IRS Tentacles Spread Overseas

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The IRS is no longer just a headache for American citizens. American tax collectors are now in the process of implementing a law that exacerbates the anti-saving, anti-investment bias in US tax policy. This will discourage individuals and businesses from investing in the United States. To be blunt, this law, the Foreign Account Tax Compliance Act (FATCA), is adding new burdens on the rest of the world which are likely to backfire on the United States.

The origins of FATCA

The FATCA legislation is the product of a misguided school of thought within the US political class which believes that there are vast sums of unpaid taxes which the IRS would be able to collect if only the rest of the world would stop hiding it from them. Politicians with this view routinely complain about so-called tax havens and support the bullying of smaller, low-tax jurisdictions. It seems that enforcement-über-alles is the rallying cry, with no thought for international comity, cost-benefit analysis, or pro-growth tax policy.

Given the fragile state of the US economy, as well as the government's terrible fiscal position, it should not be surprising that US lawmakers are getting even more aggressive in their attacks on the fiscal sovereignty of low-tax jurisdictions. President Bush and President Obama both dramatically increased the burden of government spending, more than doubling the size of the federal budget in just ten years. Combined with a weak economy, this has resulted in a flood of red ink and politicians are salivating at the prospect of more revenue.

This helps explain the passage of legislation like FATCA, which is designed to compel foreign financial institutions to become deputy tax collectors for the Internal Revenue Service. This article will explain, however, that the FATCA law may backfire by driving capital from the US economy. For all intents and purposes, US politicians are acting as if foreigners have no choice but to perpetually invest endless sums of money in the US economy. As such, they think more onerous regulatory and fiscal burdens are a risk-free policy.

Why now?

Like so many decisions in Washington DC, the adoption of FATCA was a haphazard occurrence. In early 2010, it was increasingly apparent that President Obama's so-called stimulus legislation was not working. Instead of falling unemployment, as the White House claimed would happen, the jobless rate was rising. And taxpayers were increasingly upset about stories exposing rampant waste and corruption in the USD800 billion legislation.

Not satisfied with failing only once, the politicians in Washington decided to adopt another "stimulus" package of yet more bigger government. In stepped the HIRE Act. In addition to more wasteful spending, this legislation included some special-interest tax provisions that reduced the overall projected tax receipts. Given the fiscal rules in Washington, and also because politicians wanted to act concerned about red ink to appease voter outrage, they needed a source of revenue as an "offset" for other provisions in the HIRE Act. So they incorporated separate FATCA legislation introduced by a left-wing zealot from Michigan, Senator Carl Levin.

In other words, faced with a grim economic and fiscal situation, lawmakers decided to address the problem backwards. Rather than restraining federal spending, they expanded the burden of government and fooled themselves into believing that a bigger budget could be financed by significant revenues to be extracted from the global economy. So they pulled out their crayons, drew a rainbow, predicted they'd find a pot of gold when they reached its end, and passed legislation to hunt for it.

What FATCA means

Today, reality is setting in. The fantasy has failed. Unemployment remains a serious problem, the economy is stagnant, and economists are increasingly concerned about what may happen if foreigners decide that America is a less attractive place to invest.

The rationale behind FATCA is simple in its destructiveness. Even though the US has a very high compliance rate for tax laws compared to the rest of the world, US politicians decided that more enforcement was needed to get more money to fund more spending and bigger budgets in Washington. Throwing aside any semblance of cost-benefit analysis, they then decided to spare no expense to capture every last dollar of potential tax revenue. Unfortunately, FATCA was not a wise approach. Ordinary Americans will suffer from the ensuing damage to the economy. Foreign financial institutions will endure higher regulatory burdens and compliance costs. And the FATCA law creates a powerful disincentive for foreign investment in the US. FATCA thus has the net impact of potentially reducing both economic prosperity and government tax revenues.

The Act looks to accomplish its goals through heavy use of new reporting requirements and excessive penalties for non-compliance. Institutions that do not comply with the reporting requirements on US persons – the costs of implementing the necessary changes across the financial sector will likely reach into the hundreds of billions – have already begun dropping US clients and divesting in US assets. The alternative to compliance is either a new 30% withholding tax on payments to foreign financial institutions that do not comply with the disclosure requirements, or avoiding any US business altogether. The results should have been predictable.

