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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.*

KEYWORDS: Vulnerability, Small states, Offshore finance, Banking secrecy

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.[1]

[1]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.

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 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.[2]

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.

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

[2] 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.

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: 10).

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: 148ff.). 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.[3]

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; Holzinger 2005; Sharman 2006, 2008).[4]

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

[3] 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).

[4] 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.

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 2015). 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 2008, the finance ministers of 17 OECD member states met in Paris to discuss joint strategies to combat tax havens (OECD 2008: 6), 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.[5] 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 offshore 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?

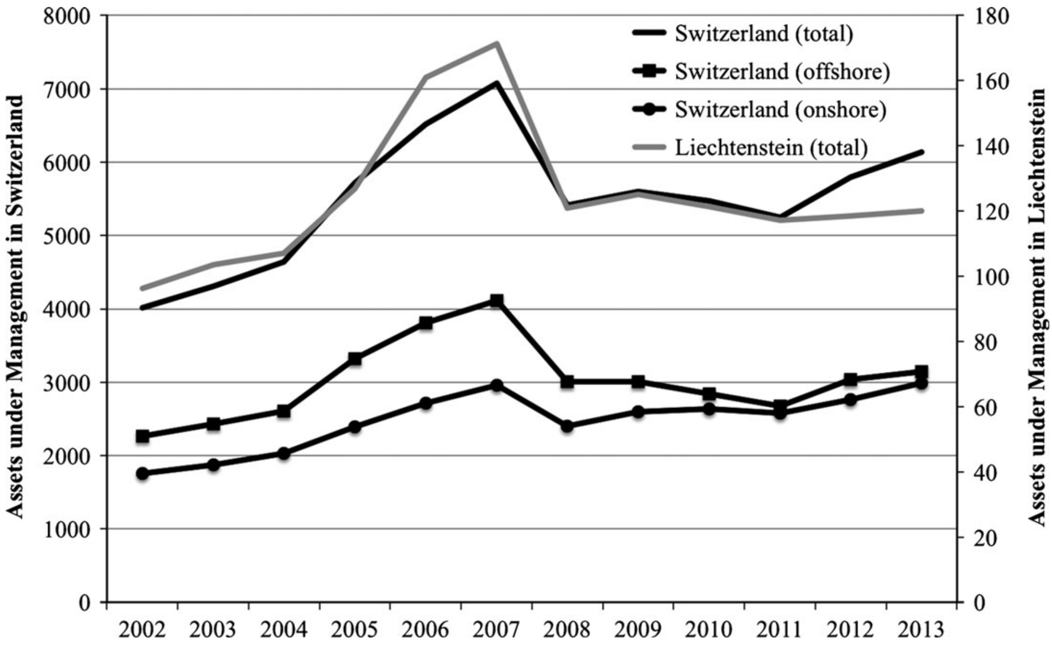
[5] Of course, these are not the only challenges the two countries faced. For instance, the EU also demanded more information exchange. However, the EU was not able to exercise the same amount of pressure as the USA, while it channelled most of its activities through the OECD.

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

Figure 1: Development of assets under management in Liechtenstein and Switzerland (2002–2013, in billion CHF)



Sources: The Swiss numbers are the result of our own calculations based on data from the Swiss National Bank, URL: http://www.snb.ch/de/iabout/stat/statput/bchpub/stats/bankench (accessed on September 8, 2014). The data on Liechtenstein are from Statistik Liechtenstein (2014: 24). Unfortunately, in the case of Liechtenstein, the available data does not allow us to distinguish between offshore and onshore assets.

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 locus 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-determination and neutrality (cf. Bornschier 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.[6]

[6] URL: http://www.llv.li/#/12281 (accessed on September 21, 2014).

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 2012). 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 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 2015). 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".[7] 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

[7] 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: 2).

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 the financial services industry.[8] 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 statement in advance of the hearing that its current practices were no longer those described in the report.[9] 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.[10]

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

[8] 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.
[9] NZZ, "LGT nimmt nicht an Hearing teil", July 17, 2008.
[10] Telephone interview, September 3, 2014.

countries. Facing exclusion from the US market, Liechtenstein had no choice but to negotiate. As Simon Tribelhorn, CEO 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".[11] 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 preparations for the transfer of information in only 26 cases (Schaub 2011: 214f.). 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: 9; GPK 2010: 3361). 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 2015). 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.[12] Clearly, Switzerland was not willing to go any further than ultimately needed.

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

[11] Telephone interview, August 25, 2014.

[12] 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.

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.[13] 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: 3).

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.[14] 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".[15] 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

[13] The Hereditary Prince's brother, Prince Maximilian, is the CEO of LGT.

[14] Interview, NZZ, "Wir sind jetzt aus der Schusslinie", March 14, 2009.

[15] 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.

client files of US persons. However, 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.[16] 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".[17]

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 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.[18]

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".[19]

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

[16] 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.

[17] Interview, Vaterland Magazin, "Wir können uns schnell ändern", March 24, 2012.

[18] 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).

[19] Interview, Tages-Anzeiger, "Die Schweiz ist keine Bananenrepublik", August 24, 2013.

indicting Wegelin & Co., which within a month was subsequently forced to sell its non-US business. The Swiss government made several 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.[20] 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 2013).

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

[20] Personal interview, September 5, 2014.

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 dropped in 2014. In October 2014, the Swiss government announced to introduce AEI by 2018.[21]

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 2006). In addition, banking secrecy is if anything more important to Liechtenstein, given its (almost exclusive) focus on offshore wealth management. Liechtenstein's 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-

[21] 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.

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.[22] 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".[23]

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 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

[22] Interview, Schweizer Monat, "Vor und nach dem grossen Kater", June 2013.
[23] Interview, Finanzplatz Schweiz, "Opportunitäten gezielt wahrnehmen", July 3, 2014.

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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