Between soft law and a hard place
- EU influence on taxation policies in Cyprus before, during and after the bank crisis

Peter Henriksen Ringstad

Master thesis
Department of Political Science
Faculty of Social Sciences
University of Oslo
Spring/April 2014
Between soft law and a hard place
-EU influence on taxation policies in Cyprus before, during and after the bank crisis

Peter Henriksen Ringstad
© Peter Henriksen Ringstad

2014

**Between soft law and a hard place** - EU influence on taxation policies in Cyprus before, during and after the bank crisis

Word count: 31,851(all included)

Peter Henriksen Ringstad

[http://www.duo.uio.no/](http://www.duo.uio.no/)
Abstract

Can the EU influence the taxation policies of member states? Most EU scholars finds that the answer to this question is ‘no’. This study explores the idea that maybe it can, by conducting a case study of a most likely case for EU influence on taxation: Cyprus. The paper examines EU influence on the taxation policies of Cyprus in the period from 2002 to 2013. During this period, Cyprus was involved in two major negotiations with the EU: the EU accession process leading up to accession in 2004 and the negotiations following their 2012 application for financial support under the European Stability Mechanism. The paper finds that both these negotiations led to transformation of policies on taxation and transparency in Cyprus under EU influence. The negotiations gave ‘teeth’ to soft law instruments on tax and transparency promoted by the EU.
Acknowledgements

I want to thank my supervisor, Bent Sofus Tranøy, for giving valuable advice and encouragement throughout the process. I also want to thank Benjamin de Carvalho and NUPI, for hosting me during my writing process. Many thanks to Copenhagen Business School and the team working on the STEAL-project, Leonard Seabrooke, Duncan Wigan and Eleni Tsingou, for inviting me to work with them for a period of time in Copenhagen, and for their warm welcome and excellent guidance. I am also very grateful for the valuable input and comments from Cathrine Brun and Nicolas Van Hear, and my friends who have read and commented along the way: Hanna Werno, Øyvind Solheim and Ragnhild Faller in particular. At last, a big thank you to my family for bearing with me during the writing process, and being incredibly supportive.

I take full responsibility for any mistakes or omissions in this thesis.

Peter Henriksen Ringstad
Oslo, April 2014.
Contents

1 Introduction 1
  1.1 EU and the power to tax ................................................. 1
  1.2 The case of Cyprus .................................................... 2
  1.3 Research question ..................................................... 3
  1.4 European tax policy in a time of crisis ............................. 3
  1.5 Disposition of thesis .................................................. 5

2 Theory 7
  2.1 European integration and Europeanization .......................... 7
  2.2 Intergovernmentalist approaches ..................................... 9
  2.3 Supranationalist approaches ......................................... 11
  2.4 Institutionalist approaches on Europeanization .................... 13
  2.5 The use of theory in this study ...................................... 14

3 Data and Methodology 17
  3.1 Research design - qualitative case study .......................... 17
  3.2 Gathering of empirical data ........................................... 18
  3.3 Semi-structured interviews .......................................... 19
  3.4 Special circumstances of the field work in Cyprus ............... 20

4 The EU and taxation 23
  4.1 Decision-making in the EU on taxation ............................ 23
    4.1.1 The European Commission ....................................... 24
    4.1.2 The Council ..................................................... 25
    4.1.3 The European Court of Justice ................................ 25
    4.1.4 The European Parliament ...................................... 26
  4.2 Tax cooridination - the emergence of an EU tax agenda .......... 26
    4.2.1 Harmful tax competition ....................................... 27
4.2.2 Instruments of tax competition - reverse engineering tax havens . . 28
4.3 EU policy initiatives to curb harmful tax competition . . . . . . . . . . . . 29
4.3.1 The Tax Package . . . . . . . . . . . . . . . . . . . . . . . . . . . 30
4.3.2 The Code of Conduct on Business taxation . . . . . . . . . . . . . . 30

5 Cyprus - background on politics and economy 33

5.1 Cyprus as an international business centre in the EU . . . . . . . . . . . . 33
5.1.1 Shipping . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 34
5.1.2 Banking . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 35
5.1.3 The Russian Connection . . . . . . . . . . . . . . . . . . . . . . . . . 36

5.2 Cyprus and the Financial Crisis . . . . . . . . . . . . . . . . . . . . . . . . 39

6 Analysing Cyprus - EU relations on tax 41

6.1 EU accession and tax reform . . . . . . . . . . . . . . . . . . . . . . . . . 42
6.1.1 Key changes to the tax system . . . . . . . . . . . . . . . . . . . . . . . 43
6.1.2 Shipping . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 44
6.1.3 Analysis . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 45

6.2 A period of stability on taxation (2004-2012) . . . . . . . . . . . . . . . . . 47
6.2.1 OECD Global Forum process . . . . . . . . . . . . . . . . . . . . . . . . 48
6.2.2 Code of Conduct on Business Taxation . . . . . . . . . . . . . . . . . 50
6.2.3 Analysis . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 51

6.3 Bank Crisis and ‘bailout’ negotiations . . . . . . . . . . . . . . . . . . . . . 55
6.3.1 The European Stability Mechanism . . . . . . . . . . . . . . . . . . . . 55
6.3.2 The Bank Crisis and Troika negotiations . . . . . . . . . . . . . . . . . 57
6.3.3 Cyprus implementation efforts under scrutiny . . . . . . . . . . . . . 62
6.3.4 ESM programme and outcome on taxation and transparency . . . . . 64
6.3.5 Analysis . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 66

7 Conclusion 71
List of Figures

5.1 Cyprus Current Account deficit to GDP .......................... 38
5.2 Cyprus Government Debt to GDP by 1st of January .............. 38

List of Tables

3.1 Interviews ........................................................................... 19

5.1 Cyprus Educational Enrollment 2010/2011 .......................... 35
5.2 Inward and Outward Direct Investment Positions ................. 36
5.3 Russian Federation: Outward FDI by Russians .................... 37
## List of Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AKEL</td>
<td>Progressive Party of Working People (of Cyprus)</td>
</tr>
<tr>
<td>BND</td>
<td>Bundesnachrichtendienst (Foreign Intelligence Agency of Germany)</td>
</tr>
<tr>
<td>DG</td>
<td>Directorates-General (Departments of the EU Commission)</td>
</tr>
<tr>
<td>EC</td>
<td>European Commission</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>ECFIN</td>
<td>European Commission DG - Economic and Financial Affairs</td>
</tr>
<tr>
<td>ECOFIN</td>
<td>The Economic and Financial Affairs Council</td>
</tr>
<tr>
<td>ESM</td>
<td>European Stability Mechanism</td>
</tr>
<tr>
<td>EWG</td>
<td>Euro Working Group</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FATF</td>
<td>Financial Action Task Force</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>MONEYVAL</td>
<td>Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism</td>
</tr>
<tr>
<td>MOU</td>
<td>Memorandum of Understanding</td>
</tr>
<tr>
<td>OECD</td>
<td>The Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PEP</td>
<td>Politically Exposed Person</td>
</tr>
<tr>
<td>TAXUD</td>
<td>European Commission DG - Taxation and Customs Union</td>
</tr>
</tbody>
</table>
Chapter 1

Introduction

A fiscal crisis is per definition an issue of expenditure versus revenue. Consequently, the fiscal crisis that currently many states in the EU is trying to manoeuvre, is at least in part a crisis of taxation. Many European states are currently by and large failing to finance their expenditures through tax revenue. The fiscal challenges that European governments face have lately brought increased attention from governments, civil society and the media to the issue of sources of fiscal revenue. As people in many European countries are feeling the impact of the crisis through rising unemployment and the rolling back of welfare benefits that follows from austerity measures, many have become angry with revelations that large and highly profitable multinational corporations like American coffee-giant Starbucks contribute almost nothing in tax, by employing elaborate tax planning schemes (The Guardian, 2013). In December 2012 the EU Commissioner on tax, Algirdas Semata, revealed that the Commission estimated that €1000 billion was lost in tax revenues by EU member states every year because of tax avoidance and evasion (European Commission, 2012b). If these estimates are even close to being realistic it is evident that the current crisis in Europe is not only a sovereign debt crisis, but also a tax crisis.

1.1 EU and the power to tax

Solving a crisis on taxation is, however, not easy for the EU to remedy, as the EU has no formal competence over the taxation policies of EU member states. Although many EU countries have integrated monetary policies in a monetary union, fiscal policy has remained in the domain of sovereign states, the result of which is an uneven economic integration of economic policies in Europe. This fact is often pointed out by the European Commission (EC), which has struggled with getting new EU legislation in place within the
field of direct taxation\textsuperscript{1}. At heart, the problem of international tax avoidance and evasion is one that arise from the difficulties of international coordination and cooperation. In an European context, the focal point of such coordination and cooperation would naturally be the European Union, and the current tax crisis can be therefore be seen as a consequence of the failure of EU integration on taxation policy.

The failure of the EU in acquiring competence on taxation, and the lack of integration of taxation policies have caused students of European integration to conclude that the EU can not influence the taxation policies of member states, a consensus Genschel and Jachtenfuchs (2011, p. 1) calls a “no taxation thesis”. In this study, I explore the idea that maybe it can. My approach to studying this is by conducting a study of a most likely case: Cyprus.\textsuperscript{2}

1.2 The case of Cyprus

There are several reasons why it would be interesting to take a closer look at the relationship between the EU and Cyprus within the field of taxation. First, the country is a relatively new member to the European Union, joining in 2004, therefore the time of EU influence is relatively short and manageable. Second, prior to joining the EU, Cyprus was widely recognised as a tax haven, for instance by offering a so-called ‘offshore’ tax system, where non-residents are offered lower tax rates than Cyprus residents. Even after the accession Cyprus had the lowest corporate tax rate in Europe, at ten percent. Third, since the turn of the century, Cyprus has undergone two major negotiations with the EU: first accession negotiations leading up to EU membership in 2004, and more recently, negotiations of a bailout under the so-called European Stability Mechanism (ESM) taking effect from spring of 2013, following a major crisis of their bank sector. Fourth, being a small island of only one million inhabitants, it can be assumed that Cypriot authorities

\textsuperscript{1}From the 1960s up until the 1980s all efforts of the Commission to create common fiscal rules and coordinating direct taxation were unsuccessful (Radaelli, 1999, p. 667). The Commission was for instance not able to pass one directive on direct taxation between 1990 and 2003 (Cattoir, 2006, p. 20)

\textsuperscript{2}’Cyprus’ will throughout this thesis be used to refer to the Republic of Cyprus. Since the invasion by Turkish military forces in 1974, the northern part of the island has been under Turkish occupation, constituting about 35\% of the island’s territory. Following the invasion, the island was largely divided along ethnic lines, with more than 200,000 refugees traveling either to or from Northern Cyprus (Sepos, 2008, p. 28). Northern Cyprus, formally known as the Turkish Republic of Northern Cyprus, has declared independence which is only recognized by Turkey. The UN controls a buffer zone which runs along the entire border between Cyprus and Northern Cyprus, and cuts the capital Nicosia in two (Sepos, 2008, p. 154).
wield relatively little influence on European politics. The combination of these factors make me assume that if you want so search for a case where the EU would have power to influence the policies of direct taxation in a member state, Cyprus would be a likely case to find it.

1.3 Research question

If no such EU influence on taxation is found even in the member state that can be reasonably argued to be a most likely case, then this does lend merit to the claim of a lack of EU influence within taxation policy. If the EU is found to have influence on taxation policy, however, then this will open up questions about the nature of the processes through which EU influences member states (often referred to as a process of Europeanization). It will also open up questions concerning what specific policy areas that EU are found to influence and through what kind of causal mechanisms this influence takes place.

This leads to the overarching research questions of this thesis: Does the EU have the power to influence member states on taxation policy? If yes, through which kind of processes can the EU influence member states on taxation policy? How has the power to influence taxation policy been changed with the recent crisis and the mechanisms such as the European Stability Mechanism? And looking at these processes, which actors are key in influencing their outcome?

1.4 European tax policy in a time of crisis

It is hardly an exaggeration that the nuts and bolts of taxation policy, as a subject, has about the same potential to capture the popular imagination as an excel spreadsheet. It might be timely, therefore, to situate the issue of tax policy within the larger context of European economic policy in a time of crisis.

By 2009, it became clear that the financial crisis that originated in the US subprime mortgage market in 2007 and 2008 was starting to have a devastating economic impact on several European governments. The European sovereign debt crisis that followed has caused states like Greece, Ireland, Portugal and most recently Cyprus to ask for financial bailouts, and many if not most European countries have substantially increased their sovereign debt to gross domestic product (GDP) ratio and run fiscal deficits. Economic giants like Spain and Italy look fiscally vulnerable, and the future of the Euro seems uncertain.
Eurozone countries that have run into deep economic crisis with high and growing sovereign debt find themselves in nasty dilemma. Since they are a part of a common currency in the euro, the economic tools they have available are limited. If they cut spending, the route of so-called austerity measures, this will likely cause increased unemployment and deepen the recession. If they don’t cut spending, they risk building up their debt to unsustainable levels where commercial actors will no longer risk lending them money, and they will be shut out of the commercial credit markets, sharing the fate of for instance Greece and Cyprus.

How an economic recession can be turned into economic growth is both an intensely debated and politicized question that divides academics and decisionmakers alike. One the one side, many argue that governments need to spend more during economic recessions, in order to kick-start the economy, aligning themselves roughly with the academic tradition building on John Maynard Keynes. If this means that the government would build up public debt then that is worrisome, but fiscal stimulus still is the priority. On the other side, many argue that the a precondition for economic growth is a sound fiscal policy, which means that it is imperative that governments tighten in their budgets and not let debt levels build up. This perspective has recently been most associated with the work of economists Carmen Reinhart and Kenneth Rogoff, who in a hugely influential 2010 article, *Growth in a time of debt*, claimed to find empirical evidence that debt levels over 90 percent of GDP was harmful to economic growth. Their work has been directly cited by the likes of Chancellor of the Exchequer George Osborne and Commissioner of Economic Affairs, Olli Rehn, to underpin European austerity policy. This work has been the subject of fierce academic controversy, recently after the discovery of grave errors in their empirical data (Herndon, Ash, and Pollin, 2013), but even earlier it was strongly contested that debt levels could be a causal explanation for economic growth. This debate has been an important academic undercurrent in the larger discussion about which direction to take for Europe in order to get out of the current crisis.

Whether you believe that economic growth is best achieved through stimulating the economy through expansionary public spending, or through encouraging growth from the private sector while keeping government spending limited, it is hard to argue that money stashed in offshore accounts or in tax havens are contributing to economic growth in Europe. So clamping down on tax evasion and tax avoidance could, for the EU countries, be one way of loosening the fiscal austerity measures without running higher fiscal deficits.

This brings back the question, can the European Union influence the policy of member states on taxation? Arguably, if the EU can not influence the member states, it will be
difficult for EU states to succeed in increasing their tax revenue through combating tax avoidance and evasion, since coordination is needed to address these issues. A related question, that will be outside of the scope of this study to answer, is the more normative question of whether the EU should be able to influence tax policy of the member states, an issue that lies at the heart of the concept of sovereignty.

1.5 Disposition of thesis

The next chapter will present the theories that will inform the analysis of my study, which are collected from studies on European integration and Europeanization. The third chapter will describe the research design and methodological approach of the study. This chapter will be followed by an introduction to EU decision-making in this policy area, as well as describing the most important EU policies on direct taxation. Chapter five is a brief background on history, politics and the economy of Cyprus. Chapter six will both describe and analyse the relations between the EU and Cyprus on taxation matters in the time span between Cyprus accession negotiations and up until the summer of 2013. The analysis will look into these as three periods, the first being the accession negotiations, the second being the period between 2004 and the recent bank crisis, and the third being the recent negotiations of a bailout caused by the bank crisis. Some concluding remarks will be made in the final chapter.
Chapter 2

Theory

In this chapter, I will present the theoretical approaches that will inform the analysis of this study. The theoretical underpinning of the explanations of this study are gathered from some of the main strands of scholarly work on the European Union; theories of European integration and institutionalist approaches to studying Europeanization. Below I will first briefly introduce these before I separately present the aspects from these theories I will highlight in my work, and briefly contextualise these within the policy area of taxation in the European Union. In the last part of the chapter I will outline how these combine to make out the theoretical framework of my analysis.

2.1 European integration and Europeanization

Students of the European Union have traditionally focused on explaining the occurrence or non-occurrence of policy-areas being integrated at a European level of decision-making. This involves transferring authority from the member states to the supranational level and creating EU systems of governance. Here, a dividing disagreement among scholars has particularly been on the relative importance of supranational institutions like the Commission, and to what extent states have the opportunity to stop or reverse the process of European integration. Historically, you can broadly separate the academic contribution on European integration into those emphasising the intergovernmental aspects of European integration and those who lend more weight to the role of supranational actors and functionalist explanations.

Scholars who are oriented towards functionalist accounts of the European integration process have argued the importance of functional self-reinforcing processes which create an increasing need for integration and harmonisation of rules, institutions, practices and
laws amongst EU countries, and that supranational institutions and actors play a vital role in this process (Sandholtz and Sweet, 2012). Those aligning with more intergovernmentalist accounts of European integration, will emphasise that the integration has been driven by the interests and actions of member states, and lend limited importance to the supranational institutions (Pollack, 2012).

