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Swiss banking secrecy and the problem of international cooperation in tax matters: A nut too hard to crack?

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Abstract

How was Swiss resistance to international cooperation in tax matters overcome? This article argues that while Swiss banks are structurally dependent on access to the United States (US) financial market, Switzerland is structurally dependent on the economic welfare of its largest banks. Taking advantage of a tax evasion scandal in the midst of the global financial crisis, this indirect dependence gave US law enforcement authorities the opportunity to exercise pressure on Switzerland by threatening to criminally indict Switzerland's largest bank. The tax evasion scandal and subsequent Swiss concessions to the US had two important consequences for international tax cooperation. First, the scandal provided a focal point for collective action that allowed other countries to coordinate their strategies and direct them against the country that had been identified as uncooperative. Second, the scandal undermined Switzerland's ability to impede collective action because the bank's public admission of wrongdoing demonstrated the necessity of international tax cooperation.

Keywords: banking secrecy, collective action problem, demonstration effect, economic dependence, focal point, international tax cooperation.

1. Introduction

The international system's capacity to devise effective governance responses to economic challenges is a key topic in international political economy research. A critical test case of this governance capacity is international tax cooperation (Eccleston 2012). As a result of financial secrecy, governments may have insufficient knowledge of taxable assets that are held abroad. Hence, owners of such assets may attempt to evade taxation by not disclosing the ownership of assets or their real size (Palan *et al.* 2010). The most straightforward solution to tax evasion is cooperation between national tax authorities. However, international tax cooperation is often likened to a prisoner's dilemma because individual jurisdictions face strong incentives to defect from cooperation, despite likely system-wide welfare benefits from such cooperation (Rixen 2008).

Nevertheless, recent years have witnessed remarkable progress with regard to international tax cooperation, culminating in the publication of a new Organisation for Economic Co-operation and Development (OECD) global standard on the automatic exchange of information (AEI) in 2014, which, by now, almost 100 countries have promised to adopt, including several well-known secrecy jurisdictions.[1] Clearly, the AEI will not eradicate harmful tax competition, but given the pessimistic assessments of the viability of international tax cooperation in the mid-2000s, this progress in international tax cooperation is remarkable (Palan 2002; Webb 2004; Eden & Kudrle 2005; Woodward 2006; Sharman 2008).

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The existing literature has highlighted two main factors that made this progress possible (Eccleston 2012; Steinlin & Trampusch 2012; Kudrle 2014; Hakelberg 2015). First, effective international tax cooperation is critically dependent on key states in the international tax regime. In particular, recent efforts to improve cooperation have enjoyed the support of the United States (US). Second, the global financial crisis opened a window of opportunity for improved cooperation because the financial sector was blamed for the crisis and several states faced unprecedented public deficits. In the words of Eccleston (2012, p. 81), "[i]n these circumstances a proposal for improving international tax transparency was arguably an idea whose time had come."

However, the US is not the only key actor whose support is necessary for effective international tax cooperation. Eccleston (2012), among others, highlights the central role of Switzerland, whose opposition to international tax cooperation was key to the failures of previous attempts to improve cooperation (Sharman 2006; Palan *et al.* 2010). Swiss banks are estimated to manage up to one third of the world's offshore wealth (Boston Consulting Group 2011). In addition, Switzerland's almost legendary banking secrecy has a long history, which is why Finkelstein (1999, p. 6) calls Switzerland "the old grand-daddy of tax havens." Hence, "the legitimacy and effectiveness of any multilateral attempt to improve tax transparency is critically dependent on Swiss support" (Eccleston 2012, p. 68).

However, until recently, Switzerland had rejected any attempts to improve international tax cooperation, pointing to its right as a sovereign state to determine its own tax laws. Importantly, Switzerland was not only able to withstand pressure from the European Union and the OECD, but also repeatedly from the US (Simmons 2001; Vogler 2005; Steinlin & Trampusch 2012). Given this history of successful resistance, the Swiss government showed no inclination to make concessions when it faced renewed international criticism in 2008. Instead, the Swiss Finance Minister famously claimed that opponents of Swiss banking secrecy would find it once again "a nut too hard to crack."[2] As it turned out, it was not. In 2014, after having made several concessions in the preceding years, the Swiss government agreed to implement the AEI by 2018.

To explain this sudden turn of events, Steinlin and Trampusch (2012) point to the important role of outside pressure, which weakened the veto possibilities of Swiss opponents of reform. After the global financial crisis had increased the salience of tax evasion, major international actors openly criticized banking secrecy and demanded reform. We agree with this account but consider it incomplete for two reasons.

First, while it seems clear that irresponsible bank behavior caused the global financial crisis, Swiss-style banking secrecy played little part in it (Engelen *et al.* 2011).[3] Nevertheless, the crisis triggered action against secrecy jurisdictions, while it did not result in substantial reregulation of derivative contracts or shadow banking. To explain this inability to reregulate finance, authors point to collective action problems resulting from jurisdictional competition for mobile resources (Rixen 2013). However, the same collective action problems are typically also used to explain why it is so difficult to put pressure on secrecy jurisdictions like Switzerland (Holzinger 2005; Rixen 2008; Sharman 2008).

Second, while there is a broad consensus that the public shaming of Switzerland as an uncooperative jurisdiction by the OECD contributed to increasing outside pressure (Steinlin & Trampusch 2012; Eccleston & Woodward 2014; Kudrle 2014), it remains less clear how countries such as Switzerland ended up on these blacklists in the first place (after having been "whitelisted" only a few years earlier). As blacklists are the result of political processes, the political process leading to their creation has to be part of any account that emphasizes their causal role.

