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Research Report

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A Global Tax on Interest Income?

Exemptions for Foreign Investors Distort Markets

Heribert Dieter

Liberalization of international capital transactions has increased the options available to investors. Today the local bank is no longer the only place to keep money; savers can choose between a wealth of options in international financial markets. One side-effect of the internationalization of capital flows has frequently been tax evasion, where interest income is often not reported to the tax authorities at home. The European Union responded to this development in June 2004 by issuing a directive on EU-wide taxation of interest income. This model could be applied globally. It would make tax evasion more difficult, strengthen the financial markets in newly industrializing countries, and open up a new source of funding for development projects.

The volume of international capital transactions has soared since the end of the Bretton Woods system at the beginning of the 1970s. The abolition of impediments to cross-border flows of capital has led investors to invest more and more capital abroad. However, higher returns abroad were not always the only motivation. In many OECD states foreigners are exempted from paying tax on interest earnings, while residents have to pay tax on the same returns. These exceptions undermine the efforts of newly industrializing countries (NICs) to develop strong domestic financial markets. The export of savings out of NICs forces borrowers there to turn to the international markets. This mechanism hampers the stabilization of the financial markets.

The Current Unregulated Situation

The United States played a leading role in introducing tax legislation benefiting non-residents. Since 1984 foreigners have been exempted from paying tax on interest income.

The economic logic is obvious. Countries that depend on capital imports, like the United States, grant tax exemption to foreigners in order to increase the attractiveness of investing. This approach is cheaper than offering higher interest rates, but takes no account of the interests of capital-exporting countries and ultimately contributes to discrediting the process of globalization.

Unequal treatment of residents and non-residents is problematic from an ethical perspective because it encourages capital flight from financially weak countries. Tax-

exemption for interest income paid to foreign investors is tantamount to a license to evade taxes.

However, the United States is by no means the only country to give foreigners preferential treatment when it comes to interest payments. Only three European Union states—Greece, Spain, and Portugal—apply the same capital yields tax to residents and nonresidents. To date the other twelve countries of the old EU have—like the United States—declined to require nonresidents to pay tax on interest income.

It is sometimes argued that this discrepancy simply reflects sensible fiscal competition, but this argument does not stand up to scrutiny. Only if residents and nonresidents were treated equally within the national tax systems could one speak of international tax competition.

Consequences for NICs

Preferential treatment of foreign investors affects NICs and post-communist transition countries particularly badly. The internationalization of the financial markets over the past 25 years has severely impaired the capacity of many NICs to retain capital in their own economies. Despite numerous positive macroeconomic indicators, many NICs and transition countries (among the latter above all Russia) are today net exporters of capital. The top 25 countries in this group have exported more than \$200 billion of net capital during the past twelve months alone.

Of course, the motives for exporting capital to OECD countries are not only to be found in the non-taxation of investment income. The desire to invest money in a stable currency is certainly generally just as important. The wish to avoid taxes is, of course, found everywhere in the world, but in societies characterized by poor infrastructure and inadequate public services the willingness to pay tax according to the rules is even less pronounced than in OECD countries.

The disadvantages suffered by NICs as a consequence of tax privileges for foreigners are considerable. Two points should be noted in particular. Firstly, the tax authorities lose considerable income. It is probable that only a very small proportion of investment income earned abroad is declared correctly in the home country. Secondly, export of capital hampers the development of strong financial sectors in the poorer countries. If domestic savings are always transferred abroad, domestic banks can no longer function as financial intermediaries. That role is then taken over by foreign banks.

The following example shows how the system works: Encouraged by tax exemption, Brazilian investors export their capital to the United States, where it is then available to the American financial system, where it can be used to finance investment or consumption at home or abroad. So it is conceivable that the capital would be used to finance investments in Brazil. In this example the main beneficiary of the transaction is the American financial sector. As far as the Brazilian government is concerned, it would naturally be very much better if domestic capital were used to fund domestic investment, without taking the detour through New York, but the tax exemptions granted to foreigners represent a substantial impediment to achieving of this goal.

Tax-Exempt Investments in Turkey

Another current example demonstrates that Germany is also negatively affected by tax privileges for non-residents. The German financial authorities are currently investigating the holders of 290,000 accounts at the Turkish central bank, where they suspect that 100,000 Turkish migrant workers have deposited funds without paying tax on the interest income. Here, too, it was a fiscal measure in the capital-importing country that encouraged the investment: since 1976 Turkey has allowed Turkish citizens living abroad to

open foreign exchange accounts at the Turkish central bank. Relatively high interest—at times more than 12 percent—was paid on the balance but there was no capital yield tax. The Turkish citizens were, however, liable for tax in Germany. The tax evasion came to light through an investigation of the Frankfurt branch of the Turkish central bank that began five years ago, but has not yet been completed due to its complexity.

