INTERNATIONAL TAX POLICY. A CURRENT
VIEW FROM THE UNITED STATES

Good evening. And greetings from a distant and oddly troubled land. The title of my lecture is "International Tax Policy — a Current View From The United States." I must insist upon the "a" before "Current View." That view, and the opinions I will express today, may not be widely shared among my compatriots.

I also want to emphasize that my focus is tax policy. Some of my comments might be seen as having a wider application. I speak to you today, however, as an observer, a teacher, and a sometime formulator of tax policy in general, and international tax policy in particular.

As I am sure everyone here knows, the United States is an exceptional country. It is the most powerful country in the world. Its economy is the largest, and the best. Its political system is the soundest. It is the richest country, the wisest, the most just. Its disposition is the sunniest. Its food is the tastiest, its women the most beautiful.

Actually, I think I will leave those last couple of topics for another day.

Naturally, the United States leads the world in a subject as important as tax policy. So naturally, its approach to tax policy, both in substance and in process, should be of keen interest everywhere.

I concede that my country's triumphant march through modern history has hit a few speed bumps in recent years. The U.S. system of government is not operating in quite the way we were taught in school. It is beset by ideological strife, confrontational tactics, soft- and some hard-core corruption. The U.S. educational system has ceased to produce an educated public. Much of the country worships at the altar of a dead movie actor who, as perhaps the first

U.S. President with Alzheimer's disease, taught the populace it could have whatever it wanted without paying for it. The so-called U.S. media are focused on binge episodes in the sports and entertainment worlds and scarcely pay attention to anything resembling news or information. (That's with a big thanks to you, Australia.) We revere hypocrisy, and appear to have made a national decision that the only things worth caring about are money, power, and celebrity.

Still, let us recall that the Dark Ages eventually gave way to the Renaissance. And let us therefore indulge the assumption that, after giving imbecility its run, a modicum of sense and proportion will eventually return. Decision-making will be made again by serious people. With that rose-colored future in mind, plus the advantage of thousands of miles of distance, I offer a few thoughts about U.S. international tax policy for a better day.

I begin by taking for granted that taxation is here to stay. (It is something of a statement in itself that we have to begin there, but we most definitely do.) Everyone wants government, even those who speak incessantly of shrinking it. Most of the folks who talk that talk are happy to enlarge government; they just operate on the assumption that the military is not government. We know today what a society truly without government looks like: it looks like Somalia, and really, who wants that? So we organize ourselves in units and expect those units to provide things we cannot efficiently provide on an individual basis.

This government thing costs money. We want public expenditures, and so we are going to need public revenue. (The common reference to tax-and-spend policies is off by 180 degrees; we live in a spend-and-tax world.) There are only a limited number of ways of obtaining the necessary revenue. We can borrow it. We can run a national lottery. We can inflate the currency. These strategies are all problematic, for all sorts of reasons. Taxation is more rational, and certainly more subject to control. So there will be taxation.

A tax system is the product of choices. Some of those choices reflect deliberate decisions to raise revenue in certain ways. Since raising revenue is the main purpose — some would say the only legitimate purpose — of a tax system, these choices are normal and to be expected. Some choices are less desirable, the collateral products of incentivizing or disincentivizing particular behavior. These are inefficient and often unfortunate because tax authorities are seldom experts on behavioral matters. When all the choices are strung together, they comprise a tax policy. It is obviously better for that policy to be thought out and coherent, rather than a jumble of uncoordinated provisions and rules.

Every country must find a way to adapt its basic tax policy — its decisions regarding the taxes to adopt, the tax base and taxpayers, rates — to international events: movements of people, assets, and income across borders. As in the case of tax policy generally, this adaptation may be thoughtful, developed, clearly expressed, explicit. Or it may be only barely articulated, identified only empirically. In some countries the adaptation is relegated to individual judgments of persons called upon to administer the laws. Those countries rely upon the sound discretion of their public servants and are curiously unconcerned about the threat of dishonesty or, what is more subtle, co-optation.

The United States has had for many years, dating to the inception of our income tax system in 1913, a fully articulated, extremely explicit tax policy in the form of written rules, interpretative guides, definitions — all spelled out in elaborate, if sometimes turgid, prose. (I pause here to note that, as a former literature student, I have occasionally thought about the prospects for a purely literary exegesis of the Internal Revenue Code; there must be at least one good doctoral dissertation lurking there.) The "Code Napoleon" approach of the United States is used for all aspects of its tax laws, including adaptation of its basic policy to the international realm. It may be a mad enterprise to endeavor to capture the totality of economic life in words, but that has been our way.