A more recent direction of research within the mainstream of EU studies have seen scholars being more preoccupied with the impact the EU has on nation states (Sedelmeier, 2012, p. 825), rather than studying how integration has taken place on an European level. This rather diverse body of work that has emerged since the 1990s has been identified with the term Europeanization. The growth in the use of this term reflects the increased attention to students of the EU in explaining the EUs impact on both member states and non-member states who are either in an EU accession process or somehow linked to the EU (Bulmer, 2007, p. 46). Europeanization is a term most commonly used in studies that look at the impact of the EU in member states. Schimmelfennig and Sedelmeier for example uses a simple definition of europeanization as “a process in which states adopt EU rules” (in Sepos, 2008, p. 3). This study, which aims at looking at the interaction and influence between the EU and a member state (Cyprus) on a specific policy area (taxation), aligns well with this group of scholarly contributions within the Europeanization literature. Much like the term ‘globalisation’, Europeanization is a term with no commonly agreed precise meaning, but one which still can be a useful point of departure when discussing changes occurring in politics and society within a European setting (Featherstone, 2003, p. 3).

Some scholars have taken a broader approach to the term Europeanization that also encompasses central elements of the earlier explanation models on European integration. Borzel (2002, p. 193) for instance, sees Europeanization as a two-way process, that encompass both a ‘bottom-up’ and ‘top-down’ dimension. While the former, which she also terms uploading, is about the construction of EU systems of governance, the latter, or downloading, is about the domestic impact of these EU systems. Olsen (2002, pp. 923-924) break the phenomena that have been referred to by the term Europeanization into five uses: “Changes in the external boundaries”, i.e. Europeanization of new member states through enlargement of the EU; “Developing institutions at the EU level”, i.e. building EU institutions of governance and normative order; “central penetration of national systems of governance”, where domestic governance systems adapt to a EU political centre and European-wide norms; “exporting forms of political organization”, i.e. countries beyond the borders of Europe import forms of political organization and governance from
2.2. INTERGOVERNMENTALIST APPROACHES

the EU and lastly “Europeanization as a political unification project” in terms of Europe becoming a more “unified and stronger political entity”.

This diversity in approaches highlights the fact that Europeanization is not a theory in itself, and can become, as warned by Goetz “a cause [i.e. the EU] in search of an effect [at the domestic level]” (in Bulmer, 2007, p. 47). Europeanization is rather a phenomenon, or range of phenomenons, that students of the EU have sought to explain. These explanations require theoretical underpinning, however. Theories are what, according to Stoker “select out certain factors as the most important or relevant in providing an explanation” (in Bulmer, 2007, p. 46) and thereby allows for building hypotheses that can be empirically tested. Although it is hard to determine the generalisation potential of the causal mechanisms found in a single case, such as this study, identifying mechanisms are still valuable for further theory development and identifying hypotheses for future testing (George and Bennett, 2005, pp. 19-25). Below follows the theoretical approaches I will use, and a brief contextualization of how these theories can highlight explanatory factors that should be explored empirically in my analysis.

2.2 Intergovernmentalist approaches

State centred theoretical approaches have been a mainstay of international relations theory throughout its history. In research on European integration, scholarly contributions that emphasise the role and the power of states have usually been labelled under intergovernmentalism. Intergovernmentalists did not arrive ‘first at the scene’ in trying to explain the dynamics of European integration, but the theoretical field evolved as scholars began to challenge the neo-functionalist (see below) explanations to European integration that had been dominant in explaining European integration up until the 1960s (Schimmelfennig, 2010, p. 37).

As a growing number of countries have integrated an increasing amount of policies under what is now known as the European Union, scholars have debated whether the 
*sui generis* characteristics of European integration calls for a unique theoretical approach when studying the European Union, or whether European integration could and should be explained by using general theories of international relations (Moravcsik, 1993, p. 474). Intergovernmentalism and liberal intergovernmentalism share the core assumptions of realist and neo-realist theories of international relations, namely that states are the key actors and that they behave as rational actors in the international system (Pollack, 2012, p. 11). However, neither classical realism and more recent, structural realist approaches
CHAPTER 2. THEORY

offer much explanation for the emergence of the European Union as a set of institutions at the European level with significant executive, legislative and judicial powers (Hix, 2006, p. 141).

According to liberal intergovernmentalists, the European Union should be studied as an international regime for policy coordination. Moravcsik (1993, p. 480) suggests that the institutional and substantive developments of the EU should be explained by sequential analysis, where one first explain the national formation of preferences, and then the strategic interaction between states at the intergovernmental level. The formulation of national policies are determined domestically, where self-interest and interest of constituencies are aggregated. This position is then brought on to the intergovernmental, or EU, level, where bargaining, power, package deals and side payments are key to the outcomes of intergovernmental bargain. Although liberal intergovernmentalists would probably not deny that the Commission could take the role as norm entrepreneur, they would stress that it is the Member States who in the end decide whether policy initiatives from the Commission are accepted and integrated to the EU level as law. This approach expects that identifying the goals of the supranational organisations such as the Commission, would therefore not be important for predicting outcomes.

By taking a state centred or intergovernmentalist approach and contextualising it to the issue of taxation in the European Union, one can extract at least two theoretical assumptions. The first is that transferring power to the EU level on taxation is something states would be generally unwilling to do. In the words of Keohane (1984), “governments put a high value on the maintenance of their own autonomy, so it is usually impossible to establish international institutions that exercise authority over states” (in Pierson, 1996, p. 128). Taxation is one of the fundamental elements of any political regime, something which has been elaborated on by a wide variety of scholars, for instance Joseph Schumpeter (1991) and Margaret Levi (1989). A national defence, a functioning legal system, police and a protection of private property rights can be seen as the minimum of what a state should provide, and all represent collective goods, the provision of which would be difficult to coordinate without a state with clear authority and ability to tax (Fukuyama, 2004, p. 10). Extracting large amounts of revenue from its citizens is a major challenge for a state, and many of the modern institutions that are taken for granted in western states today were put in place to make it easier for states to calculate and extract taxes from the population (Scott, 1999). Tax forms a central bond between the state and its citizens. The tax system, or more philosophically, the fiscal social contract, constitutes some of the fundamental features that a state is built on, and the public discussion on the scope
of tasks that a state should take on, and thereby the level of taxation that should be extracted by state from its population, is often central to any functioning democracy. Taxation lies, directly or indirectly, at the core of every state function, and is therefore considered to be one of the core aspects of sovereignty (Li, 2004, p. 144). An international or intergovernmental institution that instructs or limits the taxation policies of a national state would be constraining the national autonomy and sovereignty of that state, which is not something states generally are willing to accept, according to state centred theories.

This theoretical approach has dual implications for the expectation of state behaviour on taxation within this study. Both that EU member states would be reluctant to transfer authority on taxation to the EU, and they would be reluctant to let EU institutions such as the Commission influence their taxation policies. The reluctance of EU member states to transfer powers of taxation to the EU level under EU Treaty negotiations and the implications of this is something that will be elaborated on in chapter four. The influence of the EU on the taxation policy of Cyprus is dealt with in chapter six.

The second assumption is based on Moravcsiks liberal intergovernmentalism. In intergovernmental negotiations and bargaining processes in the EU the formulation of goals and policies that states bring to the arena of intergovernmental negotiations, are to a large degree determined by the domestic politics of the key actors involved. The EU has responded to the current financial and economic crisis by policy governance on an intergovernmental level by introducing new intergovernmental bodies such as the European Stability Mechanism, rather than the classical Community method with its focus on integration by law (the decision making under the ESM will be outlined in chapter four) (Puetter, 2012, p. 162). The assumption that will provide guidance of the analysis of the ESM negotiations with Cyprus is that the outcome of the intergovernmental negotiations will reflect the relative bargaining power of the governments involved, which will be explored in chapter six.

2.3 Supranationalist approaches

Supranational explanation models have a long history in the studies of European integration. Championed by Ernst Haas, neofunctionalism was the theory of European integration in the early days of theorizing on the European Community (Schimmelfennig, 2010, p. 37). Most empirical studies within this tradition has emphasised feedback loops and spillover effects as being key mechanisms of European integration. These mechanisms take place in a process where: 1) increased economic activity across borders create the
need for 2) the settling of disputes and creation of rules concerning this activity (supranational governance), which again facilitate 3) increased cross-border transactions which now are easier to conduct. As these will again create a new demand for supranational governance, the first integrative governance will have had a spillover effect on new areas of policy (Sandholtz and Sweet, 2012, p. 21).

Neo-functionalists differentiate between the functional and political spillover in the process of integration. Functional spillover, as described above, happens when the effectiveness of existing policies are undermined by insufficient integration and thereby creates pressure for increased integration. Political spillover is the effect that comes from supranational organisations that gain both a level of autonomy and initiative to strengthen the integration process (Moravcsik, 1993, p. 475). Neo-functionalists stress the role of supranational agents, particularly the Commission. These will consistently work to strengthen and deepen the integrative policies, regardless of the interests of powerful member states (Sandholtz and Sweet, 2012, p. 22). Commission officials can act as policy entrepreneurs and take leadership roles in engineering integration. Particularly in times of crisis, the Commission can, according to neo-functionalists, use their position to seize the opportunity to propose new policies, and negotiate outcomes in order to enhance integration (Moravcsik, 1993, p. 475).

According to Cram (1994) “the Commission has learnt to respond to opportunities for action as they present themselves, and even to facilitate the emergence of these opportunities. Much of the activity of the European Commission might well be interpreted as an attempt to expand gradually the scope of Union competence without alienating national governments or powerful sectoral interests. The Commission, acting as a ‘purposeful opportunist’, has employed a variety of techniques aimed at expanding the scope of Union competence, and the extent of its own scope for action. (in Laffan, 1997, p. 423).

Compared to intergovernmentalists, scholars applying a supranationalist approach highlight the role of non-state actors, and in particular the Commission. The Commission has, through its power of initiative, a capacity of being a think-thank for the EU as whole, and is striving for collective solutions at the European level. The DGs have institutional memory of past proposals and the responses of member states to these proposals, and are in a position to use this knowledge to propose solutions that will be accepted by the member states. Neo-functionalists particularly highlight the capacity and position of the Commission to take advantage of opportunities as they present themselves, in order to enhance policy integration and find collective solutions to policy problems (Laffan, 1997, p. 424).
2.4 INSTITUTIONALIST APPROACHES ON EUROPEANIZATION

As I will show in later chapters, the field of taxation is one where there have been relatively little authority transferred to the EU level, and one where relatively little integration has taken place in terms of EU legislation. This is, however, not for the lack of proposals from the Commission. From a neo-functionalist perspective one would expect that the Commission would be prepared to utilise opportunities and times of crisis to promote policies and negotiation outcomes that corresponds with proposals the Commission has supported in the past, and which will further integration more generally. Arguably, the fiscal crisis of the EU would be one such crisis, and the Cyprus negotiations under the European Stability Mechanism would present one such opportunity.

Therefore, a theoretical expectation from this approach would be that the Commission would seize the opportunity to broker outcomes on tax related policies in Cyprus that are in accordance with proposals and goals the Commission has set for EU policies within this area, and tackle some of the challenges of current national policies which the Commission points to as the reason for the need for European integration and coordination in this area.

2.4 Institutionalist approaches on Europeanization

Neo-institutionalism have been referred to as an approach that according to March and Olsen (1984) “deemphasises the dependence of the polity on society in favor of an interdependence between relatively autonomous social and political institutions” (in Kerremans, 1996, p. 217). What separates this from the ‘old institutionalism’, is that not only the formal aspects of decision making, but also encompasses the role of socialization and routinization within these (Kerremans, 1996, p. 217).

Taking an institutionalist approach, Börzel and Risse (2006, p. 490) theorizes two distinct mechanisms in Europeanization processes, which encompass elements of several strands of institutionalism. The mechanisms share two preconditions expecting domestic change to take. First, there must exist some degree of ‘misfit’ between European-level processes, policies and institutions and domestic-level processes, policies and institutions. Second, there must be some actors or institutions responding to the pressures arising from this misfit (Risse and Börzel, 2000, p. 1).

The first mechanism is based on rational choice approaches, and explains how member states relate to the EU as following a ‘logic of consequences’. This assumes that actors will behave in a way that will give them the maximum utility, given the situation they are in. In this theoretical approach, one will study how the EU can impact member states for
instances through sanctions or rewards. The accession process of prospective EU member states is an often used example of this, where the EU policies are generally described as being predominantly policies of conditionality. Schimmelfennig and Sedelmeier (2004, p. 670) describes this as a "bargaining strategy of reinforcement by reward", where the EU provides external incentives linked with EU accession, which are made available to target governments if they comply with EU conditions.

The second mechanism is based on sociological institutionalist approaches, where the member states relate to the EU following what Börzel and Risse (2006) calls a logic of appropriateness. This emphasises how the behaviour of actors are influenced by social roles and social norms of a given situation. EU influence could for instance take the form of socialization, or efforts by the EU to "teach" EU policies, ideas and norms to actors in member states (Schimmelfennig, 2012). The attempt of the EU to introduce a so-called soft law mechanism, the ‘Code of Conduct on Business Taxation’, which according to Radaelli (2000, p. 34) was “eminently an instrument of moral suasion”, could be seen as a deliberate strategy to influence member state tax policies through norm change and socialisation processes.

Although providing an ambitious attempt to combine competing institutionalist approaches to an overarching analytical framework, Börzel and Risse (2006) does not provide very clear instructions on under what circumstances the mechanisms are in effect. Broadly speaking, the expectations are towards states following a ‘logic of consequences’ during rapid changes, while following a ‘logic of appropriateness’ is only possible through changes over time.

### 2.5 The use of theory in this study

When studying such a complex polity as the European Union, searching for a single theoretical approach that will be able to explain its dynamics and predict its outcomes is, arguably, a futile endeavour. Rather, a more fruitful approach might be to explore the circumstances under which different mechanisms and different explanations would be likely to be relevant. According to Schmitter (2003), the different approaches of studies of European integration can largely be placed based on their approach along ontology and epistemology. Ontologically, theories differ on whether they presume processes that reproduce the characteristics of member-state participants and the interstate system they are a part of, or whether they presume that a process can transform the nature of member states and their relations. So for instance, the ontology neo-functionalism is transforma-
2.5. **THE USE OF THEORY IN THIS STUDY**

tive in that it assumes that the actors and their environment will change over the course of the integration process, while on the other hand ‘pure’ state centred approaches will assume that the nature of sovereign national states will remain unchanged, and so will their interests and the nature of international relations (Schmitter, 2003). Epistemologically, studies can be sorted based on whether the evidence they have gathered on the above-mentioned processes are focused on dramatic political events, or more gradual and undramatic changes taking place over time, such as socialisation under institutionalised interaction. Again, state centred approaches have tended to be more focused on dramatic political events, while institutionalist and supranational approaches have been relatively more interested in the more gradual and undramatic aspects of European integration.

This study, looking at two more or less ‘dramatic’ political moments of negotiations, as well as a lengthy, more prosaic, period of EU-Cyprus relations, will therefore arguably benefit from taking into account different theoretical approaches that have been found to make sense under the different epistemological conditions.

For this study I therefore will use as a precondition for assuming that intergovernmental approaches will be useful that the situation to be explained has elements of intergovernmental bargaining or negotiations at a higher-than technical level, involving elected leaders, delegated negotiators or at least high-level bureaucrats, and that governments have something ‘at stake’ in the negotiations. Similarly, I assume supranational approaches to be more relevant in processes that are technical in nature, are within policy fields where the Commission has expert knowledge, and where the Commission has advocated initiatives for increased EU integration and coordination. I find the institutional approaches of governments following a ‘logic of consequences’ in their dealings with the EU, more useful in situations where formalised decision making is clear and where the Commission is acting within clear-set rules of delegated authority, as in the case of an EU accession process. I assume that EU influence on Cyprus through changes in norms and the socialisation of goals and ideas in the Cypriot government agencies, is more likely where interaction between Cypriot representatives and EU officials have taken place over time and in an institutionalised setting.

Based on the assumptions above, and that arguably no single theoretical approach is a perfect fit for all the situations looked into in this study, I will not analyse all the observations for this study through a single ‘theoretical straightjacket’, but rather weigh the use of the theoretical approaches based on their relevance of the observations at hand. For example, while both state centred and supranational approaches will provide useful insights to explaining the outcomes of moments of high-level intergovernmental bargaining,
institutional approaches are perhaps better suited to analyse the influence taking place through the ‘everyday life’ of interaction between the EU and Cypriot representatives on a more bureaucratic level.

The two relatively recent major defining moments of negotiation regarding the relations of Cyprus to the EU are the negotiations leading up to Cyprus accession to the EU, formally taking place in May 2004, and the recent dramatic negotiations regarding a Cyprus bailout and programme under the European Stability Mechanism, which reached its climax in March 2013. The outcome of the latter negotiations could have resulted in a Cyprus exit from the Euro and cast the future of Cyprus-EU relations into unchartered waters. Both these incidents would be natural to look at, both in terms of the motives and actions of key other states, and in terms of the role of supranational institutions, and in particular the Commission.

