

## TAX ANALYSTS EXCLUSIVE

## Conversations: Daniel Mitchell and Chris Edwards

*Interviewed by Joann M. Weiner*

Daniel Mitchell is a senior fellow at the Cato Institute, a free market think tank in Washington. He also founded the Center for Freedom and Prosperity, an organization dedicated to preserving and promoting tax competition. Chris Edwards is director of tax policy at the Cato Institute and a former staffer on the Joint Economic Committee and tax manager at PricewaterhouseCoopers.

**Tax Analysts:** More than two decades ago, the U.S. and the U.K. led the world in a tax-rate-cutting and base-broadening reform effort that brought corporate rates down by more than 20 percentage points in many countries. (See Figure 1.) Yet, since then, the U.S. has not reduced its federal rate while nearly all industrial countries, except for Japan, have made or proposed sharp cuts in their rates. Despite this fact, U.S. multinationals have been slow to push for a cut in the U.S. rate. This may be because, in part, U.S. multinationals receive tax breaks from Congress that reduce their effective tax burden well below their statutory burden. In today's Congress, it is much easier for companies to obtain these tax preferences, such as on dividend repatriations or for domestic production, rather than to push for a more visible tax rate reduction.

As the Treasury Department reported, the domestic production activities deduction "is structured to be similar in effect to a reduction in the statutory tax rate, e.g., from 35 percent to 32 percent once fully phased in."

Given your interest in reducing the U.S. tax rate, have you considered marshalling your resources to push for a long-overdue U.S. rate reduction?

**Daniel Mitchell:** The United States has become uncompetitive due to its high corporate income tax rate. At 35 percent (or just under 40 percent including state taxes), the federal rate is significantly above the European Union average of 24 percent.

Other countries continue to cut their rates. Germany has just announced a corporate rate cut, France and the U.K. are also reducing their rates, and many of the newer EU member states are cutting their rates nearly in half and moving to flat rate systems. Estonia has done the right thing by eliminating its corporate income tax on retained earnings. My recent note on corporate taxes dis-

cusses this issue in greater detail. (See *Doc 2007-16578* or *2007 TNT 137-32*.)

Not only does the U.S. have a high statutory rate, it also has a high effective tax rate. A study from 2006 by Jack Mintz of the C.D. Howe Institute in Canada shows that the U.S. ranks fourth highest at 38 percent in its effective tax rate on capital. (See Table 1.) [Editor's note: The effective rate on capital in the C.D. Howe Study is the amount of corporate income and other capital-related taxes paid by a business as a percentage of pretax profits for marginal investment profits. Measures of effective tax rates are highly sensitive to the assumptions used in the calculations and are generally not comparable across studies. The C.D. Howe study is available at [http://www.cdhowe.org/pdf/commentary\\_239.pdf](http://www.cdhowe.org/pdf/commentary_239.pdf).]

Think tanks have a limited ability to steer the debate, but we are doing everything we can to educate policymakers about the anticompetitive impact of the current systems. I wouldn't be surprised if one of the Republican presidential candidates advocates a corporate tax rate cut. I don't see any of the Democratic candidates making such a proposal, although the "reasonable" left now sees that the high U.S. corporate rate is not sustainable. Recall that John Kerry proposed a small corporate rate cut in the 2004 election campaign.

### President's Advisory Panel

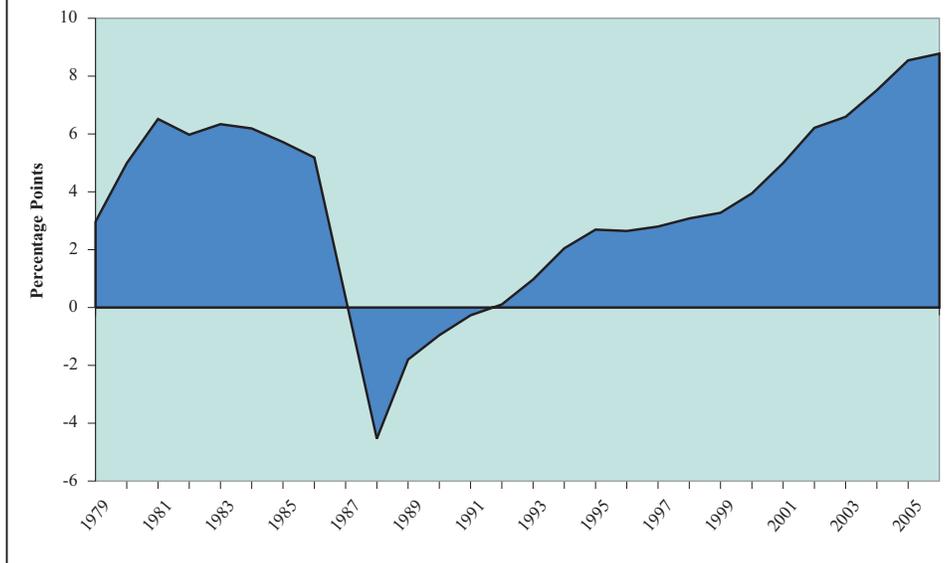
**TA:** The report by the President's Advisory Panel on Tax Reform, which came out less than two years ago, indicated that any rate cut would be rather modest, say three percentage points, because of revenue concerns. Why is it now possible to cut the rate?