I am not so naïve as to believe that any country can adopt and pursue an intellectually pure tax policy, free from the overweening influence of politics. Yet the concept of a policy does imply a body of ideas intended for a purpose or purposes that can be described. Policy, in this sense, is distinct from politics, and more than a mere catalogue of rules.

In the years when U.S. tax policymakers could realistically consider themselves leaders in the field, when the United States was not so interested in mining the policies of other nations for assistance, decision-makers could consider broad ideas — how should the foreign investor be taxed? — and proceed to genuine, objective, debate about policy ideas and alternatives. Those years seem a distant memory. Recent policy is beholden to revenue estimates, revenue gained and revenue lost, and not to anything resembling ideas. Still, there are ideas, and they are worth discussing and evaluating.

International tax policy has two broad components — the treatment of foreign persons with respect to the domestic tax base and the treatment of non-foreign, or domestic, persons with respect to the foreign tax base. The principal and overriding policy issues, for the first component, are when to assert taxing jurisdiction over the foreign person and when to afford that person the same type of taxation, on a net basis and with deductions, as applies to a domestic person. Most countries use two different bases for income taxation of foreign persons, one focused on net income, with deductions, and the other employing a flat rate, with no deductions allowed. The lines between the two bases are sometimes ill defined and sometimes defined differently under treaties than under domestic law (putting aside the subtlety of different definitions under different treaties).

For the second component of international tax policy, the chief questions are whether and how to assert taxing jurisdiction over a worldwide tax base and what measures to adopt to mitigate international double taxation, given that other tax authorities may be expected to assert jurisdiction to tax that same base. Taxing a worldwide base requires information, including information found only abroad. There is little point in making a half-hearted effort here, because there are many ways for domestic taxpayers to contrive to defeat worldwide taxation. A country is either committed to worldwide taxation or it is not.

Both components of international tax policy must be forged with due regard to certain constraints. There is, of course, the import of anticipated economic consequences, and there are international norms, which are disregarded only at a certain peril. There is as well a need for transparency and administrability. As among the three great policy virtues of efficiency, fairness, and simplicity, my own vote has always gone to simplicity.

The international aspects of tax policy are, ultimately, similar to international aspects of other types of national law. The broad issues are which country has an accepted right to tax and, when there is more than one such country, the sequencing of those rights. Policy relating to inbound taxation must take into account that some other country is likely to see the tax base in question as subject to its outbound jurisdiction. Conversely, the concerns of any policy regarding outbound jurisdiction must reflect the fact that other countries will be asserting inbound jurisdiction. The policies thus turn on a conflict of laws, as opposed to the core tax policy questions of rates, exemptions, deductions, and credits. International tax policy is primarily a matter of jurisdiction.

Every country is a country of both inbound and outbound investment, to some extent, so every country must struggle with these questions. Few countries do so with the explicitness of, and in such statutory detail as, the United States.

International tax policies of the United States with respect to income taxation were formed in tax legislation of the 1960s — the Tax Reform Act of 1962 for outbound taxation and the Foreign Investors Tax Act of 1966 for inbound taxation. At a structural level, little in U.S. law has changed over the ensuing years. The inbound rules, in particular, have undergone almost no alteration because U.S. policy-makers have operated on the unstated but strongly held assumption that the United States is an outbound nation, a capital exporter. On the outbound side, the 1962 legislation evinced a concern not so much for the threat of double or multiple taxation as for the "how" of worldwide taxation. It has proved an inconvenient fact especially for outbound tax policy that general common law — and therefore U.S. — principles recognize the separateness of the shareholder from the corporate entity in which shares are owned. That is not so obvious a proposition as might appear; the limited liability afforded by the corporate form could have been granted without any such separation. A corporation is just a piece of paper, and it is easy for a shareholder to create many pieces of paper. If each of these pieces of paper is accepted as a separate actor under the tax laws, the possibilities for manipulating those laws by earning income in a non-taxable foreign entity are legion. This can be accomplished by creating and investing in a foreign entity, by relying on transfer pricing strategies to deflect income into such an entity, by transferring assets to such an entity, perhaps by other means. The 1962 Act addressed itself to some of these threats to the tax base. It remained largely intact over the next 49 years, though it has been under great strain from the outset as companies, legislators, and occasionally the media have advanced the proposition that U.S. multinational companies require relief from U.S. taxation of their foreign business income if they are to remain competitive and provide employment for constituents.