This article analyzes how the international community was able to overcome the collective action problem characterizing international tax cooperation. In particular, by conceptualizing international tax cooperation as a *repeated* prisoner's dilemma with multiple players and theorizing the effect of exogenous events, such as banking scandals, we demonstrate that US unilateral action against Swiss banks was decisive in paving the way for collective action against Switzerland.

More concretely, following the literature on structural economic dependence (cf. Simmons 2001), we argue that while international banks are structurally dependent on access to the US-controlled, dollar-based financial system, Switzerland is structurally dependent on its largest banks' economic survival. Taking advantage of a major tax evasion scandal in the midst of the global financial crisis involving UBS, Switzerland's largest bank, this indirect dependence provided US law enforcement authorities the opportunity to exercise pressure on Switzerland by threatening to criminally indict UBS. In the case of banks, criminal indictments by US authorities are considered to be a "corporate death penalty" (Garrett 2014, p. 14). Hence, given Switzerland's structural dependence on the survival of UBS, the Swiss government had little choice but to intervene and make concessions to the US with regard to banking secrecy.

The tax evasion scandal and subsequent Swiss concessions to the US had two important consequences for collective action in the field of international taxation. First, the scandal provided a focal point that allowed other countries and international organizations to overcome collective action problems by coordinating their strategies and directing them against the country that had just been identified as uncooperative (Schelling 1960). Second, the scandal undermined Switzerland's ability to impede multilateral action because the bank's public admission of wrongdoing demonstrated that more international tax cooperation was necessary to reduce tax evasion (on such demonstration effects, see Mattli & Woods 2009).

The tax evasion scandal, thus, simultaneously facilitated and legitimized collective action. Taking Swiss concessions to the US as their focal point, critics of banking secrecy took advantage of US unilateral action to define new global standards for international tax cooperation and, subsequently, blacklist all countries that did not satisfy them. As a public shaming strategy, blacklisting does not work without convincing arguments why some rules form global standards (Barnett & Finnemore 2004). However, in the case of Swiss banking secrecy, the tax evasion scandal and the resulting US investigations clearly demonstrated that banking secrecy was part of the problem and, therefore, made it impossible for Switzerland to avert the development of new global standards.

This article is structured as follows. The next section analyzes the collective action problem that characterizes international tax cooperation, discusses how unilateral action can pave the way for multilateral action, and examines how economic dependence made Swiss banks a possible target for US unilateral action. Subsequently, we trace the repeated sequence of US unilateral action, bilateral concessions, public shaming, and multilateral concessions that ultimately led to Switzerland accepting the AEI. A final section concludes by briefly discussing why recent improvements in international tax cooperation have not changed the international system's incapacity to devise effective governance responses to economic challenges.

2. The problem of international tax cooperation

Most countries rely on a residential system that aspires to tax their residents' worldwide income – but what is this income? Countries can impose reporting requirements for all agents within their borders but because of state sovereignty, they cannot easily foist the same reporting requirements on agents outside their borders. As a result, taxpayers may benefit from transferring their assets to countries that do not exchange information in tax matters, thereby avoiding taxation in their resident country (Palan 2002).

Countries can try to overcome this information asymmetry by means of international tax cooperation, for instance, by concluding tax information exchange agreements. However, the extent to which countries sign such agreements and what these agreements cover differ widely. Most importantly, countries face strong incentives to defect from cooperation, despite likely system-wide welfare benefits from cooperation, because countries compete for mobile resources and can maximize their income by poaching other countries' tax base. International tax cooperation is, therefore, often likened to a prisoner's dilemma (cf. Genschel & Schwarz 2011).

Swiss-style banking secrecy is possibly the most prominent, but is certainly not the only example of such uncooperative strategies. Banking secrecy is based on two main pillars (Emmenegger 2014).[4] First, banking secrecy refers to legislative requirements and associated criminal penalties prohibiting banks or their employees from disclosing any information about client accounts without the owner's consent. This confidentiality requirement also includes bank interactions with foreign authorities. Second, banking secrecy concerns the 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. In particular, Switzerland refused to provide international administrative assistance in cases of tax evasion until 2009 and was long one of the major opponents of the AEI.[5]

Such uncooperative behavior, however, is widespread and certainly not restricted to a few tax havens (Sharman 2011). There are many ways to create financial secrecy, which means that uncooperative behavior can take many different forms, such as banking secrecy, anonymous trusts, foundations, or shell companies (Palan *et al.* 2010). Hence, when the OECD (2009) published a blacklist of uncooperative jurisdictions in April 2009, it contained no less than 42 countries. In addition, according to the 2009 edition of the Tax Justice Network's Financial Secrecy Index, six among the 10 countries receiving the highest scores with regard to financial secrecy were European Union (EU), G20, or OECD members, including China, the United Kingdom, and the US (Emmenegger 2014, p. 150). These three countries, however, were not among those the OECD blacklisted as uncooperative jurisdictions.

This structural situation has two important implications for international tax cooperation. First, the large number of countries that face incentives to defect complicates international tax cooperation. While a few relevant defectors are sufficient to undermine the whole regime, benefits from non-cooperation increase as the number of cooperative jurisdictions grows (Rixen 2008). Second, the fact that many different forms of financial secrecy exist implies that international tax cooperation has to address them simultaneously (Elsayyad & Konrad 2012). Addressing only some forms of financial secrecy would certainly meet the resistance of the secrecy jurisdictions suffering most from the resulting competitive disadvantages and trigger accusations of hypocrisy directed at the jurisdictions benefiting from financial secrecy not targeted by the initiative. Moreover, it may simply lead to a diversion of illicit flows to secrecy jurisdictions not affected by improved international tax cooperation.

