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ECONOMIC REASONS FOR NON-EFFECTIVE AUTOMATIC EXCHANGE OF INFORMATION FOR TAX PURPOSES

Ekonomski razlogi za neučinkovito avtomatično izmenjavo informacij za davčne potrebe

Abstract

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This paper reviews initiatives and positions of the OECD, the EU and the U.S. towards exchange of information for interest income tax purposes, and explores various economic reasons for the non-cooperative position of the U.S. on exchange of information for tax purposes. This paper leaves aside the analysis of political, legislative and administrative barriers to exchange of information for tax purposes and focuses on the analysis of possible economic reasons for U.S. non-cooperation based on the U.S. balance of payments, interest rates, financial markets, costs of financing debt, as well as other countries competing for inflow of foreign savings.

Izvleček

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Prispevek analizira pobude in vlogo OECD, EU in ZDA pri izmenjavi informacij za davčne potrebe o dohodkih iz naslova obresti. Preučuje različne ekonomske razloge za nesodelovanje ZDA pri tovrstni izmenjavi informacij. Prispevek ne vključuje analize političnih, zakonskih in administrativnih ovir pri izmenjavi informacij, temveč analizira samo ekonomske razloge nesodelovanja ZDA na osnovi preučitve njihove proračunske bilance stanja, analize obrestih mer, finančnih trgov, stroškov financiranja dolga in tudi drugih držav, ki tekmujejo za pritok tujega kapitala.

Ključne besede: davki, informacije, obresti, ZDA, nesodelovanje, EU.

JEL: K34, H2

1 Introduction

Globalization and the liberalization of economic activity are resulting in the exponential increase in cross border commercial and financial transactions. Over the last decade governments have suffered a loss of tax revenues. Therefore, greater attention has been paid to international tax harmonization and tax competition, and its potential threats and consequences. As a result of the need for greater tax revenues, governments have emphasized the need for more exchange of tax information. Exchange of information is normally effected through three different procedures: exchange of information upon request, spontaneous exchange of information, and automatic exchange of information. Recent developments evidence some progress toward increased exchange of information in tax matters (OECD 1998, 2000a, 2000b, 2001, 2005a, 2005b).

Despite the fact that some non-EU countries agreed to adopt the common rules on taxation of interest incomes, the *EU Savings Directive* (Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments), including a mechanism for automatic exchange of information, other important world economic players did not. In fact, a number of influential world economic players are missing in the list of co-operating countries.

Table 1 shows a review of those EU and non-EU countries that acceded to the *EU Savings Directive* rules on interest income taxation. Most of them adopted the automatic exchange of information mechanism.

Table 1: *Countries that adopted the EU Savings Directive or signed an agreement to follow its provisions*

EU countries	Non-EU countries
Belgium, Luxembourg, Austria, Estonia, Cyprus, Czech Republic, Denmark, Finland, France, Greece, Netherlands, Ireland, Lithuania, Latvia, Malta, Hungary, Germany, Poland, Portugal, Slovenia, Spain, Italy, Great Britain, Sweden	Anguilla, Cayman Islands, Montserrat, Aruba, Switzerland, Andorra, Liechtenstein, Monaco, San Marino, Jersey, Guernsey, Isle of Man, British Virgin Islands, Turks and Caicos, Netherlands Antilles

This paper[1] focuses on the problem of exchange of information for interest income tax purposes. In particular, it focuses on the comparison of the OECD, the

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EU and the U.S. positions in this matter. It leaves aside the analysis of political, legislative and administrative barriers on exchange of information for tax purposes and focuses on the analysis of the various economic reasons for the non-co-operative position of the U.S. on exchange of information for tax purposes.

Based on this, Section 2 outlines internationally adopted measures on exchange of information for tax purposes, mainly those adopted by the OECD and the European Commission. Section 3 studies the U.S. rules on taxation of non business interest income of non residents and discloses the non cooperative position of the U.S., in particular the position of the U.S. not to exchange information for tax purposes. It also analyses and reveals economic reasons for the non-cooperative position of the U.S. The main findings and conclusions are stated in the final section.

2 Internationally adopted measures on exchange of information for tax purposes

The OECD and the EU have intensified efforts to apply exchange of information for tax purposes over last decade. The most important adopted measures on exchange of information for tax purposes are presented below.

2.1 OECD initiative

The exchange of information for tax purposes can help combat international tax avoidance and competition. The OECD views the exchange of information among tax administrations for tax purposes as the appropriate means of international tax co-operation and an alternative to tax harmonization or unification. The OECD, nicknamed by opponents the "Paris-based bureaucracy" or "the club of high-tax nations," adopted several reports and measures associated with the exchange of information issue.

