Regional Deals and the Global Imperative:

The External Dimension of the European Union Savings Tax Directive

Abstract:

This article examines how an internal deal to tax non-resident EU savings came to depend on the co-operation of non-member jurisdictions. These efforts were both motivated and sabotaged by a policy narrative asserting that increased capital mobility poses a new global imperative for national and regional policy-making.

With the failure of the Doha Development Round of World Trade Organization talks, the prospect of a global trade deal recedes into the distant future, and regional deals become correspondingly more attractive. Yet the structure of the global economy may place limits on the feasibility of such regional deals. For much like national economic policy making, regional arrangements depend on delineating and separating increasingly borderless economic activity. Nowhere is this more true than in the trade in financial services, a \$2 trillion industry forecast to account for 10 per cent of global GDP by 2020 (R. Hay 2006: 2). The difficulty of bordered international deals is equally apparent when it comes to the closely related issue of taxing mobile capital.

The European Union (EU) Savings Tax Directive provides an important case study of how the world's most powerful regional grouping is responding to the challenge of globalisation in the vital policy areas of taxing mobile capital and regulating financial services. For years EU member states refused to commit to a regional deal on taxing their citizens' offshore savings because of worries about a global imperative: unless non-member states introduced equivalent tax measures, investors would simply avoid new taxes and regulations by relocating their money outside the EU. Because of the mobility of capital, not only would the original tax evasion problem remain unresolved, but the competitiveness of EU financial industries would also be seriously damaged (Avi-Yonah 2000). Thus, because of the belief in this global imperative, the internal deal among EU members became dependent on striking an external deal with non-

members.

The European Union can only make tax agreements on the basis of unanimity. Yet differences between Britain on the one hand, and Belgium, Austria and particularly Luxembourg on the other, deadlocked negotiations. Strict secrecy is a central attraction of the banking and financial service sectors of the latter three countries, historically allowing foreign investors to hide their savings and enjoy the interest derived tax free. Following from this, Austria, Belgium and Luxembourg were vehemently against any information sharing agreement under which they would pass on details of foreign investors' accounts and interest earnings to those same investors' home governments. Instead, they proposed a withholding tax to be levied on interest earnings. Yet Britain, fearful of damaging London's lucrative bond market, adamantly opposed the withholding tax option and insisted on information exchange.

Austria, Belgium and Luxembourg argued that tax information exchange would simply displace the problem of tax evasion rather than solving it. EU citizens would just move their money to other jurisdictions beyond the reach of any intra-Union deal, such as the British Channel Islands, the Caribbean, Switzerland or the United States. Those in the UK believed that if there was even a hint of a withholding tax, the huge London bond market would decamp to New York. Thus potential deals within the EU on information exchange and a withholding tax both hinged on the global imperative: because of the mobility of capital and investment, stricter regulations or higher taxes in one region would simply displace this investment to other jurisdictions, imposing serious costs on the financial services sector and decreasing tax revenue. As a result the eventual

compromise solution, under which members could either exchange information or apply a withholding tax, was made explicitly conditional on non-member states following suit.

Given this dynamic, the Savings Tax Directive sheds important light on the feasibility of regional economic arrangements in a globalised world. Can regional associations impose higher regulatory standards on mobile investments, or will the globalised economy and regulatory arbitrage make this impossible? For although the Savings Tax Directive did finally come into effect in July 2005, many argue that the concessions necessary to clinch internal and external deals have so watered down the solution that the original policy problem remains.

The paper concludes that the biggest impact of the global imperative has been as an influential policy narrative, understood as a simplified story of cause and effect suggesting a particular course of action. Policies narratives are the stories that policy makers and their critics use to stabilise and bound complexity and uncertainty, and thereby enable and justify particular policy choices (Roe 1994). The story of the global imperative was crucial in shaping policy makers' perceptions, arguments and actions, but was also important in explaining the political impact of the financial sector interests also.

Powerful finance industry lobbies could use this same narrative, stressing the mobility of capital and investors' intolerance of regulation and tax, to equate the national economic interest with that of their own sector. Banks and bond traders argued that ratcheting up regulation and taxes would simply displace mobile business to other competing financial centres, taking the

associated jobs and a significant portion of the tax base with it. Because member states and the European Commission had been motivated to act in the first place by this same globalisation narrative (Radaelli 1999), the business case was effective. At least judged by the extra revenue generated, the Savings Tax Directive has failed. But this failure is not because of massive capital flight from participating jurisdictions, as the global imperative would suggest, so much as the power of the global imperative as a policy narrative. Before tracing the negotiations inside and outside the EU concerning the Savings Tax Directive, it is important to further explore the concept of policy narrative and associated discourses of globalisation.

POLICY NARRATIVES AND GLOBALISATION DISCOURSE

At first glance, the efforts to promote and define the Savings Tax Directive conform to a straightforward template of material interests and power. States and industry groups sought to defend and promote clearly defined economic stakes. Britain and the Netherlands over-powered their reluctant dependent territories to impose the reforms. The eventual bargain struck generally reflected the correlation of forces backing the competing information exchange and withholding tax solutions.