On the subject of competiveness, which is a more or less constant refrain in U.S. tax policy debates, I offer two, admittedly parenthetical, observations. First, it is often asserted that the U.S. tax system works to undermine the competitive strength of U.S.-based companies by requiring them to suffer the burden of taxation that companies based in other countries are not called upon to bear. The point is clearly true in some cases. Yet I note that similar complaints about the competitive impact of the extraordinarily high level of executive compensation in the United States never seem to be voiced. The costs of that compensation can easily equal or exceed tax costs.

Second, the U.S. tax system has indeed had something of an adverse effect on competitiveness of U.S.-based companies. My impression, however, is that this negative competitive effect stems not so much from taxation of foreign income as from the very substantial distraction that the system constitutes. By holding out a potential for sizable earnings improvements through games and gimmicks, the U.S. system has tended to divert management attention away from the quality of products and services offered by the core business. A management hooked on foreign tax credit generator transactions and the like may not be paying sufficient attention to the quality of the toothpaste being produced.

Over the years there have been important changes in technical aspects of U.S. tax policy including, of course, international tax policy. Starting, I would say, with the Tax Reform Act of 1969, U.S. tax laws became dramatically more detailed and complex. Compromises reached in the legislative process assumed the form of exceptions, exceptions to exceptions, targeted rules for particular taxpayers and industries, narrow transition rules. The role of special pleaders in the process of developing the tax laws — what we call lobbyists — became much more prominent. The United States enacted a series of remarkably complicated revisions of its tax laws — in 1976, 1981, 1982, 1984, 1986, 1997, 2001, 2004, and so on. The Internal Revenue Code became virtually incomprehensible to persons not living with it on a day-by-day basis, and even to many of those persons. It is hard today to identify a U.S. tax advisor who is a true generalist, a person knowledgeable generally about the Internal Revenue Code and not specialized in just a few of its sections or sub-sections. Administration of the law has become more difficult and, as a consequence, more random. The ability of those charged with making the laws to understand what they are doing, or the collateral consequences of what they are doing, has become severely impaired.

More or less at the same time, a common sense of purpose began to dissipate among the taxpaying public. The moral case for compliance with the tax laws weakened. This was an unfortunate, even sad, development because the United States has long been blessed with two assets of great importance in the field of taxation: a basically tax compliant public and a competent and generally honest tax administration. As a matter of tax history, neither asset has found its match elsewhere in the world. But the encrustations of complexity in U.S. law, the various attacks on government, the tax system, and tax administration that surprisingly took hold in the media and among the public, and the increasing aggressiveness, unmoored from any sense of the common good, of taxpayers and, worse, their professional advisors, came fully to the fore in the 1990s. These factors are even stronger today, with the result that general obedience to the mandate of U.S. tax law has lost much of its force, and respect for the Revenue Service has declined. Under the Clinton Administration we witnessed disgraceful legislative hearings in which the agency was held up to scorn by people on the federal payroll who should have known better while so-called national leaders stood by in craven silence.

As we speak today, after months of mindless debate about raising or not raising the debt ceiling, the U.S. political process is revealed as deeply dysfunctional. Taxation lies near the heart of that dysfunction. There is active debate about foolish tax policy ideas — amnesties, unprincipled deals for particular industries, emulating the worst aspects of other nations' tax systems while abjuring any component of those systems that might have a balancing effect. (When the United States begins to emulate Mr. Berlusconi in developing its ideas on tax policy, we are obviously in great distress.) Taxpayers, especially taxpayers in the business community, pay large sums to lobbyists and other consultants seeking to reduce, again and again, the revenues they are called upon to pay to the government, all the while urging a need for better infrastructure and other government spending. In short, a sense of national responsibility is lacking. Many persons who have followed tax policy for years know the cure — lower rates and abolition of many decades of special provisions — but the political will to move from the present situation to a simpler, more understandable, and more efficient system is just not there. That move would necessarily eliminate or reduce the benefits enjoyed by some persons and the voices of those persons, expressed by their representatives who daily flood the halls of Congress, are louder than the call of common sense.