**Chris Edwards:** The U.S. has lagged in the corporate tax cutting area, in part, because it is a relatively large country and it will draw in capital for many reasons other than the tax rate. America



Daniel Mitchell

**Figure 1. Difference Between the U.S. Corporate Income Tax Rate And the OECD Average Rate (Excluding the U.S.)**



can attract capital because it has a dynamic economy and a relatively low overall government tax burden. Smaller countries are generally more nimble than larger ones and have more to gain by cutting their tax rates. These smaller countries, especially those in Eastern Europe, also use a tax rate cut to signal that they are serious about creating a competitive tax environment.

**Mitchell:** I also think that members of Congress are waking up to the issue that the U.S. corporate rate is out of line with the rates in other countries. Moreover, with the passage of time since the Enron and Worldcom corporate scandals, there is likely to be more sympathy toward tax rate cuts now than before. Hopefully, the era of corporate bashing is over and we can focus on international competitiveness.

**Edwards:** Cutting the tax rate has many side benefits. We advocate a tax rate of 20 percent, which would be below the EU and OECD averages. This lower rate would dramatically improve the competitiveness of U.S. companies and would help solve many of the tax avoidance problems plaguing our tax system today. As you know, aggressive transfer pricing and other avoidance techniques are a major concern to Congress, but they also create a big headache for multinationals because of the heavy burden of regulations devoted to stemming these practices. If we cut the rate to 20 percent, reported taxable income would balloon and people wouldn't worry much about corporate tax avoidance anymore.

### Treasury Conference

**TA:** Countries that have recently cut their rates, such as Germany, have enacted base-broadening measures at the same time. Treasury also believes in broadening the base in exchange for reducing the rate. Treasury released a background paper for its July 26 conference on business taxation and global competitiveness in which it lists the major tax preferences (i.e., "corporate welfare") in the corporate income tax. (For the background paper, see p. 399.)

The Treasury paper explains that the revenue forgone from these corporate tax preferences imposes a significant cost not only on actual revenues but also on economic efficiency. Eliminating the listed tax preferences would raise more than \$1.2 billion over a 10-year period, assuming a comprehensive income base with the same statutory tax rates as in the current system. The U.S. could use the revenue gained from eliminating these tax preferences to reduce the corporate tax rate to 27 percent.

Do you agree with the idea of eliminating these tax preferences to finance a tax rate cut?

**Mitchell:** If the revenue is used to lower rates, I am in favor of eliminating many preferences, such as ethanol subsidies (among the worse provisions in the tax code) and the research and experimentation tax credit. If the revenue estimates took into account behavioral changes caused by lower tax rates, there would be much less need to broaden the base. Sadly, official revenue estimates still ignore any Laffer Curve effect.

I get nervous when people start talking about base broadening because many politicians do not understand that the ideal business tax regime is a consumption-based, cash-flow system. Instead of getting rid of bad provisions such as ethanol hand-outs, I worry that politicians will start lengthening depreciation schedules, which would exacerbate the current system's bias against investment and whittle away the benefits of the rate cut.

**Edwards:** A corporate rate cut would create a strong dynamic response, both in terms of real investment and reported profits. Estimates by Greg Mankiw and others indicate that there would likely be a 50 percent or more feedback over time in terms



Chris Edwards

of revenue brought about by tax cuts. A Joint Committee on Taxation study from 2005 showed the economic response to a corporate rate cut would be much larger than individual tax cuts. (The JCT study is available at <http://www.house.gov/jct/x-4-05.pdf>.)

### What About a VAT?

**TA:** Michael Graetz, a law professor at Yale University, has put forth an alternative proposal, suggesting that the corporate rate could be cut to 15 percent if the U.S. adopted a VAT to finance the cut. What do you think of this proposal?

