The Hypocritical Hegemon

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The Hypocritical Hegemon: How the United States Shapes Global Rules against Tax Evasion and Avoidance.


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On 22 May 2013, Austria succumbed to the European Union’s Orwellian system. Instead of protecting the civic rights of Austrian citizens, Werner Faymann, the Austrian chancellor, abandoned the country’s freedom and sovereignty. At least in the hyperbolic rhetoric of Heinz-Christian Strache, the leader of Austria’s right-wing populist party FPÖ (Freedom Party of Austria), this is what the chancellor’s decision to end bank secrecy came down to. What had actually happened? The day before Strache aired his accusations at an urgently summoned parliamentary session, the EU’s heads of state and government had agreed to extend the automatic exchange of information (AEI) on foreign-held bank accounts by the end of the year. Data reported from banks to tax authorities would no longer be limited to interest payments, and Austria and Luxembourg, the two countries that had resisted the information exchange for decades, would finally participate. In Austria, this decision implied the abolition of constitutionally enshrined bank secrecy provisions prohibiting the dissemination of client data and thereby increasing the country’s attractiveness to tax evaders. In fact, I would learn much later that Austrian bank secrecy was the real reason my grandmother took me and my sister on annual hiking trips to Kleinwalsertal, an alpine valley on the border with Germany, during the 1990s. We—the two unsuspecting children—were covering the repatriation of savings our grandfather had hidden there from the German fisc decades earlier.

Why did Werner Faymann end Austrian resistance to the automatic exchange of information in 2013? Owing to the unanimity requirement for decisions on direct taxation, his government could have blocked the corresponding directive in the Council of the European Union. Austrian finance ministers had done so many times before. After all, bank secrecy had made the country the second-largest recipient of deposits from nonresident households in the Eurozone behind Luxembourg. This meant good business for Austrian private banks and turned peripheral regions like the Kleinwalsertal from agricultural zones into small financial centers. Moreover, the country’s citizens had become firmly attached to the concept. Interview partners from across Austria’s political spectrum told me that the public considered bank secrecy a “holy cow” not to be touched. Still, Faymann sharpened his butcher’s knife just a few weeks before general elections in September, providing Strache’s Eurosceptic FPÖ with a welcome opportunity to deplore another shift of Austrian sovereignty to Brussels.
In this book, I argue that the end of bank secrecy in Austria, and in all other traditional secrecy jurisdictions for that matter, ultimately results from a credible threat of sanctions issued by the United States. This threat was contained in a little-noticed law attached to the Obama administration’s second stimulus package after the financial crisis: the Foreign Account Tax Compliance Act (FATCA). FATCA obliges foreign banks to routinely report US clients and their capital income to the Internal Revenue Service. If a bank fails to comply, the agency is allowed to withhold 30 percent of the payments this institution receives from US sources. Because of the US market’s dominant role in international finance, no foreign bank could afford such a steep penalty. Accordingly, foreign banks began to lobby their home governments to abolish secrecy provisions preventing the banks’ compliance with FATCA. By dismantling the legal barriers to the dissemination of bank account information, however, secrecy jurisdictions also became vulnerable to information requests from third countries. Because of a most-favored-nation clause contained in an EU directive, Austria and Luxembourg were, for instance, obliged to also exchange information with other EU member states after signing FATCA agreements with the United States. Owing to similar constraints, all of the world’s traditional secrecy jurisdictions had joined a multilateral agreement on automatic information exchange by 2018.

This breakthrough stands in sharp contrast to conventional wisdom on international tax politics. According to a contractualist narrative, international capital mobility creates prohibitive enforcement costs. As soon as a tax haven makes concessions on secrecy or tax rates, so the logic predicts, investors will move their assets to a location that continues to offer the desired benefits. The payoff to remaining a tax haven thus increases with the number of governments complying with global standards. Hence, the last tax haven will benefit so much that it becomes impossible for other governments to offer equivalent side payments. In contrast, FATCA achieved global compliance with US demands through an almost costless sanctions threat. Likewise, a constructivist narrative suggests, shared international norms should protect tax havens from interventions by the international community. Since all governments wanted respect for their national sovereignty, especially when exercising their tax prerogative, they shied away from curtailing this right for others. Yet FATCA forced scores of governments to revise or repeal domestic laws, including—as in the Austrian case—their constitutions, and imposed significant adjustment costs on their economies.

Against this background, I provide a new narrative highlighting the ability of a great power like the United States to overcome the structural and normative constraints emphasized by previous accounts. Through credible sanction threats, linking market access to compliance with tax policy demands, the great power wrestles costly concessions from less powerful states, including the most sophisti-
cated tax havens. After all, the income that zero-tax jurisdictions help to hide or divert is usually earned in major economies. If that income can no longer be channeled out tax free, the tax haven loses its raison d’être from the perspective of the investor. Accordingly, the tax haven depends even more on unhindered access to major markets than on secrecy provisions or tax breaks. At the same time, an investor will have difficulty circumventing regulation by a great power through divestment or a change of location. By definition, a great power accounts for a significant share in global demand, so withdrawing from its market comes with important opportunity costs. If the great power decides to apply its rules unequivocally to all outside investors, also choosing a different conduit for an investment will not protect the investor from its regulatory reach. Finally, the United States controls access to the world’s reserve currency. Since international transactions are most often denominated in US dollars, even banks without significant US exposure need access to the currency and corresponding clearing infrastructure.