But if at one level the wrangling over the tax package can be rendered in conventional rationalist terms (self-interested actors strategically acting in line with materially-derived preferences), such an account is also crucially incomplete. Why were the Commission and key member states able to get tax co-ordination on the agenda when previous attempts had failed and tax revenues were

still healthy? Why has regulatory arbitrage not led to capital flight from those financial centres covered by the directive in the way predicted by the globalisation thesis? Why did policy-makers base the argument for European tax co-ordination on a self-defeating logic that suggests anything less than global co-ordination will be futile or actually counter-productive?

To answer these questions, and contextualise the cut-and-thrust of the strategic interaction, this article draws on concepts of discourse and policy narratives previously deployed to explain policy change both within and beyond the EU (Hay and Rosamond 2002; Hay and Smith 2005; Radaelli 1999; Roe 1994; Rosamond 1999; Schmidt and Radaelli 2004). First and most importantly, this work provides the concept of a policy narrative or story-line. A policy narrative provides a simple cause and effect story with attendant moral values that serves policy makers to both tame complexity and serve as a prompt to guide their actions (Radaelli 1999: 663-4; Hajer 1995: 56-7). As is demonstrated in the empirical sections to follow, in the process of negotiation every party relied upon the same story-line of the global imperative in communicating and legitimating their position. This story-line informed each party's understanding of cause and effect in deciding their orientation to the different policies floated.

The policy narrative underpinning the controversy over European tax co-ordination is highly congruent with the more general 'economic imperative' discourse of globalisation (Rosamond 1999; Hay and Rosamond 2002) which put tax EU co-ordination on the agenda from the mid-1990s. Substantively, this discourse of globalisation portrays a new world in which states are forced to compete for highly mobile capital by converging on a similar range of market- and

investor-friendly policies (Hay and Rosamond 2002; Hay and Smith 2005). Conceptually, this article follows Schmidt and Radaelli: ‘Discourse we define in terms of its content, as a set of policy ideas and values, and in terms of its usage, as a process of interaction focused on policy formulation and communication’ (2004: 184).

There are two features of the controversy that strongly support existing conclusions of the discourse literature. The first concerns the potential for discourses of globalisation to bring about globalisation itself: ‘In coping with what they think globalisation will be in the future companies and states make globalisation in the present’ (Cameron and Palan 2004: 2; see also Hay and Smith 2005: 125). To avoid the spectre of mobile capital compromising their fiscal sovereignty in the future states voluntarily compromise their fiscal sovereignty in the present (As the Commission presented it: ‘The apparent defence of national fiscal sovereignty has gradually brought a real loss in fiscal sovereignty by each Member State in favour of the market’ [EC 1996: 10]). Secondly, the Saving Tax Directive episode confirms the power of narratives to motivate policy change even when supporting empirical evidence is lacking (Rosamond and Hay 2002: 148-9; C. Hay 2006: 5). With OECD economies now characterised by the highest taxes at any point in human history (OECD 2007), the globalisation-induced end of the welfare state does not seem to be nigh.

But as well as tending to confirm some key claims of extant discourse work, however, the argument seeks to contest other aspects of this literature. In contrast to some of the earlier work, it is suggested here that seeming contradictions and uncertainty probably overlay genuine

contradictions and uncertainty, rather than disingenuous Machiavellian scheming (Hay and Smith 2005: 134; Rosamond 2002: 171). The article stresses the contradiction inherent in globalisation discourse, and the more specific policy narrative on the taxation of capital, which simultaneously represented an external economic imperative for the EU to act, while also invalidating the possibility of any EU response.

Taking this latter point first, there is a fundamental problem with the Commission and others using new anxieties connected with globalisation and the mobility of capital to advance the cause of EU tax co-ordination. If the global imperative really were all it is made out to be, regional deals to regulate and tax mobile capital would be no less futile and counter-productive than national policy measures along the same lines. In fact, however, the objective structural power of capital has posed much less of an obstacle to regional fiscal and financial co-ordination than policy narratives drawing on more general globalisation anxiety.

Turning to issues of consistency, although actors involved in the tax controversy certainly engaged in strategic behaviour in pursuit of materially-determined preferences, it seems that contradictions often reflected genuine uncertainty rather than cunning dissimulation. Rationalist work assumes that actors are logical in transitively ordering their preference schedule and maximising their utility over a range of alternatives. However they may differ, critics of rationalist approaches often also assume political actors are logical, even if it is a logic of appropriateness rather than a logic of consequences (March and Olsen 1989). While it may be hard to conceive of agents acting in a systematically illogical manner, some psychological studies

argue just this point. For example, through a series of detailed interviews Kull persuasively shows that for decades nuclear policy makers simultaneously held and acted on directly contradictory beliefs: that nuclear warfare would be an uncontrollable catastrophe, and that nuclear warfare was an instrument of calculated national strategy (1988). Though the stakes for the taxation of capital are of course less apocalyptic, an equivalent illogic may obtain. As the following empirical sections demonstrate, the contradictory global imperative story-line both motivated and undermined EU tax co-ordination.