Since the accession, both the finance ministry and tax authorities of Cyprus have become integrated in European level processes in many ways. Amongst these are implementation of EU-wide standards on tax information sharing and benchmarking and peer review processes around best practice standards institutionalised around the Code of Conduct on Business Taxation. In addition, Cyprus has been involved in the OECD initiative called *Global Forum on Transparency and Exchange of Information for Tax Purposes*, which have been linked to the tax work in the EU in several ways. How the government bodies in Cyprus have responded to and adapted as a consequence of these new linkages, are questions typically asked by students interested in the effects of Europeanization, and where insights from the institutional approaches of Europeanization studies mentioned above will be relevant for my analysis.

Theories are important, in that they can provide contextualised expectations of how certain outcomes can be explained and the roles of different actors in achieving these outcomes. Unfortunately, they can also provide red herrings, in terms of overly shaping ones expectations, causing one to look for certain observations while ignoring others. Observations are often time-consuming to re-examine and hard to challenge. Relatively few empirical studies are repeated in the world of social science in order to test the reliability of their observations. Therefore, it is largely by engaging in debates about the theoretical implications of observations that the cumulative field of social science research moves forward. However, the quality of this debate is to a large extent at the mercy of the quality of observations that we base our explanations on. In the following chapter I will go through the methodological decisions of my study in addition to discussing some of its potential problems and challenges.
Chapter 3

Data and Methodology

This chapter will lay out how the thesis will answer its research questions. This will include the research design and methods, and the strengths and weaknesses of these. In particular I will emphasise methodological issues relating to my field trips and interviews conducted in mainly in Nicosia and Brussels.

3.1 Research design - qualitative case study

During times of economic upheaval, such as the sovereign debt crisis of many EU countries, it is easy to assume that the change in economic situation will cause a change in the political realm. This notion, however, should be explored empirically rather than assumed. The aim of this thesis is to be able to increase the understanding of whether and potentially how the EU can influence taxation policies of member states. Particularly interesting is the impact of the sovereign debt crisis in Europe on the mechanisms through which influence can take place. The number of countries that have needed help through the European Stability Mechanism is still relatively low, and the connections between different factors and outcomes in this process are difficult to analyse quantitatively.

Approaching the subject through the use of qualitative analysis of a case study is a way of overcoming this hurdle. Where large cross-case studies are often ill-suited to investigate causal mechanisms, well conducted case studies may allow one to, in the words of Gerring (2007, p. 45), "peer into the box of causality". When conducting a case study, it is helpful to reflect on what your case is a case of. Gerring (2007, p. 37) describes the case study approach to research as an "intensive study of a single unit or small number of units (the cases), for the purpose of understanding a larger class of similar units (a population of cases)". George and Bennett (2005, p. 17) describes a case as an "instance of a class of
events”. Through describing how a case fits within a larger group of cases, it is possible for the case study to do more than inform about the particular details of the single case, but provide an opportunity for generalisation.

Although I am generally interested in the effect of the EU on the taxation policies of member states, it is doubtful that the observations from Cyprus would be broadly applicable to how the EU influence member states within this policy field. Rather, I would regard this as a case of a member state being influenced by the EU within the novel political landscape created by the sovereign debt crisis in Europe, and through the novel political instrument that is the European Stability Mechanism. Although narrow classification would imply that the scope of generalisation is limited, it could still serve as an indication, particularly on the outcome of future negotiations under the European Stability Mechanism between the ‘Troika’\footnote{Term used for the European Commission, European Central Bank and International Monetary Fund} and member states that share some characteristics with Cyprus. Since the time span of the case study stretches back ten years, this also provides an opportunity to observe continuity or shifts in EU-Cyprus relations on tax, particularly comparing the recent handling of the Cyprus bank crisis with previous periods.

### 3.2 Gathering of empirical data

Since, at the time this research was conducted, the negotiations between Cyprus and the EU were an ongoing process, where much of the information is not publicly available, I decided that using interviews was the best way to collect data. Some of the information relevant for my study would only be accessible through interviews. I do not read or write in Greek language, therefore some information exists in documents that are practically inaccessible to me because they are written in Greek. However, conducting interviews in English with informants who have this information can potentially allow me to access the information. The interviews have been supplemented by document analysis and desk studies of secondary literature. Through this triangulation of methods I hope to achieve a better understanding of the impact of the EU on the tax system of Cyprus.

The sampling of respondents was conducted through purposive sampling. This is a process where you choose respondents based on your knowledge and who you think will best be in a position to answer questions that will inform your research (Bryman, 2008, p. 458). In practice, this means that I tried to find people with first hand knowledge to the interaction between Cyprus and the EU within the field of tax policy, and with first
### 3.3 Semi-structured interviews

I chose a semi-structured approach to the interviews. This allowed me to keep a link to my research question, but still leave room open in the interview to allow the respondents emphasise perspectives, questions or topics that they found particularly important, or had more knowledge about.

The purpose of the interviews was to access knowledge about cases, situations, relations and context that were not publicly accessible from the respondents, rather than inquiring into their personal and private experiences, feelings and understandings (Andersen, 2006, p. 281). Although the interviewees are chosen for their knowledge, this does not

<table>
<thead>
<tr>
<th>Location</th>
<th>Interviews conducted</th>
<th>Interviews used in the thesis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nicosia and Limassol, Cyprus</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Brussels, Belgium</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Oslo, Norway</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12</strong></td>
<td><strong>8</strong></td>
</tr>
</tbody>
</table>

Table 3.1: Interviews

hand knowledge to the two major negotiations, the EU accession process and the Troika-bailout. This resulted in a number of interviews both in Cyprus and in Brussels, in order to hear perspectives from both sides. Interviews with respondents were mostly scheduled in advance, but some additional interviews in Cyprus were scheduled as a result of using a snowballing technique. The interview with the Norwegian Tax Authorities on May 23rd was not a part of my plan, but came as a result of specific recommendations from officials from the Commission Directorate General on Taxation and Customs (DG Taxud).

In the process of gathering data for the thesis I have planned and carried out interviews during field work in Cyprus and Brussels, and an additional interview in Oslo. A total of twelve interviews were conducted during a timespan between March 11th and May 23rd 2013. Eight of the interviews were carried out in Nicosia and Limassol, Cyprus, during field work between March 9th and March 26th. A second field work was done between April 3rd and April 11th in Brussels, Belgium. The interviews were semi-structured and had open-ended questions. I chose respondents on the basis of their expert knowledge within different fields, and the questions were partly tailored to each respondent specifically.
mean that what they say can be simply treated as objective facts about the reality. Their statements can be treated as both factual statements about the world but also normative statements that can tell us something about them and their world-view (Kjeldstadli, 1992, p. 167). It is the task of the researcher to judge when it is reasonable to treat a source as the one or the other. In doing this, it is important to use prior knowledge and other sources to triangulate and assess the factual quality of their statements (Andersen, 2006, p. 286). In my case, this would mean using the information from other interviews, documents and the media.

The interviews were tape recorded and later transcribed in full into writing. I gave information in advance to the respondents about the purpose of the research, that they had the opportunity to withdraw at any time, and that their identity could be made anonymous if they wished.

3.4 Special circumstances of the field work in Cyprus

My field work in Cyprus took place between March 9 and March 26, 2013. This was probably among the most intense political moments in recent history for Cyprus. These weeks represented the end-game of drawn out and though negotiations between the Troika and Cyprus government representatives concerning a bailout for Cyprus. There was a lot of uncertainty and confusion around the proposals at the table, and potential outcomes. There was also a lot of of rumours, many of which were picked up on and printed by the press. On March 16th, an agreement was found between the Troika and Cyprus, which was rejected by Cyprus Parliament on March 18th. Capital controls were imposed and banks were closed in order to prevent a bank run. A second and final agreement was found on March 25th, which was eventually accepted by the House of Representatives. The timing of my field work affected my work in several ways.

First, the availability of respondents was limited due to the timing of my field work. For instance, interviews scheduled in advance with Representatives from the Parliament were cancelled, and it was not possible to get any new appointments with members of the Parliament.

Second, many of the respondents were clearly very upset about the situation, and some were quite emotional during the interviews. This might not necessarily deteriorate the quality of the data, but it is something which one should be vary of when using the data. When interpreting the language used, for instance, one should bear in mind that this was stated during a very dramatic period, which could cause respondents to use more
dramatic language then they would use otherwise.

The special timing of the interviews will likely affect the reliability of the study. Reliability in data-collection is essentially ensuring that applying the same procedure in the same way will produce the same result, all else being equal (King, Keohane, and Verba, 1994, p. 25). The respondents might have responded differently to the interviews once they had time to "cool off". In addition, according to Andersen (2006, p. 281), informants are generally more useful if they can look at events, cases and their own role with a certain distance. Being in the middle of what they perceived to be dramatic events, would make it less likely that the informants would look at the events with a distance.
Chapter 4

The EU and taxation

Historically, the EU has had little or no role on direct taxation. From the 1960s up until the 1980s all efforts by the Commission introduce any legislation on direct taxation were unsuccessful (Radaelli, 1999, p. 667). No directives on direct taxation were passed between 1990 and 2003 (Cattoir, 2006, p. 20). The EU has no taxes on its own, and are unlikely to acquire taxation authority in the conceivable future (Genschel and Jachtenfuchs, 2011, p. 10). Taxation was, and remains, a field where member states are protective of their sovereign discretion (Sharman, 2008, p. 1054). This concern for protecting sovereignty has been safeguarded by the EU decision-making procedure on matters relating to taxation.

4.1 Decision-making in the EU on taxation

The EU only enjoy those competences which have been bestowed on it by the member states in the Treaties, and otherwise the competences rest with the member states (Devuyst, 2012, p. 167). With the institutional restructuring that followed from the Treaty of Lisbon in 2009, the co-decision procedure with the use of qualified majority voting was established as the ordinary EU legislative procedure and many policy areas were transferred from needing unanimity in the Council to only requiring a qualified majority (Devuyst, 2012, p. 169). Taxation, however, remains an issue where unanimity in the Council is required. EU heads of state have discussed proposals for introducing qualified majority voting within taxation in all intergovernmental conferences since Maastricht in 1991, but these efforts have failed every time (Wasserfallen, 2014, p. 421). Tax policy remains the prerogative of the national governments of the member states of the European Union.

The lack of a direct authority on taxation policy has led to a general conception of an absence of EU governance on taxation matters. Genschel and Jachtenfuchs (2011,
p. 1) finds that most EU scholars agree that tax is largely excluded from the EU policy agenda, and calls this consensus a "no taxation thesis". This is based on two notions, first, that the EU lacks a European tax resource that would provide the EU with its own revenue independent of member states, and second, that the EU has very little control over taxation policies of the member states. Subsequently, it is assumed that member states retain a substantial tax autonomy. According to the European Commission, under Community Law, the member states are generally free to design their own national direct tax systems to meet national policy goals (European Commission, 2006, p. 3). Functionally, according to the Treaties, the EU has no jurisdiction on matters of direct taxation. EU-level decision making in the taxation area is particularly difficult since it is an issue at the very heart of national sovereignty, and an area of policy where member states are generally unwilling to delegate authority (Cattoir, 2006, p. 1).

Despite the lack of competence on direct taxation, the Treaty does allow the EU institutions to take decisions on tax issues in so far as they affect market integration (Kemmerling and Seils, 2009, p. 756), namely the four freedoms. Since many issues of taxation overlap with the functioning of the Internal Market, this in practice have given the EU institutions authority to push through legislation that in many aspects cover the taxation policies of member states, particularly on indirect taxation. Indirect taxes, like value-added taxes on goods and services and excise duties on for instance alcohol or tobacco may "create an immediate obstacle to the free movement of goods and the free supply of services within an Internal Market" (European Commission, 2001, p. 8), creating the need for harmonisation and coordination of indirect taxation between the member states. Indirect taxation is, however, not the subject of this thesis.

4.1.1 The European Commission

The European Commission is the EU body responsible for proposing new EU legislation, and this also applies for taxation policies. The Commission generally have been a proponent for increased coordination and to a certain degree harmonisation of taxes between member states, and has expressed concern with the lack of coherence on policy on direct taxation in the EU (European Commission, 2001, p. 3). Their impatience with strengthening the EU coordination on tax is understandable, given the failure of getting proposals on tax passed as EU legislation. As the Commission issued their last comprehensive tax policy strategy in 2001, 16 Commission proposals for Directives lay on the table of the Council, some having been there since the early nineties ((European Commission, 2001, p. 20)
4.1. DECISION-MAKING IN THE EU ON TAXATION

Recently the Commission has estimated the amount of tax revenue lost by EU member states to be in the area of €1000 billion (European Commission, 2012b). From the perspective of the Commission, this is a problem that needs to be met with greater coordination. The view of the Commission is for instance described in a 2006 Commission communication to the Council and Parliament: "Non-taxation and abuse are equally detrimental to the interests of the Internal Market because they undermine the fairness and the balance of member states tax systems. This problem can also be addressed by better co-ordination of member states’ rules and improved co-operation with respect to enforcement" (European Commission, 2006, p. 6).

In 2012 the Commission launched an "Action Plan to strengthen the fight against tax fraud and tax evasion" (European Commission, 2012a). In it, a number of measures are proposed, including new tools for better administrative cooperation among tax authorities and strengthening of the Savings directive. It also highlights the difficulties of achieving tangible results on the area of harmful tax competition, currently under the framework of the Code of Conduct on Business Taxation: "Over the past years, making progress and achieving tangible results in the Code of Conduct Group charged with the assessment of tax measures that may fall within the scope of the Code has become increasingly difficult" (European Commission, 2012a, p. 7). It further calls on member states to take action in order to achieve the goals of the Code, which will be described in more detail below.

4.1.2 The Council

The Council is the primary legislative body of the European Union. On taxation, where unanimity is needed in the Council to pass legislation, cooperation amongst EU countries have been notoriously difficult (Cattoir, 2006, p. 2). The current voting system gives any EU member state the right to veto new legislation on taxation issues. Countries with competitive tax regimes, that have made financial services and banking vital parts of their business-model, particularly Luxembourg, Austria and Belgium, have been strong opponents of harmonising or coordinating tax policies at an EU level (Radaelli, 2003, p. 518).

4.1.3 The European Court of Justice

The European Court of Justice (ECJ) has the responsibility to interpret EU law, and ensure that its application is equal across the member states of the EU. Although little new legislation on tax matters passes the Council, this does not mean that the policy
area does not develop within the European Union. In fact, much of the development on matters of taxation comes as a result of cases being brought before the Court. Mostly, the cases brought before the Court are unilateral measures that member states have taken to protect their fiscal revenue from tax competition. In these instances, the ECJ have consistently judged unilateral protective measures to violate the freedom of settlement and of capital movements and thereby been declared unlawful (Kemmerling and Seils, 2009, p. 766). Through their rulings, the ECJ is developing the European Union tax law on a case law basis. Although unilateral measures that violate the four freedoms are allowed by the member states if they are in the public interest and proportional, the Court does not define the need to generate public revenue as public interest. Therefore sovereignty is restricted on tax policy in terms of the political space for member states to unilaterally defend against revenue loss from tax competition (Kemmerling and Seils, 2009, p. 766).

4.1.4 The European Parliament

The European Parliament is the second legislative body in the European Union. Although the Parliament has seen its powers in EU decision-making increased over the years, they play a peripheral role in decision making on matters relating to taxation. As a general rule, the European Parliament only has the right to be consulted, except in cases relating to the budget (European Parliament, 2013, p. 1). Although they have limited power, the Parliament is often an important arena where concerns on tax related issues are voiced and discussed.

4.2 Tax coordinaton - the emergence of an EU tax agenda

Not until the mid-1990s did member governments start to get concerned about the effects that economic globalisation would have on their ability to preserve fiscal sovereignty. By the mid-1990s, however, the concept harmful tax competition had found its way into the political mainstream. The lack of coordination between member states was now regarded as a threat, for instance as stated in this 1996 Commission discussion paper for ministers on the Economic and Financial Affairs Council (ECOFIN) in Sharman (2008, p. 1053): “The apparent defence of national fiscal sovereignty has gradually brought a real loss in fiscal sovereignty by each Member State in favor of the market”. In order to
understand what the nature of this loss in fiscal sovereignty is, a short introduction to the concept of harmful tax competition is in order.

4.2.1 Harmful tax competition

The strong capital mobility restrictions that were put in place by the Bretton Woods post-World War 2 financial system made the scope for international tax avoidance and evasion, and also tax competition, limited. Over the years these capital controls eroded, as market actors found ever new and clever ways of working around the barriers limiting international capital flows (Eichengreen, 2008, p. 134). Liberalisation followed and by the 1980s there had been a shift towards a much more economically integrated world, through the liberalisation of trade, looser capital controls and currency convertibility (Genschel and Schwarz, 2011, p. 340). Together, the liberalisation of capital, innovations in finance and technological changes laid the foundation for a surge in internationally mobile capital, and in the process opening the field for international tax planning. Today, these developments are a part of the process often referred to as economic globalisation.