**Edwards:** I am dead set against a VAT as an add-on. Unlike the corporate income tax, which has limited revenue-raising possibilities, the VAT is a revenue machine. I am happy that the U.S. remains the only major country without a VAT, and I would like to keep it that way. I favor replacement of the income tax with a consumption-based system, such as the Hall-Rabushka flat tax.

In the short term, I favor a territorial corporate tax system with a rate cut to 20 percent. Some multinational companies are concerned about the taxation of foreign royalties under a territorial sys-

tem. It strikes me that the solution is to go to a territorial system and exempt foreign royalty income. That would give U.S.-based MNCs strong incentives to expand their R&D in the U.S. Creating a strong economy is more important than concern about whether some foreign income is going untaxed.

**Mitchell:** I would take a VAT, but only as a replacement for both the personal income tax and the corporate income tax. The welfare states in the European Union are possible only because they have a VAT in those countries.

### The Falling Corporate Tax Burden

**TA:** The European Commission recently reported that the tax mix between capital and labor taxes has been receiving renewed policy attention “in light of the worries that increased capital mobility and the accession to the EU of a group of low-tax countries might lead to even greater reliance on taxation of immobile factors (such as labor) than has been the case so far.” (See European Commission, *Structures of the Taxation Systems in the European Union — Data 1995-2004* (2006 edition).)

The U.S. collects a far smaller share of revenue from the corporate income tax than do other OECD countries. The U.S. also imposes a heavy burden on labor, as shown by the relatively high ratios for the individual income tax and for Social Security contributions. Table 2 shows that the U.S. collects more than one-third of total revenue from the individual income tax, compared with less than 10 percent from the corporate income tax.

Data reported in the Treasury paper show that the U.S. ranks relatively low among selected OECD countries in the share of corporate income in taxes. The Treasury paper suggests that a comparison of the below-average U.S. corporate average tax rate and the above-average U.S. corporate statutory tax rate indicates that the United States may have a higher than average level of corporate tax preferences. In terms of GDP, the corporate tax makes up just 2.2 percent of U.S. income, compared with an OECD average of 3.4 percent.

In light of this shift away from capital taxation toward labor taxation, many analysts suggest that companies should pay their “fair share” of taxation and should abide by the notion of corporate social responsibility. A recent conference at Oxford University highlighted this issue. Reuven Avi-Yonah, a law professor at the University of Michigan, presented an excerpt from his paper on “Corporate Social Responsibility and Strategic Tax Behavior,” in which he argues that “corporations should not be permitted to engage in strategic behavior that is designed solely to minimize their taxes, while the state should use the corporate tax as a regulatory tool.”

**Table 1. General Corporate Income Tax and Effective Tax Rates on Capital for 2006**

	Statutory Corporate Income Tax Rate	Effective Tax Rate on Capital		Statutory Corporate Income Tax Rate	Effective Tax Rate on Capital
China	24.0%	46.9%	Canada	34.2%	36.6%
Brazil	34.0	38.8	Japan	41.9	32.2
Germany	38.4	38.1	France	35.4	32.1
United States	39.2	38.0	Korea	27.5	31.5
Russia	22.0	37.6	Spain	35.0	30.2

Source: Jack Mintz, "The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform," C.D. Howe Institute (2006).

Do corporations have a social obligation to pay a minimum tax? In evaluating corporate tax planning behavior, is it useful to distinguish between "acceptable" and "unacceptable" tax avoidance?

**Edwards:** Optimally, we would not have a corporate income tax at all, but while we do, corporations have an obligation to legally minimize their taxes and maximize their after-tax profits.

That said, however, I believe that the tax avoidance problem is not with the corporations; the problem is with the Congress. As I noted in my "Primer on Replacing the Corporate Income Tax With a Cash-Flow Tax" (see *Tax Notes*, Sept. 8, 2003, p. 1293), the complexity in the tax code distorts financial and investment decisions and spurs executives to hunt for tax shelters.

Complexity is the real problem. Enron took advantage of the special rules in the tax code that create a variety of entities, each of which has its own particular tax treatment. As Enron showed, corporations can use alternate business structures, such as partnerships, to conceal debt, change the form of financial flows, and confuse tax authorities and investors. Enron also used other business structures, such as REMICs, FASITs, and REITs, in its tax shelters. As the JCT reported, Enron "excelled at making complexity an ally." Many are surprised to learn, as I noted in my primer paper, that Enron's tax shelter activities were not even illegal. (See JCT, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," vol. 1: Report, JCS-3-03, Feb. 2003.)

**Mitchell:** Corporate tax avoidance is a symptom of the problem. The problem is that the corporate tax rate is too high.