This structural situation already undermined earlier attempts to fight tax evasion, in particular the OECD's Harmful Tax Competition initiative. During this initiative, the OECD used a blacklisting strategy to identify and sanction appropriate modes of internal and external conduct of states in the field of international tax cooperation (Webb 2004). Blacklists document whose regulations are not acceptable and by publicly listing uncooperative jurisdictions, try to "shame actors into compliance" (Barnett & Finnemore 2004, p. 16). In the case of offshore financial centers, blacklisting can damage their reputation as safe and well-regulated destinations for investors' funds and, thus, create competitive disadvantages. In addition, the public shaming of secrecy jurisdictions also gives legitimacy to sanctions that other countries might adopt as countermeasures.

The effectiveness of public shaming strategies is, however, dependent on a number of critical factors. Ultimately, anybody can create a blacklist. Whether a blacklist is taken seriously is, therefore, a function of the legitimacy of the actors creating the list and the arguments used to justify why certain regulations form global standards (Barnett & Finnemore 2004). For instance, during the earlier OECD initiative, blacklisted countries were quick to point out that the OECD, as an organization of rich countries, had failed to blacklist any of its own members, while it did not hesitate to blacklist small, non-member states. At the same time, they argued that the OECD's definition of tax havens was biased against non-member states.[6] Seeing its legitimacy questioned in this way, the OECD immediately adopted a less confrontational strategy (Sharman 2006).

Hence, until recently, no amount of international pressure had been sufficient to induce countries like Switzerland to cooperate in international tax matters and to make significant concessions with regard to information exchange (Sharman 2006; Palan *et al.* 2010; Steinlin & Trampusch 2012). However, this is not because these countries are simply too strong to succumb to pressure, but the result of collective action problems on the part of the international community. Given the parallels between international tax cooperation and the well-known prisoner's dilemma, analysts have, therefore, argued that international tax cooperation is very difficult because individual countries face (too) strong incentives to defect from cooperation (Strange 1998; Rixen 2008; Genschel & Schwarz 2011; Eccleston 2012).[7]

In this article, we argue that although international tax cooperation is indeed difficult, it is not impossible. Keohane (1984) has already observed that international politics is not a two-player, one-shot interaction (in which cooperation is very unlikely), but rather a repeated prisoner's dilemma with multiple players. This seemingly small conceptual change has important implications for collective action. In case of a repeated, multi-player prisoner's dilemma, there is typically not just one but several Nash equilibriums. In addition, a cooperative (i.e. Pareto efficient) outcome is now more likely, although it is still difficult to achieve (Ostrom 1998, p. 2).[8] As a result, in a repeated n-person prisoner's dilemma, players face an additional challenge: the simultaneous existence of multiple Nash equilibriums implies that players need to coordinate policy measures to converge toward a specific Nash equilibrium (Diekmann 2010, p. 134). Put differently, the prisoner's dilemma (the cooperative outcome is difficult to achieve) is complemented by a coordination problem (the selection of a specific Nash equilibrium).

Importantly, the different available Nash equilibriums are likely to have distributional implications. For instance, in a repeated, multi-player prisoner's dilemma, all but one prisoner could coordinate their strategies and blame the remaining prisoner whose denials would then be considered non-credible. In this scenario, the players still fail to achieve the Pareto efficient outcome (i.e. all cooperate) but the resulting Nash equilibrium is particularly disadvantageous for the player who is blamed by all other players.

Of course, the major challenge in cases of coordination problems is the selection of a particular outcome. In the case of the prisoner's dilemma example mentioned above, it is not per se clear against which player the other players should coordinate their strategies. In real life, social and technological norms often solve coordination problems (Diekmann 2010, p. 25). In the absence of norms, focal points may allow for the coordination of strategies (Schelling 1960). Focal points are solutions that players tend to use because they seem natural to them. The classic example describes the challenge of meeting a stranger at an undetermined location in a given city. While all locations are equally possible choices, most people would converge to places like the Eiffel

Tower in Paris or Grand Central Station in New York because they are likely to consider these places natural focal points.

One conclusion that can be drawn from these considerations is that some improvement in international tax cooperation can be achieved if an exogenous event, for instance, a tax evasion scandal, identified the no longer acceptable form of financial secrecy and legitimized collective action against the jurisdictions that facilitate tax evasion by means of *this form* of financial secrecy. In cases of collective action, such an exogenous event can be understood in two complementary ways.

First, such an exogenous event can offer a focal point for collective action because it allows the other players to overcome their collective action problems by coordinating their strategies and directing them against the player who has just been identified as uncooperative (Schelling 1960). Instead of blaming all other jurisdictions for their lack of cooperation, the jurisdictions not affected by the exogenous event coordinate their strategies and blame the affected one, which, as a result of the exogenous event, struggles to credibly deny the accusations.

Second, such an exogenous event can provide a demonstration effect by highlighting the economic and social cost of the regulatory status quo and, thus, the necessity of reform (Mattli & Woods 2009, pp. 22-25). In addition, such a demonstration effect also undermines the targeted jurisdictions' ability to resist public shaming. In particular, it neutralizes attempts by the targeted jurisdiction to delegitimize multilateral action against its form of financial secrecy by pointing to non-cooperative strategies used by non-targeted jurisdictions.

Importantly, this argument implies that the resulting collective action does not necessarily lead to a Pareto efficient, cooperative outcome (i.e. *all* cooperate). Rather, the jurisdictions not tarnished by the tax evasion scandal might simply converge toward a new Nash equilibrium that is more disadvantageous for those tarnished by the scandal. In terms of actual improvement of international tax cooperation, this argument implies that although this partial cooperation represents a Pareto improvement relative to the status quo ante, at least some of the expected improvements are in fact offset by a diversion of illicit flows to secrecy jurisdictions relying on forms of financial secrecy not affected by improved international tax cooperation (Elsayyad & Konrad 2012; Johannesen & Zucman 2014).

