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Threats to Financial Privacy and Tax Competition

by Richard W. Rahn and Veronique de Rugy

Executive Summary

Global economic growth and personal freedom are under attack by governments and international organizations seeking to squelch financial privacy and tax competition. Privacy rights and international tax competition are beneficial constraints on the monopoly power of governments. But high-tax nations and organizations such as the European Union are pressing for international agreements to remove those limits on government power at the expense of prosperity and freedom.

Today, individuals hold substantial wealth and have many financial relationships, so financial privacy issues have become increasingly important. Unfortunately, many nations are passing laws to undermine financial privacy with initiatives such as requiring banks to provide governments with personal financial data. In the United States the erosion of privacy started before September 11, 2001, but the war on terrorism has increased government intrusion and further eroded rights.

A parallel series of intrusions on financial privacy has occurred as governments have attempted to gain more tax revenue. Several international organizations, including the Paris-based Organization for Economic Cooperation and Development, have launched initiatives to suppress financial privacy in order to create a global net of high taxes on capital income.

Efforts to thwart tax competition through government information sharing and other initiatives have been prompted by the rise in global capital flows in recent years. Some countries, such as Ireland, have taken advantage of the new global economy and cut taxes to attract foreign investments. But the governments of many bloated welfare states feel threatened by this global reality and are taking unproductive steps to defend their high-tax economies.

The war on terrorism has given governments the green light to toughen intrusive laws at the expense of individual financial freedom. The USA Patriot Act of 2001 expands requirements that banks report on their customers. Government officials argue that bank secrecy is an obstacle to law enforcement efforts to prevent money laundering. Certainly, stopping money laundering by terrorists is an important strategy for combating national threats, but full frontal assaults on financial privacy have not been shown to aid law enforcement. Indeed, casting a government information net too wide diverts law enforcement from concentrating on individuals engaging in real criminal activities, while permanently undermining the freedoms of law-abiding citizens.

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Individual privacy rights and tax competition between nations are beneficial constraints on the monopoly power of governments.

Introduction

Global economic growth and personal freedom are under attack by governments and international organizations seeking to squelch financial privacy and tax competition. Individual privacy rights and tax competition between nations are beneficial constraints on the monopoly power of governments. But high-tax nations and organizations such as the European Union are trying to remove those limits on government power at the expense of prosperity and freedom.

In the United States, individual privacy is protected by a variety of laws. For example, the Fourth Amendment to the U.S. Constitution prohibits unreasonable searches and seizures:

> The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

Few provisions of the Bill of Rights grew so directly out of the experience of the American colonists as did the Fourth Amendment. It draws on the idea that "every man's house is his castle," a maxim celebrated in England as recognizing the right of individuals to their property against unlawful entry by the king's agents. In the modern information age, the Fourth Amendment does not limit what data the government may collect, but it does limit the means by which they are collected. For example, information searches must be based on probable cause. That is, government investigators must have a rational belief that a crime has been committed and that evidence of the crime can be found. When court cases arise, the issue is often framed as whether citizens had a reasonable expectation of privacy in the place, papers, or information that government agents have examined or taken.

Privacy is a precious commodity. People should be able to live their lives as they see fit, provided that they do not impinge on the equal rights of others. When the Framers of the Constitution struck the original balance between personal privacy and the needs of law enforcement, remote listening devices, wire transfers, and electronic bank accounts had not yet been invented. In his famous dissent in *Olmstead v. U.S.* (1928), Justice Louis Brandeis wrote: "The makers of our Constitution sought to protect Americans in their beliefs, their thoughts, their emotions and their sensations. They conferred as against the Government the right to be left alone—the most comprehensive of the rights of man, the right most valued by civilized men."[1] Financial privacy concerns the ability to keep confidential the facts concerning one's income, expenditures, investments, and wealth. Without financial privacy, many other fundamental freedoms, such as the right to property and freedom of speech, are endangered.