The legislation also has resulted in collateral damage. Many Americans living overseas have reported cases where they can no longer find banks to accept their business. Under the shadow of the FATCA regime, Americans themselves have become a toxic asset. To put it bluntly, the FATCA law is a costly barrier to cross-border economic activity. Indeed, it is a form of fiscal protectionism, thwarting the efficient global allocation of resources.

Needless damage

The worst part is the utter pointlessness of the entire endeavour. FATCA imposes a mountain of economic damage in exchange for a molehill of tax revenue.

The compliance costs for the entire banking system over the next ten years have been estimated at USD190 to USD220 billion. For these bureaucratic burdens, US politicians expect to raise less than USD1 billion per year in revenue from FATCA. Yet based on their failure to account for the subsequent capital flight, these expectations are very optimistic. And even if the expectations of one billion per year turns out to be accurate, this amounts to an infinitesimally tiny share of the US federal government's expected budget deficit for 2011.

FATCA is simply a fundamentally wrong-headed approach to tax policy. Rather than looking at how to make the US tax system more hospitable to foreign investors, more conducive to economic growth, and easier for everyone involved to understand, the US Congress decided to engage in the fools errand of trying to track down and collect every last dollar of possible unpaid tax, despite the fact that the US has relatively high compliance rates and even though the marginal cost of extracting additional revenue is much higher than the marginal benefit.

What the political class conveniently ignores is that tax compliance has less to do with vigorous enforcement and much to do with the tax rates themselves. Excessive tax rates trigger noncompliance. Citizens are only willing to support so much corruption and waste before they say enough is enough. Trying to garner one hundred percent compliance with excessive tax enforcement is impossible, but politicians find it an easier sell than going back to the public and admitting they've built a fiscal house of cards.

Greater enforcement of already high tax rates on savings and investment has a particularly destructive impact on long-run economic performance. A harsh tax treatment of capital means a reduction in saving and investment, which leads to slower growth and a smaller tax base. Thus, even from the perspective of money-hungry politicians, FATCA will likely do more harm than good. A better approach in terms of tax policy would be to move away from a tax system that is biased against savings and investment, and toward a more pro-growth policy such as a simple and fair flat tax.

A threat to human rights

As if the economic damage is not enough, FATCA has also placed particularly difficult burdens on nations which respect fundamental human rights such as financial privacy. More specifically, the law's requirements make demands of foreign financial institutions that almost surely violate privacy and confidentiality laws in some countries with strong protections of individual data. These laws are worth respecting, as they are an important safeguard for the many people throughout the world that live in countries afflicted by regular discrimination against ethnic, religious, racial, sexual or political minorities. Such vulnerable populations rely on financial institutions in nations that respect financial privacy. They need a refuge against persecution in their home countries, and the ability to protect assets can even be a matter of life and death. Unfortunately, other nations now want to mimic America's imperialistic approach, so FATCA-type laws may arise all over the globe.

Financial privacy laws are also needed for other reasons beyond state-sanctioned persecution. In many nations, there are high rates of crime, extortion, political corruption, and economic mismanagement. Mexican families must worry that corrupt bureaucrats in the tax office will sell their information to criminal gangs, creating the risk of kidnapping. Business owners in Argentina must worry about devaluation wiping out the value of bank accounts. People all over the world suffer because of corrupt judicial systems. The human toll caused by the failure of governments to maintain and uphold the basic tenets of a civilised society should be reason enough to dump FATCA.

Conclusion

Thankfully, it's not too late for the US to chart a new course. Originally, the new regulations demanded by FATCA were to be crafted and implemented by 1 January 2013. But faced with a significant backlash over the excessive costs and expensive burdens of the rule from financial institutions throughout the world, the Treasury Department has pushed back the implementation date to the middle of 2014. This additional time may prove enough to convince US lawmakers to undo the problem they have created.

Ultimately, lawmakers should consider better policies that would simultaneously boost compliance and improve prosperity. Fundamental tax reform, for instance, would eliminate the double taxation of saving and investment, thus making the entire FATCA issue moot. With a Hong Kong-style flat tax, the US would finally abandon its worldwide tax system and there would be no second layer of tax on interest, dividends, and capital gains. As such, the IRS no longer would have reason to conscript foreign institutions into acting as US tax enforcers, and it would not matter whether Americans were investing in New York or the Bahamas.

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