It is certainly easy to imagine scenarios that would lead to a tax evasion scandal. However, an additional difficulty resides in the fact that this scandal has to be convincingly linked to the jurisdiction that facilitates tax evasion by means of financial secrecy. Yet jurisdictions only create the regulatory frameworks, they do not directly interact with the tax-evading asset owner. For this, private service providers are needed that take advantage of the regulatory framework. Hence, the link between a scandal and the public shaming of a jurisdiction is not as straightforward as it might seem at first sight.

As we show in the case study below, the 2008 tax evasion scandal involving the Swiss bank, UBS, the world's largest bank with regard to assets under management, facilitated collective action by demonstrating the need to act on tax evasion and created a focal point for the other jurisdictions to coordinate their strategies (Scorpio 2013, p. 10). However, in four ways, all related to US financial pre-eminence and its ability to control market access, this scandal's circumstances were exceptional (Simmons 2001).

First, the scandal was made possible only by the fact that the Qualified Intermediary Program (QIP), implemented in 2000, had for the first time made foreign financial institutions to some extent responsible for the tax compliance of their US clients in return for access to the US securities market (Hanrehan & Shapiro 1998). However, the US could force the QIP upon foreign financial institutions only because the unique attractiveness and centrality of its financial market creates strong incentives to accept any condition for market access.

Second, the structural dependence of international banks on access to the US-controlled, dollar-based financial system also gives US authorities the opportunity to exercise considerable pressure on foreign banks like UBS. Benefiting from information obtained from a whistleblower about violations of the QIP, US authorities could threaten UBS with a criminal indictment, which is considered a "corporate death penalty" because indictments typically lead to exclusion from the all-important US market (Garrett 2014, p. 14). Hence, UBS was forced to cooperate with US authorities and provide an unprecedented amount of data on its banking practices.

Third, Switzerland's structural dependence on the survival of its largest bank (with assets around 3 times the country's gross domestic product) left the Swiss government little choice but to come to the bank's aid and make targeted concessions to the US with regard to banking secrecy regulations. Hence, against its will, Switzerland was dragged into the conflict between US law enforcement authorities and UBS.

Finally, the UBS scandal broke in the midst of the global financial crisis. In July 2008, UBS representatives were forced to publicly admit wrongdoing in a US Senate hearing (Branson 2008). By that time, public opinion in the US had already begun to turn against the financial sector, which facilitated a more robust approach by US authorities against Swiss banks (Eccleston 2012).

In conclusion, the combination of US power derived from economic interdependence and the global financial crisis gave rise to a tax evasion scandal that was sufficiently large to involve not only private actors but also the country that made these evasion strategies possible. As we demonstrate, this scandal and subsequent US investigations against Swiss banks played a central role in recent multilateral attempts to improve international tax cooperation because it provided the necessary demonstration effect to trigger collective action and created a focal point, which the other countries could use to coordinate their strategies, while also undermining any Swiss attempts to delegitimize multilateral action against banking secrecy.

3. A tax evasion scandal in the midst of the financial crisis

The financial dominance of the US allows it to impose regulations on financial intermediaries that other states cannot without losing market share (Simmons 2001).[9] Hence, in 2000, US authorities requested foreign banks to participate in the QIP, which imposed significant obligations on non-US banks in return for market access. The QIP aimed to identify US persons that held beneficial interests in US securities and ensure the appropriate withholding of US tax from payments of US-source income to non-US persons (Hanrehan & Shapiro 1998). To achieve these goals, the QIP foisted far-reaching information reporting requirements or, alternatively, a large withholding tax on all US-source income.

However, foreign banks could eliminate some of these requirements by applying for the status of qualified intermediaries. As qualified intermediaries, banks could take care of information collection by determining which of its customers were US persons subject to information sharing and which were non-US persons entitled to reduced rates of withholding tax under a treaty, thereby reducing paperwork and keeping client names confidential. Hence, the QIP made foreign financial institutions for the first time co-responsible for the tax compliance of their US clients.

For Swiss banks, the QIP created a difficult choice: they would have to either lift the veil of secrecy in case of a US client, pay a substantial withholding tax, or stop trading US securities on behalf of this client. In return, as qualified intermediaries, they could continue to trade US securities on behalf of non-US clients without disclosing their identity (and in case of a double taxation treaty without imposing a withholding tax). Hence, the QIP was compatible with Swiss banking secrecy as long as US clients of Swiss banks did not invest in US securities.

However, there was a loophole. Consistent with US law, the QIP defined the beneficial owner of an account to include corporations (Morse 2012, p. 533). The Swiss bank, UBS, used this loophole to continue to service US clients that were interested in trading US securities but refused to have their identities communicated to the Internal Revenue Service (IRS). As Levin and Coleman (2008) documented, UBS assisted its US clients in structuring their accounts to avoid QIP reporting requirements by channeling capital flows through offshore corporations, trusts, and foundations. Although legal in principle, these structures are considered illegal if their sole purpose is to avoid taxation. Hence, UBS, or at least some of its client managers, conspired against the US.

Structures based on secrecy are vulnerable to whistleblowers. In June 2007, and, thus, before the start of the financial crisis, a former UBS employee provided US authorities with detailed information on the strategies UBS used to assist US clients to avoid QIP reporting requirements (Hässig 2010). Data on secretive bank activities were available before but banks could always argue that the data were faulty, deny any misconduct but still refuse cooperation in investigations, and ultimately highlight that the data's availability was the result of theft. In this case, however, the situation was different. Not only was the whistleblower involved in these activities (and subsequently sentenced to 40 months in prison for his role in assisting tax evasion), the exposed activities were also violating the rules of the QIP. While in the past banks could always argue that clients, and not banks, were ultimately responsible for tax compliance, their new status as qualified intermediaries forced them to accept part of this responsibility for their US clients.

