The IRS's Missing 'Check'

By Jay Cochran

In the waning hours of the Clinton administration, the Internal Revenue Service released a new rule that would have required banks to report the interest they paid to "non-resident alien" depositors. The rule was met almost immediately with a firestorm of protest from bankers. The Bush administration withdrew the midnight regulation, but the IRS reintroduced it in 2002, only this time with a significantly scaled-back list of countries on whose residents U.S. banks must report. Interestingly, the listed countries are primarily members of the European Union — the same EU that has been aggressively seeking to end what they term "harmful" tax competition among nations. Combined, the 15 nations covered under the new rule account for roughly $550 billion in deposits at U.S. banks, thrifts, and other deposit-taking institutions, according to capital flows data from the U.S. Treasury.

There is a reasonable debate over whether the current non-reporting of foreign depositors' interest earnings constitutes beneficial tax competition or enables improper tax avoidance. But the IRS's proposed rule is problematic and worrisome for reasons beyond that debate. As other analysts have noted, the rule will harm Americans by driving capital abroad, though the magnitude of the deposit outflow has not, to now, been quantified. In addition, the IRS failed to follow procedural requirements — such as those in Executive Order 12866 and the Regulatory Flexibility Act (RFA) — when it released its rule, and those failures reflect poorly on the administration and the IRS.

Radical change Practically since the inception of the income tax, one aim of U.S. tax policy has been to make the United States a relatively attractive haven for foreign capital. The new IRS rule undermines that decades-long policy by, in effect, lowering the after-tax yields affected depositors can expect to earn from U.S.-based deposits. It is important to point out, however, that another part of long-standing U.S. tax policy has been to assist foreign governments by providing information when specific individuals are suspected of specific crimes. However, the United States has customarily not shared wholesale data on all individuals of a particular country — guilty and innocent alike — because such a policy is contrary to U.S. political values and contrary to our economic interests.

Analysts of the rule's impact are correct to suspect that its effects will be damaging to U.S. economic interests, but the size of those effects have not been quantified in terms

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of the likely damage to the U.S. deposit base. A study I recently completed attempts to remedy that shortcoming. (A copy of the study is available at *www.mercatus.org/papers.php*.) Based on reasonable estimates of the changes to after-tax yields on U.S. deposits and the sensitivity of depositors to changes in yields, my study estimates that the rule may induce a deposit outflow from the United States of at least $88 billion as affected European depositors seek deposit venues more in line with their preferences for yields, privacy, and security.

When our federal government spends sums measured in the trillions of dollars, an $88 billion effect may not sound particularly large, but that perception is misguided. First, consider that an $88 billion deposit outflow is more than twice the size of the reserves position of the entire U.S. banking industry. This is not meant to suggest that the reserves of our banking system would evaporate, but that such large deposit outflows would require banks to make some potentially painful balance sheet readjustments at the margin. Second, because the rule-induced changes occur at the margin, they indicate an important change in depositor perceptions — a change, moreover, that could easily spill over to other foreign depositors not yet covered by the rule. Lastly, other things equal, the natural market check on deposit outflows typically comes from an offsetting rise in U.S. deposit interest rates. By implication, an increase in banks' costs of funds obtained through deposits means the

rates charged for credit can also be expected to increase.

My estimates indicate that, to restore the relative after-tax deposit yields prevailing before the rule, U.S. short-term deposit rates would need to rise by 0.83 percent. That is, yields on U.S. deposits of less than a year's maturity would need to increase by nearly a full percentage point to restore the pre-rule relative yield differences between the United States and the EU. If the cost of credit were to rise by a similar amount, borrowing costs for all Americans would increase. Laying aside the effects on individual Americans (which could be substantial in their own right), when the federal government borrows more than $125 billion in new funds every quarter, this rule stands to increase the interest burden of that new borrowing by more than $4 billion a year.

EO 12866 and the RFA Perhaps had the IRS followed the formal procedures it is supposed to when proposing a new regulation, it would have uncovered those costs. But it did not. It skirted Executive Order 12866 — which requires a detailed accounting of a rule's costs and benefits — by simply asserting without evidence or documentation that the rule imposes no significant costs. Clearly, the IRS deposit rule qualifies under EO 12866 based on the impact to the U.S. deposit base alone and ignoring any subsidiary effects on credit costs.

The IRS did perform a perfunctory paperwork burden analysis and asserted, again without documentation or evidence, that the new rule encumbers just 2,000 banks and other depositories even though there were more than 9,000 banks and thrifts in the United States as of June 2003. Moreover, the IRS asserts that each bank will incur just 15 minutes of paperwork burden per year. This burden estimate is laughable. Simply put, even with computerized reporting, it is impossible to collect, process, validate, and distribute the information on hundreds of potentially affected accounts within a 15-minute time window. Prudent compliance with the rule requires careful production of reports, accounting validation of the reported data, and legal review of the compliance procedures, to name but a few of the incremental steps involved.

Even if, for the sake of argument, we accept the IRS's 2,000-institution count at face value, small deposit-taking institutions would still feel the rule's impact. Working backwards from the largest U.S. banking institutions toward the smallest in terms of asset size to reach 2,000 institutions, we will eventually encounter institutions with less than $300 million in assets. At that comparatively small asset level, U.S. banks average fewer than four branches per institution and have an asset base 1/1000th the size of their largest peers, according to industry data. Clearly, even by the IRS's count, it would appear some small banking enterprises have been scooped up in its regulatory net and, as such, the IRS was obliged to conduct a Regulatory Flexibility Analysis to gauge its rule's impact on small business. It did not do so. Instead, the Service simply waived its obligations with the passive assertion that "it has been determined…the regulations do not impose a collection of information on small entities, [therefore] the Regulatory Flexibility Act does not apply."

Conclusion The adjustment process that will be set in motion if this rule is finalized seems quite likely to lead to unwelcome changes in the balance sheets of U.S. depositories, as well as in the cost of funds obtained through those deposits (and by implication, in the cost of U.S. credit). The adjustments could be worthwhile if they were outweighed by benefits U.S. citizens or depositories received as a quid pro quo from our international partners who are seeking the imposition of this rule. However, the IRS has presented no such offsetting considerations in its proposed rule, nor are such offsetting benefits likely ever to emerge. Such an unbalanced conclusion becomes obvious once one considers that the overarching goal of the rule is to help the EU end harmful tax competition among nations.

It is well, however, to recall that "harmful" in this context means harmful to the tax collector, not the taxpayer. The flip side of harmful tax competition, in other words, is competition that benefits individual depositors and depositories. R