HISTORY OF THE PROBLEM

The European Union has historically had little or no policy role in relation to direct taxation. Thanks to prompting from the French presidency of the European Council, in 1989 the Commission came up with a plan to levy a common withholding tax on interest income, but this went nowhere (Dehejia and Genschel 1999). Member states generally remained protective of their sovereign discretion in setting tax policy.

Growing concerns about the effects of economic globalisation on national revenue-raising powers from the mid-1990s, however, began to open up the possibility of greater co-ordination within the EU. Member governments' fears in this area overlapped with the desire of the Commission to remedy what it saw as distortions in the single market created by tax policies tantamount to discriminatory state aid. New terms like 'fiscal degradation' and 'harmful tax competition' entered the policy lexicon to describe the prospect of states inside and outside the

EU competing to woo mobile international investment by engaging in successive rounds of tax cuts. Ultimately, it was claimed, this competitive dynamic would worsen unemployment (as taxes shifted away from relatively mobile capital to relatively immobile labour), and perhaps even threaten the European social model as a whole (EC 1996; Dehejia and Genschel 1999; Radaelli 1999, 2003). According to this policy narrative, because of the prisoner's dilemma nature of the problem, whereby individually rational actions leave all players worse off, international tax co-operation was seen as essential to avert such a fiscal 'race to the bottom'.

Two Commission documents written a decade apart give a clear sense of this prevailing policy narrative (EC 1996; Cattoir 2007). First, the view that the world has changed: 'globalisation and the closer integration of the capital markets and the accelerated penetration of new communication technologies have done much to encourage the international mobility of activities, in particular in the financial sector' (EC 1996: 3). Then the fiscal implications: 'These developments suggest that individual Member States' freedom to structure their tax systems has diminished' (EC 1996: 4); 'Tax competition between Member States and their partners in the EU, dependent and associated territories and with third countries is causing loss of tax revenue and distorting the very structure of taxation' (Cattoir 2007: 23). Then the futility of national corrective action: 'The threat of fiscal degradation on the structure of tax systems is such that, in the absence of corrective mechanisms, Member States may be unable to redress this balance through individual actions' (EC 1996: 8); 'in a world where tax bases are increasingly mobile, free-riders stand to gain more from an unco-operative policy at an international level' (Cattoir 2007: 22). The Commission's prognosis is clear: 'A deliberate and limited pooling of fiscal

sovereignty by individual Member States to their collective decision-making would have avoided an unconscious surrender of sovereignty by each of them to market forces' (EC 1996: 11); '[A] policy of co-operation at EU and international level now seems to be one of the only ways for governments to recover the room for manoeuvre they sometimes lack in tax matters' (Cattoir 2007: 23). But also present is the danger of displacement: 'Confining measures on savings to the Member States alone risked causing considerable capital flight from the Community' (Cattoir 2007: 7); 'the minimum effective rate [of tax on capital] should be at a level which would not risk driving business or wealth out of the EU' (EC 1996: 13).

The EU-level response to this new threat began to be hammered out following an informal meeting of finance ministers in Verona, Italy in April 1996. A new Taxation Policy Group was set up, chaired by the Commission, and including senior representatives from each of the national finance ministries. The general brief for the group was to come up with policy recommendations that would serve to protect government revenues, further the single market, and promote employment. However the group quickly ran into difficulties that presaged the painful negotiations and repeated delays to come. While France and Germany pushed for an ambitious agenda of tax co-ordination, Austria and Luxembourg were distinctly unenthusiastic about any dilution of their fiscal sovereignty.

Nevertheless, after strong pressure from Germany, France and Italy, some middle ground was found, and by November 1997 the group could report back to the Council with a draft response. This comprised a package of three main measures. The first, and by far the least controversial,

was to eliminate the withholding tax applied to royalties paid to associated companies within the member states. The proposal became Directive 2003/49/EC, being held up for years by the disputes affecting the other elements of the package.

The second was a code of conduct in business taxation to abolish ‘harmful tax competition’ among member states. Features of national tax codes indicative of harmful tax competition included: special tax concessions available to foreign investors but barred to locals (‘ring-fencing’); advantages available to those not engaged in any substantial economic activity; deviation from OECD transfer pricing guidelines; and a lack of transparency (Cattoir 2007: 3-4). The sensitivity of this topic led to a common realisation that a binding directive was not a feasible outcome. Instead, it was decided to move forward via a ‘soft law’ approach. A review group assessed 271 potential harmful tax practices within member states and their dependencies. Of these, 66 tax practices were publicly identified as harmful by the group February 2000. These were to be abolished by December 2005, though extended transition periods until 31 December 2010 were subsequently granted in five cases (Belgian co-ordination centres, Dutch international financing tax rules, Ireland’s foreign income regime, Luxembourg holding companies, and the Madeira free economic zone).

