

Tax Foundation's "Tax Policy Podcast"
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Scott Hodge: Thank you for tuning in today. I'm Scott Hodge, president of the Tax Foundation. Joining me for our weekly Tax Policy podcast is Martin Sullivan, who is a contributing editor at *Tax Analysts*, and a very prolific writer and commentator on a wide range on state and federal tax policies and issues. Thanks for joining us today Marty.

Martin Sullivan: Scott, thanks for having me.

Scott Hodge: Well, you recently gave some very compelling testimony before the Senate Finance Committee, about how corporate taxes around the world are being fundamentally altered by the forces of globalization. Well, except, that is, here in the United States, where you say that "by standing still, we're moving backward." Can you give us an overview on these global trends, and how the US is falling backward?

Martin Sullivan: Sure, Scott, the facts about changing corporate taxes rates in Europe I think are fascinating. Since 1996, the average corporate rate -- here we're talking not about the effective rate, but about the top statutory rates paid by the largest corporations -- that average corporate tax rate in Europe, has dropped by ten percentage points from 43 to 33 percent. That's all in the last ten years. In addition, there is a rate-cut plan in Spain, and, right now, in Germany, there's a huge debate about government's proposal to cut rates even further. So in the last decade, in the 25 countries that comprise the European union, 22 have cut their corporate tax rates, and nobody has increased their corporate tax rate.

Meanwhile, in the United States, the combined federal corporate rate is about 39.5 percent, and it has not budged at all. The last time we changed our corporate tax rate, as you know, was in 1993, and we increased it. Well, after the 1986 Act, the US could boast about having one of the lowest corporate tax rates, it now has the world's second highest. And only Japan has a slightly higher rate.

Scott Hodge: I think that one of the most interesting things that you have written about this is, as you've written, is that despite the rate cuts in Europe, corporate tax revenues have not really declined. In some cases, may have even increased in some countries. Now this isn't a case of tax cuts paying for themselves, is it? How come they're getting such counterintuitive results?

Martin Sullivan: As you know, Scott, it's not easy to explain corporate tax receipt data. This is because of the tremendous volatility that those corporate receipts have over the business cycle. If you look at what's happening in the US, where corporate tax receipts have jumped from \$132 billion, in 2003, to \$332 billion, in Fiscal 2006, you kind of get an idea of the rollercoaster ride that we're on. But in Europe, corporate rates have declined dramatically, and the revenues have stayed pretty strong, and I think there are three reasons for that.

The first is legislative response. Just as in the United States during the Tax Reform Act of 1986, Europeans have broadened their tax bases, as they closed the loopholes and restricted tax breaks when they cut the rates. Second, the lower rate means businesses in Europe no longer have to engage in a lot of transfer pricing in order to shift profits out of Europe, and that brings some revenue back in. Third, lower rates, I think, have spurred some increased corporate investment. As you mentioned, dynamic revenue estimates are often oversold, but in the case of corporate taxes, because corporate capital is so mobile, and because the corporate tax is so inefficient, I think it's important to take those dynamic effects into account. And that explains part of the story.

Scott Hodge: Well, that's interesting. You'd expect here in the United States, sort of your typical, run-of-the-mill supply-side Republican would be all over this sort of thing. But you suggested in an article, that cutting corporate tax rates ought to be, or could be, on the agenda for the next Democratic presidential candidate. Are you kind of like proposing Nixon going to China, or Clinton promising to end welfare as we know it? What makes this a good issue for Democrats?

Martin Sullivan: Well, now you've asked me one of my favorite questions.

[laughter]

Martin Sullivan: First of all, cutting corporate rates is a good issue for Republicans and Democrats. The point I was trying to make for Democrats, was whether that you like it or not, competitive pressures are driving down corporate tax rates, so you might as well deal with it proactively. I mean, look at what the Democrats did with the estate tax, they are still trying to defend 50 percent rates and that didn't get them anywhere.

European governments need revenue just as much, or more than, the US does. They are lowering their rates to increase their competitiveness, and to save their corporate taxes from extinction. There are many examples in Europe, of left-leaning governments, that have done precisely this. You can look at Spain, you can look at Tony Blair and Gordon Brown in the United Kingdom, you can look at former German Chancellor Gerhard Schroeder, the Democratic Socialist in Germany. All of them to the left of the spectrum, have cut corporate tax rates. And I think the Democrats here could learn something from them.

Scott Hodge: Before we begin to talk more in depth about tax incentives and so forth, you've recommended that maybe the US corporate rate be lowered to at least about 25 percent for us to be competitive. But what credits and deductions should maybe be at the top of our list if we want to eliminate them in order to reduce our rate down to 25 percent?