Provisions of exchange of information are included in the *OECD Model Tax Convention* in its Article 26. To improve possibilities of exchange of information, the provisions were amended in the revised version of the *OECD Model Tax Convention* in 2005. The original paragraph 1 was split into two paragraphs. Paragraph 1 states that the competent authorities of the Contracting States shall exchange information that it foresees to be relevant for carrying out the provisions of MTC or for the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States. The new paragraph 2 includes a rule permitting disclosure of information to oversight authorities. The original paragraph 2 is renumbered for paragraph 3, and its wording is without changes. Important is a newly added paragraph 4. It states that the requested Contracting State shall use its gathering measures to obtain the requested information, even though the requested State may not need such information for its own tax purposes. Thus, it is no longer possible to decline to supply information solely because the requested State has no domestic interest in such information. In addition, the impossibility of declining the exchange of requested information is strengthened by paragraph 19.8 of the Commentary. It clarifies that a Contracting State may decline to supply information upon request only in case of substantive economic reasons. The newly added paragraph 5 mirrors the banking secrecy issue, which was presented as a serious barrier to the exchange of information. It states that information held by a bank, another financial institution, nominee or person acting in an agency or fiduciary capacity, or information which relates to ownership interests in a person cannot be withheld only because of the provisions of paragraph 3 of the Article 26. Nevertheless, countries that did not adopt the regime of automatic exchange of information under Article 9 of the *EU Savings Directive* (Austria, Belgium, Luxemburg), and Switzerland have already made reservations to paragraph 5 of Article 26.

Besides the *OECD Model Tax Convention,* the OECD adopted several other important documents that deal with exchange of information for tax matters. The OECD report "*Harmful Tax Competition: An Emerging Global Issue*" (1998) defines the main criteria for determination of harmful tax regimes in the form of preferential tax regimes or tax havens. The criteria to determine preferential tax regimes are (1) the regime imposes no or low effective tax rates; (2) lack of effective exchange of information; (3) lack of transparency, and (4) regimes are ring-fenced. Tax jurisdiction is deemed to be a tax haven if the regime imposes low or no effective tax rates; there is lack of effective exchange of information; there is lack of transparency; and there are no substantial activities of foreign taxpayers.

In March 2000 the OECD Committee on Fiscal Affairs published its report "*Improving Access to Bank Information for Tax Purposes.*" The issue of banking secrecy represents one of the main barriers to accepting international exchange of information on interest incomes between tax administrations. The OECD report considers ways to improve international co-operation with respect to the exchange of information in the possession of banks and other financial institutions for tax purposes.

The *OECD Model Memorandum of understanding between the competent authorities of (State X) and (State Y) on the automatic exchange of information for tax purposes* adopted by the OECD Council on 22 March 2001 and the *OECD Model Agreement on Exchange of Information on Tax Matters* released on 18 April 2002 were the next important milestones for more effective exchange of information for tax purposes.

It can be concluded that the OECD deems a lack of effective exchange of information for tax purposes harmful as it makes it hard for foreign governments to tax income earned abroad.

2.2 EU initiatives

Several EU Directives incorporate the exchange of information procedure, for example *Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums.* Under the Directive there are three kinds of information exchange: (1) the information exchange upon request, (2) a spontaneous

exchange of information, and (3) an automatic exchange of information. While exchange of information upon request is a conceptual model similar to that under Article 26 of the OECD MTC, an automatic exchange of information is considered to be one step forward. On one hand, the automatic exchange of information is a more powerful tool to fight tax avoidance, but on the other hand it receives strong public opposition in several countries.

Council Directive of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering requires identification of customers of credit and financial institutions, insurance companies and collective investment undertakings by means of supporting evidence when opening an account or savings accounts, or when offering safe custody facilities. The identification requirement shall also apply for any transaction with other customers involving a sum amounting to EUR 15,000 or more.

The Joint Council of Europe/OECD Convention on Mutual Assistance in Tax Matters and *EU Savings Directive- Article 9 Automatic exchanges of information* forces countries to agree to automatic exchange of information for the purposes of interest income taxation to apply its provisions. Paragraph 2 states, that "the communication of information shall be automatic and shall take place at least once a year, within six months following the end of the tax year of the Member State of the paying agent, for all interest payments made during that year." The main advantages of the implementation of the EU Directive may be listed:

- Protection of tax revenues of the country of residence. The *EU Savings Directive*, in contrast to the non-exclusive right to tax interest income introduced by Article 11 of the OECD Model tax convention, introduces an exclusive right to tax interest income to the country of residence of the beneficial owner.
- Reduction of tax motivated outflow of national savings. There are differences in the levels of statutory tax rates imposed by countries of sources of interest income that are given by provisions of domestic tax law. Those differences led to speculative capital outflow from high-tax countries to low tax countries. In contrast, when the country of residence collects interest income tax in compliance with its national tax provisions, one of the main driving forces to shift savings from country of residence abroad disappears.
- Mitigation of tax competition for savings inflow among EU Member States.
- Restriction of treaty shopping. More favourable tax rates for taxes withdrawn in source countries that are incorporated in bilateral tax treaties unwittingly created a side effect: grounds for abusing the bilateral tax treaties by third entities. This worked to create the growing of global tax planning structures.
- Fighting corruption, international organized crime and money laundering Not only is the establishment of the right to taxation for a country of residence important; even more importantly, there appears to be automatic exchange of information as this may facilitate a contest against tax avoidance, corruption, international organized crime, money laundering, and terrorism.

3 Economic reasons for the non-cooperative position of the U.S.

The U.S. is a Member State of the OECD and articles of the OECD MTC may influence the U.S. approach to exchange of information on non-resident interest income. Nevertheless, the U.S. adopted the *United States Model Income Tax Convention* of September 20, 1996, which includes *Article 26 – Exchange of information and administrative assistance*. The wording of Article 26 in the revised OECD Model Tax Convention of 2005 and 2008 differs from the wording of Article 26 of the U.S. Model Tax Convention.