As capital became mobile, many predicted that the fiscal base of the welfare state would be jeopardised. Academics described how states now were in a situation where they would have to reconsider their tax systems because of the risk of part of their tax base migrating to other jurisdictions (Tanzi, 1995, p. 6). The introduction of tax payer exit as a realistic strategy and a credible implicit threat meant that states and their tax authorities now needed to compete for taxable assets and activities, rather than just impose taxes on their subjects (Genschel and Schwarz, 2011, p. 340). Particularly since the mid-80s tax competition has been an active field of research within economics (Wilson, 1999, p. 269). Research on the nature of tax competition finds that it is basically a coordination game among states, with strong and asymmetrically distributed incentives to defect for smaller (Keen and Kanbur, 2001) and more financially oriented states (Holzinger, 2005). In the EU, these findings align well with member states like Cyprus and Luxembourg being among the countries associated with a low tax and flexible regulative investment environment. Since all states in the EU have a de-facto veto right against coordination, there arguably exists an overarching institutional framework that facilities tax competition, particular since the ECJ has not allowed unilateral countermeasures from member states.
4.2.2 Instruments of tax competition - reverse engineering tax havens

Although it is natural to associate tax competition with a process where states underbid each other on the nominal tax rates on corporations and capital, this is only a limited part of the picture. In order to conceptualize which policy-areas are relevant to the term, a useful point of reference would be to look at the common denominator of policies among jurisdictions that have taken competitiveness in attracting capital, investments and business to the extreme, namely tax havens. There is a lack of a clear consensus on how to define a tax haven, both academically but especially politically, and even more so on which states fit the term. Despite the lack of clarity in definition the list of countries considered to be tax havens has changed very little since the 1980s, and neither has their roles and functions (Palan, Murphy, and Chavagneux, 2009, p. 17).

The probably least disputed definition would be to refer to the four OECD tax haven criteria from the 1998 report *Harmful Tax Competition - an Emerging Global Issue* (OECD, 1998). Compared to previous publications from the OECD, this report represented a departure in both tone and substance, and in many ways represents the introduction of harmful tax competition on the global policy agenda (Kudrle, 2008, p. 1). According to this report (OECD, 1998, pp. 26-29), a jurisdiction would be considered having a harmful tax practices if it:

1. Charged very low or no taxes on capital income;
2. Possessed a "ring-fenced" tax system that separates foreigners from domestic citizens and companies, usually making special tax concessions available to foreign investors but not locals;
3. Lacked transparency and effective regulation, for instance by not requiring registry of ownership of companies, bank accounts, legal trusts, in effect providing foreigners with a layer of protective secrecy;
4. Did not effectively participate in information sharing of tax relevant information with the authorities of other states.

This list includes tax laws and policies, but also policies related to anti-money laundering, regulation of banks and finance, company laws, public registries and administrative effectiveness. Most of the elements that do not fall directly under tax policy, are one way or the other aspects that allow some kind of secrecy. Legislative framework is a central
4.3 EU POLICY INITIATIVES TO CURB HARMFUL TAX COMPETITION

As already mentioned, on personal and company taxation, it took considerable and enduring efforts by the Commission before any kind of legislation came in place. The first EU legislation on business taxation, the Parent/Subsidiary and Merger Directives, were passed in 1990 after having been discussed for nearly 30 years and been on the Council table since 1969 (Cattoir, 2006, p. 2).

In 1996, work on new proposals for coordination of policy on direct taxation started with a general discussion of taxation in the EU through an informal Commission working group that included representatives of EU finance ministers in Verona (Cattoir, 2006, p. 2). This marked the start of a plan to achieve some EU coordination on taxation by linking several policies together in a “Tax Package”. Rather than trying to pass individual proposals, the idea was to link several proposals together in a package what would be decided on as a whole. In the words of the Commission, the package was needed because of “the need for coordinated action at European level to tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment-friendly way” (Cattoir, 2006, p. 2).
4.3.1 The Tax Package

An agreement on the package was found in 2004, albeit in a rather watered down version. The package had three elements. First, it included a new directive on savings, the European Savings Tax Directive. The objective of this was that information on savings, that is the payments on interest, was to be shared automatically to the tax authorities of the member state where the recipient of the interest payment is tax resident.

This proposal met particularly hard resistance from countries who had a large and traditionally secretive bank sector (Sharman, 2008, p. 1063). In the end, the system of automatic information exchange was introduced for all member states, except Belgium, Luxembourg and Austria. These countries would rather apply a withholding tax on the interest earnings of foreign tax residents, and transfer this withholding tax to the tax authorities of that tax resident’s member state. This way taxes would be paid, but the identity of the person with the bank account would be remain anonymous for the tax authorities of their home country.

The Directive applied for interest earnings, for instance from bonds or a bank account, but not other types of capital earnings, and had several exemptions added under the course of negotiations. The expectations for the directive were initially quite high. Germany alone estimated it would boost tax revenue with $12 billion annually (Sharman, 2008, p. 1066). Compared to this, the final directive was weak, and failed to meet its intended target: fundamentally changing the way it is possible to evade taxes among EU countries. Based on data on the amount of taxes collected due to the new Directive, this was not achieved. The numbers from the first year were under 200 million Euro in increased tax revenue for all member states. In addition, the first year was expected to be the year when most earnings were made, as in later years it was expected that the tax payers would adapt to the directive by either moving their money home or into a jurisdiction beyond the reach of the Directive (Sharman, 2008, p. 1066).

The second major element of the tax package, was a so called ”Code of Conduct on Business taxation”. Due to the sensitivity of the topic, it was realised that getting a directive in place would be impossible. Therefore, a ”soft law” approach was utilised.

4.3.2 The Code of Conduct on Business taxation

In policy areas where the EU does not have competence, there has been an increased emphasis on soft law modes of governance with the later Treaties. The idea is that instruments like benchmarking, peer reviews, voluntary agreements, guidelines and best
practices are used to facilitate policy making and for improving policy implementation in areas where otherwise the EU would not be able to coordinate policy, and where they cannot use more formal policy instruments (Peters, 2012, p. 804). The Code of Conduct on Business taxation is such an instrument. It is specifically “a political commitment and does not affect the Member States’ rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty” (Cattoir, 2006, p. 4).

The Code of Conduct on Business taxation address elements from the harmful tax practices described in the 1998 OECD report, although differing slightly. It identifies some clear criteria under which tax measures can be described as harmful. The instrument was never intended to be a general instrument for assessing tax policies in general (Cattoir, 2006, p. 3). The scope of the Code of Conduct is defined by the Council as “Tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code” (The Council of the European Union, 1998, p. 3). The harmful measures include: special treatment of non-residents, meaning for instance giving people who are not resident in a given country a discounted tax rate; ring-fenced tax systems, meaning that you have certain types of companies that are given tax incentives but who are only allowed to conduct business activity outside the country they are incorporated in; giving advantages to entities with no real economic activity, for instance shell companies or letterbox companies; special rules regarding determining profits of multinational companies, particularly rules that are not in line with OECD rules on transfer pricing; and secrecy or lack of transparency, for instance having rules and measures that allow concealment of the identity of ownership of companies (Cattoir, 2006, p. 4).

Since the 2003 Tax Package, there has been no major new legislation on taxation in the EU, however work on revising and strengthening the Savings Directive has been ongoing for years. Some new legislation has been put in place to support and facilitate the administrative cooperation among tax authorities, most recently with the 2011 Directive Enhanced administrative cooperation in the field of (direct) taxation. This directive sets down rules regarding the exchange of information upon request between tax authorities of member states (The Council of the European Union, 2011).
Chapter 5

Cyprus - background on politics and economy

This chapter will provide a short background to Cyprus, in terms of politics and economy, in order to provide a context to the analysis that will follow in the next chapter.

Cyprus applied for EU membership in July 1990 under President George Vassiliou. There were several reasons for wanting to join the European union. First, with a history of conflict and insecurity, Greek-Cypriots saw EU membership as a guarantee against future military actions by Turkey, thereby providing stability and security, and that it might also contribute to changing the dynamics of the negotiations around the division of the island, the so-called Cyprus problem. There was also optimism of EU membership contributing to increasing the quality of democracy, strengthen human rights, and promote better governance in Cyprus. Economically there were incentives to join the EU, with half of the country’s exports going to the European Common Market already in 1986, and even higher numbers for imports (Sepos, 2008, p. 39). Worth noting, the Cypriot Government submitted the application on behalf of the whole population on the island, although the Turkish-Cypriot community was opposed to the application and refused to acknowledge the right of the Cypriot Government to take such a decision on their behalf (Sepos, 2008, p. 40).

5.1 Cyprus as an international business centre in the EU

For Cyprus, establishing itself as an international centre for business and finance has been an important point on the political agenda particularly since the invasion of the northern
parts of the island by Turkey in 1974. The country has limited potential for industry, little agriculture and are heavily reliant on tourism, therefore finance and business services have been a rare growth sector providing good high-paying jobs for an increasingly educated and specialised workforce (Mullen, 2013).

The years following the EU accession in 2004 represented a period of economic growth in Cyprus, with real growth in GDP at respectively 4.2%, 3.9%, 4.1%, 5.1% and 3.6% in the years 2004 to 2008. In this period Cyprus outperformed the average growth in both the EU and the Euro-area countries every year (Eurostat, 2013). International business, finance and professional services were the major drivers of this economic growth. Professional services include lawyers and accountants catering the large amount of international business incorporated in Cyprus. The professional services sector, already large, have seen growth following the EU accession, both in terms of jobs and contribution to the economy. Between 2001 and 2011 the number employed in these sector increased from 26,000 to 35,300, contributing 9.1% of total employment in Cyprus in 2011, according to Pricewaterhouse Coopers (Mullen and Theodotou, 2012, p. 13). The professional service sector, particularly since the beginning of the financial crisis, was almost the only sector creating new graduate level jobs in Cyprus. That young Cypriots overwhelmingly sought out career opportunities in the business and professional service sector is evident from the recent statistics of fields of study of Cypriot graduate students. More than 40% of students in 2010 were enrolled or graduated within the field of business administration as is shown in table 5.1 on page 35. This number is the highest in the Euro area (Eurostat, 2012). The importance of the international business and finance sector is sharpened by the fact that in the period between 2001 and 2011, jobs in tourism, historically an important source of jobs in Cyprus, declined from 19,600 to 17,900.

5.1.1 Shipping

Cyprus has since 1963 had an attractive legislation and tax regime for the merchant shipping industry. Over time, this has attracted international business within the shipping industry to Cyprus, and it has grown in to one of the most important maritime registries worldwide. Today it is the biggest third party ship management centre in the EU (PwC Cyprus, 2013, p. 1). Due to the low corporate tax rate of 12.5%, in addition to the possibility to utilise a range of beneficial tax deductions and low capital requirements (thin capitalisation), the effective tax rate can be significantly lower than 12.5%, and Cyprus remain a very competitive tax destination for shipping registration, management and holding companies. It remains one of only two European ship registries that are open
Enrolled students and graduates of the previous year by field of study

<table>
<thead>
<tr>
<th>Field of study</th>
<th>Students</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business administration</td>
<td>15051</td>
<td>40.4%</td>
</tr>
<tr>
<td>Teacher Training</td>
<td>3428</td>
<td>9.2%</td>
</tr>
<tr>
<td>Health</td>
<td>2314</td>
<td>6.2%</td>
</tr>
<tr>
<td>Engineering</td>
<td>2253</td>
<td>6.0%</td>
</tr>
<tr>
<td>Social and behavioural sciences</td>
<td>2047</td>
<td>5.5%</td>
</tr>
<tr>
<td>Computing</td>
<td>2024</td>
<td>5.4%</td>
</tr>
<tr>
<td>Humanities</td>
<td>1972</td>
<td>5.3%</td>
</tr>
<tr>
<td>Arts</td>
<td>1863</td>
<td>5.0%</td>
</tr>
<tr>
<td>Architecture</td>
<td>1548</td>
<td>4.2%</td>
</tr>
<tr>
<td>Other</td>
<td>4670</td>
<td>12.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>37278</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

*Source: Cyprus Statistical Service (2011, p. 185)*

Table 5.1: Cyprus Educational Enrollment 2010/2011

registries, meaning that it is open to all ships regardless of nationality, and constitutes an estimated 15% of all ships under EU flags (PwC Cyprus, 2013, p. 4).

### 5.1.2 Banking

In the period following EU and Eurozone accession, Cypriot banks have consistently offered higher deposit interest rates than the EU average, attracting both domestic investors and money from abroad. Deposits in Cyprus banks have for the previous decade often returned close to double the interest rates than banks in other European countries, like Spain or Italy (Reuters, 2013). Until 2004 Cyprus imposed foreign exchange controls, and with few competitive sectors to invest in, most Cypriots put their savings in a domestic Cypriot bank (Mullen, 2013).

These factors of attracting capital from abroad and absorbing so much of the potential domestic credit, combined to create a soaring growth rate for Cypriot banks in this period. As a ratio of the gross domestic product in the country, assets in Cypriots banks increased from over 450% in 2005 to 896% in 2010. These numbers are very high, although not unique in the EU: The size of the banking system in Luxembourg is more than twenty times the size of its GDP (Stephanou, 2011, p. 128). Although boosting the growth in the financial sector, the increased size of the banking system of Cyprus increased the exposure to Cyprus to systemic risks, which will be described in more detail in chapter 6.
Cyprus: Top 20 Direct Investment Destinations for 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Inward</th>
<th>Outward</th>
<th>Country</th>
<th>Inward</th>
<th>Outward</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russian Federation</td>
<td>26389</td>
<td>19379</td>
<td>Netherlands</td>
<td>1352</td>
<td>388</td>
</tr>
<tr>
<td>Greece</td>
<td>5511</td>
<td>2869</td>
<td>Norway</td>
<td>1070</td>
<td>215</td>
</tr>
<tr>
<td>United States</td>
<td>4353</td>
<td>2863</td>
<td>Austria</td>
<td>1040</td>
<td>185</td>
</tr>
<tr>
<td>Virgin Islands, British</td>
<td>4189</td>
<td>2520</td>
<td>Cayman Islands</td>
<td>538</td>
<td>184</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3359</td>
<td>1921</td>
<td>Belize</td>
<td>377</td>
<td>149</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2634</td>
<td>1547</td>
<td>France</td>
<td>262</td>
<td>135</td>
</tr>
<tr>
<td>Guernsey</td>
<td>2337</td>
<td>1124</td>
<td>Switzerland</td>
<td>190</td>
<td>120</td>
</tr>
<tr>
<td>Gibraltar</td>
<td>2083</td>
<td>552</td>
<td>Cocos (Keeling) Islands</td>
<td>164</td>
<td>102</td>
</tr>
<tr>
<td>Germany</td>
<td>1634</td>
<td>459</td>
<td>United Arab Emirates</td>
<td>147</td>
<td>71</td>
</tr>
<tr>
<td>Ukraine</td>
<td>1393</td>
<td>443</td>
<td>Canada</td>
<td>142</td>
<td>62</td>
</tr>
<tr>
<td><strong>Total Investment</strong></td>
<td><strong>69110</strong></td>
<td><strong>47994</strong></td>
<td><strong>Source:</strong> IMF (2012)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 5.2: Inward and Outward Direct Investment Positions

### 5.1.3 The Russian Connection

The linkages between Cyprus and the Russian economy are deep, complex and have historical roots. After gaining independence in 1960, rather than aligning with the West and Nato, the first president of Cyprus Archbishop Makarios III sought out a so-called middle course for Cyprus, identifying himself with the Non-Aligned Movement. Politically Makarios was dependent on the support of AKEL, the Communist party that has traditionally maintained close ties to Moscow. The Communist party in Cyprus is the strongest in Western Europe to this day, and has received about a third of the votes in almost every parliamentary election since 1970. Over time, these political ties translated into more personal ties, as the Communist political elite in Cyprus sent their sons and daughters to be educated in the Soviet Union. Bonds were made in language as well as in personal relations (Treholt, 2013).

As the Soviet Union dissolved in December 1991, Cyprus was among the few countries were Russians could travel without a visa. In the turmoil of constructing a market economy in Russia, Cyprus was a both accessible and attractive destination for Russians to put their money. Cypriot banks, accountants, tax planners, investment managers and lawyers were more than happy to receive Russian money and business, and for those Cypriots educated in the Soviet union, language and contacts became an important source of business opportunities from the newly emerged market economy. The dominance of Russian investments to the Cypriot economy is evident when you look at the statistics from 2011.
### 5.2. CYPRUS AND THE FINANCIAL CRISIS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>6,260</td>
<td>7,898</td>
<td>3,569</td>
<td>5,204</td>
<td>4,814</td>
<td>5,827</td>
<td>5,975</td>
<td>4,516</td>
<td>2,717</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>957</td>
<td>-57</td>
<td>337</td>
<td>237</td>
<td>-257</td>
<td>265</td>
<td>314</td>
<td>313</td>
<td>11,243</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Luxembourg</td>
<td>493</td>
<td>-77</td>
<td>264</td>
<td>1,325</td>
<td>258</td>
<td>789</td>
<td>238</td>
<td>-1,789</td>
<td>13,944</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>339</td>
<td>43</td>
<td>-50</td>
<td>639</td>
<td>200</td>
<td>137</td>
<td>471</td>
<td>310</td>
<td>495</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>1,813</td>
<td>28</td>
<td>1,208</td>
<td>812</td>
<td>2,136</td>
<td>-1,343</td>
<td>1,906</td>
<td>4,015</td>
<td>31,565</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>79</td>
<td>162</td>
<td>134</td>
<td>280</td>
<td>72</td>
<td>55</td>
<td>152</td>
<td>1,150</td>
<td>70</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>354</td>
<td>357</td>
<td>402</td>
<td>511</td>
<td>-145</td>
<td>362</td>
<td>324</td>
<td>148</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>15,921</td>
<td>16,867</td>
<td>10,875</td>
<td>23,187</td>
<td>11,352</td>
<td>11,828</td>
<td>14,336</td>
<td>10,634</td>
<td>67,183</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(*all countries*)

*All numbers in USD millions. Source: Bank of Russia (2013)*

Table 5.3: Russian Federation: Outward FDI by Russians

of Foreign Direct Investment (FDI) from table 5.2 at page 36. Russia easily dwarfs the second most important source of FDI, which is Greece.