The sum invested in Turkey is estimated to be at least €13 billion. Assuming an interest coupon of 10 percent and a tax rate of 25 percent, the German treasury loses more than €250 million in revenues every year.

European Union to Tax Interest from 2005

The EU finance ministers have long criticized these possibilities for evading taxes. In June 2004, after years of negotiations, they agreed—amongst themselves and with important third countries (first and foremost Switzerland)—on rules for crossborder interest payments to private investors. The directive offers a choice between a system of reporting interest income to the investor's country of residence and the introduction of a withholding tax to be transferred to the country of residence. The main points of the new regime are:

- ▶ Twelve of the old EU states and the ten new members that joined in 2004 will introduce exchange of information in 2005. As of that date, when a German citizen receives interest income, for example in the Netherlands, the German tax authorities will be informed.
- ▶ Because they wish to retain their banking secrecy, Belgium, Luxembourg, Austria, and Switzerland will apply a withholding tax, which will rise from 15 percent in 2005 to 35 percent in 2011.
- ▶ The country levying the withholding tax will receive 25 percent of the revenue,

with the other 75 percent going to the investor's country of residence.

A Model for a Global Tax on Interest Income

The model developed in the EU could be applied globally in modified form. The following points would be significant:

- ▶ In a first phase, all the OECD states would agree to abolish interest income privileges for non-residents. It also would make sense to involve important financial markets outside the OECD—especially Singapore and Hong Kong—from the outset. A second phase would bring in the developing countries and NICs.

- ▶ All OECD countries would either report non-residents' interest income to the authorities in the investor's country of residence or levy a withholding tax of not less than 20 percent of interest income.

- ▶ The revenue from this withholding tax would be transferred to the country of residence, after deducting an administrative charge of 10 percent of the revenue sum.

- ▶ If the investor's nationality is unclear, the tax revenue would be transferred to the United Nations or another multilateral institution.

A global tax on interest income would represent a step toward reforming the much-criticized international financial markets. The following advantages could be expected:

- ▶ The efforts, especially by NICs, to develop their own financial markets would no longer be undermined.
- ▶ It would become much more difficult to evade capital yield taxes.
- ▶ Capital-importing countries would be forced to bear the real costs of borrowing, and borrowing by OECD states would no longer be indirectly subsidized by the treasuries of certain NICs.
- ▶ The introduction of a global tax on interest income would go at least some way toward meeting the criticism expressed by developing countries and NICs.

► This measure would also benefit indebted countries. Citizens of these countries—generally members of the privileged upper classes—often possess significant funds abroad. Through the withholding tax transfers, these funds would contribute to overcoming financial crises. This would also remove a central criticism that undermines the legitimacy of the current system. Under the current regime, the costs of overcoming a debt crisis are often borne disproportionately by the poorest, who are in no way responsible for the outbreak of such crises.

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Obstacles to Global Taxation of Interest Income

Of course it would be naive to think that such a proposal could be implemented quickly. The administrative cost of a global taxation regime would be considerable. Capital yields would have to be recorded in full and the income reported to the owner's state of residence. However, we can assume that, with the help of automated data processing, the administrative hurdles would be surmountable.

The political obstacles are a good deal more serious. Even within Europe, there are strict limits to the willingness of states to levy taxes on behalf of other states and transfer the revenues to the investor's country of residence. The tax authorities would be able to claim a share of the revenue to cover their direct administrative costs, but in general many countries have absolutely no intention of worsening the terms for inward investment.

Many states—first and foremost the United States—have no interest in deterring foreign investors from investing in their countries. Implementing the proposal would require a degree of willingness to cooperate among the capital-importing countries that is currently not discernible.

Of all the OECD countries, the United States would currently have the least interest in introducing uniform taxation on interest. This is because taxing interest

would make it more difficult to finance the huge American balance of payments deficit of more than \$500 billion, and because to date US financial services companies have profited from tax-free investments by non-residents.

Although it is currently rather unlikely that the OECD states will quickly be able to agree to introduce a global tax on interest income, the goal is still worth pursuing. The justified demands of developing countries and NICs for a fairer form of globalization are unlikely to die down in the coming years, and the OECD countries would gain in credibility if they abolished special treatment for foreign investors. An appropriate forum for the discussion would be the Group of 20 (the G 8 countries and the major NICs), where Germany holds the presidency this year.