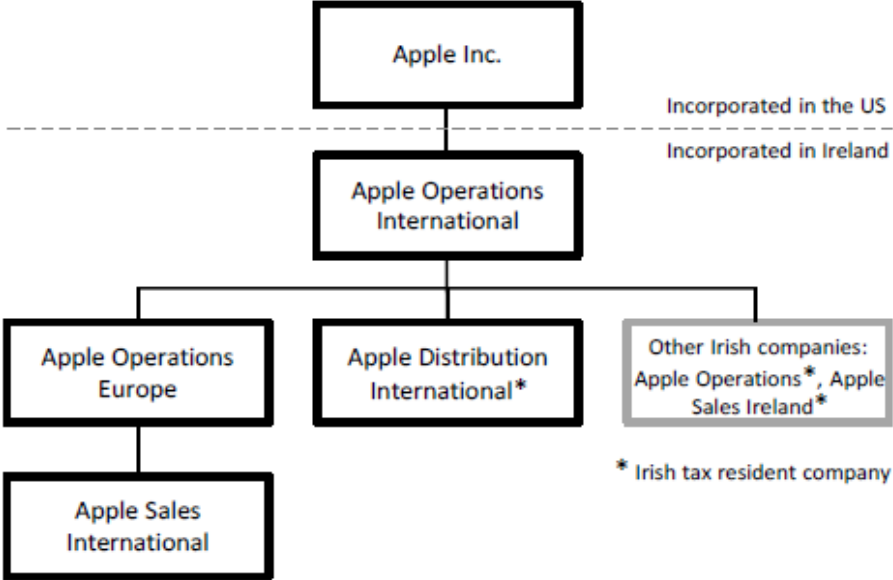
<sup>74</sup> The Finance Act moved to close this loophole by forcing stateless companies incorporated in Ireland to declare a tax residency in another jurisdiction or become liable for its full corporate tax rate in 2015 (Oliver et al. 2014).

<sup>75</sup> For pre-existing companies, such as Apple and Google, it is proposed that the new rule will take effect on 1 January 2021 rather than 1 January 2015 to allow a significant grandfathering period.

<sup>76</sup> A company was not considered an Irish tax resident if (i) it was a tax resident in another country under the application of a double taxation treaty or (ii) the company was listed on a recognised stock exchange or ultimately controlled by a person that was resident in a member state or tax treaty country and those relevant companies or subsidiaries had a trading activity in Ireland (European Commission 2016).

a holding company of the economic rights to IP for Apple goods sold outside of the Americas. It also consolidated cash for the rest of Apple’s offshore affiliates. **Apple Operations Europe (AOE)**, which made MacBooks and **Apple Sales International (ASI)**, which handled the import and distribution of Apple products outside the Americas after they are manufactured in China and was a repository for all of Apple’s offshore IP rights. ASI is a fully owned subsidiary of AOE, which is a fully owned subsidiary of AOI, which is a fully owned subsidiary of Apple Inc in the US. See Figure 1:

**Figure 1:** Apple’s corporate structure in Ireland



Source: European Commission (2016)

ASI and AOE operated in Ireland through branches and neither had a physical head office or employees. Because they were controlled by Apple Inc., which is a tax resident of the US, they were considered ‘relevant companies’ for TCA 97 and were thus not considered tax residents of Ireland. However, neither had a taxable presence in the US either because Apple exploited ‘check-the-box’ and ‘look-through’ rules to circumvent Subpart F of the US tax code (US Senate 2013). AOI

was part owned by Baldwin Holdings Unlimited, based in the British Virgin Islands. It did not have a physical office and its single director is Apple's CFO, who was located in California (Duhigg and Kocieniewski 2012). According to Fernandez and Hendrikse (2015), Apple leveraged the inherent mobility and jurisdictional ambiguity of intangible assets to arbitrage loopholes in fiscal systems. Apple's effective corporate tax rate was 1% of its European profits in 2003 and had fallen to 0.005% by 2014 (European Commission 2016). According to the EC, Apples had shifted a significant component of its worldwide sales through 'stateless' Irish subsidiaries that paid little or no corporate tax and had avoided tax on almost all profits generated in the EU for nearly a quarter of a century (European Commission 2014).

To give context to the magnitude of Apple's Double Irish structure, in 2015 Ireland experienced a sudden spike to 34.4% in nominal GDP growth when Apple on-shored \$300bn of its IP back to Ireland due to the restructuring of ASI. Termed 'Leprechaun Economics' by Krugman (2016), this was the largest recorded individual Base Erosion and Profit Shifting (BEPS) action in history and the largest quasi-tax inversion (Frank 2018). The magnitude of this distortion in Ireland's GDP attracted considerable attention from the EC and International Monetary Fund (IMF) because it led to increased EU budget contributions from Ireland (Department of Finance Ireland 2017).

### **Apple's Investigations and the EC's State Aid Ruling**

As part of a series of investigations into tax avoidance by US MNCs, in May 2013 the US Senate held hearings on how Apple Inc had avoided up to \$44bn in US taxes between 2009 and 2012. It was shown that Apple paid little or no tax on \$30bn in dividends that AOI had received from lower-tier offshore Apple affiliates or \$74bn in income booked through ASI over the period (Holtzblatt et al. 2016). Apple argued that it allocated the correct amount of income to the US for tax calculations given that the ratio of US-to-global pre-tax income was approximately

the same as the ratio of US-to-global sales. Yet 66% of global pre-tax income was being allocated to Ireland, which generated less than 1% of its sales (US Senate 2013). Large foreign countries with high corporate tax rates were allocated only 6% of pre-tax income although they should have been allocated a significant proportion of non-US income. Apple was thus avoiding tax in many other jurisdictions, particularly in Europe. The Senate's investigation concluded that Apple's actions increased the federal deficit, forced other taxpayers to shoulder the tax burden and undermined the fairness of the US tax code. They recommended that Subpart F of the US tax code be strengthened to close the loopholes being used by Apple.