What does all this mean for international income tax policy? From my point of view, appropriate U.S. developments today would include at least six elements, not necessarily in order of importance:

- First, revision of the rules applicable to inbound investment in recognition that 2011 presents vastly different circumstances for the United States than

1966; we need to accept the enormous size of foreign investment in the United States, and to develop modern and more sensible rules to deal with it; in particular, we need more effective rules to prevent the stripping of the tax base and clearer and more enforceable rules regarding the threshold for triggering net basis taxation;

- Second, adoption of targeted rules of exemption to replace the present foreign tax credit system; the system has become too complicated and top-heavy to apply and administer in a fair and even-handed way; we should rather go in the direction of exemption for business income in countries with real tax systems and a residual credit system for the remainder of the world;
- Third, distinctions should be made in both legislative and regulatory tax rules between tax havens and other low-tax jurisdictions, on the one hand, and countries with genuine tax systems, on the other; it is no longer appropriate to divide the world between "the United States" and "foreign"; we tie both hands behind our backs when we make and interpret rules on the assumption that Japan and the Cayman Islands are equivalents; in the case of low-tax income, we should require current inclusion and taxation regardless of how many tiers of foreign corporations are interposed between the U.S. taxpayer and that income;
- Fourth, curtailment of the "arm's-length method" as a means of policing transfer pricing in favor of presumptions, safe harbors, and other resource-conserving rules of rough justice; the arm's-length method is revealed

today as a product of superficial thinking; the United States is well on the way toward abandoning it but refuses to admit that;

- Fifth integration of the U.S. tax treaty network and process into overall policy goals; it is ridiculous for the Executive and Legislative branches of government to view treaties as a battleground on which they can compete for the development of business-friendly provisions; the vastly different language and references in the two sources of governing law serve to produce confusion, error, and untaxed income;
- Finally, and most crucially, ensuring that the Internal Revenue Service has the resources to do its job properly; the agency has been starved for funds for many years and is only barely able to function in today's globalized world, while Congress throws more assignments in its direction with every passing year.

Each item on this list can, of course, be debated and refined by persons aiming to achieve an efficient, fair, relatively simple tax system. I make no claim to being "right" on every point, or even on most of them. But this I know: each of these items has been the subject of altogether too much "study" and debate. I do not propose now, or possibly ever again, to prolong that agony. Within broad parameters, what needs to be done is clear. A usable product could be developed by a representative group of sensible people in approximately one week. The answers here are not so hard to identify, not so impossible to put in words. The absence of ideas is not a problem. The real problem is that persons whose ox might be scratched, let alone gored, by revisions of the present rules are in firm command of the process whereby revisions are made.

So much for substance. What about process? The situation there is discussed less frequently, and is perhaps less clear.

Tax policy in the United States falls and always will fall within the purview of established processes whereby the country makes and changes its laws generally. In my experience, those processes are poorly understood abroad and even, to some extent, within the United States. We operate with three co-equal branches of government — executive, legislative, and judicial. Unlike the parliamentary system used in much of the rest of the world, the U.S. system does not view proposals of the executive as a short step from enactment into law. Executive branch proposals are, in the best of circumstances, in the nature of starting points for discussion. (In the worst of circumstances, they are ignored.) The legislative process involves two separate and very different houses of Congress, the Senate and the House of Representatives. Especially in the area of tax law, what emerges from that process is never identical, and generally not even similar, to the proposals that enter it.

None of this is going to be altered. Our domestic system of law-making was designed to make change difficult. The United States opted early for an inefficient government system, involving multiple independent actors with invariably conflicting views. We are loathe to accord greater power and authority to any one institution or branch of government.

Still, there is room for improvement, especially in how the executive branch goes about its business.

I think the development of international tax policy can be improved, and that the United States especially could reap great benefit from any such improvement. The institutions that are central to international tax policy-making — the Organisation for Economic Development, the United Nations, to some extent the International Monetary Fund and The

World Bank —have all done commendable work. However, the development of other institutional support might bolster U.S. policy-making in immediate and specific ways.

The United States should explore the possibility of establishing affiliations with small groups of other countries that broadly share its concerns and views regarding international tax policy. These affiliations or alliances might be regional or they might be organized according to subject. They might involve regular contact in the form of scheduled meetings, or they might involve looser and more *ad hoc* connections. All that is detail. It seems undesirable, however, for the United States to proceed in this crucial field entirely on its own or to look exclusively to existing institutions for support and assistance in advancing its policy goals. Those institutions are either too political, too tangentially concerned with international taxation, or too riven by policy differences among members. What is needed are smaller associations where ideas of common concern can be debated and, it is to be hoped, mutually agreed and accepted.

I take inspiration here from the concept of "restraint of trade." Long experience teaches that businesses prefer agreement to competition. The lure of agreement is why governments adopt anti-trust legislation and also why that legislation is, at best, only partially successful. Far more appealing for potential competitors to agree on price, divide up markets, and accommodate each other than to go toe to toe in raising capital and marketing products and services. Agreement makes for a quiet life.