The whistleblower's testimony gave US authorities enough material to arrest the head of UBS wealth management in the US in April 2008. In July 2008, UBS representatives participated in a Senate hearing and publicly admitted wrongdoing on the part of UBS. However, they insisted that the problem was primarily a compliance failure and that the main fault lay with a number of client managers and not the bank (Branson 2008).

The timing of the Senate hearing, however, could not have been worse for UBS. The hearing took place only two months after JP Morgan Chase's takeover of Bear Stearns, which had been heavily subsidized by New York's Federal Reserve Bank. Moreover, only two months after the Senate hearing, Lehman Brothers collapsed, which fueled the global financial crisis. Hence, the UBS tax evasion scandal erupted in the midst of the financial crisis. The financial crisis was also one of the major topics of the 2008 election campaign for the US presidency, won by Barack Obama. As a Senator, in February 2007, Obama, together with Senators Levin and Coleman, (who later chaired the Senate hearing on UBS in July 2008 and penned the report documenting the activities of UBS in facilitating tax evasion), had already submitted the revised Stop Tax Havens Abuse Bill (first submitted in 2005), which explicitly criticized Switzerland for its banking secrecy regulations (Levin *et al.* 2007).[10]

As a result of the US investigations against UBS, there was a constant threat of criminal indictment, which could have endangered the bank's existence. An indictment indicates that a competent body has come to the conclusion that there is sufficient probability that the corporation has committed the crime. After an indictment has been served, the public prosecutor can continue to collect evidence against the corporation before the case is subject to trial in court. Hence, an indictment indicates only that public authorities are investigating against a corporation.

Nevertheless, criminal indictments often sound the death-knell for 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). Of course, it is impossible to know whether an indictment in the case of UBS would have endangered the bank's existence because UBS accepted a punitive settlement to avoid an indictment. In any case, the one (small) Swiss bank that was eventually indicted in February 2012 immediately withdrew from business.

United States authorities made it clear that they wanted access to client files. In July 2008, a district court allowed the IRS to serve a John Doe summons on UBS, requesting 19,000 client files, but because of banking secrecy, the Swiss government did not allow UBS to comply (Bondi 2010, p. 8). John Doe summons are issued to third parties to provide information on unknown taxpayers with potential tax liabilities. However, lacking documentation of tax fraud by clearly identified individuals, Switzerland refused to provide administrative assistance because of banking secrecy regulations. In parallel, the IRS requested international administrative assistance to gain access to data on UBS clients, but by February 2009 Switzerland had agreed to administrative assistance (because of the time-consuming procedure) in only 26 cases (Schaub 2011, pp. 214-215).

In late 2008, the US Department of Justice (DoJ) offered UBS a deferred prosecution agreement (DPA). In return, UBS had to admit to helping US clients avoid paying taxes, pay a fine of USD 780 million, and disclose the names of approximately 250 account holders (Bondi 2010, p. 9). The Swiss government signaled agreement but it still had the problem of how to send client files without violating banking secrecy regulations. In February 2009, the DoJ lost patience and openly threatened to indict the bank. In a letter to UBS on 17 February 2009, the DoJ wrote "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, p. 3361).

It is unclear whether the DoJ would have risked the collapse of another major global bank in the midst of the global financial crisis. However, the threat worked in that the Swiss Financial Market Supervisory Authority (FINMA) immediately agreed to use its emergency powers to suspend banking secrecy regulations and send the requested client files. On 18 February 2009, UBS could enter into a DPA with the DoJ. The Swiss Government argued that it had little choice but to accept the agreement (Hässig 2010, p. 154), while the Swiss Federal Court later decided that handing over 255 client files to the US authorities was legal because FINMA had good 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, own translation).

The US authorities, however, did not stop here. Their major interest remained the client files. Hence, the day after UBS had entered into the DPA, the IRS made a surprising move by requesting the US.district court to enforce the John Doe summons. What's more, the IRS now requested 52,000 client files (Bondi 2010, p. 2). This move was possible because the DPA only concerned (criminal) investigations of the DoJ but not (administrative) requests by the IRS. Thus, the day after entering into the DPA, UBS was once again facing legal problems. It is unclear whether the district court would have enforced the summons because courts have to consider the national sovereignty of Switzerland and the fact that UBS was bound by banking secrecy laws (Bondi 2010, pp. 13-21). However, the Swiss government was not willing to take any risks. In August 2009, the two countries signed an agreement in which Switzerland agreed to give the US access to 4,450 additional client files and give expedited review to US information requests.

In sum, US power derived from economic interdependence, the financial crisis, and the tax evasion scandal played a crucial role in poking the first holes in Swiss banking secrecy. After a whistleblower had informed US authorities of UBS' violations of the QIP, a tax evasion scandal erupted in the midst of the financial crisis. Facing the possibility of a criminal indictment against its biggest bank, the Swiss government had little choice but to use emergency measures to suspend banking secrecy regulations to save the bank from a criminal indictment. Hence, although the scandal concerned a private bank, the Swiss government could not avoid getting involved.

4. From a tax evasion scandal to collective action

The tax evasion scandal and the resulting Swiss concessions to the US triggered multilateral initiatives to improve international tax cooperation by giving legitimacy to collective action, providing a focal point the other actors could use to coordinate their activities, but also silencing one of the most important opponents to international tax cooperation.

More substantially, we demonstrate that improvements in international tax cooperation always started with US authorities exercising pressure on Swiss banks, in response to which the Swiss government made targeted concessions. These bilateral concessions then served as focal points for collective action, to which Switzerland responded by begrudgingly making similar, although not necessarily identical, concessions to all OECD member states. After these multilateral concessions, the sequence started over. While US investigations continued after the UBS DPA to include further Swiss banks, the Swiss government tried to maintain banking secrecy and, thus, made only targeted concessions. However, this strategy failed because the US continued to request further bilateral concessions.