Martin Sullivan: Well, I have no desire to pick winners or losers. But the types of things I think we can look at are cutting back on traditional, what we used to think of as the better investment incentives, like accelerated depreciation. I think we'd have to go after some sacred cows, like I think we could cut back the research credit, and tighten up some of the transfer pricing rules. The important thing to remember here is that, overall, under my proposal, corporate taxes would remain at least the same. That is, we're not

going to take anything away from the corporate sector, but we do want to get those rates lower, a more efficient tax system.

Scott Hodge: I was kind of tickled when an article you wrote titled "Tax Incentives and Economists," where you start out with a little thought experiment about what taxes might look like if government ran tax policy like the Fed runs monetary policy. Sort of getting the politics out of it. Tell us a little bit about this "social science fiction," as you call it.

Martin Sullivan: Well, now you're forcing me to confess something that I never tell anybody, which is that I'm not a trained tax economist. I did all of my early research in monetary policy, a lot of work in history of monetary policy. It's fascinating when you look at the difference between the way monetary and fiscal policies are run in this country. Early in the 20th century, legislators realized that monetary policy was too important to leave under the control of politicians. So Congress delegated a lot of discretion to the Federal Reserve. I think that it's fair to say that it's been a success, largely because politics -- particularly parochial politics -- have been kept out of that policy making. Now, meanwhile, in tax policy and fiscal policy, politicians feel they have the right and even the duty to meddle in every little aspect of the law.

In the article that you mentioned, I realize it's a fantasy, that I think we could do a little bit better if we could reconfigure our fiscal institutions in the US, so that Congress would get out of the business of picking winners and losers. It's a fantasy. I don't think it's going to happen soon.

Scott Hodge: Well, as we've all been in town long enough to watch how the sausage is made, it's not such a bad fantasy after all.

Martin Sullivan: Well, I think it's important to sometimes set high standards, and hope that maybe somebody will catch on to it sooner or later.

Scott Hodge: Well, you know that tax incentives is maybe not as big of an issue at the federal levels we're seeing now as at the state and local level where some economists, such as those the Fed bank of Minneapolis are calling it an "economic war between the states." They're smokestack chasing and offering all kinds of abatements and tax incentives, and so forth, to lure companies from one state to the next. Economists, of course, are always arguing against these types of things. But how do we reconcile the politics here and the economics? How do we convince the political class that these things are counterproductive?

Martin Sullivan: Well, Scott, you know the most basic instinct of any politician is to bring home the bacon for his constituents. And the biggest prize he can land is a job-creating new factory inside of his jurisdiction. And as long as states have that power, they'll be tempted to use it. As long as businesses are showered with these breaks, they're going to have to take them. But I think at some point businesses and state governments are going to realize that our way of doing things, competing with each other all the time is counterproductive. At some point, let's say the lawmakers in Georgia are going to realize, their real competitors aren't in Alabama, or South Carolina, but in Brazil and

China. So, we need not to compete with each state, to compete with each other, but look at producing a more efficient internal system.

Now, no state can act unilaterally. They must agree to some sort of truce, in this war between the states. Or perhaps more realistically, Congress can use its authority under the Commerce Clause, and force them, or threaten to force them. And I think that this debate, like so many, has been marred by extremes on both ends. I have a compromise between tax competition -- a proposal -- that straddles the line between tax competition and tax cooperation. Under this proposal states would all have the same common uniform corporate tax base. They would not longer get into the business of having special incentives, depreciation, or investment credits, and if they wanted to compete, they can compete purely by adjusting their tax rate or having no tax rate at all. This is something that the European Union is looking into. Again, we want to simplify the tax rules for business. We want to have the government, as much as possible, out of the business of picking winners and losers. But we still want that pressure, where the states do try to compete against each other, but just do it with the rate. I think that would be a good starting place for calming down the war between the states.

Scott Hodge: Well, it would certainly take a lot of the compliance cost and burden away from companies to not have to deal with 50 different systems, and have to bear that compliance burden.

Martin Sullivan: Yeah, I was at a conference a few weeks ago, where Joel Slemrod of the University of Michigan said that he did a survey of businesses, and he said that the number one compliance problem for corporations was complying with all 50 states' different tax laws. I think it really would be a major simplification, and I think it's up to business to maybe take the lead on that politically.

Scott Hodge: Well, Marty, thank you very much for spending some time with me, this has really been enjoyable, and fascinating. I hope that some of these ideas and facts get greater attention, because every day that we delay, it appears that we are going to continue to fall further and further behind these worldwide trends.

Martin Sullivan: Well, Scott, thank you very much for having me.

Scott Hodge: Terrific. Thanks so much.

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