Some nations, such as Switzerland, have higher standards of financial privacy than does the United States. In 1934 the Swiss federal parliament explicitly introduced criminal sanctions for the violation of secrecy about bank customers. Until then, various provisions in the Swiss civil and labor code covered bank secrecy, but sanctions did not fall within the criminal domain. A number of factors led to changes in the Swiss law. First, Nazi Germany intensified its foreign exchange controls in 1931. Adolf Hitler promulgated a law under which Germans with foreign capital were to be punished by death. To enforce the rule, the Gestapo began espionage on Swiss banks, as it was well known that many German Jews had placed assets there. Some Germans were put to death for holding Swiss accounts.[2]

Then, in 1932, a list of 2,000 French citizens who had deposited their holdings in a Swiss bank was discovered and made public by the French police. Those clients included senators, a former minister, bishops, and generals. The French government jumped on the discovery and announced that it would pressure the Swiss

in order to gain legal authority over the accounts of French citizens held in Switzerland.[3]

Those two events had a strong impact on Swiss thinking. The increasing interference of statist foreign regimes in its affairs convinced the Swiss government of the necessity of reinforcing bank secrecy and defending Switzerland's strong support of civil liberties. The Swiss government realized that a country the size of Switzerland could defend its independence only by means of clear and indisputable laws that would prohibit the violation of bank secrecy even under foreign pressure.

In the United States, passage of the Sixteenth Amendment to the Constitution in 1913 to allow the income tax triggered concerns about the right to financial privacy. Until 1913 the government did not have constitutional authority to invade financial privacy. Since 1913 U.S. courts have increasingly placed limits on financial privacy claims and permitted laws that require financial institutions to automatically provide the government with personal information. For example, a 1976 Supreme Court decision found that bank customers had no legal right to privacy of personal information held by financial institutions.[4] The rationale was that bank records are the business records of the bank, not the private property of individuals. In essence, the individual waives the expectation of privacy by voluntarily doing business with a financial institution.[5]

In response to that diminution of privacy rights, Congress passed the Right to Financial Privacy Act of 1978.[6] The law was designed to protect the confidentiality of personal financial records by creating a statutory protection for bank records. The law states that "no government authority may have access to, or obtain copies of, the information contained in the financial records of any customer from a financial institution unless the financial records are reasonably described."[7] It also requires that either the customer authorize access or there be an appropriate subpoena or summons, qualified search warrant, or written request from an authorized government authority.[8]

Erosion of Financial Privacy Rights

The Right to Financial Privacy Act exhibits both the potential and the limitations of statutory privacy protections. Peter Swire, former chief counselor for privacy in the Clinton administration, explains that the "potential is that the Act establishes fairly detailed procedures before federal officials can gain access to bank records." However, the "limitations . . . are suggested by the rather short list of circumstances where procedures are required before data about individuals, in the hand of other parties such as businesses, can be supplied to the government."[9]

Since the Right to Privacy Act was passed, its protections for individuals have been weakened. In the 1980s the act was amended to allow law enforcement to delay the moment when a bank account owner must be notified that his records have been seized in investigations of drug trafficking and espionage. In addition, as a result of legislation and court rulings, financial information can now be revealed on the basis of much weaker standards than the Fourth Amendment requirement of probable cause.

In the 1990s a new threat to financial privacy rights was created by international efforts to squelch tax competition between countries. Such efforts typically involve government sharing of individual financial and tax information. At the urging of high-tax nations, the Paris-based Organization for Economic Cooperation and Development launched its "harmful tax competition" initiative in 1998. That initiative is designed to pressure low-tax countries, such as Switzerland and Luxembourg, to weaken their financial privacy laws. The European Union has launched a Savings Tax Directive with similar goals of weakening privacy by implementing large information-sharing systems between governments.

Such initiatives are sometimes presented as efforts to combat money laundering. But a much more troubling purpose of informa-

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tion-sharing initiatives is extraterritorial tax enforcement aimed at suppressing tax competition between countries. The United Nations has its own plan to create a global tax dragnet by setting up a new international tax organization for government data sharing.

International efforts have been slowed by resistance from low-tax countries and countries with stronger traditions of civil liberties and privacy rights. Those countries are not eager to denigrate their freedoms and their strong economies by aiding foreign governments in pursuit of higher taxes. As global investment flows have risen in recent decades, countries such as Switzerland and the United States have become havens of security and privacy. Citizens of many unstable and authoritarian countries can protect their assets from inflation and seizure by greedy or corrupt regimes by sending their capital to freer and more stable countries.

Many jurisdictions, such as Ireland and the Cayman Islands, have attracted large inflows of foreign investment by providing stable economic climates, the rule of law, and low taxation. High-tax countries have cried foul, and rather than reform their own economies they have sought to block such international competition. They have pushed for international organizations—such as the OECD, the EU, and the UN—to launch initiatives to block the investment competition taking place in the global economy. But blocking competition does nothing to promote economic growth because it allows high-tax countries to preserve their inefficient tax systems.

