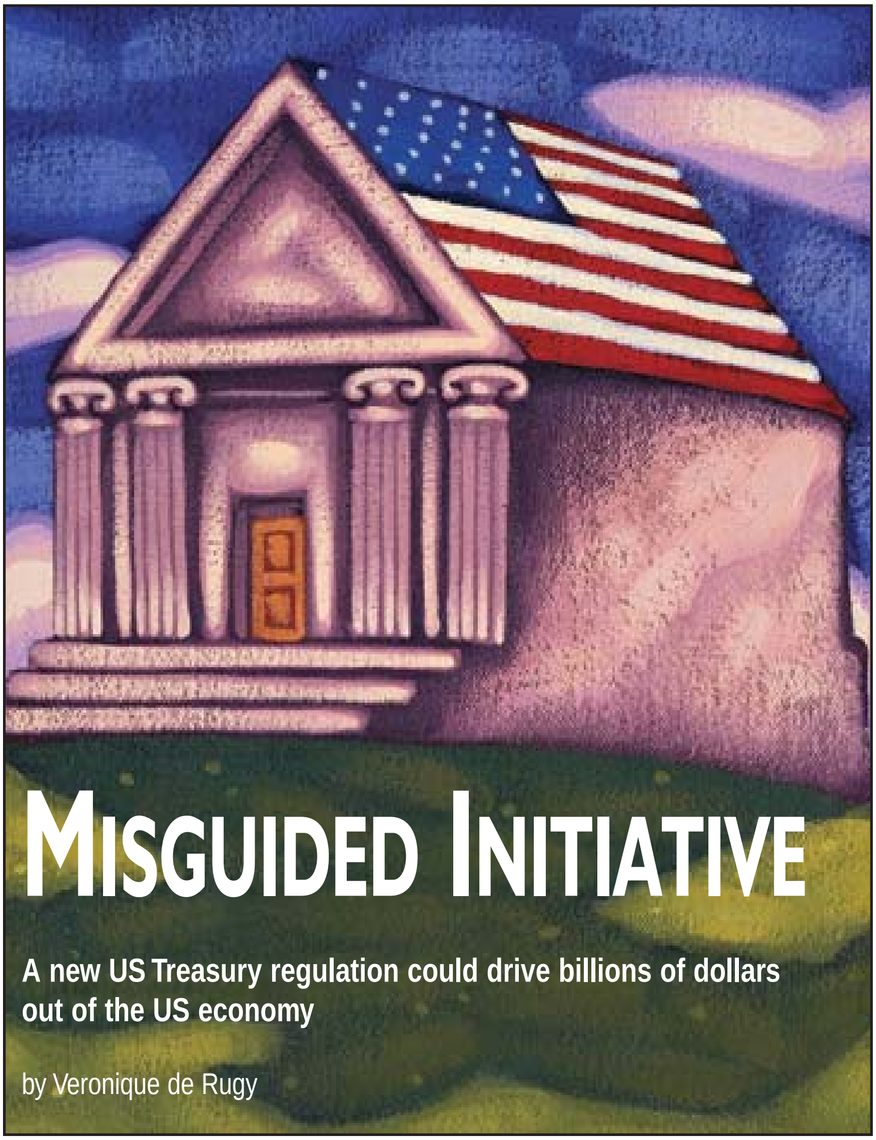

Misguided Initiative

A new US Treasury regulation could drive billions of dollars out of the US economy

by Veronique de Rugy

This year has been a frustrating one for taxpayers. While US Treasury Secretary Paul O'Neill was racking up frequent flyer miles, an IRS commissioner appointed by former US president Bill Clinton issued *REG-133254-02* to help foreign governments tax income earned in America. This misguided initiative, which would require US financial institutions to report the interest paid to foreign investors, is contrary to US economic interests, as well as the interests of those who believe in the benefits of tax competition.

The regulation also conflicts with the Treasury secretary's public statements. In fact, O'Neill is on record as saying private financial information should only be shared with other governments in response to specific requests with proper safeguards.

Costly to US Economy

This regulation would impose significant costs on the US economy. Faced with a loss of privacy, foreigners will take their money out of American banks, meaning less loan money available for families and businesses. And since the information the IRS wants to collect is not needed to enforce US tax law, it seems fair to ask whose interests the IRS and Treasury bureaucrats are serving.