Although good information or data on the nature of Russian business in Cyprus is generally not very accessible, according to Mullen (2013), you can think of Cyprus as a booking centre, or back office, for Russian companies. Since business is easier to conduct in Cyprus than in Russia, concerning rule of law, legal standards, banks, access to international professionals and so on, “everything gets booked” through Cyprus. Goods that are sold from Russia to the EU market are often first sold from a Russian company to a Cypriot company, before they are sold on to its destination. In addition, many Russians have their wealth placed in Cypriot banks and financial institutions.

As shown on table 5.3 at page 37, Cyprus has been the primary destination of outward FDI from Russia in later years, but this pattern clearly changed in the first quarter of 2013, where investment in Cyprus fell and investment in the UK, Luxembourg and the British Virgin Islands in particular soared. The increase in FDI to competing international financial centres might be an indication that Russian capital were seeking new ‘safe harbours’ following the Cypriot bank collapse. Elaborating on this, is however beyond the scope of this study.
CHAPTER 5. CYPRUS - BACKGROUND ON POLITICS AND ECONOMY

Figure 5.1: Cyprus Current Account deficit to GDP

Source: (Trading Economics, 2013a)

Figure 5.2: Cyprus Government Debt to GDP by 1st of January

Source: (Trading Economics, 2013b)
5.2 CypruS and the Financial Crisis

The Cypriot economy weathered the first wave of the international financial crisis rather well. But by 2009 growth in the economy of Cyprus ground to a halt, and dipped into recession. Among the smaller countries, Cyprus, together with Malta, stood out as being the countries in the Eurozone with greatest increase of debt issuance compared to GDP in 2009 (Broeck and Guscina, 2011). This year also saw Cyprus run its largest current account deficit, as shown in figure 5.1 on page 38. As is shown in figure 5.2 on page 38, government debt to GDP sharply increases after 2008.

This same period saw the two largest banks, Cyprus Popular Bank (Laiki) and Bank of Cyprus, increasing their exposure to Greek debt even as Greek bonds were being dropped by the financial institutions of most other EU countries. By December 2010, a stress test by the European Banking Authority revealed that Bank of Cyprus had 11 billion euros worth of outstanding loans in Greece, amassing to 30 per cent of their total loan book. For Laiki, the figures were even higher, 19 billion euros making out 43 per cent of their total portfolio (Reuters, 2013). Much of this, 2.4 billion and 3.4 billion of Bank of Cyprus and Laiki respectively, was Greek government debt.

In an effort to rescue Greece from their sovereign debt crisis, a write down in the nominal value, a so-called debt haircut, was imposed on holders of Greek government bonds in October 2011. For Laiki this write-down was large enough to wipe off more than their 3.2 bn euros of capital, while Bank of Cyprus lost 75% of their capital at the stroke of a pen. This blow to the two largest banks had a detrimental effect, both economically and politically, on Cyprus. The decision cost Cypriot banks roughly 25% of the country’s GDP. The Cypriot government was unable to raise the money needed by the banks on the island, and the government also needed new loans to fund its budget deficit and to refinance maturing debt. By mid-2011 Cyprus had been effectively shut out of international credit markets, and it became inevitable for the Cypriot authorities to ask for outside assistance (Der Spiegel, 2012a). This involved applying for a programme under the European Stability Mechanism, which will be the subject of section 6.3 of the next chapter.
Chapter 6

Analysing Cyprus - EU relations on tax

This chapter will analyse how EU has impacted taxation policies in Cyprus by looking at relations between Cyprus and the EU at three periods of time. The recent negotiations under the European Stability Mechanism, and the outcome in terms of tax policy for Cyprus will be given emphasis, and will be dealt with as the last part of this chapter. The two time spans preceding this episode are the negotiations between Cyprus and EU on accession to the EU and the interaction between Cyprus and the EU in the period between accession and the recent crisis, and will be covered in chronological order. The three time periods, and the nature of EU- Cyprus relations in these periods differ significantly from each other, both in terms of the length of time the periods represent, and the level of government that were involved. Both EU accession negotiations and agreeing a bailout under the European Stability Mechanism were obviously negotiations of immense importance and priority at the highest level, while the interaction between these two periods often involved bureaucrats rather than elected leaders. Although directly comparing these time periods is difficult, they provide context to each other and together give a broad coverage of EU- Cyprus relations on tax during the history of Cyprus in the EU.

As described in chapter 2.5, the theoretical approaches for this analysis will be utilised to a varying degree based on how relevant they are for the different types of EU-Cyprus interaction covered by this study. This chapter will explore occurrences of intergovernmental bargaining or negotiation taking place directly or indirectly between Cyprus and one or more member states during the EU accession process and the negotiations surrounding the ESM programme. In these episodes it is also relevant to examine the role of the Commission, and whether the Commission was taking a leading role in pushing for
CHAPTER 6. ANALYSING CYPRUS - EU RELATIONS ON TAX HARMONISATION OR SPECIFIC TAX RELATED POLICY-OUTCOMES. THIRDLY, IT WILL BE RELEVANT TO INVESTIGATE WHETHER ACCESSION TO THE EU HAS BEEN FOLLOWED BY AN “EUROPEANIZATION” OF POLICIES OR INSTITUTIONS IN CYPRUS, EITHER AS THE RESULT OF RESPONDING TO INCENTIVES OR THROUGH MORE SUBTLE SOCIALISATION OR LEARNING PROCESSES THROUGH THE INSTITUTIONALISED INTERACTION WITH THE COMMISSION AND OTHER MEMBER STATES IN AN EU SETTING OVER TIME.

6.1 EU accession and tax reform

“When we started the negotiations, the EU told us that there is no way that a country can join with a 4.5% corporation tax system” - George Vassiliou, chief negotiator of the EU accession (Vassiliou, 2013).

Cyprus’ application to EU membership was accepted, in principle, in 1993, but accession negotiations did not take place until 1998 (Anderson, 2008, p. 12). The chief negotiator on behalf of Cyprus was George Vassiliou, who had by then been succeeded by Glafcos Clerides of the Democratic Rally as President. The primary goal of the negotiations was for Cyprus to adopt and implement the acquis communautaire, the body of European Union law. From the start the EU made it clear to Vassiliou that Cyprus needed to change their tax system, which at the time was a classic offshore tax system with a 4.5% corporation tax (Vassiliou, 2013). In order to prepare for EU accession, Cyprus planned a complete reform of their tax system.

In August 2001 the Ministry of Finance engaged Dr. Wolfgang Gassner, an Austrian professor at Vienna University of Economics and chairman of the accounting firm Deloitte & Touche Austria as an external advisor to the reform of the tax system (Savvides, 2002, p. 5). He was to become the main architect behind the new tax system in Cyprus. Gassner had played a central role in the process of aligning the Austrian tax code to the acquis in the accession process of Austria, that joined the EU in 1995. He emphasised the need for a substantial tax reform in Cyprus, with the goal to create a tax system that conformed with European Law and the acquis, satisfied the OECD who had initiated a campaign against Harmful Tax Competition, yet making the tax system as competitive as possible in the framework of what he called ”Global Tax Competition” (Gassner, 2001, p. 2).

The finance ministry of Cyprus commissioned Savvas Savvides, a Cypriot chartered accountant, to work together with Gassner as a consultant to the finance ministry for the tax reform. Savvides at the time was running his own accounting firm, after previously being a senior tax partner at KPMG and the former chairman of the Institute of Chartered Accountants in Cyprus (Savvides, 2013).
6.1. EU ACCESSION AND TAX REFORM

6.1.1 Key changes to the tax system

Amongst the key issues the EU addressed in the tax reform was that Cyprus needed to dismantle their system of different tax rules for resident and non-resident tax payers (Savvides, 2013). This is a classic trait of an offshore tax system, where resident tax payers are ring fenced, and subject to one set of tax rules, while non-resident businesses and individuals are subject to another, and usually much more lucrative, set of tax rules. These sort of practices were both discriminatory according to EU law, as well as not being in line with the OECDs guidelines under the project Harmful Tax Competition (Gassner, 2001, p. 5). The principles in the OECD project were emphasised by the EU negotiators during the accession negotiations:

“Businesses that came to Cyprus and then go out of Cyprus, not investing in Cyprus. Not conducting business in Cyprus but outside Cyprus. This we called in the beginning offshore businesses. Then we named (them) international business companies. They had 4,25% rate of tax. Ok, this OECD said no, this is harmful tax competition. You make schemes to attract investors in your area, and pay nothing, and therefore they leave other countries to come to Cyprus. They didnt like this. They asked Cyprus to change this. And this was in the 1990s. When Cyprus filed an application to the European Union” - Savvas Savvides, consultant for the finance ministry during the pre-accession tax reform (Savvides, 2013).

In all, the tax reform consisted of 17 pieces of legislation, enacted in June and July of 2002 (Gassner, 2003, p. 23). In addition to abolishing the preferential treatments based on territoriality, the old tax system had a myriad of exemptions, deductions, allowances, special rates and other incentives that the new tax system sought to clear out. The overall strategy of the tax reform was to cut the rates of income tax, as the same time as broadening the tax base with the goal to make the tax system more transparent, easier to administer and more efficient (Gassner, 2003, p. 24). The opportunity to cut rates in income tax came from the need to harmonise value-added taxes (VAT) and excise duties with the European Union, where the minimum rate was 15%. This meant that Cyprus had to significantly increase their taxes on consumption, which effectively doubled the income from indirect taxation. This increase in revenue provided the financing for a lowering of taxes from direct taxation (Gassner, 2003, p. 24). As Cyprus joined the EU with a reformed tax system, it had the lowest income tax rate in any EU country with 10% (Vassiliou, 2013). This secured the role of Cyprus as a very lucrative destination to place
business, investments and capital for corporations and individuals from EU countries, and a strategic gateway to the European markets for outsiders.

According to Gassner (2003, p. 26) the new tax system would in many cases be more attractive for International business companies than the old. This is due to the fact that non-residents of Cyprus would be subject to no withholding tax on dividends and interests, would be exempt from tax on foreign dividends and profits from permanent establishments abroad, would be able to offset foreign losses against profits in Cyprus, in addition to the already mentioned very low tax rate. This would make the Cypriot tax regime amongst the most competitive in the world for instance for holding companies. According to Vassiliou (2013) the competitive tax regime that Cyprus entered the EU with, set a precedent for other EU countries:

“Now you may say this is lower than other countries. When I negotiated it was the lowest. Since then many countries copied us. So you can say that originally it was a Vassiliou or Cypriot idea, but gradually it became a European idea for many countries. And even countries where the tax system is slightly higher, it is still essentially. In that sense you could say that European Union could be divided into two groups of countries, countries that have a high level of social services and so on, like the Scandinavian countries, and a relatively high taxation system, and countries that have (...) lower taxation system.” - George Vassiliou, chief negotiator of the EU accession (Vassiliou, 2013).

6.1.2 Shipping

During the EU accession negotiations, questions were raised from the EU concerning the shipping tax regime in Cyprus. According to Savvas Savvides, who was a central participant of the tax reform in Cyprus, the EU recognised that the tax regime in Cyprus was not according to EU law. The tax benefits that Cyprus offered for registering shipping business amounted to this sector being practically untaxed in Cyprus. Still, the EU allowed Cyprus to retain their very competitive framework for the shipping industry. According to Savvides (2013), this was allowed because of the importance of shipping business to the economy in Cyprus.

“The EU on merchant shipping said: “Yes we acknowledge that this is not according to the EU law and environment, but we will accept it, because we want to encourage other European countries to explore and exploit merchant shipping business”. (...) They saw the importance of merchant shipping to a
Merchant shipping grew in importance for the economy of Cyprus since they first introduced ‘tax free’ laws for the sector in 1963, and over time Cyprus has grown into one of the largest ship registries in the world. The merchant shipping regime was revised in 2010 with the arrival of a new directive from the EU.

6.1.3 Analysis

The reform of the tax system in Cyprus leading up to Cyprus joining the EU took place without much political pressure or interference from government leaders from other EU member states. Political leaders were concerned with the implications of EU accession for the relationship with Turkey and the impact on the Cyprus question, but according to Cypriot representatives to the negotiation process (Savvides, 2013; Vassiliou, 2013), there were no objections in the Council from EU state leaders during accession negotiations to the very competitive tax system Cyprus would be joining the EU with. The seemingly lack of strong interests from individual member states during the tax reform and accession process suggests that the usefulness of applying the perspective of intergovernmental bargaining in explaining the outcome is limited. However, it does suggest that there were not any EU member states at the time that viewed it as particularly important to prioritise putting pressure on the tax regimes of countries like Cyprus, in order to limit tax competition in the EU. It might also be useful to use this approach to explain the imperative of maintaining a competitive tax regime from the Cypriot perspective, where companies involved in international business and finance constitutes the most politically influential sector. Arriving at such conclusions from this approach are however speculative, and comes up short since the negotiations lack one or more states that represents counterparts to the negotiation process.

As described in chapter four, the institutional set-up of the EU has exposed EU member states to increased tax competition by integrating markets and lowering barriers for businesses to relocate across borders. At the same time, establishing EU policies on taxation has been notoriously difficult, and the efforts by the Commission to pass legislation on direct taxation has usually been either stopped or significantly watered down in the Council. In addition, the ECJ have consistently ruled against unilateral defensive
measures by member states in order to protect themselves against tax competition (Kemmerling and Seils, 2009, p. 755). In combination, this would seem to foster a dynamic of tax competition that would put pressure on the sources of fiscal revenue of member states, a situation that from a neo-functionalist perspective would be expected to create pressures for increased integration and harmonisation, and that the Commission would play an important role in pushing for that harmonisation.

Accession negotiations on tax took place primarily on a technical level between Cypriot representatives and the Commission. Commission representatives during the negotiations made clear that tax practices that were identified as harmful by the OECD project on harmful tax practices needed to be changed. In particular this meant abandoning the “offshore system” of different tax rates for domestic and international businesses. However the Commission did not challenge Cyprus entering the EU with a very competitive tax regime, which in practice “lowered the bar” on competitive tax regimes within the EU. In some areas where they could easily be pushing for more harmonisation they also refrained from doing so, as in the case of the tax regime on shipping. I do not find evidence of a strong agenda from the side of the Commission to push for general tax harmonisation between Cyprus and the ‘average’ tax level of EU member states through the accession process.

Sharman (2008, p. 1055) points to the need of the Commission to establish a discourse where fiscal sovereignty was under threat from the dangers of market pressures and tax competition, in order to be able to introduce EU-wide policies in a policy area that have been characterised by the unwillingness of member states to give up national sovereignty. The result of this was the identification of specific harmful features in the OECD harmful tax competition project. These elements would constitute key elements of the EU Code of Conduct on Business Taxation that was agreed upon shortly after Cyprus’ tax reform and EU accession. Both the Code of Conduct and the OECD harmful tax competition project take a soft law approach, but are clear in identifying certain tax policies that are regarded as inappropriate.

This approach was reflected in the negotiations around the EU accession process for Cyprus. Rather than seeking to address the general issue of tax competition, the Commission was clearly addressing the more specific elements regarded as harmful in the policy instruments described above, and making reference to the Code of Conduct on Business Taxation. It is possible to view this process as a successful transfer of a new discourse into soft law and norms formulated by the Commission and accepted by the member states, which further translated to policy changes on tax in Cyprus. On “harm-

ful practices” such as the offshore model of differentiated tax rates between national and international businesses, the EU was absolutely clear in their demands for a Cyprus tax reform, and Cyprus took this into account when shaping their reformed tax system. For Cyprus, the soft tax laws of the EU were given teeth through EU conditionality under the process of accession. The Commission negotiated in the accession process from a clear position of strength, with Cyprus being a small and rather unimportant European state. Schimmelfennig (2012) uses accession conditionality as an example where policies are transferred to prospective EU member states who respond to pressures by following a “logic of consequences”. I find this to make sense as in terms of describing how the Cypriot government responded to conditionalities on changes in their tax policy as a part of their accession process.

I do not find that the accession negotiations provided conditions where you would expect to find socialisation or learning processes to take place within the policy area of taxation. Neither do I find evidence of Cyprus adopting policies or shaping institutions through what Börzel and Risse (2006) labels a “logic of appropriateness”, during the limited time and interaction during the accession negotiations. However, this study have limited observations to base conclusions in either direction on this.

6.2 A period of stability on taxation (2004-2012)

The eight years between joining the European Union and until the recent crisis and bailout negotiations was a period of stability in the Cyprus tax system. The corporate tax rate remained at 10 percent, and little was changed in terms of legislation regarding taxation or the practices of the tax authorities, according to Cyprus Finance Ministry officials (Cyprus Finance Ministry, 2013). During this period, Cyprus was engaged in two international processes in the EU and the OECD that followed up non-binding commitments related to taxation policies. These involved states monitoring each other, performing peer reviews and discussing the implementation of stated objectives, often referred to as “soft law” instruments. The EU process was based on the Code of Conduct on Business Taxation (The Council of the European Union, 1998), an EU instrument that was generally based on the same principles as the 1998 OECD “harmful tax practices” initiative.