One month later, in June 2013, the EC launched an investigation into the historical Irish tax rulings that allowed Apple to pay far less than Ireland's corporate tax rate of 12.5%. They focussed on two agreements, in 1991 and 2007, that produced an effective tax rate in the low single digits. In June 2014, the EC then launched an investigation into whether these deals breached EU state aid rules, concluding in August 2016 that they did. They argued that Ireland signed the deals, which amounted to illegal tax subsidies, so as not to risk thousands of jobs and other economic benefits that Apple brought to Ireland. In its ruling, the EC referred extensively to Article 9 of the 2010 OECD<sup>77</sup> Model Tax Convention and the OECD's Transfer Pricing Guidelines, as well as its arm's length principle. It states that international intra-group transactions should be priced as if they had been carried out between unrelated parties. The commission argued that transactions between Apple's subsidiaries did not meet the standards of an arms-length transaction and that within the meaning of Article 107(1) of the EU Treaty, the selective advantages

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<sup>77</sup> Despite its central role in international tax matters, the OECD has only recently been studied systematically (Mahon and McBride 2009; Woodward 2009; Martens and Jakobi 2010; Carroll and Kellow 2011; Pal 2012).

bestowed on Apple were effectively being financed using state resources that distorted competition and trade between member states and was thus incompatible with the internal market.

The EC cited Articles 16(1) and 16(2) of Regulation (EU) 2015/1589 that obliges the EC to order the recovery of unlawful aid, including interest, from the date it was granted, subject to a limitation period of 10 years under Article 17. The EC ordered that all profits and interest from ASI and AOE should be allocated to their respective Irish branches for the purposes of calculating back-taxes which amounted to €13bn covering the 2003-2014 period and that Ireland was to recover this amount from Apple (European Commission 2017). As discussed in Garrett (1992), the EU is buttressed by a powerful legal system that seeks to protect the integrity of the single market and according to José Manuel Barroso, it was deemed necessary from a European perspective to try to level the tax playing field in Europe (author's interview, 9 January 2019).

### **Why did Ireland fight the ruling?**

Apple and Ireland both contested the ruling and to some extent unified their responses. They argued that no selective treatment had been granted to Apple and that the tax rulings were governed by Irish law through Section 25 TCA 97. They also argued that retrospective recovery should be excluded, and Apple strongly disputed the technicalities of the calculation of the profit attribution of ASI and AOE to their Irish branches. Both also expressed concerns about the procedural fairness of the EC's investigation, including bias, and questioned why it took twenty-two years to contest the original deal.

Whilst it is obvious why Apple did not want to pay €13bn in back-taxes, it is more puzzling that Ireland did not want to receive it. According to Pierre Moscovici, the EC's Commissioner for Economic and Financial Affairs, Taxation and Customs, the Irish Government's appeal against the EC's ruling was a "strange decision",

given the potential for social and/or economic programs in a country that had been severely damaged by the financial crisis. The EC's ruling would redistribute €2,700 per capita in cash to Ireland; enough to pay for its health service for a year. But Ireland wanted to send a signal to MNCs that it was a safe harbor for FDI and that this was not going to change (author's interview Pierre Moscovici, 4 January 2019).

Since the 1950's, the entire political economy of Ireland was based on achieving job creation and economic development through low corporate taxes and a pro-business regulatory environment. These policies attracted companies such as Apple and Google through the 1980's and 1990's. In a purely rational sense, the value of Ireland's MNC's and their domestic spillovers were higher than €13bn in back-taxes. Also, FDI was popularly perceived as essential to the economic development of Ireland and according to Sorcha McKenna, Head of Dublin McKinsey Office: "there was little public appetite for disrupting Ireland's economic model for two main reasons. Firstly, Ireland was successfully recovering from one of the most severe recessions of any Eurozone economy in the wake of the 2008 financial crash and did not want to rock the boat with MNC's. Secondly, Ireland was concerned about the potential loss of reputation and credibility from losing a state aid case that imposed retrospective taxes because it affected Ireland's attractiveness for FDI; MNC's would think twice if there was a risk that Ireland could come after taxes in the future" (author's interview, 14 January 2019).

The link between low taxes and foreign investment is well studied. Empirically, Agostini (2007) shows that a 1% increase in a US state's corporate tax rate will decrease FDI by 1% and Djankov et al. (2010) show that a 10% increase in corporate tax rate drops FDI as a share of GDP by 2%. According to an extended baseline model of tax competition (Genschel et al. 2016), small countries like Ireland undercut the tax rates of large countries to attract capital because they suffer smaller welfare losses from a 'race to the bottom' in tax rates (Bucovetsky 1991;

Kanbur and Keen 1993). For a small country with a narrow domestic tax base and a relatively large pool of foreign capital to attract like Ireland, there is a higher cost/benefit ratio to capital tax cuts than in a large EU country with lots of domestic capital and smaller pool of foreign capital to attract. Undercutting does not necessarily imply higher capital tax revenues for the small country, especially if its capital tax rate is close to zero, but under the neo-classical assumption of full employment, FDI can push up the capital-labor ratio, increase the efficient use of host country resources, fuel labor demand, lead to higher employment and wages, free the labour it displaces for more productive activity, and ultimately leads to higher tax revenues from improvements in both labor and consumption (Genschel et al. 2016). Yet if there is permanent un- or under-employment, foreign investment can bid up the wages for a small domestic labour elite while consigning some workers to the ranks of marginados (Moran 1978).