The third and most fraught aspect of the package related to the taxation of non-resident EU savings. Many EU nationals illegally evaded paying tax on their interest income by maintaining bank accounts outside their home state. Among EU members, Austria and Luxembourg were the major recipients of these funds, thanks in large part to their strong tradition of bank secrecy. The

ease with which savers could escape tax obligations in relation to interest payments created pressure to set taxes on capital at a low rate, rather than see capital simply flee across the border. The failure of German efforts to introduce a national withholding tax in 1989 and 1993 because of the resulting capital flight were seen as powerful demonstrations of this dynamic, and of the general truth of the policy narrative of the global imperative. Once the members had agreed on the need to tackle the taxation of non-resident savings (albeit reluctantly in some cases), the Commission committed to return with a draft directive by the middle of 1998.

Presented in June 1998, the draft directive enshrined a dual approach that came to be known as the ‘co-existence model’. This model suggested that member states could comply with the directive by one of two means. The first was to require the automatic exchange of information pertaining to the investment income of non-resident savers from other EU countries. This would mean that, for example, banks in Austria would report the interest income of all account holders who were resident in Germany to the German tax authorities to ensure those account holders declared their interest income for tax purposes. The second was to apply a withholding tax (at a minimum of 20 per cent) on the income of non-resident EU investors. In this case, German residents who had bank accounts in Austria would either pay the withholding tax to the Austrian authorities (who would then remit most of this money to Germany), or obtain a refund of this tax by showing evidence that they had paid tax on this income in Germany.

INTRA-EU NEGOTIATIONS

The intra-EU controversy that developed centred on the relative merits of the withholding tax and information exchange options. For those countries most strongly committed to one or other model, commercial interests were plainly determinative. But in each case these commercial interests were premised on the policy narrative of the global imperative. On the one hand, Austria, Belgium and especially Luxembourg were very reluctant to compromise their strict banking secrecy by engaging in information exchange. The banking industry in each country was adamant that the information exchange option would cause massive capital flight as foreign savers moved their money elsewhere rather than face tax bills on previously untaxed interest income. In threatening to use his country's veto, in June 2000 Prime Minister Junckers of Luxembourg declared that there would be 'blood on the table if certain other delegations [read: the UK] do not change their point of view' (quoted in Gilligan 2003: 59).

But the City of London was equally insistent that applying a withholding tax would wreck the \$3 trillion international bond market, which would sooner relocate rather than face such a tax. Although the withholding tax would only apply to natural persons (i.e., not legal persons like companies) who were only a small minority of bond traders, it was argued that the administrative costs for banks to identify those covered by the Directive would make the Eurobond market uncompetitive. A spokesperson for the City of London emphasised the rock-solid opposition of the private and public sectors to such a tax: 'the British government, with full backing from the City of London, has made very clear that, if a solution acceptable to all which does not damage London's financial markets cannot be found, the UK will use its veto' ('A Tax on Competitiveness', *Financial Times*, 26 January 2000). Both sides thus determined their interests

in line with a common cause-effect story of tax and capital flight.

Despite their differences, all members agreed about the danger of displacement if the deal was to bind only EU member states and leave out crucial external financial centres, another key feature of the policy narrative. The dependence on the compliance of third parties was made explicit at the June 2000 Feira Council:

In order to preserve the competitiveness of European financial markets, as soon as agreement has been reached by the Council on the substantive content of the Directive, the Presidency and the Commission shall enter into discussions immediately with the US and key third countries (Switzerland, Liechtenstein, Monaco, Andorra, San Marino) to promote the adoption of equivalent measures; at the same time the member states concerned commit themselves to promote the adoption of the same measures in all relevant dependent or associated territories (the Channel Islands, Isle of Man and the dependent or associated territories in the Caribbean) (Bulletin EU 6-2000 5/8 Annexes to the Presidency Conclusion).

Anticipating the difficulty of convincing third parties, the Commission were not pleased at this express linkage (Author's interview EC).

The high-point of the British-backed plan came at the Fiera Council, when it seemed that all members would have to participate in tax information exchange. But the remainder of 2000 saw fierce opposition to this prospect from Austria and Luxembourg. An Ecofin meeting in Paris in November was marked by significant compromises that gave rise to a new draft from the

Commission in July 2001. Although specifying universal information exchange as the ultimate goal, countries preferring to apply a withholding tax were granted a long transition period before being obliged to exchange information. The final compromise, however, had the critical proviso that at the end of the transition period the members applying the withholding tax would only switch to exchanging information if the Swiss and other third parties did likewise, as adjudged by the unanimous vote of the Council. The make-or-break clause of the internal compromise thus concerned the conduct of external actors, without whose co-operation the agreement was a dead letter.

EXTERNAL ACTORS 1: THE DEPENDENT TERRITORIES

The narrative of displacement described the fear that ratcheting up tax and regulatory standards might simply drive capital and business outside the borders of the EU (see EC/2003/48 para. 24). At first glance it may be hard to see why securing co-operation from member state dependent territories loomed so large in the internal-external linkage. The Caribbean portions of the Kingdom of the Netherlands (Aruba and the Netherlands Antilles), the British Crown Dependencies in Europe (Jersey, Guernsey and the Isle of Man) and the United Kingdom Overseas Territories (Anguilla, the British Virgin Islands, the Cayman Islands, Montserrat, and the Turks and Caicos Islands) in the Caribbean are geographically tiny and their combined populations are well under one million.

