A New Era in Corporate Taxation

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Martin A. Sullivan
Contributing Editor
Tax Analysts
www.taxanalysts.com

Mr. Chairman, Ranking Member Baucus, and members of the Committee, thank you for the opportunity to appear before your committee. Today I would like to share with you some developments in international corporate taxation. I think these changes are so striking that they represent a "New Era of Corporate Taxation." After laying out the facts, I will briefly explain the underlying causes of these changes and then suggest some ways the United States should respond.

PART I. THE FACTS

Like everything else, corporate taxes around the world are being fundamentally reshaped by the forces of globalization.[1] Let's take a quick look at Europe, home of five of the world's ten largest economies.

Fact Number 1: Statutory corporate tax rates in Europe have declined dramatically over the last decade.

In Figure 1 we see that the average top statutory corporate tax rate for the 25 countries of the European Union has dropped from 43.2% in 1996 to 32.6% in 2006--a drop of more than 10 percentage points.[2]

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[1] This section is based on two recent articles: "On Corporate Tax Reform, Europe Surpasses the U.S." *Tax Notes*, May 29, 2006, p. 992; and "A New Era in Corporate Taxation, *Tax Notes*, Jan. 30, 2006, p. 440.

[2] All the corporate tax rates referred to in this testimony are statutory rates paid by the largest corporations. They all include both national and sub-national taxes. EU average tax rates are weighted by national GDP so the effect of a country's tax rate on the average tax rate depends on the size of its economy.