To add insult to injury, this misguided regulation is warmed-over Clinton policy. Indeed, this proposal is based on a scheme first floated three days before Clinton left office. The original Clinton proposal, *REG -126100-00*, like the IRS scheme, would force US banks to report the deposit interest they pay to account holders from other countries.

The IRS admitted then, and still admits now, that this regulation is not designed to help the US Government collect taxes. Instead, it is intended to help foreign governments tax income earned in America.

The IRS still refuses to conduct a legally required cost-benefit analysis. Why? To hide the fact that this regulation would have a terrible effect on US economic performance, possibly driving several hundred billion dollars out of the US economy.

To its credit, the George W. Bush administration initially blocked the Clinton proposal. But this turned out to be a short-term victory. With O'Neill trotting around the globe giving US tax dollars to corrupt foreign governments, the IRS figured it could re-package the Clinton proposal. The only difference is that the original Clinton regulation required reporting on all foreign depositors, while the latest proposal targets residents of 15 major European nations and a few other countries like New Zealand and Australia.

By resuscitating this initiative, the IRS demonstrated its willingness to put the interests of European tax collectors above the interests of the American people and jeopardize an already weak economy. This bureaucratic blow is particularly disconcerting at a time when Europe's welfare states are using the World Trade Organization and the European Union to undermine America's competitive advantage in the global economy.

Bad Policy

There is no economic justification for this regulation. Not only is it bad policy, it also completely disregards existing laws. Since 1921, interest on bank deposits paid to non-residents has been tax-free unless connected with the conduct of US trade or business.

In theory, the proposed regulation would not change the tax-free status of such interest, but they would require every bank operating in the US to report to the IRS all interest paid to nonresident alien individuals so that the IRS could pass such information on to its tax treaty partners. And, of course, the main burden of this data collec-

Estimates indicate foreigners have invested about $5 trillion in US banks and companies.

tion would rest on the shoulders of US banks.

Over the years and on several occasions, Congress has debated whether or not to retain the tax exemption on bank deposit interest. Each time, it ended up making the exemption permanent. And for good reasons: thanks to attractive tax and privacy laws, America has become a safe haven for international investors. Estimates indicate foreigners have invested about $5 trillion in US banks and companies. These funds are a source of capital that generate jobs, promote business expansion and boost our financial markets.

There can be no question, however, that huge amounts of this capital will flee the US if the IRS forces financial institutions to act as informers. There are many jurisdictions around the world that would welcome these investors and their funds, countries and territories that respect financial privacy and understand it is not their role to enforce the misguided tax laws of other nations.

The US Treasury is, of course, well aware of the massive outflow of funds from US banks that this regulation will inevitably trigger. Bankers and economists expressed their fears during the first hearing on the proposed regulation in June 2001. Did that change the Treasury's attitude toward the regulation? Absolutely not. Despite a change in administration, Treasury bureaucrats decided to move forward with the regulation, after slightly repackaging it, and decided to ignore the harm it would cause to the American people.

Attack on Tax Reform

Last but not least, it is important to underline that this new IRS regulation is also an attack on tax reform. The much-needed movement towards a flat tax is based on the sound economic principles that income should never be taxed more than once and governments should only tax income earned inside national borders. This new regulation would hinder the effort to reform the tax system since foreign governments would have the power to double tax income earned in America. Once again, in pushing this regulation forward, bureaucrats at the Treasury decide to ignore the White House's position about the need for tax reforms.

Make no mistake, if the IRS regulation is implemented, fewer foreigners will invest money in the US. Most importantly, those who already have money in the country will shift their investments to other lower tax jurisdictions like Switzerland, Hong Kong or the Cayman Islands. The American economy will suffer and there will be fewer jobs for US workers and a lower standard of living for all Americans.

If Paul O'Neill really believes in what he says, he should stop by Washington sometime, talk to the White House about policy positions and regain control over the bureaucrats at the Treasury and the IRS. ■

Veronique de Rugy is a fiscal policy analyst with the Cato Institute (www.cato.org), a non-profit public policy research foundation headquartered in Washington, DC. She may be reached by e-mail at: vderugy@cato.org