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As has the U.S. government, European governments have used the new terrorist threat to pass new rules ostensibly aimed at stopping money laundering, but those rules also attempt to stifle international tax competition. In 2001 the European Parliament passed a resolution calling for "common action to impose adequate controls on the international financial markets and to abolish offshore banking and tax and secrecy havens in order to effectively counter money laundering practices."[10] European finance ministers are also considering adopting a UN resolution that would toughen sanctions against financial centers that fail to comply with transparency and information-exchange guidelines. The fight against terrorism is being used to end the beneficial tax competition created by offshore financial centers and other jurisdictions with competitive investment climates.

The EU and the OECD have argued that bank secrecy laws are an obstacle to law enforcement and lead to money laundering. But there is little evidence that wholesale assaults against financial privacy help law enforcement. Indeed, there is substantial evidence that large and complex information systems divert law enforcement from concentrating on those individuals who are most likely to engage in criminal activity. Instead, a more constructive approach to fighting terrorism would be to move away from all-embracing information gathering toward much more narrowly focused money-laundering laws.

The OECD's Campaign against Tax Competition

The OECD is a multinational organization made up of 30 democratic nations, including the United States; its original mission was to collect and disseminate economic data. However, like other governmental organizations, the OECD is engaged in continuous "mission creep." In the late 1990s it emerged as the leader in a campaign aimed at stamping out "harmful" global tax competition. It released a major report describing the issue in 1998 and followed up with reports in 2000 and 2001 identifying supposedly harmful tax practices and blacklisting 41 jurisdictions with tax policies of which it did not approve.[11]

The OECD says that, instead of being a beneficial force, international tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals."[12] In other words, tax competition is a threat to expansive welfare

states that have high taxes and practice large-scale redistributions of wealth. As borders have opened up in recent decades, the businesses and individuals that are targets of heavy taxation have moved their activities to more hospitable locations to escape such backward and unreformed governments.

The OECD has been pressuring blacklisted low-tax countries to either increase taxes or rescind their strong financial privacy protections. A main OECD focus has been on nullifying tax competition with greater government information sharing of private financial data. The idea is to give tax collectors in each country access to information about the economic activities of citizens abroad, in the hope that this will eliminate the attractiveness of low-tax countries. Many countries attempt to tax individuals on their income on a worldwide basis, so gaining access to foreign information helps high-tax countries sustain their high tax rates.[13] The OECD has also campaigned against particular tax rules—"harmful preferential tax regimes"—in major countries, including the United States, Canada, Australia, and various European countries.

The UN's Proposed International Tax Organization

The United Nations launched its own anti-competition initiative in 2001 when it issued a report calling for an international tax organization (ITO) to develop norms for tax policy, engage in surveillance of tax systems, and negotiate with countries to get them to "desist from harmful tax competition."[14] The report suggests that an ITO "could take a lead role in restraining the tax competition designed to attract multinationals."[15] The game plan is to create greater financial information sharing among members and impose direct taxes to fund the UN without going through member states.

Another suggestion in the UN report, one that is appalling from a civil liberties point of view, is that the new ITO operate a global system of taxing emigrants because brain drains "expose source countries to the risk of economic loss when many of their most able citizens emigrate."[16] The idea seems to be that a global governmental body would, for example, assess a tax on new citizens of the United States of Chinese origin and send the money back to the government of China. Communist countries routinely used emigration taxes as a means of stopping their citizens from fleeing oppressive regimes, and now the UN is endorsing that totalitarian idea.

The European Union's Savings Tax Directive

The European Union has moved aggressively to try to stop tax competition between member countries and to stifle broader international tax competition. A recent European Parliament fact sheet explains that "the objective of more recent moves towards a general taxation policy has been to prevent the harmful effects of tax competition, notably the migration of national tax bases as firms move between Member States in search of the most favorable tax regime."[17] To eliminate tax competition, the EU has moved toward harmonizing certain taxes across countries. The most far-reaching effort has been the imposition in 1992 of a minimum standard value-added tax (VAT) rate of 15 percent.

