

## Does Punishment Work (at Least in International Tax)?

**Author :** Adam Rosenzweig

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Niels Johannesen and Gabriel Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, 2014 [Am. Econ. J. Econ. Policy](#) 65.

The OECD is currently undertaking a major study of virtually every significant issue confronting the international tax regime through its “base erosion and profit shifting” (BEPS) project. Among the proposals for reform include the familiar call for increased penalties on non-cooperative states. In fact, punishment has served as a core feature of virtually every modern attempt to combat tax competition.

But does punishment really work in this context? [Niels Johannesen](#) and [Gabriel Zucman](#) address precisely this question in their paper *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*. The best way to describe the project is to quote the abstract:

During the financial crisis, G20 countries compelled tax havens to sign bilateral treaties providing for exchange of bank information. Policymakers have celebrated this global initiative as the end of bank secrecy. Exploiting a unique panel dataset, our study is the first attempt to assess how the treaties affected bank deposits in tax havens. Rather than repatriating funds, our results suggest that tax evaders shifted deposits to havens not covered by a treaty with their home country. The crackdown thus caused a relocation of deposits at the benefit of the least compliant havens.

This paper provides an extremely important and timely contribution to the international tax literature. Anecdotal evidence about the effectiveness of punishment has been mixed to date, and there has been little empirical data directly on the question. Further, the question taps into a larger debate over the underlying, root causes of tax competition more generally. By providing empirical data directly on this question, Johannesen and Zucman move the debate forward in an extremely valuable way.

As background, the traditional approach to tax competition provides that cooperation over tax matters benefits every country of the world. An observed lack of cooperation, therefore, must represent some form of institutional failure (whether it be political economy, irrationality, etc.). Such failure, in turn, justifies punishment in response. Under this theory, every country added to the cooperative list as a result would move the world closer to the ideal result.

A competing theory has begun to emerge, however. Under this “holdout” theory, it is assumed that cooperation—while in the best interest of the worldwide regime as a whole—is not necessarily in the best interest of every individual country. Rather the holdout problem arises when the benefits to any one country of holding out increase as other parties agree to cooperate. Suppose the Cayman Islands ceased to be tax haven tomorrow. Would that make it more or less valuable for Bermuda to remain a tax haven? The punishment approach would say it becomes less valuable, while the holdout theory would say it becomes more valuable.<sup>1</sup>

Johannesen and Zucman provide a unique data set to analyze precisely this question. More specifically, they ask whether punishing certain countries for adopting bank secrecy resulted in less overall use of bank secrecy—consistent with the punishment theory—or simply in the shifting of assets to other bank secrecy jurisdictions—consistent with the holdout theory. They find compelling evidence that assets simply shifted to other bank secrecy jurisdictions.

This is potentially a ground-shaking finding. The punishment theory has, for the most part, served as the intellectual basis for international tax policy over the past two decades. Real-world successes were pointed to in support of the theory while failures were explained as the result of inadequate measures. Either way, more (or differently tailored) punishment was typically justified.<sup>2</sup> If Johannesen and Zucman are correct, however, this story no longer holds. In fact, taken to its logical extreme, their findings could undermine the punishment theory as the intellectual basis for international tax policy altogether. Hopefully, as a result this paper can help move the policy debate away from the punishment theory and towards the holdout theory, ultimately resulting in a more efficient and effective international tax regime.

By itself, this would be a significant contribution. The holdout theory, if true, would mean that the world faces a collective action problem in which the primary issue would be whether cooperation from every country in the world was possible.<sup>3</sup> Conversely, increasing cooperation by a handful of countries—one of the stated goals of BEPS—could potentially make the regime worse off for everyone.<sup>4</sup> To this end, Johannesen and Zucman argue that “[f]rom a normative viewpoint, our paper thus lends support to the idea ... that a ‘big bang’ multilateral agreement should be preferred to the current sequential approach.” While this may be correct as a theoretical matter, it is difficult to imagine every country of the world meeting in one place and agreeing to a new, comprehensive international tax regime. So where does that leave things?

Although Johannesen and Zucman support the call for a multilateral treaty, their results could also support side payments, or a multinational tax institution, or a number of other legal structures.<sup>5</sup> Ultimately, then, I believe this paper highlights the need for increased dialogue between public finance and legal experts in this area, especially given the unique opportunity to revisit all of these issues through BEPS. Economists are good at measuring and quantifying issues, and providing disciplinary rigor to analyzing difficult questions. Lawyers know how to implement policy, how to build institutions, and how to anticipate taxpayer responses. Both are necessary to build a real-world regime, and each can learn from the other. Hopefully, Johannesen and Zucman, as part of a larger project, can help further this process.

1. See Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 Wm. & Mary L. Rev. 923 (2010). [?]
2. For a survey, see Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 Conn. L. Rev. 675 (2011). [?]
3. See Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 Va. Tax Rev. 555 (2007). [?]
4. citing Elsayyad and Konrad, *Fighting multiple tax havens*, 86 J. of Int'l Econ. 295 (2011). [?]
5. See Adam H. Rosenzweig, *Thinking Outside the (Tax) Treaty*, 2012 Wis. L. Rev. 717. [?]

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