The OECD Global Forum process, although not being an EU instrument, will also be covered in this chapter as the standards and performance reviews from this process feeds into the work of the EU on tax information exchange. As I will return to in the last section of this chapter, the EU has emphasised the need for Cyprus to comply with
the standards of the OECD Global Forum in the recent negotiations under the ESM. Therefore, it is arguably an instrument of EU influence. The OECD Global Forum process focuses on implementing the effective exchange of information for tax purposes between tax authorities that have signed information sharing agreements based on the OECDs model tax convention.

6.2.1 OECD Global Forum process

The OECD, under the auspice of the G20, established the so-called Global Forum Transparency and Exchange of Information for Tax Purposes in 2000 for both OECD and non-OECD members. The purpose was to introduce a multilateral framework for the work being done in the OECD on tax transparency and exchange of information for tax purposes. The Global Forum carries out monitoring and peer-reviews on how well the members fulfil the standards of exchange of information as described in the OECD Model Agreement on Exchange of Information on Tax Matters from 2002 (OECD, 2012, p. 5). This is a standard that allows the tax administrations, the competent authorities, from countries that have signed a tax agreement with each other based on the OECD model agreement, to request the exchange of tax-relevant information on their own tax residents. The request must be detailed and specific. For instance if an information request is made for the details of a bank account, precise information on that bank account must be provided. “Loose” requests are referred to as “fishing expeditions” and are not supported through the OECD information exchange framework. Although this framework allows for information to be exchanged, it is often time-consuming for the tax authorities, and you need precise knowledge in advance on what you are looking for.

The peer reviews recommend areas for improvement and the Global Forum also facilitates technical assistance to jurisdictions in meeting the standards. In their reviews, countries are listed as compliant, largely compliant, partially compliant or non-compliant. The OECD cannot impose sanctions on countries that do not follow the standards. Therefore, arguably, the main incentive for member states to comply with the standards are to avoid the reputational risk of being defined as not complying.

1For instance, in the case of Norway, this request would be based on the double taxation convention signed between Norway and Cyprus from 1951. At the time of writing, a total of 12 such information requests have been made to the Cyprus tax authorities, which have resulted in five cases where information have been exchanged, and three that still are pending response. In several of the instances where information was exchanged, however, the Norwegian tax authorities have found that the information has not included bank transcripts. Responses usually take between 6 to 18 months (Norwegian Tax Authorities, 2013).
Cyprus exchanges information based on a network of 44 bilateral Double Tax Agreements as well as with EU members under several EU instruments (OECD, 2012, p. 8). The effectiveness of transferring information and the usefulness of the information exchanged depends on a number of factors, both in the legal framework and in terms of the implementation of laws and on how the competent authorities administrate information requests. First, the information requested must be available to the competent authorities, either in government registries, or through accessing information from banks or other third parties (OECD, 2012, p. 17). Ideally, the information should be up-to-date and reliable. However, the quality of information available for exchange relies on for instance whether companies need to file annual accounts that are audited, and if these requirements are being properly enforced. Similarly, if it is allowed to own shares of a company through bearer shares it is practically impossible for competent authorities to possess or obtain information on ownership of such shares, making information exchange impossible. The requirements for availability of information on ownership information and accounts for tax purposes partly overlap with anti-money laundering regulations such as defined by the international Financial Action Task Force (FATF) recommendations (OECD, 2012, p. 8).

All members get reviewed in the Global Forum process, and the peer reviews are carried out in two phases. The first phase is a review of the legal and regulatory framework, and the second phase is a review of implementation. The report from the phase one review of Cyprus was published in 2012, and the second phase report was published in late 2013 (OECD, 2013).

For Cyprus, a number of shortcomings were identified in the first phase of their Global Forum peer review, covering the legal aspects of their tax information exchange. One legal issue that was pointed out by the peer review was a loophole in which companies who are based and conducting business outside of Cyprus, but are incorporated in Cyprus, were exempt from the duty of keeping accounting records and underlying documentation for their company (OECD, 2012, p. 8). Another issue pointed out by the first phase OECD review was the existence of unidentified owners through the use of bearer shares (OECD, 2012, p. 33). A third was that the use of trust structures of ownership, which is quite widespread in Cyprus, allows for concealment of the identity of beneficiaries through the use of Cyprus trusts. The accounting and ‘book-holding’ requirements of trusts were also identified as unclear under Cypriot law (OECD, 2012, p. 39). The availability of bearer

---

2As per March 2012

3A share that is owned by whoever holds the physical stock certificate. Owners of bearer shares are not registered, and ownership is virtually impossible to track.
shares, corporations which lack company accounts and concealed ownership identities through the use of trusts are all instruments that can be used deliberately in order to obtain secrecy for either tax avoidance or money laundering purposes. Therefore, these instruments arguably provide the Cyprus legal system with certain ‘tax haven capabilities’.

### 6.2.2 Code of Conduct on Business Taxation

The EU Code of Conduct on Business Taxation, described in chapter 4.3.2, was introduced with the 2003 EU ”Tax Package”. The Code, similarly to the OECD Global Forum, has an element of peer reviews, although not as formalised as the Global Forum process. Being a ”soft law” instrument, the compliance with the Code cannot be enforced by the Commission or brought before the European Court of Justice. There are monthly meetings in the Code of Conduct group which take place in Brussels, and a Cyprus representative participates in all meetings. In the Code of Conduct Group, member states can bring the tax measures of other member states up for discussion, as stated in the Council decision establishing the Group:

> “Any Member State may request the opportunity to discuss and comment on a tax measure of another Member State that may fall within the scope of the code. This will permit an assessment to be made of whether the tax measures in question are harmful, in the light of the effects that they may have within the Community.” (The Council of the European Union, 1998, p. 4)

Given the informal nature of the work of the Code of Conduct Group, measuring its impact on member states is difficult. The group does not make formal announcements, nor are minutes of its meetings available to the public. Every six months a new member states takes on the Presidency, and at the end of term the sitting Presidency delivers a progress report to the finance ministers of the EU in the ECOFIN Council. As previously mentioned, Cyprus conducted a tax reform prior to EU accession where one of the explicit goals was to make the Cyprus tax system compliant with the Code of Conduct. After joining the EU, it has not been found to have had harmful tax practices in place by the Code of Conduct Group. In interviews, Cyprus Finance Ministry officials emphasised that Cyprus is committed to being fully compliant with the Code: “basically whatever is being decided there, we comply with it. (...) We never had any complaints that we dont comply with it, or anything like that” (Cyprus Finance Ministry, 2013).

The Commission Directorate General on Taxation and Customs (TAXUD), is the EC body on taxation. With the Code of Conduct Group primarily being based on the peer-based interaction of member states, the role of the Commission is rather limited. Although being instrumental in monitoring whether member states adopt laws that are defined as ‘harmful tax practices’, the Code of Conduct does not empower the Commission with neither the opportunity nor resources to monitor the effectiveness and implementation of tax policies of member states. They “can’t look them [member states] over the shoulder”, as an EC officer expressed it in an interview (European Commission, 2013b). I find no indications that the Commission has taken an activistic role within the work of the Code of Conduct Group to press for policy changes on taxation in Cyprus during this time period.

6.2.3 Analysis

As I described in chapter 2.5, the theoretical approaches of chapter two will be applied to the analysis to a varying degree based on their relevance. This section has focused on the EU-Cyprus interaction on tax policy in the period between 2004-2012. The interaction described above has primarily taken place as institutionalised interaction on a bureaucratic or lower-level diplomatic level, through instruments such as the OECD Global Forum and the EU Code of Conduct Group. The period lacks any major episodes of intergovernmental negotiation or pressure from other member states for Cyprus to apply changes to their taxation policies. I have found no evidence of any pressure from other governments linked to the performance of Cyprus on these standards. I therefore find that analysing it from a theoretical approach of intergovernmentalism has limited usefulness.

Supranational approaches of EU studies would likely be able to provide insights into the role of the Commission within the Code of Conduct group. However, the lack of information available on the work of this group and the limited scope of this study disallows elaboration on this. I therefore focus the attention to how Cyprus has responded to the involvement in these two international institutions, the EU Code of Conduct Group and the OECD Global Forum. Following from the institutionalist approaches from chapter two, one could explore whether actors or institutions in Cyprus has responded to these initiatives by following a ‘logic of consequences’ or a ‘logic of appropriateness’.

Responding through a ‘Logic of consequences’...

First, it is possible to consider both the Code of Conduct Group and the Global Forum as institutions that provide an ‘institutional frame’ for action, with a defined set of rules,
decision-making procedures and risk of sanctions for non-compliance for members. If existing policies of Cyprus are not in alignment with standards or stated goals that these institutions have prescribed, Cyprus would, following a ‘logic of consequences’, need to weigh the potential costs of non-compliance against the various costs of changing policies. The Code of Conduct had direct consequences for the tax policies of Cyprus during the 2002 tax reform, as already described. Since accession, however, there are no clear cases of the any taxation practices in Cyprus being challenged and thereby directly influenced by the Code of Conduct Group.

The Code of Conduct is not a monitoring instrument for the administrative effectiveness of tax related policies in EU member states. It defines laws on taxation that are identified as ‘harmful’, and monitors whether member states introduce such laws. In the group, member states can discuss whether new tax laws introduced in other member states should be considered ‘harmful’ or not. It is not a legal instrument, and violation of the Code of Conduct can not be brought before the European Court of Justice. The systems in place to monitor the effectiveness of administrative and regulatory tax related policies are much weaker than the ability to monitor introduction of new tax laws. This might have some significance, as laxity in the implementation or ‘policing’ of laws and regulations related to tax policies can present corporations and individuals with opportunities to avoid tax in a similar fashion as creating a legal regime consisting of ‘harmful’ tax laws. Although a situation of a ‘race to the bottom’ of tax competition is most often discussed concerning ‘competing’ legal regimes, the same dynamic can play out through laxity in implementation and administrative regulation as well. In the hypothetical situation where a member state would want to pursue a strategy of tax competition in order to attract investment and business, arguably the Code of Conduct creates an asymmetrical opportunity structure that favours pursuing a “race to the bottom” of regulatory and administrative laxity, rather than through a competitive legal regime. Pursuing such an hypothesis and measuring any such effect is, however, beyond the scope of his study. Within the limited data available through the work of this study, I do not find evidence of any direct effect of the Code of Conduct influencing Cyprus to make tax policy decisions towards ‘tax competition’ on regulatory or administrative laxity. Institutional analysis on whether the EU institutions on taxation as a whole promote ‘regulatory tax competition’ among member states, might however be a fruitful area of future research. In terms of legislation, the fact that Cyprus have not had laws challenged under the Code of Conduct does not necessarily mean that it has been without influence. It is possible that the Code has drawn a ‘red line’, acting as a deterrent against introducing new ‘harmful’ tax laws.
and practices.

Unlike the Code of Conduct Group, which have monthly meetings in Brussels, the Global Forum requires less frequent participation from its members. During the period in question, up until 2012, the objective of the peer reviews of Cyprus have been to assess whether Cyprus had the legal framework in place that would allow them to effectively acquire and, in accordance with their bilateral and EU tax treaties, exchange information on tax residents from other countries with economic or legal presence in Cyprus. The Global Forum does not have the power to impose sanctions on members that are found to be non-compliant in the peer reviews. For Cyprus, the legal assessment peer review found several weaknesses that are described above. In interviews with Cyprus Finance Ministry officials, they pointed out that one recent change made, requiring all companies incorporated in Cyprus to keep accounting records, was done specifically because it was recommended by the OECD Global Forum Peer Review of Cyprus (Cyprus Finance Ministry, 2013). This suggest that the reputational risk of being found non-compliant by the Global Forum process has been taken seriously by the Cypriot government, and have had some influence on taxation policies. That the Global Forum, similarly to the Code of Conduct Group, up until recently primarily have focused on legal framework, could have contributed to Global Forum members being primarily concerned with complying with legal framework, rather than focusing on implementation or administrative capacity. Since the first assessment on the implementation and administrative aspects of information exchange in the case of Cyprus was concluded after the negotiations of an ESM programme and the initiation of an ESM programme, it will be touched upon in the next section.

Applying a theoretical framework in which states are assumed to follow a ‘logic of consequences’ to the admittedly limited evidence available for this study, there are no solid basis for drawing strong conclusions on how the institutional frameworks of the EU Code of Conduct Group and the OECD Global Forum has influenced tax policies in Cyprus. Both of these institutions lack “teeth”, and the reputational damage of non-compliance for members is hard to measure, even though some changes are ascribed to recommendations by the Global Forum. Both institutions share an emphasis on legal framework over implementation and issues such as administrative capacity or effectiveness. It is however not possible to conclude that this has influenced Cyprus towards more emphasis on compliance of legal framework, while allowing a relative ‘laxity’ in regulatory and administrative standards.
or a ‘logic of appropriateness’?

The EU have relatively recently introduced governance instruments that are not legally binding for member states, such as the so-called ‘Open Method of Coordination’, introduced with the Treaty of Amsterdam in 1997. As described in chapter 4.3.2, these ‘soft law’ approaches, often used in policy areas outside of EU competence, involve a framework for member states to decide on guidelines and best-practice-standards, introduce benchmarks, conduct peer-reviews and decide on recommendations for action within a defined policy area. The intention is to allow coordination take place between member states without imposing it upon them through law. Meanwhile, in EU studies, new explanation models on processes of Europeanization have emerged, focusing on how the behaviour of state actors often follow a ‘logic of appropriateness’ rather than a ‘logic of consequences’. Where in the latter, state actors are assumed to be following a rather rational approach in terms of defending or maximizing their interests at stake in outcomes, in the former, agents are assumed to be often looking for solutions or outcomes that are appropriate, in line with accepted ideas and norms of behaviour or according to values or principles that are agreed upon and shared within the group. From this perspective, the ideas, solutions, norms and values influencing government behaviour within a policy area can over time be influenced for instance through the participation in international institutions or organisations.

For Cyprus, an economic attaché permanently based in Brussels participate in the meetings in the Code of Conduct group, if necessary supplemented by Cyprus Finance Ministry officials who will travel to Brussels. As described above, Cyprus has not had any instances where they have refused to comply with decisions made in the Code of Conduct Group. In interviews, Finance Ministry officials emphasised that Cyprus took decisions from the Code of Conduct Group seriously: “it’s not law, but we do our best to comply” (Cyprus Finance Ministry, 2013). The fact that participation in the group is mainly limited to a permanent official in Brussels might suggest that the scope for ‘socialisation’ of key decision makers on tax policy in Cyprus government is limited.

An social institutionalist approach to Europeanization effects would be interested in whether government representatives have experienced ‘socialisation’ or ‘learning’ as a consequence of participation in EU institutions such as the EU Code of Conduct Group. Measuring such socialisation or learning effects are difficult, and beyond the scope of this study. In case of the Global Forum, recommendations for legal changes have been followed up by Cyprus with specific reference to the OECD Global Forum peer reviews. Whether government actors have initiated such changes because they are ‘appropriate’, or due to
the risk of reputational damage, is not possible to determine given the evidence at hand. The Commission, although being present both as a member to the Global Forum and the Code of Conduct Group, appears not play a dominant role in neither of these institutions. This study therefore suggests that the EU Commission have wielded limited influence on Cyprus through the soft law instruments of the Global Forum and the Code of Conduct on Business Taxation group, during the time span between EU accession and the start of the ESM negotiations.

6.3 Bank Crisis and ‘bailout’ negotiations

The nature of EU- Cyprus relations shifted fundamentally as Cyprus was forced to apply for support through a programme (often referred to as a bail-out) under the European Stability Mechanism, and this will the subject of this section. First, the institutional set up and decision-making procedure and the role of member states and the Commission in the European Stability Mechanism (ESM) will be explored. This will be followed by a brief narrative of how the events around the bank crisis and the negotiations of a bail-out unfolded. Third, the section will cover two assessment reports on the implementation of tax information exchange agreements and anti-money laundering standards, which were carried out during and after the negotiations. Fourth, the outcome of the ESM negotiations will be analysed more specifically in terms of their effect on taxation policies of Cyprus. The chapter will finish with an analysis of how the negotiations led to these outcomes, using theoretical insights and approaches from chapter two.

6.3.1 The European Stability Mechanism

The European Stability Mechanism (ESM) is an intergovernmental treaty set up outside of the Lisbon Treaty, and signed by all EU member states on 25 March 2011. The ESM was put in place as crisis management mechanism in response to the pressure on the Euro caused by sovereign debt crisis suffered by a number of EU countries (Fabbrini, 2013, p. 1). The ESM is therefore not formally an EU body, it has its own institutions and is formally an intergovernmental organization under public international law. The Board of Governors of the ESM consists of Ministers of Finance of member states from the Euro-area as voting members, with the European Commissioner for Economic and Monetary Affairs and the President of the European Central Bank (ECB) as observers (Fabbrini, 2013, p. 13). When a member state applies for a program from the ESM, it is expected that a similar request is made to the IMF, and the IMF and ESM cooperates
and coordinates very closely throughout the crisis management and negotiation process.