In 2000 the EU launched the Savings Tax Directive.[18] That directive seeks to create an agreement between EU members and six non-EU nations—the United States, Switzerland, Liechtenstein, Andorra, Monaco, and San Marino—on how to tax interest income earned by foreign investors. Originally the EU sought to implement a consistent withholding tax rate applied to all interest in all EU member states. But that initial solution was rejected by those jurisdictions where banking secrecy is paramount. After much debate, the EU put a compromise agreement forward. Under this proposal, selected nations would choose

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between imposing withholding taxes on such income at a specific rate or requiring automatic exchanges of information on investment earnings between governments to enable home countries to tax such income.[19]

Here is how it would work: If an Italian citizen made a bank deposit in Luxembourg, the bank paying interest on the deposit would either have to impose a withholding tax on such income at a specific rate or send information on the investment earnings to the Italian government to enable it to levy a tax. The idea is to eliminate the incentive to invest capital in low-tax jurisdictions since no matter where you invest you end up being taxed at your home-country rate.

Implementation requires unanimous support from all EU member nations and six non-EU jurisdictions. A number of European low-tax jurisdictions (including some British crown colonies) have announced that they will not agree to the EU Savings Tax Directive unless the United States, Switzerland, and others also agree to it or adopt "equivalent measures" to provide exchange of information. The Swiss have refused to accept the EU directive if it means that they would have to violate their commitment to financial privacy and systematically send financial information about investors to foreign governments regardless of whether the investors are suspected of a crime. Austria, Belgium, and Luxembourg under certain conditions may impose withholding taxes to be remitted to the home countries of foreign investors on a country-by-country basis, but without identifying the holders of specific accounts.

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U.S. Treasury Regulation on Reporting Deposit Interest

In January 2001 the outgoing Clinton administration issued a proposed interest-reporting regulation titled "Guidance on Reporting of Deposit Interest Paid to Nonresident Aliens."[20] It would require U.S. banks to report interest earned by foreigners to the Internal Revenue Service. Since 1921 interest on bank deposits paid to nonresidents and foreign corporations has been tax-free unless the interest was effectively connected with the conduct of U.S. trade or business. Congress debated the wisdom of retaining the tax exemption on bank deposit interest on several occasions and each time renewed the exemption.[21] In 1984 Congress enacted a portfolio interest exemption repealing the tax on interest received by nonresident aliens on most portfolio debt instruments. At that time, Congress again made it clear that the goal was to attract foreign capital to the United States.[22]

Since the United States does not tax the earnings on those deposits, there is no need for the U.S. government to track the deposit amounts or interest earnings. All that needs to be established is that payments of interest are going to foreigners. If the U.S. government collected information about income earned by foreign investors, it would have an obligation to share that information with the governments of the investors' home countries. Thus, the proposed new regulation would be the equivalent of an automatic information-sharing agreement with other nations. It means that no evidence that a crime has been committed would be required for the information on U.S. investors to be shared with other governments. The IRS would collect the information about income paid to foreigners and automatically forward it to the investors' home countries.

The regulation would impose a large compliance burden on U.S. financial institutions and reduce beneficial inflows of foreign investment. U.S. capital markets would be damaged if a significant portion of the estimated $1 trillion attracted by the current interest tax exemption were withdrawn.[23]

Why would the United States want to shoot itself in the foot with such an economically damaging proposal? It appears that the proposed regulation was released because the Treasury Department wanted the United States to become a full participant in global tax exchange networks envisioned by groups such the OECD, the UN, and the EU. Indeed, in the Background and Explanation section of

the proposed regulation, the IRS explains that it "wants to help enforce foreign government tax systems." But the United States has no interest in helping high-tax foreign governments defend their uncompetitive tax systems.

Since taking office, the Bush administration has slowed down the ambitious plans of the OECD and the EU to construct an international cartel to curb tax competition.[24] There has also been substantial opposition in Congress to U.S. involvement with the OECD initiative.[25] The Bush administration has also stated that it will not support the EU Savings Tax Directive despite continuing pressure from the EU. However, the administration is considering supporting a modified version of the interest-reporting regulation that would apply only to certain OECD countries with which the United States has a tax treaty. Such efforts should be halted because they infringe on U.S. economic freedoms and would damage the U.S. economy.

A key danger of adopting this IRS regulation, even in its modified form, is that the EU will claim that the United States has satisfied the "equivalent measure" to provide exchange of information standards. That would put Switzerland in the position of sole opponent to the EU Savings Tax Directive. In other words, the adoption of the IRS regulation would have the domino effect of allowing the EU to move forward with its international tax harmonization scheme. Instead, the United States should stand up for civil liberties and economic freedom and oppose the EU's efforts.

Is Tax Competition Harmful?

According to the OECD, "harmful" tax competition is a problem that requires international agreements to stop.[26] The OECD, the EU, and to some extent the U.S. Treasury have supported solutions to the supposed problem that would require countries to share large amounts of tax information. That would allow governments to tax citizens on a global basis and limit tax competition.