As discussed above, the tax evasion, as well as the US Senate report, the public hearing, and UBS' admission of guilt increased international pressure on Swiss banking secrecy by demonstrating the need for multilateral action. *After* the announcement of the Senate Hearing, calls for improved information exchange were voiced for the first time at the G8 meeting in Toyako in July 2008 (Organisation for Economic Co-operation and Development 2009, p. 10). Three months later, in October 2008, the finance ministers of 17 (out of then 30) OECD member states, without Swiss participation, gathered for an unofficial meeting at OECD headquarters to discuss joint strategies against tax havens (OECD 2008, p. 6). Following the meeting, the French and German Finance Ministers explicitly demanded a new blacklist of jurisdictions that facilitated tax evasion, including the OECD member state, Switzerland. The OECD Secretary General concurred by noting that the “fight against tax havens and for financial transparency has absolute priority” (Sucher 2008). A new OECD blacklist was announced for 2009.

At the G20 meeting in Washington in November 2008, the fight against tax evasion was also a major topic. Although created in response to the global financial crisis, the G20 called in its Washington Declaration for more information sharing in tax matters and called on countries with “banking secrecy” (i.e. *not* any form of financial secrecy) to commit to international standards with regard to information exchange (Washington Declaration 2008). Importantly, as mentioned above, several G20 members are major offshore financial centers. However, none of them specializes in banking secrecy and all of them could, therefore, avoid getting blacklisted. Hence, the tax evasion scandal served as a focal point for collective action.

The new OECD blacklist was eventually presented at the G20 meeting in London in April 2009. However, before its official publication, the new blacklist was disseminated as a draft. On the draft version, published on 5 March and, thus, two weeks after UBS had entered into a DPA, Switzerland was listed as an uncooperative jurisdiction. Concerned about its international reputation, Switzerland responded only eight days later by dropping the controversial distinction between tax fraud and tax evasion in case of international administrative assistance. As a consequence, on the final blacklist, presented on 2 April, Switzerland was no longer classified as an uncooperative jurisdiction but still remained on the “grey list” because it had not signed a sufficient number of double taxation agreements that contained these new regulations concerning international administrative assistance in case of tax evasion (OECD 2009). After having signed 12 such new agreements, Switzerland was removed from the “grey list” in September 2009. Hence, after several decades of successful resistance, Switzerland finally agreed to provide international administrative assistance on request in cases of tax evasion.[11]

Not surprisingly, the Swiss government publicly questioned the criteria for being included on the list, noting that “the fact that Switzerland as a founding member of the OECD was never included in the discussions on drawing up lists is particularly strange” (The Daily Telegraph 2009). While the criteria for inclusion are indeed questionable (Emmenegger 2014, p. 159), it is striking that the OECD decided to emphasize banking secrecy – and not just any form of financial secrecy – and adopted its more confrontational approach immediately after the US investigations had shown how Swiss banking secrecy regulations facilitated large-scale tax evasion. After the tax evasion scandal involving UBS, the Swiss Government no longer had the ability to credibly question the blacklist’s legitimacy.

Opponents of banking secrecy, however, were not satisfied. After the official declaration of the G20 summit in London had pronounced the era of banking secrecy to be over, the European Commission (2009) proposed in April 2009 to start negotiations with Switzerland on the implementation of an improved system of exchange of information in tax matters. The Swiss government showed no interest in such discussions, but events in the US continued to increase pressure on banking secrecy.

Following the August 2009 agreement between Switzerland and the US, in which the Swiss government agreed to transfer 4,450 client files to the IRS, international pressure on Swiss banking secrecy increased once again and legitimized countermeasures. While Italy imposed new unilateral sanctions against Swiss firms (March 2010), it became increasingly clear in autumn 2009 that French and German authorities were actively purchasing client information stolen from Swiss banks. The Swiss government expressed its irritation, wondering why it was acceptable for democratic countries to buy stolen data, but to no avail.

In December 2009, the Swiss government reacted to this new situation by proposing bilateral agreements on anonymous cross-border withholding taxes. This withholding tax would have allowed foreign clients of Swiss banks to regularize their assets while staying anonymous. Hence, foreign governments would receive the taxes, but Switzerland would have been able to avoid the AEI (Grinberg 2012).

The Swiss withholding tax proposal, however, was doomed to fail. By the time the Swiss withholding tax regime was launched (December 2009), the US was about to pass the Foreign Account Tax Compliance Act (FATCA), which was a *direct reaction* to the loopholes in the QIP that the UBS scandal had exposed (Harvey 2012). Under pressure from the US, in June 2012, Switzerland finally declared its willingness to implement FATCA, which forces Swiss banks, in return for market access, to directly send all requested information on US clients (if these clients agree) to the IRS. If clients do not agree to have their data sent directly, the IRS can request them by means of administrative assistance. Hence, in its bilateral relationship with the US, Switzerland gave up on banking secrecy.

However, FATCA only concerns the future. It does not give US authorities access to past records of US clients of Swiss banks. Hence, US pressure increased once again, thereby launching another round of the familiar sequence. After the conclusion of the investigations against UBS, US authorities had data on 4,700 former UBS clients. In addition, as part of the settlement, US authorities had received information about the banks to which former UBS clients had transferred their accounts after the investigations had started. Finally, as part of two offshore voluntary disclosure programs in 2009 and 2011, approximately 33,000 US persons, often clients of Swiss banks, had come forward to regularize their assets. With this information, US authorities had sufficient material to continue their investigations. By 2011, it was clear that US authorities were investigating other Swiss banks, including Credit Suisse, Switzerland’s second-largest bank.