Some argue that economic policies like Ireland's undermine efficiency by constraining the ability of benevolent governments to supply optimal levels of tax-financed public goods (Wilson 1999; Zodrow and Mieszkowski 1986) or result in economic distortions such as a lack of domestic innovation (Stiglitz and Pieth 2016). Others insist that tax competition enhances efficiency by limiting the ability of predatory governments to over-tax domestic society (Brennan and Buchanan 1980; Weingast 1995). Other commentators have even argued that due to problems of international tax avoidance, corporate tax should be abolished. Mankiw et al. (2009) argue that consumption should be taxed instead because capital taxes distort intertemporal consumption plans, discourage saving, and because capital accumulation is central to the aggregate output of the economy. At a minimum, aggressive tax avoidance by MNCs might also imply lower optimal corporate tax rates, as Sandmo (2005) argues with respect to personal income tax rates<sup>78</sup>. Toder and Viard

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<sup>78</sup> See also Harberger 1962, Fox and Luna 2002 and Feldstein 2008.



(2014) suggest replacing corporate taxes with shareholder taxes. But the redistributive effects of these policies are non-trivial and depend on whether one views corporate tax as tax on capital, pure profit, entrepreneurship or risk taking (Stiglitz 1976).

It is however possible that Apple earned rents in its dealings with Ireland. In published excerpts from meeting notes in 1990, Apple's tax adviser states to Irish Revenue that Apple was reviewing its worldwide operations and was 'prepared to accept' profit attributable to its Irish branch of \$30-40m, admitting that there was no scientific basis for the figure but that it would not prohibit the expansion of Apple's Irish operations (European Commission 2016). In the Penrose-Kindleberger framework (Penrose 1959, 1968; Kindleberger 1965), MNC's rents from negotiating power stem from some combination of scarcity value to a country, product differentiation, stability of technology and the absolute size of any fixed investment they make. Governments will pay rents from a weak negotiating position if they have a small local market, their rate of growth is low and alternative foreign investment opportunities are limited. These were all true of the conditions surrounding both Apple and Ireland in 1980's.

However, if politicians and civil servants become too close to the marketing of an OFC, it can lead to state capture, where they develop legislation that serves the purposes of the OFC against popular interest (Harrington 2016). They can also become instruments of foreign powers that subvert political processes by co-opting local elites to promote self-interested policies. They can even overwhelm local economies through inflation in the property and labour markets and displace local entrepreneurship and capital (Moran 1978). Regulation can become subordinate to promotion, which can further change norms (Roberts 1995). State capture increases the likelihood of reactions from international organizations that seek to protect their economies from fiscal and regulatory degradation (Christensen and Hampton 1999). That fact that the EC has challenged Ireland is thus a necessary

but insufficient condition to conclude as to the degree of state capture of Ireland by either Apple, or more broadly MNCs who utilized the double Irish tax structure.

In Ireland's rebuttal to the EC's state aid ruling, their main defense was along the lines of sovereignty in that the contested tax rulings had been governed by Irish law at that time under Section 25 of TCA 97. They argued extensively that there was no scope for applying OECD guidelines because they were non-binding on member states like Ireland<sup>79</sup>, let alone retrospectively as the transfer pricing framework was only introduced in 2010 (European Commission 2016). Ireland argued that they had even voluntarily incorporated these principles into Irish law by inserting Part 35A of the OECD's Transfer Pricing Guidelines into TCA 97, through Section 42 of the Finance Act 2010, but that this did not apply retrospectively to the 1991 and 2007 deals. According to Enda Kenny, the former Prime Minister of Ireland (2011-2017): "Ireland appealed this case on the basis that our corporate tax rate has been transparent and applies across all sectors equally. Ireland has been very clear that no special deals have been arranged for any companies and that all discussions in this area are conducted by the Revenue Commissioners, which is independent of the Executive Government. Had Ireland arranged a special deal for any company, then all others could have sought similar facilities" (email, 1 February 2019).

As much of the untaxed profits that the €13bn related to were generated in Europe, Ireland also had reason to be concerned about the both the loss of sovereignty from the EC's ruling and its uncertain future consequences, particularly as Ireland's legitimate claim to the money was debatable. According to the Irish Finance Minister, Paschal Donohoe, Ireland wants to defend its position legally within the European Union, but the €13bn is not owed to Ireland. "We believe it is due to other jurisdictions across the world. Ireland is not a global tax collector and we believe

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<sup>79</sup> Member since 1961.

that this issue is going to be dealt with by the consequences of the tax reform package that was just implemented in the US. They have created an incentive for the repatriation of earnings and they have in effect brought in minimum effective tax rates for global companies. In the upcoming case, that is due to begin before summer, we will be making it very clear that any economic activity associated with Ireland was taxed in Ireland, but the taxation that is due on the global economic activity of Apple is due elsewhere” (author’s interview Paschal Donohoe, 25 January 2019).