Describing tax competition as "harmful" is an odd position for the OECD to take because economists usually praise competition as encouraging production efficiency and higher growth rates. Competition between governments serves the same function by encouraging efficient provision of government services by restraining the government's monopoly power.[27] Competition between governments provides politicians with incentives to improve government efficiency and save taxpayers money.

With growing international flows of labor and capital, national governments are becoming more like local ones as they compete for taxpayers across national borders. As a result, tax competition may help prevent wasteful government spending by limiting the ability of governments to increase taxes.[28]

Efforts to restrict tax competition have focused on propping up high tax rates on capital income, such as dividends, interest, and capital gains. Yet an important conclusion of public finance literature is that in an open world economy countries should reduce tax rates on capital income to zero.[29] Tax competition helps move the tax system in that efficient direction. With tax competition, governments have an incentive to move away from capital taxes due to fear of capital flight.[30] Indeed, since the 1980s tax competition has spurred reductions in income tax rates on individuals and corporations, and a number of countries have moved toward efficient flat tax regimes.[31]

People aiming to stifle tax competition often assume that competition is a zero-sum game. In reality, the large economic gains made possible by tax rate cuts mean that tax competition can be beneficial for all countries. As countries adopt more efficient tax systems, economic growth is maximized, and all citizens have higher incomes. All countries end up better off as each country pursues its own interests. Europeans in high-tax countries would benefit as their bloated governments cut out unproductive spending and focused more energy on creating more efficient and lean government services.

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Tax harmonization initiatives aim to place higher taxes on capital, yet capital formation is the key to economic growth.[32] Higher taxes on savings and investment result in less investment, lower real wage growth, and more poverty. World Bank data show that jurisdictions with low taxes on capital income and a strong commitment to financial privacy are also the world's richest. Those jurisdictions include Luxembourg, Liechtenstein, Switzerland, Bermuda, and the Cayman Islands, which had among the highest per capita gross domestic products in the world in 2002.[33]

A study by Enrique Mendoza assessing the potential effects of European harmonization of capital income taxes finds that the results could be the opposite of what European policymakers suppose. He concludes that "this policy, if enacted along the lines followed in harmonizing value-added taxes, yields large capital outflows and a significant erosion of tax revenue for Continental European countries while the opposite effects benefit the United Kingdom."[34] Empirical studies have found that capital flows are becoming increasingly sensitive to taxation.[35] Thus, the way for Europe to retain and attract capital is for countries to sharply reduce capital income taxes.

Financial Privacy vs. Information Sharing

Governments Are Infamous for Abusing Information

To protect law-abiding citizens, governments need to collect data on individuals suspected of criminal actions or those who represent a threat to national security. But governments should be required to do so in a way that protects privacy rights as broadly as possible.[36] Information is power for governments. Unfortunately, that power can be abused by careless or criminal acts by government agencies. Governments and their employees are susceptible to abusing privacy by snooping, leaking information in order to damage enemies, and other destructive activities.

People who are trustful of governments sometimes ask why privacy from government matters if one has no unlawful actions to hide. But experience shows that governments often abuse the public trust and do not observe established safeguards on collection and dissemination of data. For example, scandals occasionally erupt at the IRS regarding employees snooping or politicians using the agency to further personal agendas. In 1995 more than 500 IRS agents were caught illegally snooping through tax records of thousands of Americans, including acquaintances and celebrities. In response to the ensuing scandal, the IRS fired five employees and claimed to implement new privacy protection measures. Those new measures failed as hundreds of IRS agents were caught snooping again in 1997.[37] A similar case of abuse occurred this year in Britain when officials of the Inland Revenue Service were found to have provided to journalists tax information about certain celebrities.

More recently, the U.S. General Accounting Office released a stinging report on the government's compliance with privacy laws. The GAO found that personal data in many cases are not being adequately protected.[38] In a survey of 25 federal agencies, the GAO found a significant lack of compliance with the federal Privacy Act of 1974. The study reported the existence of 2,400 federal databases containing personal information on citizens.

Information abuse scandals are probably inevitable when governments assume such large powers of information collection. Other governments no doubt have worse privacy records than does the U.S. government since many do not have the safeguards that are supposed to be followed in the United States. Thus, there is a substantial civil liberties danger in entering into international information-sharing agreements. Information exchanges with foreign regimes that have poor civil rights track records could lead to data being used against political opponents and other enemies. In many countries, government employees accept bribes and are prey to extortionists or businesses seeking information on competitors.