Several days before the end of the Clinton administration, the IRS commissioner appointed president Bill Clinton issued proposal on regulation REG-133245-02 to help foreign governments to tax interest incomes of non-US residents earned in the USA. The "Clinton-era IRS regulation" did not come into force. While the Clinton Administration supported the OECD effort in the field of exchange of information, in contrast, the Bush Administration withdrew support for the part of the OECD initiative on "harmful tax competition." On May 10, 2001, U.S. Treasury Secretary Paul O'Neil clarified the U.S. reservations on the OECD's harmful tax practices initiative. He announced that "the U.S. does not support efforts to dictate to any country what its own tax rates or tax systems should be, and will not participate in any initiative to harmonize world tax systems" (O'Neil, 2001). According to O'Neil, the OECD project is "not in line with tax and economic priorities (of the U.S.)."

In 2005, the Treasury renounced the interest-reporting requirements and recommended adopting a regulation (REG-133254-02; REG-126100-00) and *Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens*.[2] Recently some important changes were made in the proposed draft of the Regulation, particularly adjustment of the list of countries to be covered by the Regulation. Latin American countries were deleted from the list. This might be due to the risk of capital outflows from U.S. commercial banks. The list of countries to be covered for the purposes of the collecting and exchanging of information contains 15 developed countries, the majority of them EU Member States: Denmark, Finland, France, Germany, Greece, Netherlands, Ireland, Italy, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom. Even though the IRS regulation on banking information reporting is prepared, it is sharply criticized and the views of strong public opposition are presented.

In order to investigate possible economic reasons for non-U.S. cooperation in the automatic exchange of information, one should turn to the issue of taxation of non-resident interest incomes under the U.S. Internal Revenue Code. A provision on the treatment of non-resident interest income

[2] See: U.S. Treasury, Internal Revenue Service, Guidance on Reporting of Deposit Interest Paid to Non-resident Aliens. *Federal Register* (2002), p. 50386-50389.

tax is more than 80 years old. Interest paid on bank deposits held by foreign persons has been effectively exempted from U.S. income tax since 1921 if the income is not effectively connected with the conduct of a U.S. trade or business. Under Sections 871(i) and 881 (d), interest earned on certain deposits by non-resident aliens is exempted from the 30-percent tax even though the interest is treated as U.S.-source income. According to Gustafson *et al* (2001, 4040), exemption of interest earned on certain deposits on bank accounts held by non-resident aliens from taxation is aimed "to encourage foreign persons to use U.S. banks and savings institutions." Subject to favourable tax treatment are certain types of portfolio investment interest income paid to non-resident aliens. Under §§871 (h) and 881(c). most interest payments to foreign persons on publicly traded debt securities, e.g. bonds and other debt issued by the U.S. government, that are either registered obligations or are bearer obligations will not be subject to the withholding tax. It must be assured that interest is payable only outside of the U. S. to foreign persons; requirements are specified in Section 163(f)(2)b. "Although the U.S. government does not advertise the existence of these benefits to foreigners, banks and brokerage houses see to it that any foreigner who needs to know does know about them" notes Langer (2000, 6). A favourable tax treatment of interest income in the case of non-residents has an important economic consequence: it effectively reduces interest costs to the U.S. government to be paid to foreign investors. This is because decision making of foreign investors is influenced, along with other factors, by the after-tax return on investment.

Mastromarco and Hunter (2003, 159–178) summarise the reasons against IRS regulation to manage the collection of information by financial institutions. It is an example of the extraordinary degree to which privacy rights must be sacrificed in order to sustain extraterritorial double taxation of savings in today's digital world. The U. S. government would become the business-tax collector for European countries wishing to impose double taxation on investments in the U.S. None of the initiatives is actually needed to enforce U.S. tax law. All the proposals are economically harmful and legally dubious because they would require the IRS to exceed its statutory authority by taking actions that would drive investments away from the US and stifle beneficial competition among nations to attract mobile capital by providing a better tax environment. They are all nearly the same proposals simply reconstituted in a different form.

Therefore, to summarise, reasons for non-U.S. cooperation can be described in four areas (Cochran 2004, 2): (1) political, (2) legislative, (3) administrative and (4) economic.

Financial privacy rights represent one of the traditional democratic rights. There is no doubt that financial privacy is an important issue particularly in the U.S., a country that traditionally keeps and protects privacy rights. Privacy rights are highly valued by Americans and this can explain the strong resistance of the U.S. government against exchange of information on interest income paid to non-resident aliens. This paper leaves aside the analysis of political, legislative and administrative barriers on exchange of information for tax purposes and focuses on the analysis of possible *economic* reasons for U.S. non-cooperation with the help of (1) the U.S. balance payment; (2) interest rates, financial markets and costs of financing debt, and (3) competition of other countries for foreign savings inflow.

3.1 The U.S. balance of payments

According to the OECD's report "*Towards Global Tax Cooperation,*" issued in 2000, jurisdiction meets the definition of tax haven when at least two of the four conditions apply. No cooperation in effective exchange of information on non-resident interest income, plus no effective taxation of selected non-resident alien interest income, meet two of four criteria to define a tax haven. Based on this, the biggest tax haven of all in the U. S. is Manhattan (Mitchell 2001, 6; Langer 2000, 2).

