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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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DO LAWYERS NEED ECONOMISTS?

Review of Katja Langenbucher, Economic Transplants: On Lawmaking for Corporations and Capital Markets (Cambridge U. Press, 2017)

Reuven Avi-Yonah
The University of Michigan

Katja Langenbucher's outstanding book seeks to address the question of why and in what ways have lawyers been importing economic theories into a legal environment, and how has this shaped scholarly research, judicial and legislative work? Since the financial crisis, corporate or capital markets law has been the focus of attention by academia and media. Formal modelling has been used to describe how capital markets work and, later, has been criticized for its abstract assumptions. Empirical legal studies and regulatory impact assessments offered different ways forward. This excellent book presents a new approach to the risks and benefits of interdisciplinary policy work. The benefits economic theory brings for reliable and tested lawmaking are contrasted with important challenges including the significant differences of research methodology, leading to misunderstandings and problems of efficient implementation of economic theory's findings into the legal world. Katja Langenbucher's innovative research scrutinizes the potential of economic theory to European legislators faced with a lack of democratic accountability.

I would like to address the question whether economic theory and modeling are useful for lawyers by focusing on another field, tax law, where economists have been very influential. Many US law schools now have economists with no law degree teaching tax law, and several of the leading younger tax law professors at top schools have economics PhDs as well as JDs.

However, I have some doubts whether economic theory is really useful for tax law (as opposed to empirical research, where lawyers can learn from econometric analyses of data). Let me give one example. The US until 2017 has always taxed US persons (both corporations and individuals) on their worldwide income "from whatever source derived", as permitted by the US Constitution (Amendment XVI), because that was the best measure of ability to pay. But a problem arose in the 1930s because rich US individuals would transfer their foreign source income to "incorporated pocketbooks", i.e., shell corporations that they controlled in tax havens. For example, Colonel Jacob Schick, who invented the electric razor in the army, transferred his patent to a shell in the Bahamas, then gave up his US citizenship in 1935 and moved to Canada to live out his retirement (he died in 1937).

Congress responded by enacting the "foreign personal holding corporation" regime that taxed individual US shareholders in foreign corporations they controlled if over 60% of the corporations' income was passive (dividends, interest, capital gains or royalties). There was no economic theory involved: It was a pure question of fairness, since it was considered unfair for

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rich people not to pay tax on such mobile income while domestic wage earners were taxed at rates as high as 94%.

In the 1960s, the Kennedy Administration decided to apply a similar regime to the income of foreign corporations controlled by US corporate parents- i.e., to "controlled foreign corporations" or CFCs. However, this time the rationale given was not fairness (despite the unfairness of taxing domestic corporations but not CFCs) but rather "capital export neutrality" (CEN), an economic theory invented by Peggy Musgrave in the 1950s. Stanley Surrey, who was the first Assistant Secretary of the Treasury for Tax Policy, liked working with economists and was a close friend of Richard Musgrave, his Harvard colleague and Peggy's husband. Surrey decided invoking CEN was a more "scientific" justification than fairness, although in general he cared deeply about fairness in the tax code.[1]

CEN stood for the idea that it is inefficient not to tax CFCs because that violated "export neutrality" by creating an incentive to invest overseas rather than in the US.[2] Until the 1990s, it was the guiding principle of US international taxation.[3] But in the 1990s, the multinationals wanted to reduce their taxes on foreign source income, and they got the economists to come up with a counter theory, capital ownership neutrality (CON), which argued that it is inefficient to impose tax on foreign source income of US CFCs if foreign countries do not do the same.[4] As Willard Taylor (a very experienced tax lawyer) has argued, CON is just a fancy name for competitiveness.[5] But CON was successful in giving cover to Congress to ultimately (in 2017) abolish the tax on CFCs even when their income was repatriated to their US parents- a blatant deviation from the "from whatever source derived" rule.

In my opinion, the ultimate blame rests on Surrey, because it was completely unnecessary to bring the economic concepts into play- the tax on CFCs could be fully justified on fairness grounds. It is unfair to tax a domestic corporation in full and a US corporation operating

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[1] On Surrey and horizontal equity see Avi-Yonah, Reuven S. and Fishbien, Nir and Mazzoni, Gianluca, Stanley Surrey, the Code and the Regime (July 4, 2019). U of Michigan Public Law Research Paper No. 652. Available at SSRN: https://ssrn.com/abstract=3414965 or http://dx.doi.org/10.2139/ssrn.3414965.

[2] STAFF OF THE HOUSE COMM. ON WAYS AND MEANS, 90TH CONG., 1 LEGISLATIVE HISTORY OF H.R. 10650, 87TH CONG., THE REVENUE ACT OF 1962, at 126 (Comm. Print 1967) (Statement by Hon. Douglas Dillon, Secretary of the Treasury, Before the Committee on Ways and Means of the House of Representatives, on the President's Message on Taxation, May 3, 1961): "Either we tax the foreign income of U.S. companies at U.S. tax rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad."

[3] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study, Office of Tax Policy, Department of the Treasury (December 2000).

[4] Desai, Mihir A. and Hines, James R. Jr. (2003), Evaluating International Tax Reform, *National Tax Journal*, **56**:3, pp. 487-502.

[5] Willard Taylor, What's 'Neutral' About This? *Tax Notes Int'l*, May 30, 2011, p. 715.

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through a CFC at zero. It is also dangerous not to tax income of CFCs because of the opportunities to shift income to them from the US, as clearly evidenced by the $3 trillion amassed by US multinationals in low-tax jurisdictions between 2005 and 2017.

But there is light at the end of the tunnel: As Langenbucher also shows, after the financial crisis, the influence of economic modes in law has diminished. In addition, many contemporary economists follow the lead of Thomas Piketty in advocating higher taxes on the rich and on large corporations.[1] I would, however, argue that lawyers need to be careful before relying even on these economic models, because they do not want to follow Surrey in granting too much power to the economists.

[11]See, e.g., Emmanuel Saez and Gabriel Zucman, *The Triumph of Injustice: How the Rich Dodge Taxes and How to Make Them Pay* (2019).

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