United States authorities again requested client files, but the Swiss government was reluctant to share information. Confronted with new threats that some Swiss banks might be indicted, the Swiss government made some minor concessions but ultimately insisted that client files could only be obtained through international administrative assistance. Not satisfied with the progress, the DoJ indicted the small bank Wegelin & Co., in February 2012, which resulted in the bank's collapse. After the indictment, The Economist (2012) noted that Wegelin & Co. was "a mere pawn in a much bigger game played between Switzerland and America over banking secrecy and tax fraud." After this renewed demonstration of power, Switzerland made a series of further bilateral concessions. Among others, in spring 2012, Switzerland accepted group requests by the US in cases of administrative assistance.

These Swiss concessions to the US once again fuelled multilateral efforts by demonstrating the continued need to act on banking secrecy and by providing a focal point for collective action. In early 2011, after US authorities had announced the start of their investigations against further Swiss banks, the OECD threatened Switzerland with a new blacklist if Switzerland would not reform its banking secrecy regulations. The threat turned into action in June 2011, when the OECD, in the framework of the Global Forum on Transparency and Exchange of Information for Tax Purposes, listed Switzerland as a jurisdiction "needing improvement" in three specific areas to advance to the second round of the peer-review process (OECD 2013). Shortly after being listed, the Swiss government committed to implement the three necessary changes to be removed from the list. As the Swiss government argued, Switzerland cannot afford to be denounced as an uncooperative jurisdiction because such denouncements could easily trigger sanctions against the whole Swiss economy (Bundesrat 2012, pp. 8-9).

The Swiss concession to the US to allow for group requests in cases of international administrative assistance also triggered multilateral action. After having made this concession in the hope of reducing US pressure on Swiss banks, Switzerland now faced international demands to also extend the OECD model agreement to allow for group requests. Ultimately, the Swiss government did not oppose the extension of the OECD model agreement in July 2012. As the Swiss ambassador to the OECD explained, there was no point objecting to emerging global standards without support from a global alliance. Instead, he argued, Switzerland should try to influence how the emerging global standard is implemented (Handelszeitung 2012).

However, by summer 2012 it was becoming increasingly clear that there was no way around the AEI. In June 2012, Switzerland and the US published a joint statement, in which they announced discussions about FATCA. In the same month, the OECD informed that it had begun working on a concrete proposal on how to implement the AEI, while only one month later the US and five large EU members agreed on an intergovernmental approach to improve tax compliance based on FATCA (Grinberg 2012, pp. 306-307). After Switzerland had agreed in principle with the US on how to implement FATCA in December 2012, EU representatives explicitly welcomed the agreement and demanded the same kind of cooperation from Switzerland.

In addition, in December 2012, Luxembourg signaled readiness to give up its opposition to the AEI within the EU Tax Savings Directive. Given the EU's "most favored nation" clause, Luxembourg would not have been able to find agreement with the US on the implementation of FATCA without offering at least the same conditions to the other EU members (Hakelberg 2015). Austria and Luxembourg officially accepted the AEI within the EU in April 2013. However, their commitment was made conditional on the participation of Switzerland in the EU's system of AEI, thereby increasing international pressure on Switzerland.

In a press conference in December 2012, the Swiss Finance Minister still explicitly rejected the AEI. However, she also announced the creation of a new expert group intended to develop strategies to improve the Swiss financial sector's competitiveness. In addition, in the subsequent Q&A, she mentioned, for the first time, that the AEI might be unavoidable.

The expert group, which presented its findings in June 2013, acknowledged the reputational damage already suffered and emphasized the importance of accepting international standards (Brunetti 2013). It concluded by recommending that the AEI be accepted as part of a new global standard, in particular, to avoid further international criticism, a suggestion that was subsequently endorsed by the government.

In a media conference, the Swiss Finance Minister later justified the need to implement the AEI. Pointing to international pressure on Swiss banking secrecy, she noted that current debates would once again lead to two lists. One list would contain the countries that had committed to implement the AEI, while the other would contain the rest. The Finance Minister then added that although she did not "like talking about the color of lists, you can imagine that there is one we would prefer (Widmer-Schlumpf 2014)."[12] Clearly, Switzerland could no longer afford the reputational damage that continued resistance to the AEI had caused.

5. Conclusion

After many decades of successful resistance to international pressure, Switzerland finally agreed to soften its banking secrecy regulations and accept the AEI in tax matters. For advocates of financial transparency, this is good news, not least because Swiss agreement to curtail banking secrecy is of high symbolic value given Switzerland's central role in offshore wealth management. However, in light of the history of international tax cooperation, recent events raise the theoretically important question of how Swiss resistance was ultimately overcome. International tax cooperation is bedeviled by collective action problems, in which cooperation is further complicated by the fact that many different forms of financial secrecy exist. Hence, previous attempts to rein in tax evasion largely failed. Why was this time different?

This article has argued that US unilateral action against Swiss banks paved the way for collective action to overcome Switzerland's resistance to international tax cooperation. In particular, Swiss banks' structural dependence on access to the US financial market allowed US authorities to impose conditions for market access. After some Swiss banks had violated these conditions, US law enforcement authorities could pressure these banks into disclosing information on their US clients. The Swiss government tried to stop the banks providing access to this data. However, Switzerland's structural dependence on the banks' economic survival ultimately forced the government to accept the violations of banking secrecy regulations. As a result, the tax evasion scandal not only affected the banks involved, it also tainted the image of the country that made these business practices possible.