Both high standards of financial privacy and favourable tax treatment of non-resident alien interest income, may help to attract capital inflow into U.S. bank accounts and Treasury securities. It is likely that non-cooperation in taxation of non-resident interest income, together with weak cooperation in the mechanism of exchange of information, may generate a *competitive economic advantage* for the U.S. At the same time, attracting capital inflow to the U.S. means outflow of savings from other countries, among them European Union Member States.

In order to understand the size of the stake in this game, one should study foreign capital inflow to the U.S. In particular, the focus should be on savings of non-resident aliens in U.S. bank accounts, as well as private holdings of U.S. government securities by non-resident aliens. Data on them can be sourced from the U.S. International Transactions Accounts Data and from international investment position. . Table 2: shows data for the years 1987, 2004 and 2007 on goods, and capital and financial flows reported in U.S. international transactions accounts data. Favourable tax treatment of interest income, financial privacy and banking secrecy may, to a certain extent, work as incentives to attract foreign capital inflows into U.S. bank accounts. On the other hand, these incentives should be considered only alongside other determinants of capital inflow known from the literature.

From 1987 to 2004, the sum of foreign-owned assets in the United States rose from $247,100 to $1,533,201 million, and to $2,057,703 million in 2007. Other foreign assets in the U.S. increased from $201,713 million to $1,135,446 million in the same period, and to $1,646,654 million in 2007. The inflow of foreign capital into U.S. Treasury securities increased within the same period from $ -7,643 million to $93,608 million in 2004, and by 2007 the total sum rose quickly up to $156,825 million in 2007. While the total annual inflow of foreign savings reported as U.S. liabilities by U.S. banks for non-residents was $335,206 million in 2004, in 2007 the sum quickly reached $532,813 million. Within 17 years, from 1987 to 2004, this kind of capital inflow increased by 26%, while the change between 2004 and 2007 was 63%.

Table 2: *U.S. International Transactions Accounts Data (Millions of dollars)*

	1987	2004r	2007
Current account			
Exports of goods and services and income receipts	457,053	1,574,326	2,463,505
Imports of goods and services and income payments	-594,443	-2,114,837	-3,082,014
Unilateral current transfers, net	-23 265	-84,482	-112,705
Capital account			
Capital account transactions, net	365	-2,369	-1,843
Financial account			
U.S.-owned assets abroad, net (increase/financial outflow (-))	*-79 296*	*-1,000,870*	*-1,289,854*
Foreign-owned assets in the United States, net (increase/ financial inflow (+)) of which	*247,100*	*1,533,201*	*2,057,703*
Foreign official assets in the United States, net	45,387	397,755	411,058
U.S. Government securities	44,802	314,941	230,330
Other U.S. Government liabilities/11/	-2,326	-134	5,342
U.S. liabilities reported by U.S. banks, not included elsewhere		69,245	108,695
Other foreign official assets/12/		13,703	20,095
Other foreign assets in the United States, net	201,713	1,135,446	1,646,645
Direct investment	58,470	145,966	237,542
U.S. Treasury securities	-7,643	93,608	156,825
U.S. securities other than U.S. Treasury securities	42,120	381,493	573,850
U.S. currency	3,866	13,301	-10,675
U.S. liabilities to unaffiliated foreigners reported by U.S. non-banking concerns	18,363	165,872	156,290
U.S. liabilities reported by U.S. banks, not included elsewhere	86,537	335,206	532,813
Financial derivates, net	n.a.	n.a.	6 496
Statistical discrepancy	-7,514	95,030	-41,287
Memoranda:			
Balance on current account	-160,655	-624,993	-731,214

Source: Bureau of Economic Analysis.

Table 3: *Net International Investment Position of the United States at Years-end, 1987, 2004, 2007 (Millions of dollars)*

	1987	2004	2007
Net international investment position of the U.S.[1]	*-63,968*	*-2,245,417*	*-2,441,829*
U.S.-owned assets abroad:	*1,646,657*	*9,340,634*	*17,639,954*
U.S. official reserve assets	162,370	189,591	277,211
U.S. Government assets, other than official reserve assets	90,681	83,062	94,471
U.S. private assets	1,393,476	9,067,981	14,983,691
Direct investment at current cost	478,062	2,498,494	3,332,828
Foreign securities	188,598	3,436,718	6,648,686
U.S. claims on unaffiliated foreigners reported by U.S. non-banking concerns	177,368	793,556	1,176,027
U.S. claims reported by U.S. banks, not included elsewhere	549,457	2,230,535	3,826,150
Foreign-owned assets in the U.S.:	*1,710,495*	*11,586,051*	*20,081,783*
Foreign official assets in the U. S.:	283,058	2,011,899	3,337,030
U.S. Government securities	220,548	1,509,986	2,502,831
Other U.S. Government liabilities	15,667	16,287	24,024
U.S. liabilities reported by U.S. banks, not included elsewhere	31,838	207,647	405,707
Other foreign official assets	15,005	215,239	404,468
Other foreign assets:	1,427,437	9,574,152	14,543,701
Direct investment at current cost	334,552	1,742,716	2,422,796
U.S. Treasury securities	82,588	561,610	734,776
U.S. securities other than U.S. Treasury securities	341,732	3,995,506	6,132,432
U.S. currency	39,545	271,953	271,952
U.S. liabilities to unaffiliated foreigners reported by U.S. non-banking concerns	110,187	600,161	959,544
U.S. liabilities reported by U.S. banks, not included elsewhere	518,833	2,402,206	4,022,195
of which, by area [2,3,4]:			
Europe	*n.a*	*785,632*	*1,581,526*
Canada	*n.a*	*27 873*	*59,437*
Caribbean financial centres	*n.a*	*1,199,447*	*1,915,705*
Latin America, excluding CFC	*n.a*	*83,093*	*115,659*
Asia	*n.a*	*160,510*	*277,298*
Africa	*n.a*	*8,366*	*16,183*
Other	*n.a*	*17,614*	*25,393*