Can Information Sharing Stop Capital Flight?

To curtail capital flight, the OECD and the EU are seeking to implement a global system of automatic information sharing. The OECD recommends that tax authorities adopt its memorandum of understanding that, for tax purposes, promotes automatic exchange of information about dividends, interest, capital gains, wages, and other sources of income.[39] For example, if a French resident invested in the United States, the U.S. government would automatically inform the French government of the transaction so the French government could tax it. The goal is to reduce incentives for individuals to invest in lower-tax foreign countries so that their capital stays at home. That would reduce beneficial tax competition because no matter where French citizens invested their money they would end up being taxed at the French tax rate.

That is the goal of OECD and EU efforts, but governments will probably be unsuccessful at stopping tax-driven capital flight in today's sophisticated global economy. Financial capital is the most mobile of all the factors of production. Dramatic reductions in communication costs, huge gains in computer power, the rise of new techniques such as public key encryption, and the Internet have facilitated rising capital flows.[40] Deputy Finance Minister Vito Tanzi of Italy has described how globalization has combined with electronic commerce to create "fiscal termites" eating away at tax bases in high-tax countries.[41]

The EU is trying to clamp down on international capital flows and wants U.S. support. The EU's Savings Tax Directive seeks not just to amass information on investment flows within the EU but to require U.S. assistance in enforcing its tax laws. The EU notes that "precisely because of the risk that the proposal could incite paying agent operations to relocate outside of the EU, the European Council decided that the adoption of the Directive would be preceded by discussions with the United States and key third countries."[42]

But it appears that unless the EU convinces every single nation to share information, capital will always be able to find a low-tax haven. Indeed, if the EU is successful in getting some investment havens to join its information-sharing system, it will provide incentives for other countries to lower their own taxes and increase their provision of financial privacy to attract capital. In the digital age, electronic walls can be breached and partial information-sharing schemes will not work as planned.

Government Information Sharing Should Be Selective and Limited

Governments need procedures for sharing information in order to combat terrorism and other international criminal activity. However, information sharing needs to be placed under rigid constraints to prevent abuses. For example, information should only be shared narrowly among democratic governments that have legal regimes with enforceable limits on the use of such information. Such limits should include that governments share information only on individuals or organizations that are reasonably suspected of criminal activity.

By contrast, plans are being proposed to create broad automatic information-sharing agreements. Under the EU's initiative, for example, U.S. banks would have to report financial information about their foreign customers to the customers' home governments, regardless of whether the customers were suspected of crimes.[43]

Government information collection that is too broad is not only abusive of civil liberties but is often counterproductive in fighting crime. The fight against money laundering in the United States in recent years illustrates the problem. The U.S. government collects a huge amount of information from financial institutions through mandated automatic reporting. But the government does a poor job of analyzing that data to stop laundering. For example, under the Bank Secrecy Act of 1987, the federal government requires financial institutions to file Currency Transaction Reports whenever an individual conducts one or more cash transactions in a single day involving more than $10,000.[44]

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Even moderately sophisticated criminals find the CTR system fairly simple to evade. The system is also ineffective because the huge volume of reports generated creates a needle-in-the-haystack problem of finding criminal activity. Between 1987 and 1995, the government collected 77 million CTRs.[45] No showing of probable cause is required to access the reports that are stored in a database open to all U.S. Attorney's Offices and 59 law enforcement agencies.[46] Yet, on the basis of those 77 million records, only 3,000 money laundering cases were filed, resulting in 7,300 defendants charged, 2,295 guilty pleas, and 580 guilty verdicts.[47]

The system's compliance burden and privacy infringement are very high relative to the small amount of criminal activity halted. President Bush's former National Economic Council chairman, Lawrence Lindsey, noted the problem: "In excess of 100,000 reports were filled by innocent citizens in order to get one conviction. That ratio of 99,999 to one is something we should not tolerate as a reasonable balance between privacy and the collection of guilty verdicts." [48]

Congress did respond to the problem of the overwhelming volume of paperwork created by the 1987 CTR law. In 1994 it passed the Money Laundering Suppression Act, which aimed to reduce the volume of CTRs by streamlining the CTR process with exemptions for certain classes of customers.[49] But those changes have not stemmed the massive flood of information created by the reporting system. The government's Financial Crimes Enforcement Network (FinCen) reports that "the number of CTRs filed is still extremely high with 12.3 million CTRs in 2002."[50]