By preventing tax havens from abetting tax evasion and avoidance, however, the great power may also remove competitors for foreign investment. In fact, the Obama and Trump administrations have consistently refused to reciprocate the automatic reporting of account information they impose on everyone else. Tax evaders who used to hide their wealth in Switzerland have reacted by shifting their assets into trusts registered in secretive US states such as Nevada or South Dakota. Accordingly, the value of foreign deposits in the US has rapidly increased since the passage of FATCA, whereas it has sharply declined in most traditional secrecy jurisdictions. Although the US may thus have become the most important secrecy jurisdiction for EU residents, member states have been unable to wrestle reciprocity from the US government. The common market and consensus on automatic exchange of information with each other apparently do not suffice to match US power. The reason is that the EU suffers from regulatory dispersion in tax matters. Every decision on direct taxation, including the blacklisting of tax havens and the implementation of economic sanctions, still has to be made unanimously. Hence, a single veto is enough to prevent countermeasures from the entire EU. Unless member states centralize regulatory authority with the European Commission, the United States will thus be able to sustain its hypocritical stance on financial transparency.

If the US government has the power to tackle tax evasion by US residents with foreign accounts by imposing hypocritical standards on the rest of the world, however, a second puzzle emerges. Next to the enforcement of financial transparency, the Obama administration had also promised countermeasures to corporate tax avoidance at the outset of the administration’s first term. Moreover, the administration had an opportunity to press for change in negotiations over the base erosion and profit-shifting (BEPS) project launched in 2013 by the Organisation for
Economic Co-operation and Development (OECD). Still, the administration ended up defending the international tax system’s status quo against reform proposals from European governments. Thereby, the Obama administration perpetuated an orthodox interpretation of the fundamental principles of international tax law, which allow multinationals to geographically separate taxable income from underlying economic activity. Why did the Obama administration use US power to curb tax evasion by US households but not to limit tax avoidance by US multinationals?

To understand when the United States enforces and when it obstructs progress in the global fight against tax dodging, we need to analyze the nation’s domestic politics. The easiest way for a government to maximize the sum of tax revenue and domestic production is regressive tax reform. Such reform shifts the tax burden from mobile capital to immobile labor and consumption. Since workers and consumers cannot usually exit the country as easily as investment, this strategy minimizes the risk of losing tax base to higher tax rates. Since the rich earn a larger share of their income from capital than the poor, whereas the poor spend a larger share of their income on consumption than the rich, however, this strategy also shifts the tax burden from the strongest onto the weakest shoulders and exacerbates income inequality. Therefore, voters with a preference for redistribution often oppose regressive tax reform. A Democratic government is thus more likely to support progressive tax reform that puts the largest burden on the strongest shoulders. For this strategy to be effective, however, the administration needs to prevent the most potent taxpayers—wealthy individuals and profitable corporations—from shifting their wealth and income abroad. Hence, a Democratic administration should be in favor of countermeasures to tax evasion and avoidance.

But this support is not enough for countermeasures to materialize. Affected interest groups may wield enough power in the political process to block proposals increasing their effective tax burden. This power depends on their ability to access policymakers, credibly threaten them with divestment, and convince them of the legitimacy of their tax avoidance schemes. A multinational corporation could, for instance, threaten to cut jobs in a policymaker’s electoral district if she supports higher taxes on its foreign income. Alternatively, the corporation could stress the legality of its tax-planning strategy, shifting the blame for tax avoidance toward legislators writing incoherent tax codes. In contrast, wealthy individuals who evade taxes by underreporting their foreign income break the law. Despite their access to policymakers, these individuals may thus find it difficult to openly state their case. Tax-evading individuals should thus wield less power in the political process than tax-avoiding multinationals. Accordingly, a Democratic administration should adapt its position to opposition from tax-avoiding multinationals but not to opposition from tax-evading individuals.
When we look at international tax policy from this perspective, we understand why FATCA creates new reporting requirements for foreign banks but none for US financial institutions. The Obama administration wanted to curb offshore tax evasion by US taxpayers. Simultaneously keeping US wealth managers from abetting tax evasion by foreign taxpayers would have provoked resistance from the financial sector, endangering the survival of the entire legislative project. Hence, the United States forced all other governments to deliver data but spared domestic banks from a meaningful increase in financial transparency. Likewise, we understand better why the Obama administration defended the international tax system’s status quo against European attempts to curb base erosion and profit-shifting at the OECD. After its own attempts at keeping US multinationals from deferring tax payments on their foreign profits had failed, reforms proposed by European governments could have attributed some of that untaxed income to their coffers. Hence, the Obama administration decided that minimizing the foreign tax burden of US multinationals was still better than having European governments increase their tax take at the expense of the United States. Accordingly, US multinationals started to pay taxes on their foreign profits only once the Trump administration provided tax-haven conditions itself, reducing the applicable tax rate from 35 to 10.5 percent.

Does this narrative imply that international countermeasures to tax evasion and avoidance can never be implemented against the will of powerful interest groups in the United States? Since market power is decisive in international tax politics, this book suggests that bargaining dynamics will change only once the EU centralizes regulatory authority over international tax matters. Centralization would enable member states to request compliance from foreign banks and corporations as a bloc. If access to the common market was at stake, even US banks and multinationals should be willing to report account data or pay tax on their local business profits. The European Commission’s state aid investigations into selective tax advantages granted to Amazon, Apple, or McDonald’s may effect progress in this direction. By instructing EU tax havens to claw backforgone tax payments from privileged corporations, the Commission creates uncertainty over the legality of their sweetheart deals. As this reduces EU tax havens’ attractiveness as destinations for profit-shifting, they lose their competitive advantage over other member states and may eventually become more interested in common rules.