Source:[1] International Investment Position of the United States. Year-end positions 1976-2007; [2] 2004 data: Table 10a (Bach, 2005, 61); [3]2007 data: Table 10 (Bach, 2008, 63). [4]Statistical discrepancy is due to the fact that data *by area* are final while data on position are preliminary. Note: r – revised, p – preliminary, CFC – Caribbean financial centres.

Within the last 20 years, U.S. has become the biggest capital importer in the entire world. Table 3 reports stock of U.S. capital held *abroad* and stock of foreign capital *in* the U.S., using data from the international investment position of the U.S. for years-end 1987, 2004 and 2007. In 2004, thanks to the stock of foreign-owned assets in the U.S. totalling $11,586,051 million, which exceeds U.S.-owned assets abroad of $9,067,981 million, the international investment position is increasingly negative. Foreign capital inflow was continuously increasing during next three years, still being higher than capital outflow. In 2007 the negative balance of the U.S. investment position resulted in $-2,441,829 million compared to $-2,245,417 million in 2004.

Graph 1 illustrates development in the stock of U.S. capital abroad and in the U.S., and net investment position. While in 1987 the U.S. reported a slightly negative investment position of $-63,968 million, 20 years later the international investment position of the U.S. is enormously negative and represents $-*2,441,829* million (Table 3).

3.2 Interest rates, financial markets, and the costs of financing public debt

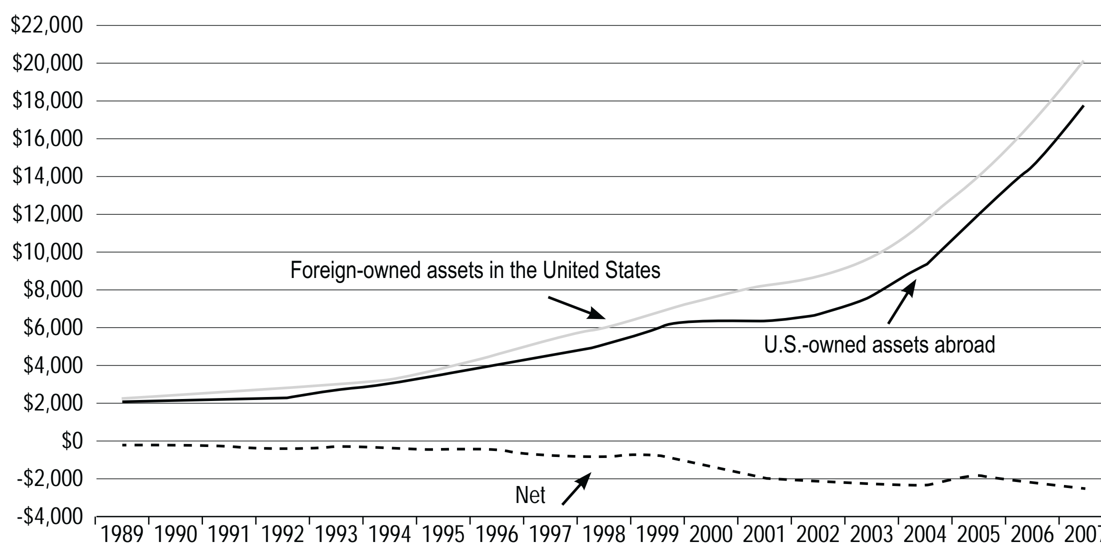
According to Cochran (2004, 1–15), the new rules on reporting information and consequently residence-based taxation of interest incomes earned by non-residents in the U.S. may negatively affect the depositor choice to invest in the U.S. The economics of depositor choice can be described as follows: bank deposits are sensitive not only to nominal but also to real interest rates. Investors' decisions to deposit money or buy securities are based on the inflation rate as well as on after-tax interest income return. Residence-based taxation of interest income earned by non-residents in the U.S. will result in lower after-tax interest income earned in the U.S. Due to lower after-tax returns, deposits are likely to outflow from U.S. banks accounts. Graph 2 illustrates the geometry of depositor choice. Cochran (2004, 3) estimates *static* effects of the proposed rules: outflow of $87 billion from U.S. banks accounts. Not only may static effects of proposed rules deteriorate the U.S. economy. There may be further spill over, *dynamic* effects of the proposed rules. The chain of most likely further spill over economic consequences of the new reporting rules may look as follows: (1) Deposit outflows will result in reduction of the U.S. deposit base. (2) In order to keep the amount of deposits stable, measures to offset interest income taxes are likely to be adopted. Namely, U.S. interest rates are likely to be increased. (3) Higher interest rates will mean that credit will become more expensive for all U.S. borrowers, including the federal government. (4) Higher interest rates will translate to lower securities prices through an opportunity cost connection. (5) If adjustment of interest rates were not adopted, non-resident aliens would withdraw deposits out of dollar denominated assets, which would result in a lower value of the US dollar.