Yet because of the intangible nature of financial services, physical smallness has proved to be no

obstacle to hosting vast amounts of wealth (see Table 1). Thus the Cayman Islands (population 40,000) is reputedly the world's fifth-largest banking centre (Palan 2003), while the British Virgin Islands (population 22,000) has registered 707,392 International Business Companies (IBCs) over the last two decades (BVI Financial Services Commission Statistical Bulletin 2006). Without these dependencies on board, any EU deal would be out-flanked if EU residents could simply relocate their savings to dependencies that neither exchanged information nor applied a withholding tax.

Table 1: External Position of Banks, Assets in Billions of US Dollars

	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006
Guernsey	112	113.6	121.7	135	142.4	183
Jersey	168.7	244.5	283.7	307	360.1	444.1
Cayman Islands	823.2	1,015.2	1,038.9	947.2	1,216.1	1,661.9
Netherlands Antilles	N/A	39.1	33.6	30.2	24.3	21.5
Luxembourg	519.2	594.9	683.6	766.7	753	901.1
Switzerland	711.4	805.1	849.8	920.6	966	1,122
Singapore	407.4	415.6	442.6	506.2	541.5	603.5
United States	1,115.1	1,158.6	1,397.7	1,770.7	1,923.6	2,305.1

(Compiled from BIS Quarterly Reviews, September 2002 p.A8, June 2005, p.A8, June 2007 p.A8)

The dependencies all enjoy a large measure of self-government, setting their own tax laws and budgets and are legally outside the EU (with the exception of Gibraltar).

If compliance with the Savings Tax Directive from the dependent territories was in the interest of

the EU, it was very hard to see why it was in the interest of the dependencies themselves. All have low or no direct taxes, instead raising revenue from import duties and licence fees from foreign investors. Collecting financial information and reporting it to 15 (later 27) foreign countries is expensive. The dependent territories were just as convinced by the logic of the policy narrative as EU members. Applying a withholding tax would cause a further displacement: if savers were prepared to move their money from Luxembourg to the Cayman Islands to avoid the Directive, why would they not be prepared to move this money again from the Cayman Islands to a fully sovereign financial centre with zero direct taxes, like the Bahamas? But as the internal deal was structured, unless every dependency approved the code of conduct, the whole tax package, including the Savings Tax Directive, would fail.

The Dutch and even more so the British governments made it clear that the interests of the territories came a very distant second to those of the metropole. Gordon Brown in particular promised the compliance of the British dependencies to his EU counterparts before either the territories themselves or the Foreign and Commonwealth Office were informed, leading to tensions with each. The dependent territories faced a stark choice: whether to comply and make the best of things, or seek to resist application of the EU measures, given that the territories were legally outside of this body.

The tax package posed an acute problem for Jersey's financial services sector, which comprised well over half the island's economy. In 2002 the UK Treasury began to pressure Jersey to quickly commit to the tax package. Using the standard vehicle for Treasury leaks to the press, the

Financial Times reported one official as follows: ‘Our patience with Jersey has snapped. Because of the intransigent position Jersey is taking... the whole debate about the withholding tax could be re-opened. We are not prepared to put at risk the interests of the City of London. We went through tortuous negotiations in the EU to reach a deal which prevented a withholding tax being imposed on the City. We are not prepared to see that package unravel’ (‘Bond Market Risk from Tax Haven Jersey’, *Financial Times*, 15 April 2002). Despite the unattractiveness of the Savings Directive, authorities in Jersey decided that they had no choice but to comply with the tax package. There was a resigned acceptance that attempting to take on the UK on this matter, or the EU as a whole, was simply a losing proposition.

In the Caribbean, the Cayman Islands worried that compliance with the tax package would cost \$50 million a year as customers placed their money elsewhere. The report that came up with this figure again revolved around the policy narrative of the global imperative:

The brute fact is that the expected return on investment, net of tax, for many Europeans placing their funds in the Cayman Islands will be less than the expected return in a non-reporting country, also with no withholding tax. Capital, in the form of investments in Cayman Institutions, can be moved cheaply and quickly (‘Cayman Braces for \$50 million Loss from Savings Tax Directive’, *Tax-news.com*, 4 February 2003).

Illustrating the lack of evidence for this conventional story, the figures in Table 1 illustrate show how wide of the mark this prediction proved to be.

The Caymans launched a challenge in the EU Court of First Instance, arguing that under Article 230 of the Treaty Establishing the European Community the writ of EU law did not extend to the Cayman Islands. The case was successful in that the Court declared the matter a bilateral concern between the UK and the Caymans. But since all the arm-twisting was being done by London rather than Brussels, this did not materially improve the Caymans' situation. The British government clearly signalled that it was prepared to revoke the Islands' self-government and impose the necessary legislation directly. In early 2004 Chief Minister of the Caymans McKeeva Bush noted: 'I am not one that is normally pushed around, [but] I believe that you can only push so much. In effect then, our two alternatives are that we either reject the proposal and allow the UK government to put it in to place, or we agree, take what is offered and say, "I live to fight another day"' ('Cayman MPs Vote to Accept EU Savings Tax Directive', Tax-news.com, 18 February 2004). In a sop to local sentiment, the UK offered rather meagre compensation, a tax treaty and recognition of the local stock exchange.