During the negotiations, a unit from the ECFIN Commission is empowered by the Euro-area creditor states to negotiate on their behalf. The role of the Commission is to negotiate a credible programme that on the one hand ensures that the member state (in this case, Cyprus) will adjust to meet the key objectives of the programme, for example debt sustainability in the medium to long run. At the same time the Commission imposes conditions at the country that it identifies as instrumental in trying to get economic development back on a better path. In Troika negotiations, therefore, the European Commission balances between being the firm representative of the creditor countries, and being the one actor that can draw up a holistic policy package for the country concerned, that can actually be implemented (European Commission, 2013a).

The interaction with member states during the negotiating phase is, according to Commission officials, not very intense (European Commission, 2013a). At the outset of negotiations, they are mandated by a statement of the Eurogroup to undertake negotiations. In the case of Cyprus this was a statement of 27 June 2012. According to the statement, the key objectives of the programme would be to “ensure the stability of the financial sector (...), carry out the fiscal adjustment to support the ongoing process of fiscal consolidation, (...) [and initiate] structural reforms to support competitiveness and sustainable and balanced growth” (Eurogroup, 2012). The negotiating unit regularly reports to the Euro-area member states of the so called EWG, the Euro Working Group, about the progress of the negotiations. The Commission negotiate freely, and present the member states with the in-principle Memorandum of Understanding (MOU) at the end of negotiations between the Troika and Cypriot government. At this point, the financing needs to be supported through an unanimous decision amongst the creditor countries. In the case of the Cyprus bailout, Germany and France would between them provide almost half of the funding of the programme, with Germany being the largest creditor. This clearly positions these countries as the most influential of the creditors. In the last resort, the outcome of the negotiations would need support from the major creditors because, as explained by a Commission official, “if the biggest lender would not support the programme there would not be a programme” (European Commission, 2013a). Before going into the outcome of the negotiations, however, a short introduction to the bank crisis and the unfolding of the negotiations is in order, which will follow in the section below.
Several aspects contributed to setting the stage for an unprecedented banking crisis in Cyprus. Most significant, as mentioned in chapter five, was the exposure to the Greek economy. Cypriot banks expanded their loan operations in Greece considerably since 2005, and also invested heavily in Greek government bonds. When Greece was hit hard by an economic and financial crisis, it was inevitable that it would spill over on Cyprus. Domestically, banks in Cyprus were also suffering under poor quality of loans, particularly issued within the real estate sector. As a result, depositor confidence in Cypriot banks deteriorated, adding further pressure on the liquidity of banks. By 2008, liquidity levels were deteriorating, and by 2010 indicators on the soundness of Cypriot banks revealed that their financial situation was vulnerable and that they were threatened by insolvency (European Commission, 2013c, p. 33).

Banks became heavily reliant on funding from the central bank, and the Cypriot government stepped in to provide further capital as private investors became increasingly reluctant to invest in Cypriot banks (European Commission, 2013c, p. 34). This in turn increased the fiscal pressure on the government. By mid-2011 the government of Cyprus was de-facto shut out of financial markets for long term bonds and needed to pay rising interest on short term bonds. By the second half of 2011, the Cypriot economy was in recession (OECD, 2013, p. 12). It became clear that Cyprus was in need of outside assistance. That outside assistance first came from Russia. The Cypriot President at the time was Demetris Christofias from the communist AKEL party, which had good relations with Moscow. He managed to secure a 2.5bn euro loan from Russia in the fall of 2011 (European Commission, 2013c, p. 35). This helped Cyprus temporarily cover their budget deficit. The Cypriot finance minister, Kikis Kazamias, called it “a friendly agreement with no strings attached” (Financial Times, 2011). However, it soon became evident that Cyprus needed additional assistance, and Russia was not willing to carry the weight of financing Cyprus on their own. By July 2012 all three major international credit rating agencies had downgraded Cyprus government bonds to junk status. Cyprus was left with the only option of applying for a program under the ESM, which they did in June 2012. The application meant that Cyprus would start negotiating about the terms of a bailout with the so-called Troika consisting of the ECB, the IMF and the EC negotiating on behalf of a group of Eurozone creditor countries (Financial Times, 2012).

The president when negotiations started, Christofias, did not want to be the one to sign off on the kind of austerity program that would inevitably be the outcome of the negotiations. His communist party AKEL was both ideologically opposed to, and
unwilling to be held responsible for the unpopular budget cuts, selling off of government assets and other measures that Cyprus would need to undertake in order to find an understanding with the Troika. Elections were coming up in Cyprus in the spring of 2013, and Christofias would rather have a final agreement be found after the elections (European Commission, 2013a).

Since a finalized memorandum of understanding (MOU) needed to wait until after the elections, the Troika and Cyprus reached a so-called in-principle MOU in November 2012. In December 2012 the Cypriot parliament passed a number of laws and decisions in order to meet the criteria of this agreement. In Cyprus, the agreement was by many perceived as being the final outcome of negotiations with the Troika (Vassiliou, 2013), and that what remained was to merely formalize the agreement after elections.

Elections in Cyprus were held in late February 2013, and gave Nicos Anastasiades from the centre-right Democratic Rally the presidency with 57.5% of the vote (BBC News, 2013a). His new government had little time to loose in securing an agreement with the Troika. Cyprus had a 1.4 bn eurobond payment due in the beginning of June, and with at least a month or so needed to get a deal passed through parliaments both in Cyprus and Eurozone-countries like Germany, a deal had to be struck by the end of March or beginning of April at the latest (Mullen, 2013). Intense negotiations, primarily in Nicosia, ensued with Commission and IMF representatives flying in on a frequent basis. Finding a solution would prove more difficult than many in Cyprus had hoped for. Since November, several factors contributed to complicate the negotiations. First, the estimates for the amount needed to bail Cyprus out were revised upwards after the in-principle understanding was made in November. By January, the need of funds was estimated around 11 billion euros, up from an estimate of 9 billion some months earlier (Business Insider, 2013). Second, and perhaps more importantly, was the strong resistance to a Cyprus deal from Germany.

German resistance and money laundering allegations

In Germany, many were opposed to the idea of bailing out a country that had experienced a sustained period of growth based on what they perceived as an irresponsible and morally dubious business-model, namely being a ‘tax haven’ or haven for ‘black money’. Politically, the debate on whether Cyprus was a haven for ‘black money’ sprung to life in November 2012, as an intelligence report from the German Bundesnachrichtendienst (BND) was leaked to German newspaper Der Spiegel, warning that a bailout of Cyprus would in effect be a bailout for Russian oligarchs (Der Spiegel, 2012b). The idea of us-
ing money from German taxpayers to save the wealth of Russian oligarchs infuriated the German public, offended Cypriots and became an important source of mutual distrust between Germany and Cyprus during the remainder of the Troika negotiation process.

The political climate in Germany was, after broad media coverage on the link between Cyprus and Russian money, quite negative to the deal. A deal also seemed to have little backing in the German parliament. Elections were due in September 2013 in Germany, and tax havens was an issue of growing concern among voters. German taxpayers were already increasingly opposed to the idea that Germany needed to pay for what many felt was irresponsible economic behaviour in countries like Greece and Spain. The leader of the German social democrats, Sigmar Gabriel, expressed their views on the situation in January 2013: “As things currently stand, I can’t imagine German taxpayers bailing out Cypriot banks, whose business model depends on abetting tax fraud”. The leader of FDP, the junior coalition partner in German government, Rainer Brüderle, commented that “if the impression would persist that the German taxpayer has to be liable for black money in Cyprus, then aid would not be justifiable” (Business Insider, 2013).

For Cyprus, the allegations were not unprecedented. The reputation as a money laundering haven has followed Cyprus since revelations that former Yugoslav President Slobodan Milosevic laundered hundreds of millions of dollars through bank accounts and front companies in Cyprus in the 1990s (Working and Chernyakova, 2002). Milosevic used front companies and offshore bank accounts in Cyprus to avoid the international embargo and buy military equipment that were used in the wars in Bosnia and Kosovo. Cypriot officials, however, rejected such characterisations and say they ignore substantial reforms introduced since EU accession. According to the longtime head of Cyprus’s anti-money-laundering agency, Eva Rossidou-Papakyriacou; “Cyprus is doing a lot more than other countries [to combat illegal financial activity]” (Wall Street Journal, 2013). Most Cypriots saw being a tax haven or money laundering haven as a thing of the past (Vassiliou, 2013). This was backed up from the Cypriot side with reference to a number of assessment reports from the European anti-money laundering monitoring agency, MONEYVAL, in which Cyprus was found to have an adequate regulatory framework for anti-money laundering (Vassiliou, 2013).

---

4The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, a monitoring body of the Council of Europe
Drawn out negotiations and risk of Euro exit

In order for the negotiations of a MOU to succeed, Cyprus needed to find an agreement on a country program that satisfied the criteria of both the International Monetary Fund, the European Central Bank and the European Commission negotiating on behalf of eurozone country creditors. For the IMF, their main concern in these situations are that the program agreed on must set the program country on track to an economic trajectory of sustainable debt levels in the medium to long run. During the course of the March negotiations, it became clear that the Troika demanded from Cyprus that alternative sources of funding were found in order to limit the amount of new debt taken on by the Cypriot government. If Cyprus was granted all their capital needs in terms of new loans from the Troika, their debt levels would simply be too large, and they would not be able to steer their economy back to sustainable debt levels, according to the IMF (European Commission, 2013a). The question was where the money should come from.

Under severe pressure an agreement was found on March 16, 2013 between the Troika and Cypriot negotiators. The precise details of the negotiations are still unclear and disputed, as neither side wants to assume the responsibility of tabling the proposal that was agreed upon. It stated that depositors in Cyprus banks would be "bailed-in", meaning that depositor money would be taken to meet the banks capitalisation needs. Basically this was a one-time tax put on all depositors with money in Cypriot banks. Large depositors, with more than 100,000 euros in their bank accounts, would have 9.9% of their deposits bailed in. Smaller depositors would have 6.75% of their funds bailed in (The Economist, 2013a). This proposal created an outrage. According to EU laws bank deposits up to 100,000 euros are protected and insured by the governments, and many felt that the proposal was illegal. In the days following the proposal announcement both sides tried to blame the other through the media. Eurozone representatives blamed Cyprus, and claimed that the outcome came as a result of business interests in the Cypriot parliament that wanted to protect non-Cypriot large depositors in Cyprus (Financial Times, 2013b). In Cyprus, meanwhile, it was seen as an EU idea and an attack on Cyprus and a punishment based on the perception in Germany and other countries of Cyprus being a "money laundering haven". This was the impression for instance of Athanasios Orphanides, governor of the Cyprus Central Bank from 2007 to 2012, in an interview to the Economist in the end of March 2013 (The Economist, 2013b).

During the negotiations, according to the Financial Times, the ECB threatened Cyprus that failure to reach an agreement would mean that they would cut off emergency low-cost loans to Laiki, the second largest bank, which would cause it to collapse and most
likely bringing Bank of Cyprus down with it. EU officials were convinced that President Anastasiades would not put the future of the country at risk, and that he would secure that the proposal would be passed in parliament before putting it to the vote (Financial Times, 2013a). However, the March 16 proposal met fierce resistance in the Cypriot parliament and was, to the surprise of most outside Cyprus, voted down, with not a single vote cast in favour. This immediately cast the economic future of Cyprus back into doubt, and sent shockwaves throughout the Eurozone. A Cyprus exit from the Eurozone was at this point not perceived as unlikely.

The week that followed was probably among the most intense in the more recent political history of the country. Banks closed in order to prevent capital flight emptying the country’s banks. The ECB threatened to cut off liquidity to the island. President Anastasiades threatened both to resign and to withdraw Cyprus from the Eurozone. However, by March 25 a new proposal was tabled which seemed to be able to create agreement. This time, insured depositors up to 100,000 euros would be protected, in accordance with EU laws. Laiki would be resolved and split into a bad bank, which would be run down over time, and a good bank, which would be incorporated into Bank of Cyprus. Uninsured depositors, equity shareholders and bond holders of Laiki would be contributing to the resolution of the bank, in effect, taking losses. For Bank of Cyprus, uninsured depositors had their assets frozen and converted into bank equity, in order to secure that the bank over time reaches a 9% capital ratio. Cyprus would receive a 10 bn Euro loan under a European Stability Mechanism programme, which would not be spent on recapitalising Laiki Bank and Bank of Cyprus (Eurogroup, 2013).

Final agreement on an ESM Programme was finally found between Cypriot authorities and the European Commission (EC), the ECB and the IMF on 2 April 2013. This laid down a comprehensive policy package for the period 2012-2016, supported by financing for a total amount of up to EUR 10 billion. On 26 April, the Cypriot authorities and the Commission, acting on behalf of the ESM signed a MOU based on this agreement, and it was passed in Cypriot House of Representatives 30 April 2013 (European Commission, 2013c, p. 37). The agreement with the Troika meant that Cyprus would be operating under a European Stability Mechanism (ESM) programme for the foreseeable future.

Although the ESM is an intergovernmental facility, and not an EU body, it is generally perceived as an instrument of the EU by the public. However, in many ways an ESM programme has much more in common with an IMF country surveillance programme than any EU instrument (European Commission, 2013a). During negotiations, given how the issue of whether Cyprus were adequately implementing their anti-money laundering stan-
standards had become a central part of the debate surrounding the bailout, Cyprus agreed to let Moneyval and an independent auditor, Deloitte, do an assessment of the implementation of anti-money laundering measures in Cyprus banks and government institutions. In addition, the OECD ‘Global Forum on Transparency and Exchange of Information for Tax Purposes’ had rolled out the second part of Cyprus’ peer review assessment some months before, which would also investigate the implementation aspects of whether Cyprus was effectively exchanging up-to-date and reliable information for tax purposes with their tax treaty partners.

6.3.3 Cyprus implementation efforts under scrutiny

The objective of the Moneyval report was to investigate the implementation of key aspects of anti-money laundering regulation which include requirements for banks and finance institutions to: know who their customers are; conduct assessments on customers based on risk of money-laundering, corruption and tax evasion, in which case high-risk customers should be more closely monitored; routines for due diligence and monitoring based on risk profile, and; reporting of suspicious transactions to finance intelligence units. Finished in late April 2013, a summarised version of the confidential Moneyval report was immediately leaked to the press upon completion. The report, conducted on six Cypriot credit institutions, was quite damning towards how the anti-money laundering regulations of finance institutions in Cyprus had been implemented, and stated that “findings significantly revise its previous, more favourable assessment of Cyprus AML system” (Moneyval and Deloitte, 2013, p. 1).

According to the report “the institutions included in the sample did not appear to uphold a suitable degree of accuracy in gathering and documenting relevant information from customers, and therefore were not consistently in a position to understand the purpose of the account, define the customers business economic profile and evaluate the expected pattern and level of transactions.” (Moneyval and Deloitte, 2013)

The report assessed a sample of 390 customers, of which the top 180 depositors and top 90 borrowers in Cypriot banks were included, in addition to 90 randomly selected customers. Approximately 10% of the customers in the sample were ‘politically exposed persons’ (PEPs), which the banks had not detected or ‘flagged’. In one sampled bank, 58% of the customers were identified as ‘high risk customers’ by the audit. When investigating the identity of depositors, 27% of client files had inaccurate information on who was the
beneficial owner of the account. Around 90 percent of the top depositors and borrowers included in the sample were legal persons such as trusts or companies, and 70% of the cases with complex ownership structures used nominee shareholders and an average of three layers between the stated bank customer and the beneficial owner of the account. In only 9% of these instances were the identity of the beneficial owner independently verified by the bank or a third party. In the four years between 2008 and 2012, the six credit institutions had only conducted four internal investigations for possible money laundering (Moneyval and Deloitte, 2013, p. 3). In terms of filing suspicious transaction reports, no customers from the sample were reported to the Financial Intelligence Unit between 2008 and 2010, one was filed in 2011 a few in 2012. When reviewing transaction logs, the audit found 29 potentially suspicious transactions during the past 12 months alone, none of which had been identified as deserving further scrutiny or potential reporting by Cypriot banks (Moneyval and Deloitte, 2013, p. 4). In addition, the assessment noted the large backlog of registration of documents at the Company Registrar, and that the Registrar generally did not follow up when companies failed to submit annual returns or financial statements (Moneyval and Deloitte, 2013, p. 4). To sum up, the report finds that “while identifying no regulatory weaknesses, both reports suggest that there are substantial shortcomings in the implementation, by banks, of AML preventive measures.” (Moneyval and Deloitte, 2013, p. 4)

The Global Forum assessment, while being published some months after negotiations ended, complement the picture drawn up by the Moneyval report. In sum, it finds Cyprus to be non-compliant on the implementation of its regulatory framework on transparency and exchange of information for tax purposes. Key aspects of tax information exchange partly overlaps with the above mentioned anti-money laundering framework and includes: the ability to access up-to-date annual returns from a company register; access to financial information from third parties such as banks and access to the beneficial ownership behind companies and trusts. The OECD assessment found that between 2008 and 2012, on average only 23% of companies filed annual returns (OECD, 2013, p. 36), and over half are not filed even a year after their deadline. In such cases, Cypriot authorities could sanction against companies for failing to comply with the tax legislation by imposing a yearly fine of EUR 100 (OECD, 2013, p. 37). The report states that “The low compliance rate of filing annual returns with the Registrar may have resulted in Cyprus not exchanging up-to-date information, since this is the primary source used by Cypriot authorities for obtaining ownership information on companies and partnerships” (OECD, 2013, p. 8). In terms of how the authorities had handled requests for information, fifteen countries
made a total of 650 requests between 2008 and 2012, of which half received information, usually after long delays, while the others either received no or incomplete information (OECD, 2013, p. 48). Although having well-designed legal frameworks that were in line with international standard both for anti-money laundering and for sharing information for tax purposes, Cyprus was not actually implementing these through administrative and regulatory practices, and thereby leaving their laws on these policy areas largely ineffective.