In his testimony to the US Senate, Tim Cook, the Chief Executive Officer of Apple, repeatedly referred to both the level and complexity<sup>80</sup> of US taxes, which according to PwC (2009) averaged a Total Tax Rate of 44% for US companies around this time<sup>81</sup>. He argued that Apple would bring the money back to the US if it had a reasonable tax rate and called for an overhaul of the US tax system to better reflect the digital age and changing nature of the global economy (US Senate 2013). “We were waiting for US tax reform, which we knew would come, and following it we paid \$38bn in US taxes; this was a tug of war about who we pay tax to and the US and Ireland agree with us. Ireland was accused of giving Apple a special arrangement, but Irish law applied to all companies. Also, Apple is subjected to US taxes, but on a deferred basis; there was no ‘stateless’ income. What this is really about is how to tax multinationals in the modern world. There are fairness arguments on all sides, but the current laws say that taxes are paid where value is created and for Apple that is in the US. People may want to change the law, and that’s ok, but we can’t just go changing laws retrospectively. It may well

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<sup>80</sup> The US tax system is also more complex than in any other country. In addition to 30 federal taxes, companies are potentially liable for thousands of state and local taxes. Although state and local taxes account for only 24.5% of US taxes borne and collected, companies spend 41.7% of their compliance budget on these taxes, double that of federal taxes (PwC 2009).

<sup>81</sup> Although the average effective tax rate of US corporations was 12.6% in 2010, mainly due to the proliferation of organisational forms such as partnerships and profit shifting overseas (US Government Accountability Office 2013).

be up to the OECD to decide how multinationals divvy up taxes, but the public was led to believe that Apple does not pay its taxes, this is not true.” (author’s interview Tim Cook, 22 January 2019).

### **Why are the Irish people quiescent?**

According to José Manuel Barroso: “on the one hand, the Irish people have largely stood by their government’s decision to fight the EC’s ruling. But on the other hand, they would be happy to receive such a large windfall, which is difficult for politicians to argue against in the era of austerity” (author’s interview, 9 January 2019). So why are the Irish people quiescent in a situation of potential conflict with their government? Either voters (i) are not informed, do not understand or do not care, (ii) they are informed, but wrongly that appealing the EC’s ruling is the right course of action or (iii) they agree with their government.

There has been significant media attention around this issue in Ireland, which has high levels of education, a small and interlinked population, and a strong sense of national identity and independence. In the information age, it is generally understood that people have a good flow of information, although they may seek it from biased sources, or it may be false or misleading. Either way, it seems hard to argue towards the ‘disenfranchised’ hypothesis in the 21<sup>st</sup> century in one of the highest GDP per capita countries in the world. According to Enda Kenny: “this matter has been commented on during the making of these arrangements extensively by the media. The public are quite aware of the outcome to date” (email, 1 February 2019). Whilst the US Senate suggested that these issues are simply too complex for most people to understand, even if MNC’s methods of tax avoidance are complex, the end result and its implications are fairly obvious to a typical voter; fewer public services or a higher price for existing ones. Given that the Irish are informed, and understand the headline arguments, they may however have more

pressing issues of concern, such as the recent crisis and its socio-economic impacts. It is also possible that political disillusionment could be showing up in other ways than in the media or at the ballot box, such as through increased instances of tax avoidance by the populace.

The notion that the information that they form opinions and expectations around could be false or misleading could be termed the 'fake news' hypothesis. It is linked to the third-dimension of power of Gaventa (1980). The way in which power affects the political actions of 'non-elites' has three dimensions. The first is through plurism prevailing in the resolution of key issues. The second is through suppressing certain participants and issues from political dialogue so that some groups benefit at the expense of others. The third dimension is through changing demands and expectations to prevent awareness of issues prevalent to another group's best interests. This is considered the most insidious use of power. The hypothesis is therefore that power may have been used to pre-empt the manifestation of conflict over tax issues in Ireland, or made them non-issues, and suppressed alternative options from public dialogue that led people into taking a suboptimal political approach.

Or people simply agree with their government. Popular support, or at least the lack of popular contempt, for the Irish government's stance would suggest that people perceive that the benefits of appealing the EC's ruling outweigh the costs. A typical voter likely understands that the political economy of Ireland brought in companies like Apple, who did what they were intended to do: Generate jobs and economic benefits in addition to social and technological benefits that generated significant financial flows through expenditure and wages in conjunction with sales, payroll, income and dividend taxes. There has not been any significant polarization of consumption, such as the boycotting of Apple goods, that would indicate significant public anger at Apple either.

Ireland has benefited from the considerable domestic spillovers from Apple's presence, not least the growth in its highly respected tech industry, as well as among the industries that cater to it, as well as improvements in capital and labor. Apple and other MNC's have also propped up property markets and induced skilled and unskilled immigration. But these benefits are possibly concentrated among certain groups of society, such as in urban centers or among professionals. Ireland has a distribution of relative winners and losers in the Apple case and it is possible that certain sections of society gained very few direct or indirect benefits from Apple's presence, and thus to whom €2,700 was a good payoff. In rational economic terms the question boils down to whether the loss of utility from Apple's tax practices are compensated for by the gain in utility from Apple's presence and spillovers.

According to Paschal Donohoe, Minister for Finance of Ireland, there are many reasons why the Irish public were understanding of their government's position, including a very high level of support for fairness and impartiality of the Irish Revenue Commissioner, the Irish taxing authority. "In the aftermath of the EC's decision, they decided that we did not have taxing rights on Apple's foreign earnings and this had a big effect on the debate within Ireland. Also concerns about undermining the integrity of our tax code play a role because the EC is suggesting that we had a special deal for one company. We don't do that in Ireland" (author's interview Paschal Donohoe, 25 January 2019). It is possible that the winners in this episode are the very people who have the potential to sway political actions, set the pressing issues, and mis-inform the losers that they are actually winners. But the risk here is that if the economic establishment avoids taxes and earns rents, with support from the political establishment, and the media misleads the public, then as the losers determine they are losers, populist ideas will flourish. The notion of 'elites' in the political, economic and media establishments is central to populism and increasing in usage in public discourse; perceptions of an unjust tax sys-

tem that benefits elites and MNCs may well be undermining tax and political systems, and even changing norms and ideologies. Either way, it is well established in development economics that material inequality is bad for investment and growth, that countries with higher income inequality have not significantly outperformed countries with lower income inequality (Alesina and Perotti 1996), and can lead to populist and protectionist movements as well as social unrest (Burgoon et al. 2019).