For the other dependent territories, being both smaller financial centres than the Caymans and generally more dependent on transfers from the metropole, discretion was the better part of valour. Despite their constitutional equality with the Netherlands, and the costs imposed by the tax package, Aruba and the Netherlands Antilles concluded that they had no choice but to comply (Author's interview Aruba). Led by the British Virgin Islands, the smaller UK centres concentrated on pointing out the heavy costs the tax package would impose, and appealing to London to defray these costs.

EXTERNAL ACTORS 2: THE MICRO-STATES, THE UNITED STATES AND SWITZERLAND

The problem of displacement was once more key in explaining how an internal EU tax deal came to depend on the agreement of non-member sovereign states. Although securing the compliance of British and Dutch territories was important, by itself this was not felt to provide adequate coverage to ensure success. Other non-member sovereign states needed to be somehow convinced to comply. In 2000 these were specified as the four European micro-states of Andorra, Liechtenstein, Monaco and San Marino, as well as Switzerland and, most ambitiously of all, the United States. Despite their formal powers of self-government, a mix of veiled threats and modest compensation had been sufficient to bring the dependent territories into line. The feasibility of the same tactics was more complicated when applied to the micro-states, very uncertain in relation to Switzerland, and laughable in connection with the United States.

Although San Marino does have a private banking industry, it is not economically significant. Monaco and Andorra both have no direct taxes and tight banking secrecy. Of the four, however, Liechtenstein has the biggest financial services sector, and once again a long tradition of bank secrecy (Duursma 1996). Additionally, Liechtenstein is less vulnerable to EU member pressure, as it is in currency and customs union with Switzerland. It quickly became apparent that all four states were reluctant to commit to any deal with the EU until they had seen if and under what conditions Switzerland would comply. Familiar concerns about the competition for mobile investors explained this wait-and-see attitude (Author's interview Liechtenstein).

At the other end of the spectrum, the European Commission was faced with the challenge of gaining the co-operation of the United States. The Commission failed. But in an exercise of collective suspension of disbelief, the member states agreed that the US refusal to either apply a withholding tax or exchange information was consistent with the requirement for third party 'equivalent measures'. The rather thread-bare justification was that the US had tax treaties with most EU members that provided for information exchange. It bears emphasising, however, that the very limited scope for information exchange on request under these treaties is in no way equivalent to the much more demanding requirement for automatic information exchange specified in the Directive (Author's interview EC; Spencer 2005).

Despite the clear impracticality of pushing the sole super-power into an agreement that made it a de facto tax collection agency for the EU, there had been some early hopes that Washington might be more forthcoming. In particular mid-level US Treasury officials evinced considerable sympathy for the goals of the Directive, and also placed a high premium on the international exchange of tax information to defeat tax evasion. In 2002 Treasury proposed regulation 133254-02 according to which US banks would be routinely required to report to the US Internal Revenue Service interest paid to account holders who were resident in the 12 EU countries that had opted for information exchange (as well as non-EU countries like Australia and Norway) (Spencer 2005). This proposal had, however, provoked strong opposition from the US banking industry, which issued dire predictions of capital flight and job losses should banks be required to provide such information. Later the President's Director of the National Economic Council stated

bluntly: ‘the Administration does not support the EU Savings Directive—there is zero interest in it’ (quoted in Gilligan 2003: 63). Rather than beat its head against this wall, the European Commission cut its losses and declared victory.

Logically, if there was any truth to the narrative of the global imperative, the refusal of the US to co-operate should have immediately doomed the tax package. All parties had consistently argued that if investors had an easy option to avoid measures to tax interest income, they would take it. As a result, those countries that implemented the Directive would actually be worse off than under the status quo, as capital flowed out, taking with it a share of both the tax base and the financial services industry. Indeed, if capital did not flow out to the US in this manner, the whole rationale for the Directive would be invalidated. The American defection meant that any EU efforts to tax non-resident savings would be either be hugely counter-productive, if the narrative was correct, or based on entirely mistaken premises and thus unnecessary, if the narrative was wrong. Yet after this public and point-blank rejection from world’s biggest financial centre, the other players carried on using the same story.

If EU member states were prepared to be flexible on the notion of ‘equivalent measures’ in relation to the US, the same was not true of Switzerland. Switzerland came to be the key external actor in relation to the tax package, even though the failure to enlist the US should have made the Swiss position moot. The Commission began with the aims of securing automatic information exchange from the Swiss, and of keeping the negotiations separate from discussions about a package of other bilateral trade and travel issues between Switzerland and the EU. But from the

outset, Switzerland pushed the alternative idea of a withholding tax with most of the proceeds to return to the EU, maintained that the savings tax issue must be linked with the other bilateral matters, and insisted that it would not budge on banking secrecy.