FIGURE 1
While European Corporate Tax Rates are Declining
US Rate Has Not Moved

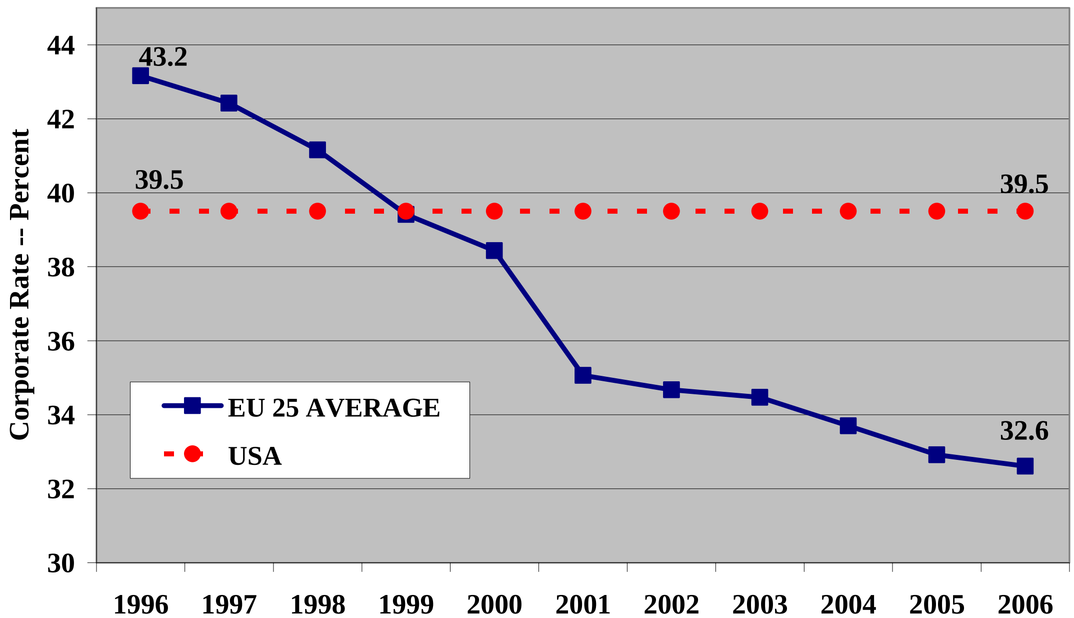


FIGURE 2
Corporate Rate Are Falling in Both
Large and Small European Countries

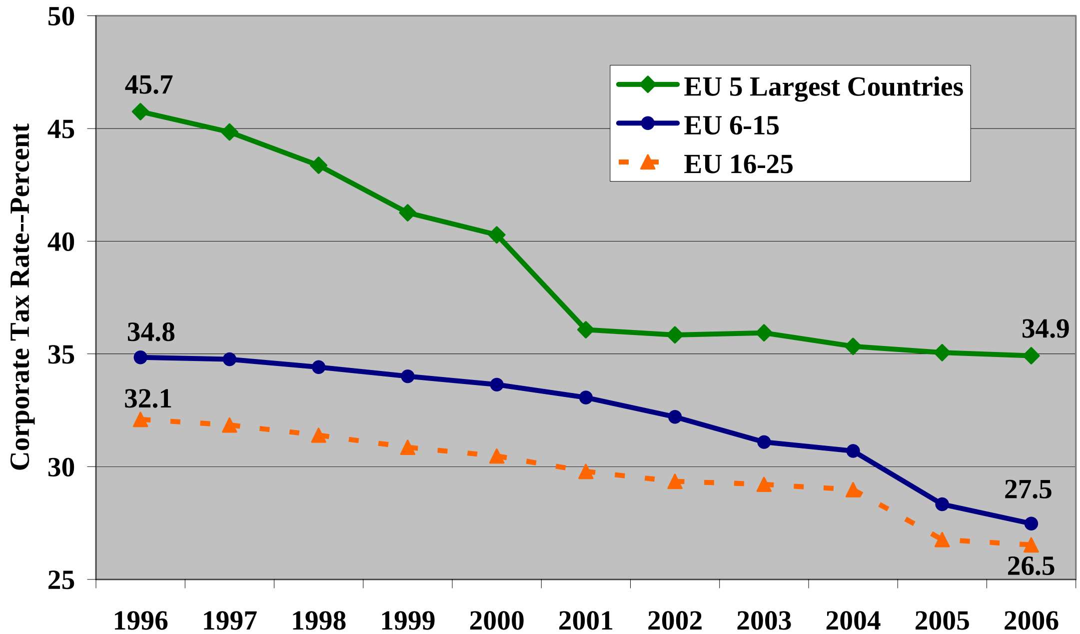


FIGURE 3
By Standing Still We are Moving Backward: Difference Between U.S. Corporate Rate and Average European Rate