There are other economic reasons to attract capital from abroad to the U.S.:

- *Current account balance.* In 2007 the total U.S. current-account deficit reached $-731,214 million, which is beyond 5 percent of GDP[3] and is one of the largest in the nation's history. To finance huge U.S. imports, it is possible to use foreign savings, which the U.S. has already done.
- *Lack of domestic savings.* For 20 years foreign capital inflow significantly helped to fill the lack of home country savings and keep the American "anti-savings"

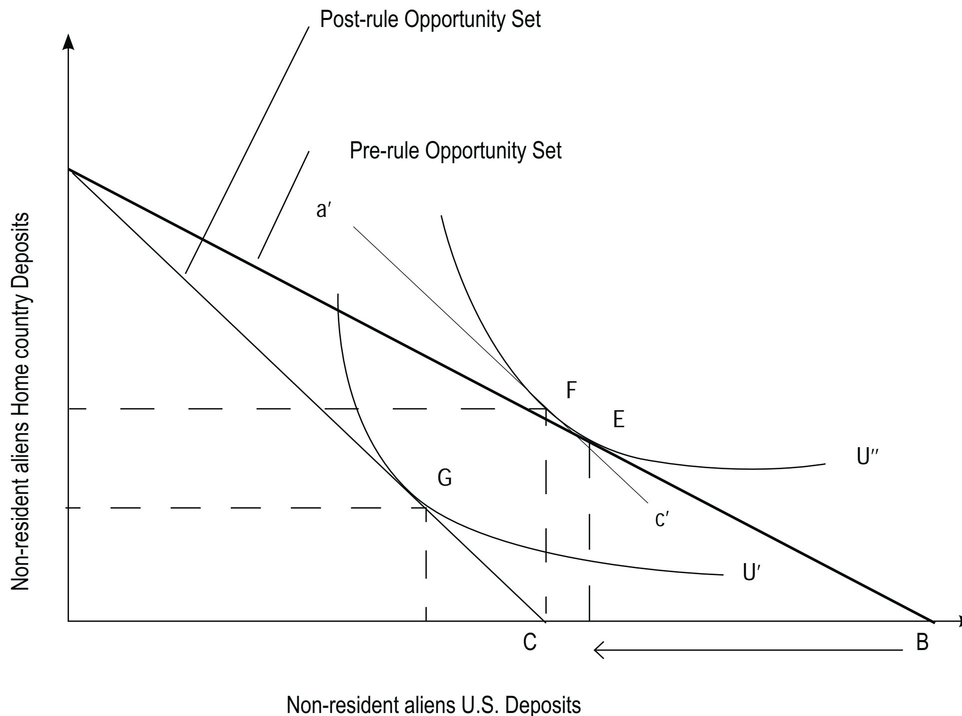
[3] The U.S. GDP in 2007 was 13,807.5 billion dollars

Graph 1: *Net International Investment Position of the United States at Years-end, 1989-2007 (Millions of dollars)*



Source: http://www.bea.gov/newsreleases/international/intinv/2008/pdf/intinv07_fax.pdf

Graph 2: *The Geometry of Depositor Choice*



Source: Cochran (2004, 4)

tax policy that works as an incentive to domestic aggregate consumption - a strong driving force to support domestic economic growth. Not surprisingly, the OECD report on the U.S. economy (OECD, 2005) states that "key objectives of tax reform should be to remove the most obvious anti-savings biases in the tax code" (OECD 2005, 6).[4]

- *Federal government budget deficit.* Foreign capital inflows represented more money to finance the federal government budget needs in case American households show lower savings rates, which has usually been the case. Stock of non-official foreign assets represented by the U.S. Treasury securities increased from $82,588 million in 1987 to $561,610 million in 2004, and since then even more rapidly to $734,776 million in 2007 (Table 3).
- *Ability to keep a modest tax burden.* Foreign funds inflow and stock may work as a way to protect the American government against the necessity of adopting the unpopular measure of increasing personal and corporate income taxes in order to create tax revenues to fund the federal government budget deficit. Not only is a low tax burden important from the political point of view. Keeping the tax burden lower in comparison to the EU may attract further foreign capital inflow and increase foreign asset stocks in the U.S. Foreign capital inflows indirectly protected the low effective tax burden that the American economy offers for home and foreign investors against the necessity of increasing it.
- *Job creation.* Additionally, foreign capital worked as an important economic source to create job opportunities and consequently support economic growth, growth of GDP and growth of corporate and personal income tax bases. As a result, the U.S. unemployment rate has been about 5 percent over the past decade, while the EU-15 has had little private-sector job creation and an average unemployment rate of 9.0 percent over the last decade. Not surprisingly, the OECD recommends tax reform in the U.S., while one of the key objectives of it should be to remove the most obvious anti-saving biases in the U.S. tax code.