Governments have a product, and governments are most definitely in competition. They compete to attract capital, to bolster home-grown industries, to support currencies. One of the means by which they compete is the tax laws. We have seen much evidence in recent years of governments granting special dispensations — tax holidays, amnesties, tax subsidies — for the purpose of competing more aggressively to attract business attention and investment. For at least the past two decades, there has been an ongoing competition through lowering income tax rates, especially the corporate tax rate, providing incentives designed to influence business behavior, and otherwise actively employing tax laws as a marketing tool.

This results in what is sometimes referred to as a race to the bottom, an appropriate term. It encourages favored addressees to cast around the world for provisions found in the laws of some countries but not others. The argument can then be made that countries lacking those provisions are undermining competitiveness, and losing whatever contest is being waged, because the other countries are more generous.

This is not healthy. Governments should think about acting more like businesses. They should recognize the appeal of restraint of trade, when that trade is the commerce in ever greater tax benefits. To that end I suggest steps toward a modest cartelization of government industry, ongoing communications among governments facing similar issues and problems that might provide a bulwark against ceaseless tax competition. I am referring not to “harmful” tax competition, a term of the OECD. I am referring to tax competition, period. Affiliations among like-minded governments for the purpose of developing tax policy strikes me as one way to forestall the sort of race to the bottom that developed countries have embarked upon and that could end up bankrupting them all.

Specific topics to be addressed in such like-minded groups might usefully include transfer pricing, efficient mechanisms for exchanging information, anti-abuse measures, international tax arbitrage, standardization of source rules. The list could go on.

The multi-lateral institutions that now concern themselves with international tax policy cannot serve the purpose I have in mind. They are too unwieldy to permit useful discussion of technical subjects. Agreement on all but the most general and anodyne of points is beyond their reach. Policy pronouncements accompanied by reservations, exceptions, and individual country qualifications have their uses, but what is truly needed is the ability to develop policy within a small group or groups of similarly minded countries.

Such discussions might permit the United States and other countries to address problems of tax evasion and avoidance far more effectively than any of them could on its own. They would avoid the necessity of accommodating the interests of countries with different interests and very different views.

Again, my naiveté may be showing. There will, of course, be politics both within individual countries and in the commerce of ideas among them. Nevertheless, the countries I have in mind face strikingly similar problems and issues. It is very much in their interest to cooperate, in the name of preserving their tax bases and implementing sensible international tax policies. To understand the dynamics in the area of international taxation, consider a three-legged stool, with governments represented by two of the legs and the taxpayer by the third. It is always in the interest of any two of those legs to make common cause against the third. For the sake of governments, better that the governmental legs seize the initiative.

The suggestion of a loose, and non-binding, group or groups of similarly situated countries seems practical and feasible. Fiscal sovereignty would in no way be surrendered. Costs would be minimal. Even if such a group determined to maintain a staff, like the Joint International Tax Shelter Information Centre (involving the United States, the United Kingdom, Australia, Canada, and Japan), that staff could be lean. Its function would be to perform research and provide support on technical subjects and perhaps to serve as liaison with the OECD and the United Nations.

Countries participating in such a group would be under no compulsion to adhere to group findings or recommendations. However, it is conceivable, at least, that those findings and recommendations would carry a weight beyond anything achievable by ideas of a purely domestic genesis within any given country. Recommendations enjoying broad support among a group of countries perceived as peers might go some distance toward counteracting domestic political and lobbying pressure. Certainly the dynamics of the domestic political process might change if it could be credibly represented that other, potentially competing, countries are contemplating a similar policy course.

In a sense this suggestion runs counter to movements witnessed in recent years among the established institutions. They have adopted a goal of ever greater inclusivity, broadening their memberships, seeking more and wider viewpoints. That is all well and good, but the by-product tends to be an unwillingness to promote or even discuss views and policies that may run counter to the interests of any member of these institutions. The United States has definable tax policy interests, including international tax policy interests. Those interests would be served, in a highly globalized world, by greater communication with counterparts. If a next step is to bring policy agreements and recommendations to a wider audience, it would be perfectly possible to foresee presentations to appropriate units of the larger institutions.

In sum, a current view of international tax policy from the United States is not a pretty picture. The processes of the United States for calm and rational discussion of these matters seem badly and sadly broken. The substantive rules in place are out of date, wooden, and in need of resuscitation. The United States can no longer claim the mantle of intellectual leadership in this important, if little understood, policy area. I wish I could be more sanguine but, as someone who knew the U.S. tax policy process, and particularly the U.S. international tax policy process, when it stood for excellence and provided leadership, I do not regard the present moment as a time for national optimism.