**Edwards:** Regarding whether tax avoidance can be classified as acceptable or as unacceptable, I would say that corporations are able to comply with the letter of the law while violating the intent of the legislation. But, again, I suggest that the problem lies with the tax code, not with the taxpayer.

**Mitchell:** I agree. The irresponsible party in tax avoidance is at the political level, not at the corporate level. As long as the actions taken as part of

corporate tax planning are legal, then corporations should be allowed to apply the law. If Congress is not happy with this situation, then it should change the law.

**Edwards:** The battle over private equity highlights a general problem with the income tax. The carried interest issue has arisen because of confusion surrounding the treatment of capital gains, combined with the many different structures we have under the current tax code — C corporations, partnerships, etc.

Determining what is "wages" or "capital gains" seems to differ depending on whether we are talking about individuals, flow-throughs, or C corps. A consumption-based system, such as Hall-Rabushka, would get rid of separate capital gains treatment and have a more consistent tax base.

### Tax Havens

**TA:** In May the Senate Finance Committee held a hearing to evaluate the impact of offshore tax havens on U.S. tax payments. At that time, Finance Committee Chair Max Baucus, D-Mont., held up a photo of a modest office building in the Cayman Islands that is home to more than 12,000 companies and remarked that these companies were mere shell companies "whose sole purpose is to evade U.S. taxes." Tell me, what legitimate business could U.S. taxpayers have in the Cayman Islands?

**Mitchell:** The senator should take a look at Delaware. More than 100,000 entities have registered at one address in that state and about 200,000 are registered at another address, but they conduct their real activity elsewhere. The place of registration is merely a reflection of the quality of a jurisdiction's business law. Delaware also protects the privacy of investors. European tax collectors, for instance, complain it is even less transparent and more secretive than the Cayman Islands.

States like Delaware and jurisdictions like the Cayman Islands should exist because their pro-growth tax policies put pressure on high-tax countries, such as France and Germany, to reform their antigrowth tax policies. Once governments realize that the goose that lays the golden egg can fly away,

Table 2. Composition of Tax Revenues in the U.S. and the OECD, 2004

Type of Tax	United States	OECD	Difference Between the U.S. and OECD Countries
Individual income tax	34.7%	24.6%	10.1%
Corporate income tax	8.7	9.6	-0.9
Employee social security contributions	11.6	8.5	3.1
Employer social security contributions	13.3	14.9	-1.6
General consumption tax	8.5	19.1	-10.6
Excise taxes on goods and services	7.1	11.4	-4.4
Property tax	12.0	5.6	6.4
Other taxes	4.1	6.2	-2.1
Total taxes	100.0	100.0	0.0

Source: OECD (2006).

then they will be more concerned about keeping that goose happy at home.

Tax competition is driving the shift toward better tax policy. In the absence of a Margaret Thatcher or a Ronald Reagan, it is up to market forces to keep pressure on high-tax countries.

**Edwards:** Let's take Enron and its activities in the Cayman Islands. The Joint Committee on Taxation (JCS-3-03, p. 376) concluded that Enron was in the Caymans because it had a persistent inability to use federal tax credits, and so it created a deferral structure of tiered subs for each (real) foreign project investment. That does not seem unethical to me — it just wanted what MNCs in other (territorial) countries get by the normal tax rules. As I note in my primer paper, in testimony to Congress, Lindy Paull, then the JCT chief of staff, essentially said regarding Enron's tax shelter activities that "I don't know if you could call it illegal." Indeed, it was normal MNC tax planning. Of course, it's crazy that MNCs have to go through all these machinations to avoid the U.S. worldwide tax reach.

### The OECD and Harmful Tax Competition

**TA:** I recently interviewed Jeffrey Owens, head of the OECD's Centre for Tax Policy and Administration. (See *Tax Notes Int'l*, May 28, 2007, p. 913.) He believes that the OECD project has been quite successful, as demonstrated in part by the creation of the Global Forum on Taxation that brings together financial centers in more than 80 OECD and non-OECD countries. The Global Forum has developed key standards in transparency and effective exchange of information in taxes. The Forum on Harmful Tax Practices has led to the elimination of harmful preferential tax regimes in the OECD members. The OECD has developed a productive working relationship with the new "participating partners," many of which used to be known as tax havens. From an initial list of more than 40 potential tax havens, as of July 24, when the OECD an-

nounced that Liberia has committed to implement a program to improve transparency and establish effective exchange of information in tax matters, just 4 jurisdictions remain on the list of uncooperative tax havens. (For a discussion of the OECD project, see *Tax Notes Int'l*, Apr. 16, 2007, p. 229.)