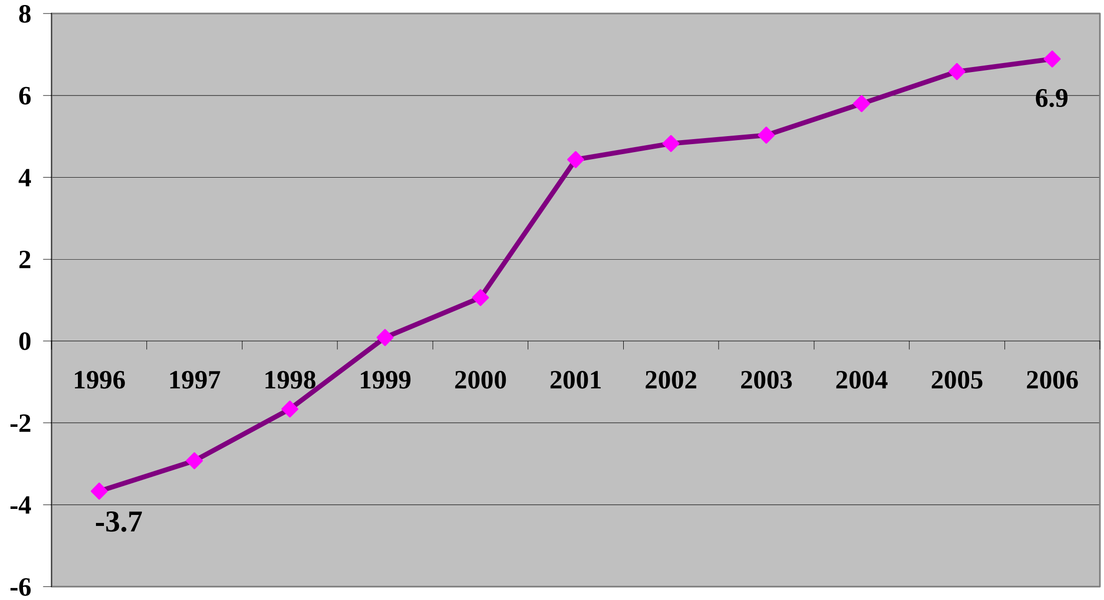
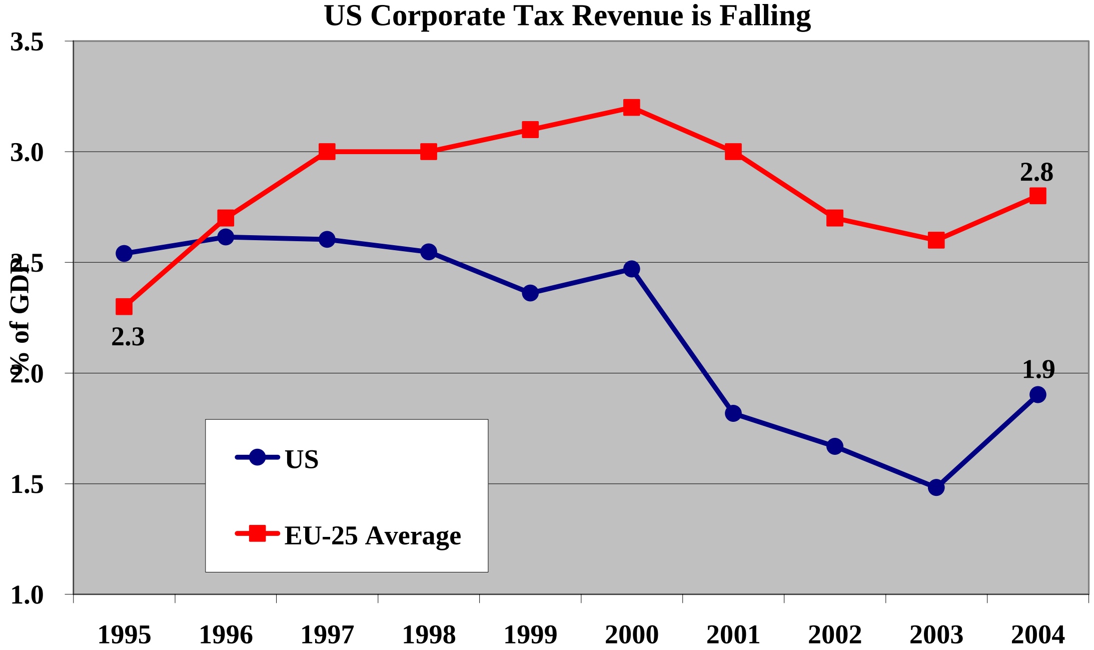


FIGURE 4
EU Corporate Tax Revenue is Rising, US Corporate Tax Revenue is Falling



There has been a lot of publicity about flat taxes and low tax rates in the former communist countries of Eastern Europe. But it would be a mistake to think that all, or even most, of the decline in statutory rates shown in Figure 1 is attributable to smaller Eastern European countries. Figure 2 breaks down the EU average into three categories: the five largest economies, the other 10 EU countries that were part of the EU before 2003, and the 10 new—primarily eastern European countries—that joined the EU in 2003. It's true that the rates are higher for the large countries than for the new entrants. But the *decline* in corporate rates in the five largest countries (10.8 percentage points) has actually been greater than the decline of rates in the new EU countries (6.6 percentage points).