6.3.4 ESM programme and outcome on taxation and transparency

The ESM programme objectives were to set Cyprus on path to return to sustainable growth by addressing weaknesses in the financial sector, government spending and initiate a number of structural reforms. The size of the programme was set to 10 billion Euro, to be paid out in tranches based on assessments of whether Cyprus are meeting the goals of the programme performance criteria at specific deadlines. The first tranche was paid on May 13, and the second at the end of June. In order to cover the governments deficit a number of initiatives were set out, including wage cuts for government employees, savings in social benefit programmes, reform of pension schemes, increased excise duties on alcohol, tobacco and fuel, a long term broad public sector reform and budgetary framework reform, and initiation of a large privatisation plan that aims to “consider the privatisation prospects of state-owned enterprises and semi-governmental organisations, including, inter alia, CyTA (telecom), EAC (electricity), CPA (ports), as well as real estate /land assets.” (European Commission, 2013c, p. 51). In addition, the programme included several elements on policies and regulations on taxation and corporate and financial transparency. In the following, all policy changes between November 2012 and May 2013 will be viewed as outcomes of the ESM programme negotiations, although some changes were decided and carried out on the basis of the November in-principle agreement, and therefore before the final agreement was found in April 2013. The changes in taxation policies, and tax rates, can be seen largely as measures to increase fiscal income and reduce the fiscal deficit, while the transparency measures where aimed at meeting some of the shortcomings described in the section above on tax information exchange and anti-money laundering implementation.

The taxation policies included in the ESM programme included: increased taxation on property; increase in excise duties on alcohol, tobacco and petrol; a gradual 2 %increase in value added tax (VAT); increased withholding tax on interest; the implementation
of a bank levy on consumer deposits; and an increased corporate tax rate from 10% to 12.5% (European Commission, 2013c, pp. 45-48). In addition, the Cypriot authorities also committed to start work on a comprehensive tax reform plan, “aiming to to improve the effectiveness and efficiency of tax collection and administration for implementation as of the budget year 2014” (European Commission, 2013c, p. 87). The low withholding tax on interest and a low corporate tax rate has both contributed to making Cyprus an attractive place for international business and finance in the past, and even after the increase these tax rates will remain amongst the lowest in the EU (i.e. on level with the corporate tax rate in Ireland which is also 12.5%). Fundamentally changing the tax structure of Cyprus was neither in the objective of the Commission, the ECB nor the IMF, and the ESM programme did not alter the fact that the Cyprus tax regime is very favourable for international business (European Commission, 2013a).

Programme measures towards increased transparency

“In 2012 and 2013, Cyprus made a number of changes to its legal and regulatory framework and practice to increase transparency and further comply with the international standard on transparency and exchange of information for tax purposes.” (OECD, 2013, p. 16)

The Cyprus ESM programme included an action plan containing a number of measures aimed at increasing financial transparency. The MOU also makes a direct reference to the above mentioned Moneyval-report, and states that the recommendations of said report will “be implemented without further delay” (European Commission, 2013c, p. 45). Below are some of the main elements in the financial transparency measures of the MOU:

- Cyprus, under the agreement with the Troika, must change their laws to “enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity)” (European Commission, 2013c, p. 72). The agreement involved specific measures to reform the work of the financial intelligence unit and enhancing customer due-diligence and suspicious-transaction reporting procedures.

- Cyprus also agreed to address the concerns that corporations and trusts in Cyprus were misused for tax evasion and financial secrecy, and agreed to an “action plan on entity transparency to revise the legal framework and ensure its dutiful implementation, so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts
in response to requests related to money laundering and tax matters” (European Commission, 2013c, p. 72).

- As a part of the action plan Cypriot authorities agreed to “promptly revise relevant pieces of legislation, including, inter alia, the Trust and Company Services Provider law and the Anti-Money Laundering law (...) in addition, directives and circulars issued by supervisory authorities (CBC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) will be revised to lay down clear implementing procedures that are in line with relevant legislation and international standards” (European Commission, 2013c, p. 72).

- Furthermore, Cypriot authorities agreed to “establish trust registers with the supervisory authorities and launch a third-party assessment of the functioning of the Registrar of companies. The trust registers will be for all trusts established under Cyprus law, will be kept by the relevant supervisory authorities in order to enable them to carry out their duties, and will contain the name of the trust and the name and address of the trustee” (European Commission, 2013c, p. 72).

- The MOU also commits Cyprus to “implement the recommendations put forward in the in-depth review of Cyprus’ legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues” (European Commission, 2013c, p. 89). The latter evaluation refers to the one described in chapter 6.3.3.

The MOU includes specific deadlines for each of the points above, with implementation of the measures in the MOU being a conditionality for the release of future tranches of the ESM programme financing continuing forward to 2016. Implementation is to be closely monitored by the Commission and the IMF. In combination, these changes represent at least a comprehensive revamp of taxation and transparency policies comparable to the tax reform prior to EU accession.

6.3.5 Analysis

In the following I will provide an analysis of the ESM negotiation outcomes on taxation, by applying some of the theoretical insights from chapter two to provide explanations to the outcomes and looking closer at the role of the different actors involved in the process.
6.3. BANK CRISIS AND ‘BAILOUT’ NEGOTIATIONS

Intergovernmental aspects of the negotiations

During the most heated phase of negotiations, when banks closed and protesters surrounded the House of Representatives, it was Angela Merkel who was the face of the ‘enemy’ that people drew on posters and slogans, not the EU, the IMF or the Commission. The popular perception was that these negotiations were intergovernmental in nature. The natural starting point for analysing the outcome of the bailout-negotiations from a state centred approach, would be to identify the key states involved in the process. According to the liberal intergovernmentalism of Moravcsik (1993, p. 480), the policy positions these states bring into the intergovernmental level of bargaining are determined by domestic politics, as an aggregation of self-interest and the interest of political constituencies.

Although a number of Euro-area member states would contribute to the Cyprus ESM programme financing, almost half of the funds would come from Germany and France alone. These were also the countries were the handling of the Cyprus bailout was given the most attention, both by the media and politicians. German press in particular covered the Cyprus bank crisis widely and a number of interviews were conducted with German politicians both in German and international media. As previously described, key German politicians and members of government expressed their opinion against what they described as an unsustainable Cypriot business model which attracted foreign investors with high interest rates and low regulation. French politicians expressed themselves along similar lines. The French Finance Minister, Pierre Moscovici, said to the press: “To all those who say we are strangling an entire people... Cyprus is a casino economy that was on the brink of bankruptcy” (BBC News, 2013b). There seemed to be a clear will amongst the most influential lenders to the ESM to ‘act tough’ on Cyprus.

From the Cypriot side, there seemed to be a clear understanding going into the negotiations with the Troika that considerable restructuring and reform was going to be needed on government spending and the public sector (Mullen, 2013). At the same time, proposals of “bail-in” on depositors of the troubled banks as well as the Troika imposing increased corporate taxes and other measures that would negatively effect the “attractiveness” of Cyprus as a centre for investment and finance, was seen as punitive and met with resistance in Cyprus (Vassiliou, 2013).

As described in the previous sections, the outcome of the negotiations involved a large number of measures to be implemented by Cyprus within the field of taxation, as well as included a bail-in of depositors of the restructured banks. From the perspective of liberal intergovernmentalism, this is to be expected, given the strong bargaining position
of the two most powerful states of the Eurozone, which were also the two largest lenders to the ESM programme, Germany and France. Indeed, after a final agreement was found, the German Finance Minister Wolfgang Schäuble said: “It was the result the German government always stood for” (BBC News, 2013b).

Supranational actors

Explaining that strong domestic pressures among the lender states to ‘act tough’ on Cyprus led to a ‘tough outcome’ for Cyprus, unfortunately does not go a very long way in terms of explaining the details of the highly technical and precise negotiation outcome that is the ESM country programme for Cyprus. Both situations of crisis, and negotiations of a highly technical nature that requires highly specialised knowledge and competence, are conditions under which supranational theoretical approaches predict that supranational actors can seize opportunities that arise to promote integrative policies and expand their own competence (Laffan, 1997, p. 423).

The opportunity for the Commission to promote integrative policies through its role as a broker is arguably increased by the fact that they negotiate on behalf of the Eurozone creditors in the ESM negotiations. The lenders, providing the Commission with a negotiating mandate, and obviously signalling their interests for the outcome of the negotiations, are not taking part directly in intergovernmental negotiations. In addition, agreement has to be found with the IMF and the ECB, the two other parts of the Troika, which have highly technical conditions for accepting a programme, in order to ensure that it is fit to set the programme country on path to debt sustainability. In sum, this acts as a restraint on the degree to which powerful states such as Germany can dictate the terms of the negotiation outcome.

In the case of the Cyprus negotiations, the key role of the Commission provided an opportunity for the DG on taxation to upload policy preferences into the ESM country programme. The MOU includes references to a number of community law, for instance on exchange of information, where DG Taxud identified areas for the Commission negotiators where Cyprus could perform better. These included prescriptive and precise measures on how Cyprus should implement changes to more fully be in compliance with the EU directives and standards (European Commission, 2013a). In addition to the MOU prescribing how Cyprus should move beyond what is required through minimum directives, the MOU provides clear instructions on measures to achieve compliance with soft law instruments such as the OECD Global Forum. The Commission has promoted soft law mechanisms on taxation due to the failure of passing EU legislation and facilitating an
integration and coordination of policies for the EU-area as a whole. However, the effects of these measures for Cyprus have been, as pointed out in the section above, limited. By setting compliance with soft laws as conditionality to payments of future tranches of ESM programme financing, the Cyprus bailout has given teeth to soft law measures on tax and transparency.

Cyprus has used the flexibility that exists within both the EU and the OECD framework to create a tax system that is perhaps the most attractive in the EU, in terms of low taxes and light regulation. Although this will not change fundamentally after the implementation of the ESM programme, the programme will in some ways contribute to ‘raising the bar’ on tax and transparency practices that are considered unacceptable in the EU.

Logic of avoiding the worst consequences

How did Cypriot authorities respond to the pressures for change that were created by the bank crisis? I find little evidence that favours a interpretation where the policy-changes that eventually Cyprus agreed to, through an agreement on an ESM programme, were the result of Cypriot actors following a ‘logic of appropriateness’. An ESM programme was not the preferred way out of the bank crisis for Cyprus, but they were forced into one after having depleted their other options, included one successful and later failed attempts at receiving financial support from Russia.

Without access to any negotiating parties on the Cypriot side, I will not elaborate much on the logic followed by Cypriot authorities during the negotiation. But my reasoning is that it makes sense to characterise the way Cypriot authorities responded as a quite rationalistic behaviour under immense pressure, and with several potential outcomes, such as an Euro-exit, which would likely have spelled disaster for the economic future of the island. In this context, it is timely to note that the changes on taxation were hardly the most fiercely contested aspects of the ESM programme from the Cypriot side. Other aspects, such as the bail-in of depositors and the many cuts on social sector spending, caused more upset among the population. The changes to policies on taxation and transparency, many of which prescribed more rigorous implementation to ensure the implementation of policies that Cyprus had ‘endorsed’ through participation in soft law mechanisms, were not met with strong resistance from the Cypriot side during the negotiations (European Commission, 2013a). By that point, the choice between ‘soft law’ and a hard place was an easy one.
Chapter 7

Conclusion

According to most students of the European Union, the EU cannot wield influence on the taxation policies of member states. This thesis set out to explore the idea that maybe it can.

In my analysis, I find that at two points during the period under study, have negotiations with Cyprus empowered the EU to transform policies on taxation and transparency in Cyprus. These negotiations are the EU accession negotiations for Cyprus, and the negotiations of a Cyprus programme under the European Stability Mechanism.

Both these cases have allowed the European Commission to insert policies from soft law instruments as conditionalities on Cyprus. During the accession, compliance with the Code of Conduct on business taxation was set as a requirement for the pre-accession tax reform, while during the recent bailout, compliance with the OECD Global Forum on Transparency and Exchange of Information for tax purposes initiative, as well as compliance with anti-money laundering standards, was inserted as conditionalities to payments of future tranches of ESM financing. The outcome of the negotiations under the European Stability Mechanism was clearly influenced by the interests of the largest lenders, France and in particular Germany. Still, in my analysis, I find that through its role as a broker for the group of Eurozone lenders, the EC was instrumental in shaping the contents of the ESM programme on taxation and transparency policies. In both instances, however, the changes to tax and transparency policies went beyond stronger implementation of these instruments, and included for instance increase in corporate tax rates.

Do these findings go against the ‘no taxation’ thesis of a lack of EU power on taxation policy? Maybe not. Neither of these changes came as a result of the EU passing new legislation and thereby integrating taxation policies for the EU as a whole. I can also not
argue that soft law instruments such as the Code of Conduct has had much influence during the period between these moments of negotiation. If we are to transfer these findings to a member state that has not gone through similar moments of negotiation, therefore, I would not expect to find much EU influence on taxation policies. My analysis also finds that instruments such as the Code of Conduct might have allowed for competitive pressures on regulative laxity and weak implementation to emerge, due to their primary focus on legal framework.

**EU crisis management**

The management of the sovereign debt crisis in Europe has changed the nature of EU governance, and the relations with member states. This holds true in particular for countries like Portugal, Ireland, Greece and Cyprus. Euro area member states have integrated their monetary policies, but the Lisbon Treaty clearly puts fiscal policies and financial policies under the prerogative of the national governments. Following from this, financial and fiscal policies are to be decided through the intergovernmental method. As the euro was increasingly threatened by the sovereign debt crisis affecting many euro area countries, new crisis management instruments were established as intergovernmental treaties outside of the Lisbon Treaty. This study has looked closer at one if these, namely the European Stability Mechanism.

ESM programme countries like Cyprus are voyaging unchartered waters in terms of their relationship with the European Commission and euro zone creditor countries. Under the newly adopted ESM Economic Adjustment Programme for Cyprus, many decisions regarding core functions of the state in Cyprus are now in practical terms being taken elsewhere. Cyprus have committed to far-reaching and deep structural adjustments in order for their economy to be set on a path that according to Commission and IMF trajectories will make their debt levels manageable in the medium- to long term. The continuous monitoring of the performance requirements for future programme payments and the likely introduction of re-negotiations on the programme content, has given a bargaining position and level of power to the Commission over a member state that to my knowledge is unprecedented in the history of the European Union. For Cypriots, it feels like they have lost their sovereignty.

Economists have long argued that a monetary union will have to be underpinned by a fiscal union in the long run (Grauwe, 2013, p. 27). So far, the economic integration remains unbalanced between monetary and fiscal policy. From the perspective of neo-functionalist approaches of European integration theory, therefore, the policy area of
taxation have hardly ever aligned more neatly with the preconditions assumed to create a functional need for increased European integration. For now, however, such as in the case of Cyprus, the integration of EU member states to the fiscal policies promoted by the EC is taking place on a piecemeal and case-to-case basis. Member states have so far resisted transferring fiscal competences to the EU level, and dealt with the crisis through intergovernmental coordination (Puettter, 2012). For Cyprus, fiscal policy integration has already taken place, at least for the next years ahead.
Bibliography

Personal Interviews

Cyprus Finance Ministry (2013). *Personal interview with officials from Finance Ministry of Cyprus (13.03.13).* Nicosia.

European Commission (2013a). *Personal Interview with officials from DG Ecofin - Cyprus Unit (08.04.13).* Brussels.
— (2013b). *Personal Interview with officials from DG Tax and Customs Commision (06.04.13).* Brussels.

Mullen, Fiona (2013). *Personal Interview with director of Sapienta Economics (11.03.13).* Nicosia.

Norwegian Tax Authorities (2013). *Personal Interview with officials from Norwegian Tax Authorities (skattedirektoratet) (13.05.13).* Oslo.

Savvides, Savvas (2013). *Personal Interview with accountant and former finance ministry consultant (12.03.13).* Nicosia.

Treholt, Arne (2013). *Personal Interview (13.03.13).* Limassol.

Vassiliou, George (2013). *Personal Interview with former President (13.03.13).* Nicosia.

Newspaper articles

BBC News (2013a). *Cyprus election: Nicos Anastasiades elected president (25.02.2013).*


— (2013a). *Cyprus: A poor diagnosis, a bitter pill.* (22.03.13). URL: http://www.ft.com/intl/cms/s/0/a8c52cc6-92e6-11e2-b3be-00144feabdc0.html.

— (2013b). *Cyprus parliament rejects bank levy.* (19.03.13).

Reuters (2013). *Euro zone clamor drowned out Cypriot bank warnings.* (22.03.13). URL: http://www.reuters.com/article/2013/03/22/us-cyprus-banks-


Statistics


EU DOCUMENTS


EU documents


Journal articles and books


Moneyval and Deloitte (2013). *Cyprus - Effective implementation of customer due diligence measures - level of implementation of preventive measures by financial institutions - summary report of main findings*.


Risse, Thomas and Tanja A. Börzel (May 2000). “When Europe Hits Home: Europeanization and Domestic Change”. In: *European Integration online Papers* 4.15.