### **Who wins and who loses from Apple's tax avoidance?**

The question of who loses financially from corporate tax avoidance is straightforward; governments and their publics, particularly in countries which have a low share of value creation and high share of corporate revenues. According to Genschel et al. (2016), the bill for aggressive capital tax cuts by small countries is paid for by labor in larger high tax countries via (i) lowered tax redistribution from reduced domestic capital stock and (ii) depressed labor demand from a fall in the capital-labor ratio. Rixen (2016) finds that (i) nationally organized SMEs are burdened as they are not able to exploit tax avoidance strategies, (ii) that generous tax incentives can also raise private returns above social returns and the lowest earners who depend more on government redistribution are hardest hit and (iii) that tax competition has also compelled developed and developing countries' governments to pursue less redistributive policies. But reductions in capital taxes are countered by the political difficulty of shifting tax burdens onto labor, retrenchment in social spending, and increases in public deficits and debts (Swank 2006).

On the contrary, MNC's like Apple and its stakeholders are the clear beneficiary. It has been suggested that Apple's corporate governance was focused on the interests of its shareholders and managers above other stakeholders (Barrera and Bustamante 2018) and because equity ownership is very concentrated, so too are the benefits of stock returns relative to wages (Saez and Zucman 2016). For Apple's

shareholders these returns have been extraordinary; rising from \$0.50 per share in 1980 to \$220 today, or approximately 17.5% compounded annually since Apple incorporated in Ireland. This amounts to a total return of 44,000% over 38 years. As the risk/return dynamics of Apple were skewed towards corporate bonuses and stock returns, the principle beneficiary of Apple's tax avoidance was likely employees who were shareholders, particularly senior managers as they typically own shares.

In fact, as governments have tried to balance fiscal revenues against FDI, the share of income accruing to capital relative to labor has increased in a majority of countries and industries since the mid-1970's (Karabarbounis and Neiman 2013; Bridgman 2014; Jones 2015). Whilst Elsby et al. (2013) show that this downward trend has its origins in reductions in the compensation of payroll employees due to the offshoring of the labour-intensive component of the supply chain, they also show that stock options and other incentive-based pay in the investment banking and tech sectors, as well as tax avoidance have played a role. Whilst the capital-labour income-share ratio is not a perfect measure of inequality, because it does not capture wage inequality (Bridgman 2014; Gordon and Dew-Becker 2008), the income-share of the top 1% has also doubled from 9% in 1976 to 20% in 2011. Incomes at the very top of the 1% are the most unequal, driven by pay increases among the so-called 'working rich', such as Chief Executive Officers (Piketty 2014). The average Chief Executive Officer pay of a large corporation is now 361 times that of the average worker, up from 42 times in 1980 (Warren 2018).

The marginal product of top executives in large corporations is unobservable and difficult to estimate, but changes in it through time cannot explain the abnormal rise in executive pay observed over the last few decades. This has been variously attributed to changing pay norms, a switch from hierarchical to incentive-based pay-models, and 'superstar' (Rosen 1981), 'tournament' (Lazear and Rosen 1981; Persson and Sandmo 2005) and 'winner-takes-all' earnings dynamics (Frank and



Cook 1995). But even relative to ‘market-driven’ top earners (pop stars, athletes, bankers and lawyers), so-called ‘management-power-driven’ top earners (corporate managers and Chief Executive Officers) have an excess component to their compensation (Bebchuk and Grinstein 2005) and this may relate in part to self-serving reciprocity on pay committees (Gordon and Dew-Becker 2008).

Increasing wage inequality since the 1970’s is generally explained by the steady increase in relative demand for skilled labour due to skill-biased technical change and the growing exposure of unskilled workers to international competition through globalization (Katz and Autor 1999; Acemoglu 2002; Atkinson 2007). However, such dynamics cannot explain why the greatest increases in wage inequality over the last 40 years have occurred at the top of the income distribution, i.e. among skilled workers, driven primarily by executive pay increases and linked to falling corporate tax rates (Piketty 2014; Elsby et al. 2013). Following a proliferation of conservatism and neo-liberal economic ideologies across OECD countries (Wallerstein and Przeworski 1995; Swank 2006), corporate tax cuts have redirected money away from governments and boosted the income share of corporates in the economy over time, making them more powerful, and feeding through into executive pay distortions as well as higher returns to capital than labor; further fuelling inequality (Alvaredo et al. 2013; Piketty 2014). Falling corporate tax rates are also linked to a general fall in the progressivity of US federal taxes between the 1960’s and 2004 (Piketty and Saez 2007); falling personal income taxes have further increased the return to bargaining efforts of top executives (Alvaredo et al. 2013) and increased political pressure to cut top taxes rates further and reinforcing income inequality (Atkinson et al. 2011). Tax avoidance can simply be considered as a special case of a regressive tax cut (Piketty and Saez 2003), and in this way can also be linked to raising inequality (Atkinson and Stiglitz 1976).