Over the last decade, 22 out of the 25 countries that now compose the European Union have cut their corporate tax rates. In the United Kingdom, Conservatives lowered the corporate tax rate from 40% to 33% in the early 1990s. When Britain's Labor Party took over it lowered the corporate rate to the current level of 30%. France reduced its rate from 41.7% in 1998 to its current rate of 33%. Italy's corporate tax rate was 53.2% in 1996; it is now 37.3%. And Spain has announced it will reduce its rate from 35% to 30% in the near future.

Meanwhile, the U.S. corporate tax rate has not budged. The last time the United States changed its top corporate tax rate that rate *increased* from 34% to 35% in 1993. Taking into account state taxes (to be consistent with the EU data that include sub-national taxes), the combined state-federal rate for the United States is 39.5%.

The end result of all this is that the current U.S. corporate tax rate is higher than the corporate tax rate in *all* 25 EU countries. There is only one country in the world with a higher tax rate, Japan. And that rate is only a fraction above the U.S. rate.

Figure 3 shows that by doing nothing we have fallen behind. In 1996 the U.S. corporate tax rate was 3.7% *below* the EU average. By the end of 2004 the U.S. rate was 6.9% *above* the EU average.

Fact Number 2. Despite large rate cuts, European corporate tax revenue has not declined.

There are two reasons to expect that European corporate tax revenues should have declined over the last decade. First, of course, there are the lower tax rates. Second, we know there has been a fair amount of profit shifting from high-tax to low-tax countries—through adjustment of transfer prices and the use of cross-border intra-company loans. Yet, despite these trends, the drops in revenue one might have expected have not materialized.

You can see this in Figure 4. It shows corporate tax revenues as a percentage of GDP in the EU and in the United States. Corporate revenues jump around a lot over the business cycle so the pattern isn't crystal clear. But certainly there has been no decline in the EU. There, corporate tax revenues increased slightly from 2.8% of GDP during the five years from 1995 to 1999 to an average 2.9% of GDP during the years 2000 through 2004. In contrast, the trend for the United States is down. The U.S. five-year average for 1995-99 was 2.5% of GDP; for 2000-04 the average dropped to 1.9% of GDP.

Fact Number 3. To offset the cost of rate cuts, European governments broadened their corporate tax bases.

Part of the surprising strength of European corporate tax revenues is probably due to increases in profits. As to the amount, we cannot be sure because of the difficultly economists have in measuring profits on a consistent basis across countries.

But we do know for sure that part of the strength in revenue is attributable to actions taken by European governments to reduce tax benefits and increase their corporate tax bases. In a summary description of tax developments, a May 17 report[3] from the European Union notes that corporate rate cuts in Austria, Belgium, Cyprus, France, Germany, Hungary, Portugal, Slovakia and the United Kingdom coincided with cutbacks in corporate tax breaks. The report concludes that rates cuts and "reductions in the scale of deductions and exemptions" were the two dominant trends in EU corporate taxation over the last decade.

Economic research supports this view. According to calculations by a team of British economists, depreciation schedules across Europe have become less generous.[4] Two notable examples are the United Kingdom and Ireland, which both eliminated expensing.

I'd like to close this "facts" section with a summary of the recent history of the corporate tax in Germany, Europe's largest economy. In 2000 the government, under the control of Social Democrats, reduced the top corporate tax rate from 54% to 39%. But this was not the end of the Social Democrats ambitious plans for rate cuts. Before his loss at the polls in September 2005, then-Chancellor Gerhard Schroeder had proposed a further reduction in the corporate rate from 39% to 33%. How did the German government propose to finance the rate cut? Germany's former Finance Minister Hans Eichel explained at the time: "As there is no room for tax giveaways in public budgets, we will have to offset the rate cut by broadening the tax base. This is the only way we can finance all the necessary measures without taking on new debt."

PART II. WHY REFORM NOW?

Rate cutting and base broadening—the kind we see taking place across Europe--is the essence of tax reform. Few economists doubt that rate-cutting, base-broadening tax reform is a big plus for competitiveness. It's a major step toward reducing government's role in the economy. By reducing distortions, it increases efficiency, productivity, and—

[3] *Structures of the Taxation Systems in the European Union - Data 1995-2004*, May 17, 2006.
[4] Michael Devereux, Rachel Griffith, and Alexander Klemm, "Corporate Income Tax Reforms and International Tax Competition," *Economic Policy*, October 2002.

ultimately—wages. It also makes taxation simpler, removes the incentive to bend the rules, and appeals to people's sense of fairness.