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Other government reporting systems have the same problem of excessive information collection and high compliance costs. The Anti–Money Laundering Act of 1992 added the Suspicious Activity Report to the government's arsenal in the war on money laundering. It aimed to track suspicious wire transfers.[51] The collection of SARs, which are filed with the Treasury Department, started with 52,069 filed in 1996.[52] The following year SAR volume increased 56 percent to 81,200 reports. The number of SAR reports has kept increasing with 162,700 SARs filed in 2000, 203,538 in 2001, and 224,200 in 2002.[53]

CTRs and SARs are costly for financial institutions. According to the American Bankers Association, the cost of meeting all the reporting requirements imposed by the U.S government totals about $10 billion annually.[54] SARs are difficult to comply with partly because of the lack of clear and objective guidelines. And as a result, like CTRs, they have been shown to be ineffective. In 2002 the total number of CTRs and SARs filed was 12,524,200, and, according to FinCen, that year only 1,106 money-laundering cases were filed.[55] That means that one person was charged, and far fewer convicted, for every 11,324 reports filed.

Congress made financial reporting systems even broader and more complex with passage of the USA Patriot Act in 2001.[56] For instance, the law created a series of reporting requirements for brokers, insurance companies, real estate agents, and other businesses. Those new requirements will create a new flood of data into the government's hands, making it even more difficult to find the needle of criminal activity in the haystack of data.

The Patriot Act also created reporting requirements for foreign governments. In particular, Title III of the act, called "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001," targets what is called "Jurisdictions of Primary Money Laundering Concern." Sections 301 and 302 describe criteria that the secretary of the Treasury should use to identify such jurisdictions and lists the sanctions to be applied to them if they do not agree to share data with the U.S. government.[57] Some of the criteria used to identify money-laundering jurisdictions seem appropriate. But others have nothing to do with money laundering and appear to be aimed at punishing countries that have low taxes. For example, the bill seeks to impose sanctions on jurisdictions that offer "special tax or regulatory advantages to nonresidents" and on countries "characterized as a tax haven

or offshore banking or secrecy haven." Yet at no point is a reason offered to explain why low taxes are supposed to facilitate illegal money laundering. In sum, excessive information collection and information sharing by governments will limit beneficial capital flows and infringe civil liberties, while not being effective in stopping crime.

Conclusions and Recommendations

Efforts to increase information reporting and information sharing between governments are said to be needed to fight terrorism and money laundering. But such initiatives are often used to achieve another goal: shielding high-tax nations from international tax competition. The battles against terrorism and money laundering can be pursued without destroying financial privacy or damaging beneficial tax competition.

A number of constructive proposals were developed in a May 2001 report by the Task Force on Information Exchange and Financial Privacy titled "Report on Financial Privacy, Law Enforcement and Terrorism."[58] The task force, chaired by former senator Mack Mattingly, was composed of former law enforcement officials, tax attorneys, and economists.[59] It developed a program that would enhance the ability of governments to fight terrorism and organized crime, while increasing the financial privacy of ordinary law-abiding citizens.

The task force recommended the formation of an international Convention on Privacy and Information Exchange composed of democratic governments that respect the rule of law and have strong safeguards to prevent information from being obtained by governments and hostile parties for inappropriate purposes. The proposed convention would streamline and improve exchanges of information for law enforcement purposes. Under no condition would that information be used for tax purposes. The convention would establish restrictions on the uses to which collected information could be put and establish a private right of action to enforce individual legal rights under the convention.

The task force also proposed that money-laundering laws be better targeted. So that investigators are not buried in a mountain of currency transactions reports and suspicious activity reports, a system should be developed such that the activities of persons on a watch list are reported by financial institutions to appropriate authorities. Persons could be placed on the watch list if the government had a reasonable and significant suspicion of unlawful conduct.

Countries should work with jurisdictions committed to low taxes and financial privacy to obtain information about criminals, rather than bully them to raise their taxes. Efforts by the OECD and the EU to achieve tax harmonization are getting in the way of countries cooperating and exchanging information about terrorists. The OECD, the EU, and the U.S. Treasury proposals to share information broadly and systematically should be rejected. The creation of a UN international tax organization should be opposed.

Tax competition and financial privacy are necessary for both high economic growth and enhanced personal freedom. Tax competition and financial privacy are not in conflict with law enforcement efforts against terrorism. Indeed, tax competition and financial privacy should be celebrated as important bulwarks of individual liberty.

Tax competition and financial privacy are not in conflict with law enforcement efforts against terrorism.