The talks formally opened 7 May 2002, much later than many members had wanted. By September the talks had got nowhere and France, Germany and Britain were increasingly frustrated. These three countries asked Frits Bolkstein, the internal market Commissioner, to draw up a list of sanctions that could be applied to Swiss interests in the event of continued stone-walling over information exchange. EU foreign ministers threatened to shelve proposed liberalisation measures for trade and travel with Switzerland. Ecofin suggested withdrawing operating licences for Swiss banks within the EU and limiting capital movements to Switzerland ('Squeezing the Gnomes', *Economist*, 3 October 2002). In response the Swiss broke off negotiations.

There was a strong suspicion that Luxembourg was giving *sotto voce* encouragement to the Swiss, in the hope that the whole deal would collapse. Bolkstein began to limit his presentations to finance ministers to oral submissions after many internal EU documents mysteriously found their way to Swiss negotiators. But Bolkstein also criticised Britain for its hard-line position, which greatly limited the Commission's ability to offer or accept compromise solutions short of automatic information exchange ('I Cannot Stand Tax Cheats: Frits Bolkstein', *Financial Times*, 7 October 2002). A tense Ecofin meeting 8 October 2002 saw Austria and Luxembourg reject any sanctions against Switzerland, while Bolkstein angered the UK by indicating that the

Commission was no longer pushing for automatic information exchange with the Swiss. The disunity within the EU was in stark contrast to united efforts of the Swiss government and banking industry, arguing that information exchange would merely lead to capital flight to non-compliant jurisdictions. In the absence of a united front, EU sanctions were not a credible threat. And once Ecofin had agreed on a de facto co-existence model allowing a withholding tax option in early 2003 the rationale for any tough stance against the Swiss position faded. In 2004 the Commission conceded both the withholding tax solution and the link with the other bilateral agreements.

THE IMPACT OF THE DIRECTIVE

By 1 July 2005 the tax package had finally entered force. The directive on the taxation of royalties was in place, much later than it would have been absent the linkage with the other two elements of the package. The 66 harmful tax practices identified by the Primarolo group had been dismantled or modified so as to remove their harmful characteristics (with the five exceptions). All the EU members and dependent territories had introduced either the withholding tax or the information exchange option. Finally, Switzerland and the four micro-states had also introduced a withholding tax, with the United States rather implausibly adjudged to have 'equivalent measures' in place.

Directive 2003/48/EC officially enshrines the UK's preferred position on universal information exchange, but de facto reflects the co-existence model. Austria, Belgium and Luxembourg are

allowed to levy withholding taxes in lieu of automatic information exchange, ostensibly before switching to information exchange in 2010. Starting at a rate of 15 per cent, this tax will be increased to 20 per cent from July 2008. Twenty-five per cent of the resulting tax revenue is retained by the collecting country, with the remainder remitted to the investor's home country without revealing that investor's identity. Switzerland and the four micro-states are covered by the same withholding tax arrangement, except that they retain the tax instead of switching to information exchange after 2009, with the rate increasing to 35 per cent from July 2011. In Austria, Belgium and Luxembourg, those impacted can avoid the withholding tax by giving permission to their bank or other financial institution to pass the details of their interest income to their home country's tax authorities. Crucially, however, for the three EU members to switch from the withholding tax to information exchange in 2010 Switzerland and the micro-states must agree to exchange tax information relating to specific tax payers on request (a much less stringent condition than exchange information automatically) (2003/48/EC para. 18). All of these states bar San Marino have explicitly refused to do this, and thus on present indications the current two-track solution looks likely to persist for the indefinite future.

What difference has the Savings Tax Directive made? The initial rationale was that EU savers were hiding large amounts of money outside their home countries to evade paying tax on interest generated by these savings. The hope was that the combination of information exchange and a withholding tax would bring in major new revenue flows to EU governments, particularly Germany, Italy and France. Although most member states have adopted information exchange (including all 12 new members), the jurisdictions suspected of hosting the bulk of the hidden

funds have opted for the withholding tax option (Austria, Belgium, Luxembourg, Switzerland, the four micro-states, and the Crown Dependencies).

If this suspicion is correct, the total withholding taxes collected should provide a reasonable indicator of success. Even though figures are only available for the six-month period July-December 2005, both the European Commission and industry critics of the Directive have previously argued that the initial tax take should be the biggest, with a tailing off subsequently despite the increasing rates at which the withholding tax is levied. The logic behind this prediction was that once investors had been hit by the tax 2005-06, they would either re-structure their affairs to avoid the tax (e.g. by forming a trust), or move their funds to a jurisdiction beyond the reach of the Directive, or simply return their money home and give up the offshore option altogether (Author's interviews EC, Cayman Islands, Liechtenstein).