In a purely rationale sense, Apple's management felt that either the probability of detection, penalties and/or resulting stigma of avoiding tax were low enough relative to the significant financial benefits they gained. But firms like Apple must weigh the costs and benefits of helping to finance the provision of collective public goods from which they benefit versus paying lower taxes and receiving fewer benefits. If everyone avoided tax to the fullest extent possible by law, society would suffer as goods and services that are under-priced by the market, such as psychiatric units, are closed down. Although Apple pays large sums of tax across its value chains, via sales, payroll, income and dividend taxes, they arguably avoided billions in corporate taxes in Europe. Why? In essence, because loopholes allowed them to legally and their profit seeking motivation at the margin exceeded their social conscience.

In some ways the question really boils down to who bears the corporate tax burden? Is it stockholders in the form of reduced returns, workers in the form of lower wages or consumers in the form of higher prices? When it is avoided, does it lead to higher shareholder returns, better paid management and employees, or cheaper products? There is a mixed-distribution of winners and losers from Apple's tax practices that is complex, but at the extremes it seems hard to dispute that senior managers have done well and Apple's effective tax rates in Europe were likely suboptimal in terms of an equity-efficiency trade-off. Whilst in some sense legality is the right test, Apple's moral motivation for perusing such aggressive tax avoidance is questionable; it is morally comparable to tax evasion and thus stigmatized (Allingham and Sandmo 1972). Apple argued that IP income shifting can actually increase the welfare of high-tax countries by allowing MNCs to not outsource their high-paying R&D jobs and operations in the US to low-tax countries. That is, eliminating IP income shifting may result in an increase in corporate tax revenues at the expense of a shift in real R&D activities overseas and the resulting loss of domestic spillovers might exceed the social benefits of higher taxes. The value

split of US corporate activity is approximately 1/3 to shareholders, 1/3 to employees and 1/3 to the government through taxes<sup>82</sup>. Thus, if corporate tax avoidance is considered a special case of tax cut, either the consumer benefits over the company, or shareholders and employees - possibly in an uneven way - benefit from a corporate tax redistribution and will see a boost in their consumption relative to that of the public.

## **Conclusion**

In this paper we have analyzed the puzzling state aid case of Apple and Ireland versus the EC. Specifically, we focus on the peculiar outcome that Ireland is fighting the EC against receiving €13bn in back taxes from Apple. We explore the prevalence, rationale and scale of tax avoidance by MNCs, the political economy of Ireland, Apple's tax avoidance mechanisms, and the resulting US Senate and EC investigations into their relationship. We combine a range of literatures from the fields of economics and politics including the dependencia literature on MNCs, optimal tax rates, development economics and inequality, and combine their insights with interviews from some of the key figures involved from all three sides of the argument. We ask three questions of this case and the answers we present give rise to rich insights into a range of prevalent issues in political economy, including the distributional issues and discord around tax competition, tax design, globalisation, corporatization, state capture, sovereignty, power, legitimacy, morality and inequality.

Firstly, we ask why did Ireland fight the ruling? We find that is it because Ireland wants to protect its economic model of attracting FDI through low taxes and low regulation, suffered a loss of sovereignty from the EC's ruling, and was concerned

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<sup>82</sup> The sum of US taxes borne (corporate tax) and collected (value added tax) amount to around 10% of revenues and 100% of profits (PwC, the World Bank and International Finance Corporation 2017).

about the legitimacy of Ireland's claim to the tax windfall and the EC's approach. In turn, this raises questions about why the Irish government has popular support for a policy that stops the redistribution of €2,700 per capita to the Irish people. We argue that the Irish are largely quiescent with their government's stance because they believe the benefits of defending their economic model outweigh the benefits of receiving a short-term payoff, and have concerns about the independence of Ireland's institutions. To what extent they are correctly informed as to the merits and risks of this approach is a moot point and requires a more holistic analysis of who wins and who loses from international corporate tax avoidance. We argue that the shareholders and employees of MNCs gain at the expense of individuals and SMEs in high-tax countries who are unable to make use of tax avoidance strategies, as well as those who depend heavily on tax redistribution. Management-power-driven senior executives benefit the most and our analysis serves to reinforce previous links between corporate tax avoidance and increasing income and wealth inequality.

Our study necessitates more theoretical and empirical modelling of (i) who should shoulder the tax burden and (ii) how to tax MNCs in the 21<sup>st</sup> Century. The interactions between the various stakeholders discussed in this paper are complex and the implications of policy-driven redistributions are non-trivial. There is also room in the literature for the same theoretical and empirical frameworks that have been used to study optimal personal income tax rates in the presence of tax avoidance to be applied to determining optimal corporate tax rates under similar conditions. The extant literature suggests that well-considered tax rates might incentivise a lower propensity to avoid tax and a higher elasticity of taxable income; the recent Trump tax cuts that included tax discounts for MNCs to repatriate deferred income were based on this reasoning. In equilibrium taxes should be as low as possible on the one hand to maintain civil societies' needs but on the other hand not incentivize moral hazard on behalf of governments, stifle growth and innovation, or incentive

large-scale tax avoidance and evasion. Different countries will naturally have different spending needs and hence tax rates, but in the presence of fair rules and standards, tax competition could be healthy.