That's always been the case. But now, there is more reason than ever to reform corporate taxes. In this new era of corporate taxation, it is not accelerated depreciation and tax credits that are the big draw for corporate investment. It's the reduction of corporate tax rates.

Why the change? There are several reasons.

First, as economies move away from manufacturing—as intangible assets become more important than plant and equipment, as the rate of profitability per dollar of physical capital increases—it is a straightforward matter of arithmetic that rates play a larger roll than conventional incentives in determining the after-tax profit of investment decisions.

Second, as transportation and communications costs have dropped, and trade barriers and currency controls have also declined, there is more cross-border investment than ever. In the old days—say, before 1995—economists were thinking about how to use taxes to get a *domestic* firm to boost its *domestic* investment on the margin, for example, by 3 or 4%. In that case—that is, in the case of investment of borderline profitability—traditional incentives can mean a lot. And because this was the type of investment governments were trying to encourage, using tax credits and depreciation was a revenue-efficient way for governments to provide investment incentives.

But with increased capital mobility, economists have changed their thinking about how taxes motivate investment. Under the new paradigm, governments are trying to influence location decisions of multinationals. Because these decisions involve large chunks of investment—not just those marginally profitable—tax rates matter more than tax credits.

Finally, as mobile as capital may be, profits are more mobile. In deciding where to channel profits, tax rate differentials are all important, and conventional incentives don't matter at all.

What does all this mean? It means that without increasing the deficit and without changing the overall tax burden on the corporate sector, a government can protect its revenue base, increase investment, and increase competitiveness. As the figures above show, that's exactly what EU countries are doing.

PART III. WHAT ABOUT THE UNITED STATES?

In order to return to the competitive position held in the mid-1990s, the U.S. corporation tax rate would have to be reduced significantly.

Proposal: Cut the federal corporate tax rate from 35% to 25%. Offset the revenue loss by broadening the corporate tax base.

I am not one who puts much stock in claims that tax cuts pay for themselves. But if ever there was a case that a tax policy could change behavior and those changes in turn would yield revenue offsets, this is it. With corporate tax reform, there would be some increase in overall economic growth (increasing revenues from all sources, not just the corporate income tax). There would be some shifting of real investment into the United States—as plant closings would decline and inbound investment increased. Finally, artificial profit shifting out of the United States would slow down and there would be incentive to begin shifting profits *into* the United States.

But these changes would only partially offset the costs of lower tax rates. To finish the job there would still need to be some major cutbacks in corporate tax breaks. To help get you started I'll give you a list of base broadening proposals that could pay for a big reduction in the corporate tax rate. These types of proposals, which ordinarily would be nonstarters in most tax bills, become possible in the context of tax reform. How do we know this? We saw it happen in this very room 20 years ago.[5]

- ***Reduce depreciation allowances***.

The Treasury Department estimates that accelerated depreciation is one of largest tax expenditures. Treasury figures show that bringing tax depreciation into conformity with true economic depreciation could raise tens of billions of dollars annually.[6] In Tax Reform Act of 1986 Congress reduced depreciation allowances to help pay for corporate tax rate cuts.

- ***Eliminate the deduction for domestic production activities.***

This is almost like a rate cut for a big part of the corporate sector. It should be repealed to pay for a real rate cut for the whole corporate sector. The revenue saving from repealing this provision would be over $10 billion annually.[7]

- ***Tighten transfer pricing rules—particularly those pertaining to cost sharing arrangements.***

There are no official estimates for revenue saving from tightening transfer pricing rules. I have estimated that profit-shifting out of the United State to a single country, Ireland, cost

[5] After 17 days of markup, the Senate Finance Committee on May 6, 1986 ordered (by a 20-0 vote) that tax reform legislation (H.R.3838) be favorably reported. The final version of the bill reduced the top corporate tax rate from 46% to 34%. It also lengthened depreciation lives and repealed the investment tax credit.