In this light, the very low totals of withholding tax collected (of which a quarter was retained by the collecting country) have been a major disappointment for the Directive's supporters. The figures even undershot the low estimates of its detractors: Switzerland collected €102 million, Luxembourg €48 million, Jersey €13 million, Belgium €9.7 million, Guernsey €4.5 million and Liechtenstein €2.5 million (Cattoir 2007: 16). Compare these figures with the hundreds of billions of Euros in savings that the directive set out to catch, and the estimates of the boost to tax revenue possible with an effective regime for taxing non-resident interest income, set at \$12 billion annually for Germany alone ('Taxing Matters', *Economist*, 3 April 1997). In April 2007 the Commission expressed a continuing 'degree of disappointment' with the way the directive

had worked thus far ('Brussels to Tighten Savings Tax Law', *Financial Times*, 9 April 2007).

What is the commercial effect of the Directive? The movement of €7 billion into specially exempt bonds in July 2005 was directly attributed to the selective coverage of the Directive ('Bond Fund Sales Highlight EU Loophole', *Financial Times*, 24 October 2005). Products like offshore portfolio bonds have enjoyed increased popularity since 2005 for the same reason (Lowtax 2006). To what extent has the global imperative, the problem of displacement, undermined the measures to tax EU residents' offshore savings? In moves widely regarded as an effort to attract funds beyond the reach of the new measures, from 2001 onwards Singapore tightened bank secrecy, eased residency requirements, and made its trust laws more internationally competitive ('Jurisdictions in Focus: Singapore', *Offshore Investment*, June 2006: 28-35). Swiss and Liechtenstein banks have also expanded their presence in Singapore. As a result the city-state has seen a 25 per cent growth in funds managed in 2006 ('A New Treasure Island', *Economist*, 19 August 2006). Hong Kong and Dubai have also seen impressive growth, again ascribed in some measure to the displacement effect from Europe and the Caribbean dependencies. In response the European Commission has begun discussions with both Singapore and Hong Kong on expanding the coverage of tax information exchange, though such advances have so far got a frosty reception (European Council press release 13989/06, 23 October 2006; Author's interview Hong Kong).

But, despite their predictions of massive commercial disruption, capital flight and administrative expense, the major financial centres among both EU member states and dependent territories

have continued to enjoy steady growth (see Table 1). Despite the gaping hole in the coverage of the directive represented by the US, let alone the other non-participating centres, the nightmare scenario of regulatory arbitrage and capital flight has failed to emerge. The evidence has once more failed to support the basic premise of EU tax co-ordination.

CONCLUSIONS

Are regional deals feasible in light of the global imperative? The Savings Tax Directive produces mixed messages. Some have argued that the failure to pick up the hoped-for extra revenue (at least so far) would tend to indicate that this regional deal has fallen afoul of the globalisation-induced capital mobility. At least in this sense even the expanded co-operation between the 27 member states, the associated territories, and the third parties may have been insufficiently encompassing. But although there has been some movement of funds to Singapore, Hong Kong and other non-participating centres, the magnitude of outward capital flows is far lower than would be needed to explain the very low revenue totals. As the figures in Table 1 suggest, the tax package has not been the ‘suicide pact’ some observers suggested it would be for the financial services industries in EU and other participating financial centres (www.freedomprosperity.org/eu/eu).

Instead, it seems as if most investors have been able escape the Directive while keeping their money inside the EU. It is not so much the global imperative that has frustrated the ambitions of the Commission and key member states like Germany, as the loop-holes created during the long

negotiating process. Both the British and Luxembourg governments stated right from the start that they would do whatever it took to protect their financial industries. Increasing tax revenue could only come at the expense of damage to the financial services industry abroad, but never at home. Hence the exemption of companies, trusts, many kinds of bonds and other more exotic financial products.

Underpinning this stance were discourses of globalisation and the policy narrative of the global imperative. This story allowed some governments and the Commission to put tax co-ordination on the policy agenda, but also enabled other states and industry lobby groups to subvert the solution. The latter could successfully argue that standards which were bad for the industry were also bad for the nation. ‘Punishing’ the industry would only displace capital to foreign centres, thus actually reducing tax revenues, as well as damaging the EU and destroying jobs. The conventional picture of globalisation as the increased mobility of capital that was so important in moving tax co-operation on to the EU agenda from the mid-1990s was also critical in limiting the policy response. For despite the fierce disagreements between the various governments, everyone, inside and outside the EU, accepted the centrality of the displacement problem.

Pushed to its logical conclusion, if the displacement problem were so central, however, then the tax package should have met an early and decisive failure rather than lingering on and stumbling over the finish line. If the global imperative really were global then no EU country should have supported anything less than a completely global solution. In contrast, earlier economic analysis has shown that withholding tax and information exchange solutions can be Pareto improving

even without the co-operation of third country tax havens (Huizinga and Nielson, 2002).

If so much political capital has been invested in the Savings Tax Directive, on present indications there will be little to show for it in fiscal terms. Despite talk of reviewing the coverage of the Directive, it is extremely unlikely that sufficient loop-holes will be closed to make a difference in tax revenues. Rather than reflecting the objective power of newly-mobile capital, this impasse is instead the product of the policy narrative of a global imperative, a story which has captured the imaginations of policy-makers and capitalists alike.

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