The case continues in summer 2019 through a court trial, the outcome of which will have a significant effect on the future path of the debate on global tax competition, sovereignty in the EU, and the power and responsibilities of multinational corporations in a globalized world. The public pressure that has resulted from this episode has seen governments on both sides of the Atlantic working to eliminate the most aggressive forms of tax avoidance by closing some of the loopholes discussed in this paper. Also, transfer pricing rules have been strengthened and governments have been brought in line with them (Lohse and Riedel 2013). For instance, in 2014 the OECD released a 15-point action plan supported by the G20 called Base Erosion and Profit Shifting (BEPS) to move toward international coherence in corporate taxation. The aim of BEPS is to realign taxation with relevant economic substance and ensure that taxable profits cannot be artificially shifted (Kaye 2014). It requires MNC's to disclose their allocations of income, economic activity, and taxes paid to the relevant tax administrations across the countries in which they operate. Still, international tax co-operation, co-ordination and distributional problems pertain and are unlikely to be resolved absent a multilateral approach via some global tax governance mechanism, possibly under the auspices of either the OECD or UN. Rixen (2016) outlines the institutional design of such an International Tax Organisation but due to the complexities and sensitivities of such an approach, progress to date has been slow.

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## 6. Conclusion

This thesis looks at the roles of power, legitimacy and sovereignty in solving cooperation problems over international taxation. It provides a set of case studies on exercises of power by dominant states and IOs in order to enact change in tax havens, the legitimacy of their approaches, and the limits of sovereignty in a globalized world. Specifically, I have analyzed the surprising demise of Liechtenstein's and Switzerland's banking secrecy regulations, the bringing of tax havens in line with global tax standards and money laundering regulations, and the EU's attempt to stop Ireland from facilitating international tax avoidance by MNCs. This body of work contributes to the field of international political economy in number of ways.

Firstly, I have documented, analyzed, contrasted and compared the various mechanisms and instruments of power available to dominant states and IOs in solving these cooperation problems. That is, promoting fairness-based rules and standards, the logic of appropriateness, extraterritorial assertion of law, blacklisting, restrictions on market access, and economic and legal sanctions. In this way, I have shown that coercion has played an important role in overcoming these cooperation problems, particularly where the scope of the problem was large and/or results were wanted quickly. Secondly, I have shown that contrary to the suggestions of the bulk of the literature on offshore finance, sovereignty and the resulting boundaries of regulatory jurisdiction have not protected the economic models of tax havens. That is, in solving cooperation problems, Westphalian sovereignty has been relaxed in favor of newly legitimized norms, such as transparency, fairness and equality. Lastly, I have shown that many of the instruments and exercises of power used to solve these cooperation problems are of debatable legitimacy. FATCA and the FATF's Recommendations in particular stand out for their debatable procedural legitimacy in overriding state consent, even if their intended outcomes were more

easily justifiable. Lastly, I have unpacked and disentangled many complex political, economic and social processes by combining secondary sources with hundreds of interviews and exchanges that have generated a wealth of primary research. These have included the views, opinions and thought processes of many of the key people at the center of the various initiatives and conflicts that I have analyzed.

Under their new regimes, the tax havens I have studied have had to bare significant adjustment costs and are now less attractive economic centers. This will likely depress wage levels, tax revenues and welfare within these states (Hakelberg 2016; Genschel and Seelkopf 2015). Even if they are pragmatic and adaptable in the sense of Katzenstein (1985), this body of work begs the questions of what do these states do next? Can they replace losses in capital and labor through new economic models and innovation? If they cannot, they may have to accept losses in sovereignty and welfare as the expected costs of globalisation. Although an extreme case, Nauru was forced to withdraw from international financial services, has no solvent banks and depends on foreign aid and maintaining immigration detention centers for Australia. FATF Executive Secretary Rick McDonell, who spent time in Nauru for the FATF's investigations, informed me that the FATF never considered the social impacts and implications of their approach; it was beyond their remit (author's interview, 31 January 2018). But who has? It has been argued previously that economic coercion can lead to a reduction in quality of life and security, lead to human rights abuses, and widen the income gap (Gibbons and Garfield 1999; Weiss 1999; Cortright et al. 2001). All of which are present in today's media accounts of Nauru.

This raises questions about the quasi-regulatory and quasi-legal powers of technocratic IOs such as the OECD and FATF in solving cooperation problems. My work highlights that they exercise distinctive forms of social power and authority and are uniquely placed among IOs to take the lead on a range of international issues.

But given their eminence in such matters, there are surprisingly few academic studies that look at the powers that they wield, the legitimacy of their approaches, or the social effects of their policies (Woodward 2009; Mahon and McBride 2009; Martens and Jakobi 2010; Carroll and Kellow 2011; Rose 2015). My work attempts to bridge some of these gaps, but calls for further research in this direction, especially in terms of social impacts. There are negative externalities to the various approaches and initiatives that I have documented, such as discord and increasing inequality, particularly for states with more marginal economies. Inequality is one of the most pressing issues of our time (Stiglitz 2019). Should tropical islands be resigned to growing bananas (Sharman 2006)?

This thesis also raises questions about the time-varying role of IOs in solving cooperation problems and promoting global governance mechanisms. The OECD's role has evolved significantly over the years from the economic reconstruction of Europe to international tax policy. The FATF's mandate has evolved from combatting drug trafficking to terrorist financing, non-proliferation and most recently corruption. The same instruments of power that were used to stem the flow of Columbian drug money, were then used to crack banking secrecy, then terrorist financing in the wake of 9/11 and are currently being used to curb DPRK's and Iran's proliferation activities. These IOs have laid down mechanisms of power and control over the years that can be repurposed depending on the political agendas of their member states. Many would argue that even the EU's role has evolved, from its origins as a free-trade area toward a federalist super-state. Pauly (1999) casts doubt on the wisdom of extending IOs mandates as they are prone to becoming conduits for their powerful member states' agendas. Barnett and Finnemore (2004) and Eccleston and Woodward (2014) argue that IOs pursue goals and policies that can ultimately create contradictions to the IO itself, and in some cases end up behaving in a manner which is explicitly contrary to the IOs long-term goals. Ban et al. (2016) argue that the global regulatory regime is being extensively

shaped by IOs that exhibit very particular institutional agendas and biases. In this way, like Swedlund (2017), I argue that political scholars need to pay close attention to the institutional incentives of rule-implementing agencies as well as their political motives and tendency towards mission creep.