The conflict between Switzerland and the US had important consequences for collective action to improve international tax cooperation. While the tax evasion scandal clearly demonstrated the need for collective action, Swiss concessions served as focal points because they allowed international organizations and countries critical of Swiss banking secrecy to coordinate their strategies and direct them against Switzerland. Swiss calls to extend the campaign's focus to other forms of financial secrecy were simply ignored because they would have complicated – if not made impossible – collective action. At the same time, the demonstration effect of the tax evasion scandal effectively undermined Swiss attempts to delegitimize multilateral action against banking secrecy, even though the campaign did not address all forms of financial secrecy. Faced with a public shaming campaign it could not delegitimize, the Swiss government had no choice but to reform its banking secrecy regulations.

The surprising demise of Swiss banking secrecy, thus, not only highlights that effective international tax cooperation is critically dependent on key states in the international tax regime, such as Switzerland and the US, it also shows how tax evasion scandals can serve as focal points that help overcome collective action problems and how control over market access gives US authorities the ability to enforce change unilaterally. At the same time, it raises doubts about the viability of ongoing multilateral initiatives in case the US should withdraw its support. Quite possibly, the US is the only country to ensure that other key players, such as Switzerland, toe the line. However, no actor is able to muster sufficient power to ensure continued US support.

Thus, this article demonstrates that it is too early to proclaim a new age of financial transparency. There are still numerous other ways to obfuscate the ownership of financial assets. Whether the international community will show equal vigor in its attempts to regulate shell companies and anonymous trusts is doubtful given that a considerable share of shell companies and trusts originate from powerful countries, such as the UK and the US (Ndikumana 2014). There are also clear signs that other financial centers are keen to take Switzerland's place as the world's leading offshore wealth manager (Johannesen & Zucman 2014). In addition, harmful practices in the field of corporate taxation are still largely unconstrained and many analysts are skeptical about the extent to which the OECD's current Base Erosion and Profit Shirting initiative will effectively limit harmful tax competition (Devereux & Vella 2014; Dourado 2015). Hence, despite recent success, collective action problems are likely to continue to bedevil attempts to improve international tax cooperation. The international community will likely have to wait for the next "demonstration effect" before new substantial improvements are possible.

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Notes

1 Unlike previous standards that provided for exchange of information on request, the AEI expects jurisdictions to send pre-agreed information each year without having received any specific request.
2 He said, "An diesem Bankgeheimnis werdet Ihr euch die Zähne ausbeissen." This statement cannot be literally translated but corresponds to "a nut too hard to crack."
3 Although facilitating tax evasion of individuals, banking secrecy plays little role in the excessive use of opaque derivative contracts that obfuscate the real extent of financial risks taken.
4 Some definitions of banking secrecy add a third pillar: the clarification of customer identity by self-regulation as enshrined in the agreement on the Swiss banks' code of conduct (Steinlin & Trampusch 2012).
5 Swiss law distinguishes between tax evasion and tax fraud. Purposefully altering documents is considered tax fraud, a criminal offence, and is subject to international assistance. In contrast, simply not declaring assets without altering documents is considered tax evasion, an administrative offence, and is not subject to international assistance. The reason for refusing international assistance is the principle of dual criminality, which implies that Switzerland provides assistance only in cases that are also a criminal offence in Switzerland.
6 As the OECD (1987, pp. 20–21) acknowledged early on, "attempts to provide a single definition of a 'tax haven' are bound to [be] unsuccessful." Nevertheless, a few years later, the OECD defined tax havens as jurisdictions that impose no or only nominal taxes, have laws or administrative practices that prevent the effective exchange of relevant information with other governments, lack transparency, and are characterized by the absence of a requirement that the economic activity be substantial (OECD 1998, pp. 22-23). Conveniently, this definition of tax havens made it virtually impossible for OECD member states to qualify. A few

years later, the OECD changed its definition again, dropping two of the four original criteria (Sharman 2006, p. 17). In its 1998 report, the OECD offered another vague definition of tax havens, noting that "the fact that a country offers itself as a place, or is perceived to be a place, to be used by nonresidents to escape tax in their country of residence may be sufficient to classify that jurisdiction as a tax haven" (OECD 1998, p. 21). The OECD (1998, p. 16) added that harmful tax practices include the poaching of a tax base that "rightly belongs to the other country." However, who decides to which a country a tax base rightly belongs?

7 Analytically, collective action problems correspond to n-person prisoner's dilemmas (Hardin 1982).

8 Axelrod (1987) has shown how, in repeated games under a restrictive set of conditions (e.g. the choice of the discounting parameter), cooperation can become a dominant strategy. However, in many real-world settings, such as international tax competition, repetition is still unlikely to lead to cooperation.

9 For a more detailed analysis of the conflict between Switzerland and the US, see Emmenegger and Eggenberger (2015a). For a discussion of the domestic political response in Switzerland to US and international pressure, see Emmenegger and Eggenberger (2015b).

10 Changes in the US Presidency already played an important role in the OECD's Harmful Tax Competition initiative. Only four months after the inauguration of President Bush in January 2001, the new Treasury Secretary O'Neill publicly criticized the campaign, leading the OECD to quietly drop its July 2001 deadline for sanctions in case of continued resistance to the global standard (Webb 2004, pp. 813-816).

11 Previous OECD efforts to promote information exchange had been hampered by OECD members, such as Switzerland. The global financial crisis and the resulting elevation of the G20 to a Leaders Forum now opened a window of opportunity for the OECD. Taking advantage of the G20's push for more information exchange, the OECD freed itself from some of the arduous consensus requirements of its internal decisionmaking process. By creating a blacklist of uncooperative jurisdictions for the G20 rather than by acting on behalf of its members, the OECD could bypass the likely resistance of reluctant member states. Eccleston and Woodward (2014) even argue that it was the OECD that pushed the G20 to emphasize banking secrecy and tax evasion in its Washington Declaration (rather than the other way around).

12 The condition to accept the AEI only if it is made a *global* standard was quietly dropped in 2014.

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