Notes

1. *Olmstead v. United States*, 277 U.S. 438, 478 (1928) (Brandeis, J., dissenting), http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=US&vol=277&invol=438.

2. Micheloud & Co., "Historical Origins of Swiss Bank Secrecy," 2003, http://switzerland.isyours.com/e/banking/secrecy/history.html.

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4. In *United States v. Miller*, 425 U.S. 435 (1976), a bank customer claimed a Fourth Amendment right

with regard to records of checks, deposit slips, and other items related to his accounts at two banks. The customer argued that the records should not be provided to the government. The Supreme Court denied the customer's claims, holding that the materials were the business records of the banks, not the private papers of the individual.

5. Peter P. Swire, "Financial Privacy and the Theory of High-Tech Government Surveillance," Brookings-Wharton Papers on Financial Services, 1999, pp. 391–442.

6. 12 U.S.C. Secs. 3401–22, available at http://www4.law.cornell.edu/uscode/12/ch35.html.

7. The Right to Privacy Act of 1978, Sec. 3402, p. 3407, available at www4.law.cornell.edu/uscode/12/3402.html.

8. Also, the statute prevents banks from requiring customers to authorize the release of financial records as a condition of doing business and states that customers have a right to access a record of all disclosures.

9. Swire, p. 413.

10. "Parliament Resolution on the Extraordinary European Council Meeting in Brussels on 21 September 2001," Bulletin EU 10-2001, http://europa.eu.int/abc/doc/off/bull/en/200110/p10406.htm.

11. Organization for Economic Cooperation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998), www.oecd.org/daf/fa/harm_tax/Report_En.pdf. See also OECD, *Toward Global Tax Co-operation* (Paris: OECD, 2000), www.oecd.org/pdf/M00014000/M00014130.pdf; and OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (Paris: OECD, 2001), www.oecd.org/pdf/M00021000/M00021182.pdf.

12. OECD, *Harmful Tax Competition*, p. 9.

13. For more information, see Center for Freedom and Prosperity at www.freedomandprosperity.org.

14. The UN's proposal can be found at www.un.org/esa/ffd/a55-1000.pdf.

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17. European Parliament, "Fact Sheet 3.4.9. Fiscal Policy and Taxation," October 20, 2000, www.europarl.eu.int/factsheets.

18. European Union, "Savings Tax Proposal: Frequently Asked Questions," Memo/01/266, Brussels, July 18, 2001, http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip011026/memo01266_en.pdf.

19. See also Dan Mastromarco and Lawrence Hunter, "The U.S. Anti-Savings Directive," *Tax Notes International*, January 13, 2003, pp. 159–78.

20. U.S. Department of the Treasury, "Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens," www.treas.gov/press/releases/reports/po33011.pdf.

21. For more information, see Marshall J. Langer, "Proposed Interest Reporting Regulations Could Cause Massive Outflow of Funds," March 19, 2001, www.freedomandprosperity.org/Articles/tni03-19-01/tni03-19-01.shtml.

22. See The Deficit Reduction Act of 1984, Pub. L. No. 98-369.

23. Analysts believe that this exemption may have attracted about $200 billion in foreign capital to the U.S. economy. Nevertheless, the amount of capital that could be affected both directly and indirectly by the IRS was estimated by Steve Entin, president of the Institute for Research on the Economics of Taxation, to be around $1 trillion. www.iret.org/pubs.html.

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32. See American Council for Capital Formation, Center for Policy Research, "International Comparison of Corporate Income Taxes, Consumption Taxes, and Capital Formation," May 1995, www.accf.org/IntCompCIT.htm.

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59. The task force included former U.S. Sen. Mack F. Mattingly, former Rep. Jack F. Kemp, former attorney general Edwin Meese III, David R. Burton, Veronique de Rugy (Cato Institute), Stephen J. Entin (Institute for Research on the Economics of Taxation), James W. Harper, Esq. (PolicyCounsel.com, Privacilla.org), Lawrence A. Hunter (Empower America), J. Bradley Jansen (Free Congress Foundation), Dan Mastromarco (Prosperity Institute, Argus Group), Daniel Mitchell (Heritage Foundation), Andrew Quinlan (Center for Freedom and Prosperity), Richard W. Rahn (Discovery Institute), Solveig Singleton, Esq. (Competitive Enterprise Institute), Mark A. A. Warner (Hughes, Hubbard & Reed), and the Hon. John Yoder, Esq. (Burch and Cronauer).

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