As for the limitations of this thesis, firstly, due to the complexities of defining power and the resulting lack of fully-specified theories about it (Stone 2011), I have purposely simplified my running definition to the ability to enact change. In this way, I have avoided getting bogged down in mapping the various instruments and exercises of power I have studied onto the precise typologies of power in Barnett and Duvall (2005) and others. Where possible, I have relied on the somewhat oversimplified typology of hard versus soft power of Nye (2004, 2008) but acknowledge that deeper, more considered and more elaborate definitions of power would enrich this body of work further. Secondly, because legitimacy is a tricky concept, I never definitively argue for or against the legitimacy of the various approaches studied. I merely highlight where questions can be raised about the legitimacy of certain practices and processes and frame arguments in terms of differences in outcome legitimacy (eradicating money laundering is legitimate) versus procedural legitimacy (is it right to exercise anti-terrorist financing sanctions on a tiny tropical island and close down its only bank?). Given its subjectivity, I leave making strong conclusions about the legitimacy of the various approaches that I have documented to the reader. At a minimum this thesis suggests that the imposition of automatic exchange of information, tax standards, Anti-Money Laundering (AML) regulations, and state aid rulings on tax havens, should be viewed as instances of redistributive co-operation under duress rather than mutually beneficial deals (Oatley and Nabors 1998; Hakelberg 2016).

The findings of this thesis have important implications for the future direction of global governance, which according to some authors is the only way to get people to cooperate on economic, environmental, security, and political issues, settle their

disputes in a nonviolent manner, and advance their common interests and values. However, international tax cooperation, coordination and distributional problems pertain. This body of work suggests that the utopian solution to such complicated and emotive issues is via a multilateral approach that combines well-considered, fairness-based and inclusive policy, ratified and endorsed by broad membership IOs such as the UN, and is supported by multilateral sanctions for failure to comply. Rixen (2016) outlines the institutional design of an ‘International Tax Organization’ but due to its complexities and sensitivities, progress to date has been slow. The expected benefit of such an approach would be a level playing field in international taxation that stops a race to the bottom in tax levels, public services and welfare, particularly in large high-tax states. But it would involve infringements on sovereignty as an expected cost, as well as the likelihood of capital and labor transfers from more marginal economies to less marginal ones. By analogy, a level playing field in soccer has not typically helped Ireland, Switzerland or Liechtenstein in their endeavours to beat Germany.

Some argue that absent an adequate supply of global governance, states are likely to retreat behind protective barriers and re-create the conditions for enduring conflict (Barnett and Duvall 2005). But there has been significant push back against the neo-liberal ideals that underpin globalization in recent years, perhaps most evident in Europe. Where Stein (2008) states: “Nowhere is the decline of sovereignty more apparent than in Europe”, I would add that nowhere is the push-back against the decline in sovereignty more apparent than in Europe. Structural economic imbalances, political discord, populism, the rise of extremist views, anti-immigration sentiment and now country exit are serious existential threats to the future of the European project; one of the center pieces of globalization and governance models. In this way, this thesis strikes at the heart of another pressing issue of our time: more globalization and governance, or more sovereignty and independence? In many ways, this schism is related to the capital versus labor debate that is a key

theme in this thesis, and the field of political economy more generally. Laborers with little capital – the precariat – can use populism and their equal voting rights in the political process to address power imbalances versus elites and the other distributional winners from globalization. I find myself asking, how can their co-operation problems be solved?

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## **Curriculum Vitae**

Katrin Eggenberger joined the World Economic Forum in January 2016. She is working closely with Prof. Dr. Klaus Schwab, Founder and Executive Chairman of the World Economic Forum, on a new global digital platform for start-ups, tech entrepreneurs, businesses, governments and universities called UpLink, for the purpose of serving the 17 Sustainable Development Goals (SDGs) of the United Nations. In her capacity as Chief of Staff, she had staffed him on travel to over 25 countries. In an additional capacity, she heads the World Economic Forum's Community of Chairpersons, which is comprised of over 100 of the world's most influential chairpersons of large corporations who meet to discuss in an informal and trusted manner the key challenges they face today. Katrin is Asian Forum on Global Governance Fellow 2016, Atlantic Council Millennium Fellow 2019 and Maurice R. Greenberg Yale World Fellow 2019.

Prior to these roles, Katrin was visiting researcher at Harvard University's Berkman Klein Center for Internet & Society and joined the Liechtenstein Institute on Self-Determination (LISD) at Princeton University's Woodrow Wilson School of Public and International Affairs. In 2014, she completed classes at the London School of Economics and Political Science (LSE) and University of Cambridge.

From 2002 until 2014, she worked at several financial institutions in Liechtenstein and Switzerland, latterly as a Director-level manager in Switzerland's oldest private bank, heading their fund-based wealth management department. She received her MSc and BBA degrees from the University of Liechtenstein. Katrin is a native of Liechtenstein and Switzerland. She competed for 20 years in team sports internationally.