Given these achievements, wouldn't you describe the project as highly successful in bringing about greater transparency and more effective exchange of information on tax matters?

**Mitchell:** The OECD project has been an expensive failure. Yes, persecuted low-tax jurisdictions have agreed to become "participating partners" in the OECD Global Forum, but this is a Potemkin village exercise. Every year or two, all the OECD and tax haven jurisdictions get together and talk about how wonderful it would be to have a level playing field. But so long as nations like Switzerland, Luxembourg, Singapore, and the United States maintain their attractive laws for nonresident investors, there is no obligation for so-called tax havens to emasculate their pro-growth policies. Since I wake up every morning thinking of how to throw sand into the gears of the OECD and EU tax harmonization projects, this is good news.

To be fair, while I disagree with the core goal of OECD's anti-tax-competition project (to help high-tax nations double the tax income that is saved and invested, even when the economic activity takes place outside their borders), not every feature of the project is antigrowth. Special tax breaks distributed behind closed doors is not good tax policy, for instance, so perhaps the project has had a positive impact in these areas.

**TA:** The main concern I have about the criticism of the OECD project is the false charge that the OECD project was designed to harmonize tax rates or to set a minimum tax rate. The report made it explicitly clear that the project had no intent — implicitly or explicitly — to harmonize tax rates.

Given that clear statement, why did so many attack the project for allegedly attempting to dictate tax rates?

**Mitchell:** Although the report did not explicitly say it would harmonize tax rates, by pursuing the theory of capital export neutrality (CEN), it implicitly argues that tax rates should be harmonized. Under CEN, taxes should not affect where a taxpayer invests. Thus, the outcome of this theory is that a taxpayer should not be allowed to benefit from better tax law in another jurisdiction because in so doing, CEN will be violated and the location of investment will be altered. (Interestingly, proponents of CEN assume that high tax rates — which are more likely in the absence of tax competition — have no impact on the level of investment.)

**TA:** Many argue that the effort to curb harmful tax competition imposes collateral damage on developing countries. What is the evidence for this?

**Mitchell:** If the OECD had succeeded in its project to harmonize tax rates, then we would have seen harm in many of the blacklisted tax haven jurisdictions. We also would have seen economic damage in high-tax nations since politicians would be more likely to raise tax rates in the absence of competition. But since the OECD has failed in its project, we have been spared its harmful effects.

**TA:** I challenge your statement about the lack of beneficial effects from the project. The OECD project has been highly successful.

Nearly every day I read reports that another former tax haven is changing its policies to comply with the OECD's (and the EU's) project. For example, Jersey and the Netherlands have signed a bilateral agreement to exchange information for tax. In May the Isle of Man sent a heated letter to the Treasury Department protesting its listing as a tax haven in legislation introduced in the Senate this year, noting that it has led the way in cooperating with the OECD to devise new ways to exchange information and that "the Isle of Man is an active, constructive and pragmatic participating partner in the OECD Global Forum on Taxation and is ac-

knowledged by the OECD as a responsible International Finance Centre." (See *Doc 2007-12892* or *2007 WTD 105-22*.)

I could provide much more evidence, but I think you get the point. I wouldn't say that the OECD should hang up a sign saying "Mission Accomplished," but I would give it credit for welcoming the tax havens into the circle and making them participating partners in the project. There's a lot more information exchange taking place now and a lot more transparency thanks to the OECD project than there would have been without the OECD.

**Mitchell:** I would say that you give the OECD too much credit. The U.S. has been able to bully many jurisdictions into many tax information exchange agreements, but this is a result of U.S. power, not the OECD. In fact, I argue that the tax havens decided that they would "surrender" to the United States to get the OECD to back off. Once the U.S. was "appeased," then the havens were in the clear.

I suggest that it is the Financial Action Tax Force that has had greater success through the broad implementation of "know your customer" rules. But, on the other side, it probably has caused the most damage because the regulations impose very high costs with very little benefit.

I also would like to note that the research shows no evidence that tax havens have more "dirty money" than nontax havens. The tax havens have an enormous stake in preserving their reputation. Just think of the consequences that would have fallen on the tax havens if the September 11 terrorists had used a bank in the Bahamas for their financial transactions instead of a U.S. bank? Tax havens cannot afford to shelter criminals. I'm not saying that there is no money laundering in the tax havens, only that there is no evidence that it is any more prevalent in the havens than elsewhere.

Again, I suggest that the law and order approach taken by the OECD is not working.

Reducing corporate tax rates will solve most of the problems facing the OECD, the United States, and the other member countries. ■