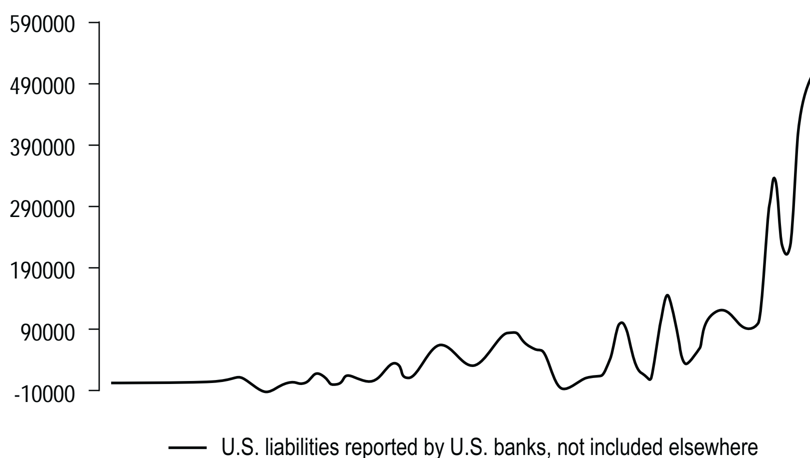
3.3 Competition of other countries for foreign savings inflow

A stable, developed and growing U.S. economy might have attracted foreign investment inflows. As Table 3 and Graph 3 show, annual inflows of foreign capital recorded in U.S. bank accounts increased rapidly during the period 1960 – 2007.

The total amount of U.S. liabilities to foreigners, except foreign official agencies, reported by U.S. banks and securities brokers was $2,402,206 million at the end of 2004. As Table 3 and Graph 4 show, the majority of this sum was held by Caribbean financial centres ($1,199,447 million), while

[4] Note: The most egregious, the OECD's report states, is the deductibility of mortgage interest payments and the availability of that deduction for private consumption expenditure.

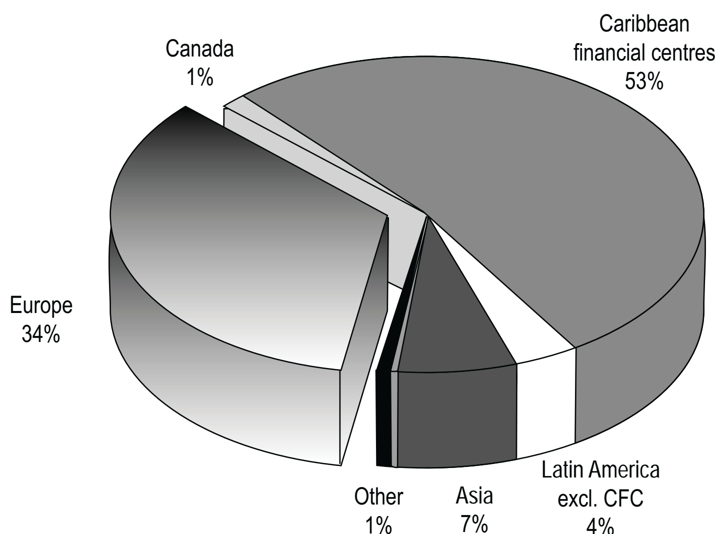
Graph 3: *U.S. liabilities reported by U.S. banks, not included elsewhere, 1960-2007 (Millions of dollars)*



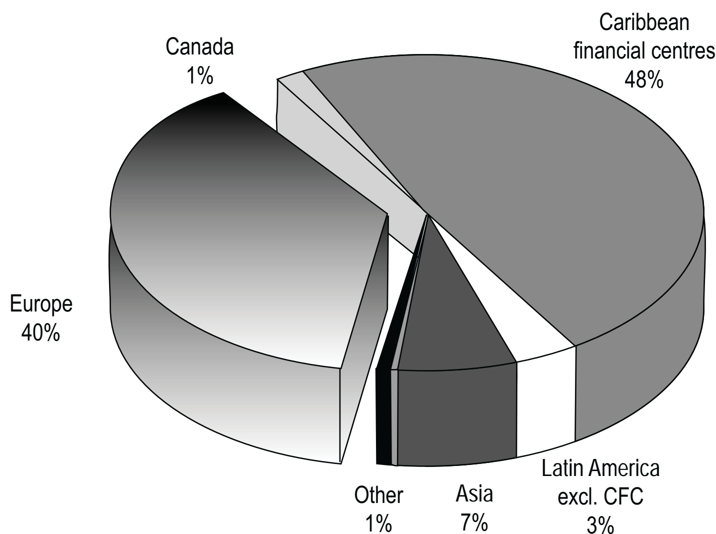
Data source: International Investment Position of the United States. Year-end positions 1976-2007 (http://www.bea.gov/international/)

Graph 4: *Stock of U.S. liabilities reported by U.S. banks, not included elsewhere, by area, 2004 and 2007*

Panel A: *2004*



Panel B: *2007*



Data source: Bach (2005, 61) and Bach (2008, 63) 1

[1] Table 10a and Table 10.

the second biggest holder was Europe ($785,632 million). By 2007 the total amount of U.S. liabilities to foreigners, except foreign official agencies, reported by U.S. banks and securities brokers even doubled, and at the end of 2007 the amount was $4,022,195 million. Again, the majority of this sum was held by Caribbean financial centres ($1,199,447 million), however the percentage share decreased from 53% to 48%. Europe remained the second biggest holder of stock ($1,581,526 million), but, in contrast to the Caribbean financial centres, its percentage share on total amount of the U.S. liabilities to foreigners *increased* from 34% in 2004 to 40% in 2007. Europe's holdings represent stock of capital, which flew out from Europe to the U.S. Interest incomes associated with this sum represent a *potential* tax base for residence-based interest taxation – a principle adopted by the *EU savings directive*. Without effective exchange of information it is likely that this potential interest tax base will not produce any tax revenues for the EU Member States, which are countries of residence.