[6] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives*, Chapter 19, "Tax Expenditures," Table 19.2.

[7] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives*, Chapter 19, "Tax Expenditures," Table 19.2.

the U.S. Treasury at least $2 billion in 2002.[8] The revenue gains from an overhaul of these rules could be enormous.

I commend this committee's efforts to investigate the fairness and the appropriateness of results under Advanced Pricing Agreements. Unlike private letter rulings provided by the IRS, APAs are not disclosed to the public, so it is hard for us ordinary citizens to know the details. IRS officials may tell you the APA program is a success because they are "moving cases," but from what I can see in the data, the APA program is not protecting U.S. revenue. I look forward to public disclosure of the committee's findings.

To prevent inappropriate profit shifting and to raise revenue, the rules for cost sharing arrangements should be significantly tightened. I do not believe the regulations proposed by the Treasury Department, if finalized, would cause anything more than a temporary disruption to tax planners' efforts to transfer U.S. developed intangibles to tax havens.[9] I would suggest the starting point for effective rules should be to deny intangible holding companies in tax havens the privilege of entering into cost-sharing arrangements.

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- ***Prevent income shifting to low-tax countries through related-party loans***.

Related-party loans are not like real loans, but the tax code treats them that way. Multinational corporations take advantage of this and the lack of restrictions on hybrid entities under the infamous "check-the-box rules.[10] I would suggest a good starting point for putting a lid on these manipulations is that all deduction-generating interest payments on interest from related party loans be disregarded for tax purposes. I can't put a figure on the revenue pick-up from this type of change, but this loophole is a favorite among tax planners, there is undoubtedly big money involved.

- ***Eliminate or reduce tax credits***.

Some of our tax credits are, simply, abominations.

On the top of my list is the section 29 nonconventional-source fuel tax credit as it applies to chemically modified coal. Take perfectly good coal; spray it with kerosene or some patented magic formula; get huge tax benefits.[11] It should be repealed without a second thought.

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[8] "The IRS Multibillion-Dollar Subsidy for Ireland," *Tax Notes*, July 18, 2005, p. 287.

[9] "Half the Profits for None of the Work," *Tax Notes*, Sept. 12, 2005, p. 1243.

[10] "International Tax Planning: A Guide for Journalists," *Tax Notes*, Oct. 4, 2004, p. 32.

[11] "Former JCT Chief Turns Loser into a 'Winner'," *Tax Notes*, Mar. 13, 2006, p. 1126; and "Multibillion Dollar Coal Credit: Lots of Form, Little Substance," *Tax Notes*, Oct. 6, 2003, p. 34.

Most tax credits are simply well-intentioned but ineffective.[12] Energy credits generally and employment credits, like the work opportunity tax credit, fall into this category. They could be eliminated and there would be no major setbacks to the national well-being.

Even the venerable research credit could use a good trimming.[13] When it was first enacted in 1981, it was lean and mean. Because research is good for society as well as the company that performs it, there was excellent economic justification for subsidizing it. And because of its incremental design, the research credit could pack its incentive effect where it would do the most good—on *increases* in research. But the research credit of 2006 is no longer lean and mean. Instead of challenging taxpayers, it coddles them. In the recent decade the annual revenue loss from the credit has skyrocketed. And for all this cost, it is doubtful the credit has any significant effect on actually increasing research--especially for the billions of dollars of credit refunded as a result of research credit studies by accountants years after research is performed.

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That concludes my remarks. Thank you for your attention. I welcome your questions today or anytime.

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[12] "Tax Incentives and Economists," *Tax Notes*, Apr. 3, 2006, p. 20.

[13] "Research Credit Hits New Heights, No End in Sight," *Tax Notes*, Feb. 18, 2002, p. 801.