Advocates for keeping the status quo in terms of financial privacy rules and favourable tax treatment of non-resident interest incomes pointed out that there was a real threat of potential outflow of savings belonging to non-residents if the rules were adjusted in order to meet requirements under the *EU Savings Directive*.

Disclosure of interest income recipients to tax administrations in EU Member States would lead to taxation of those incomes in the resident countries by using resident countries' tax rules. According to Langer (2002, 404), for more than 80 years, U.S. banks have paid tax-free interest to foreign persons. More than US $1 trillion in bank deposits are held in the U.S. by non-resident aliens and foreign corporations. "If the United States had ever seriously tried to tax the interest paid on these deposits, much of the money would have immediately disappeared from the United States, probably to one of the other OECD countries that similarly exempt bank deposits interest paid to foreigners" (Langer 2002, 404).

Conclusions

Potential negative effects for the U.S. from automatic exchange of information for tax purposes arise from political and economic grounds:

- *Political effects.* The U.S. would lose its image as a country that strongly protects financial privacy rights. In investors' eyes, this would mean an increase of political riskiness of investments in the U.S.
- *Static economic effects.* There might be direct outflow of deposits from U.S. bank accounts. Potential direct outflow might be $1,581,526 million, which is the sum of U.S. liabilities reported by U.S. banks held by European Union residents. In fact, the estimated amount of direct capital outflow is much lower. Cochran (2004) estimates that deposit outflow from U.S. bank accounts due to changes of rules would be around $87 billion.
- *Dynamic economic effects.* Dynamic economic effects may arise from spill over economic effects of proposed rules on automatic exchange of information. They may result in higher interest rates, less capital to support economic growth and job creation.

Non-cooperation of the U.S. in automatic information sharing and no effective taxation of interest incomes sourced in the U.S. most likely motivated part of the outflow of savings from the EU, as it provides much less favourable conditions in terms of financial privacy rights and after-tax returns. Apart from capital outflow, the second negative outcome of the U.S. non-cooperation is that EU Member States record lower real tax revenues than potential tax revenues could be. If negotiations between the U.S. and the EU on U.S. compliance with *EU Savings Directive* were successful, the EU could expect less capital outflow and an increase of interest income tax revenues. Besides, there are also further dynamic effects as EU capital may help to accelerate economic growth and job creation within the EU.

Taking into account a certain rationale behind the current U.S. unwillingness to cooperate on automatic information sharing, an important question arises. It is questionable whether the idea to adopt principles of automatic information sharing and residence-based taxation of interest incomes, which is implemented only within a group of regionally integrated countries (EU), leaving the rest of the world in a non-cooperative position, may bring the expected benefits. Less favourable interest income tax treatment in the EU in comparison to the U.S. may motivate outflow of EU capital to the U.S. or, now that the U.S. is in a financial crisis, to other, mainly non-European emerging markets. An unexpected result might be that certain EU member states, in particular those who adopted automatic exchange of information and do not offer other favourable conditions, may suffer losses instead of the originally expected benefits.

If proposed IRS regulation on automatic information sharing is adopted, it is likely that capital would flow away from the U.S. but at the same time the EU would not be satisfied with its expectations. Most probably capital will flow to non-OECD and non-EU countries. Adoption of information sharing may build competitive advantages in terms of capital inflow for those countries that keep financial privacy and favourable tax treatment of interest income. From this point of view, non-participation of the three EU countries in automatic exchange of information seems to be a rational decision protecting those countries from capital outflow.

Taking into account competition for capital inflow between the U.S. and the EU, awareness of the possible effects of information sharing and residence-based taxation of interest incomes on the direction of capital flows is legitimate. In these circumstances, there is ground for further economic research. In particular, the questions should be

answered: whether, how and to what extent directions of capital flows in the world economy depend on information sharing and effective taxation of interest incomes.

Violation of financial privacy rights and adoption of residence-based taxation of interest incomes in high-tax EU countries may boost further capital outflows from the EU member states to countries that do not disrupt financial privacy rights and favourable tax treatment of interest income. From this point of view, adoption of the *EU Savings Directive* only on a regional basis, but not globally, may cause the expected positive effects of the *EU Savings Directive* to be offset by negative effects coming from capital outflows from the EU.

It is likely that regional cooperation may produce even worse outcomes than no cooperation at all. In order to be meaningful, tax co-operation should not be just a regional issue but a global one as well. To raise other global players' willingness to cooperate, the EU should develop a better strategy than the *EU Savings Directive* in terms of symmetry of tradeoffs between involved parties.

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