CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

February 15, 2013

Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This letter responds to concerns you raised about the Congressional Budget Office's (CBO's) report *Options for Taxing U.S. Multinational Corporations*, which was released on January 8, 2013. We continue to believe that it presents the key issues fairly and objectively and that its findings are well grounded in economic theory and are consistent with empirical studies in this area. Nevertheless, because of the complexity of the subject and the diverse views of experts in the field, we agree that it would have been desirable to seek comments from more outside reviewers. It is always our goal to seek outside reviewers for CBO studies who represent a broad range of views and perspectives.

Following is a discussion of the various issues you raised regarding the report.

External Review

You expressed concern about the process through which the report was subject to outside peer review. To ensure that its analyses are objective, analytically sound, and clearly presented, CBO engages in rigorous internal review of all of its analyses and draws on the knowledge and insights of outside specialists with a variety of perspectives and from a variety of disciplines.[1] Those external reviewers are selected for their technical expertise—not for their viewpoints on particular subjects. Although their comments are helpful to CBO in ensuring the accuracy, clarity, and objectivity of material in its reports, the agency is not bound by them and takes full responsibility for the final product.

Because the taxation of multinational corporations is a particularly complicated issue, CBO chose two external reviewers from very different backgrounds: Dr. Kimberly Clausing, the Thurmond A. Miller and Walter Mintz Professor of Economics at Reed College, who was asked to review the economic analysis, and Professor Steven Shay of Harvard Law School, who was asked to review the

[1] For additional information, see Congressional Budget Office, "Our Processes," www.cbo.gov/about/our-processes.

accuracy of the discussion of tax law. Both reviewers provided useful comments and advice on a draft of the report that they received in February 2012.

Dr. Clausing has conducted extensive empirical research on international tax policy, much of it focused on the movements of investment and profits between countries—which is central to the report. With Dr. Reuven Avi-Yonah, she is the coauthor of several papers that developed and analyzed options for formula apportionment, which is an approach that would exempt a share of worldwide income earned by U.S. multinationals from U.S. taxation and thereby move the United States closer to a territorial tax system (see page 23 of the CBO report).

Professor Shay is a well-known and respected international tax lawyer with experience both in government and in the private sector. From 1982 to 1987, he served in the Office of International Tax Counsel—part of that time as International Tax Counsel—in the Office of Tax Policy in the Department of the Treasury. During the next two decades, he was a partner with the law firm Ropes & Gray. Professor Shay rejoined the Treasury Department in 2009 as the Deputy Assistant Secretary for International Tax Affairs. Since 2011, he has been a professor at the Harvard Law School.

Given the complexity of the topic and the diversity of views among experts in the field, however, we agree that we could have benefited from review of the report by additional external readers.

Citations in the Report

You also raised concerns about the academic citations in the report, particularly references to work by Dr. Clausing and Professor Edward Kleinbard. CBO's analysts are specialists who keep up with emerging research. In preparing reports, they carefully review a broad array of academic papers and government publications on the topic at hand. For this report, the author reviewed numerous research articles and papers, focusing on those that presented empirical analysis of the response by firms to the tax treatment of foreign source income, without regard to whether the authors favored or opposed a particular type of tax system. CBO's reports, however, do not explicitly reference every study that an analyst reads, nor do most of them contain bibliographies. Instead, CBO generally uses footnotes to cite references for facts or empirical research discussed in a report and to give readers additional information about analytical methods or background information about points made in the text. The report on the taxation of multinational firms follows that approach; even so, it references more than 30 different academic papers and government publications.

Six footnotes in the report cite work by Dr. Clausing, whose research is cited more often than that of anyone else in the report; indeed, she was selected as a reviewer in part because of her record of publishing on relevant issues. Nearly all of the citations to Dr. Clausing's work were to studies that had appeared in peer-reviewed academic journals. Half of them, moreover, refer to one study, "Multinational Firm Tax Avoidance and Tax Policy," published in the *National Tax Journal.*[2] That article

[2] Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4 (December 2009), pp. 703–725.

contains the most recent and most comprehensive review of the evidence on firms' investment and profit-shifting responses, including Dr. Clausing's own analysis of the data. In two footnotes, CBO's report cites the chief finding from Dr. Clausing's study—that firms appear to be more likely to move reported income than to move real investment in order to reduce their tax liabilities. A third footnote refers readers to the study to learn more about the methodology used to derive its findings.

An article by Professor Kleinbard (former chief of staff for the Joint Committee on Taxation) was cited once in the report (on page 5) to support this statement: "Other provisions and regulations [of the U.S. tax system] … also contribute to a partially territorial system."[3] That statement is a common characterization of the U.S. tax system, and similar statements can be found throughout the literature. (See, for example, a 2010 Tax Foundation publication, which states, "The U.S. system for taxing foreign earnings blends aspects of both a worldwide and territorial system.")[4]

In addition, you inquired about the source for this statement on page 22 of the report: "In general, countries with territorial (or exemption) tax systems collect less revenue, all else being equal, than they would with worldwide tax system." The source was an article by Dr. Clausing, "Corporate Tax Revenues in OECD Countries," published in *International Tax and Public Finance* (vol. 14, no. 2, April 2007, pp. 115–133); that reference should have appeared in footnote 41, rather than footnote 42.

Scope of the Report

In addition, you questioned how CBO described the rationale for taxation of multinational corporations and assessed the consequences of such taxation. Many criteria could be applied to evaluate current law regarding the tax treatment of U.S. multinational corporations and policy options for changing that treatment. One set of criteria concerns how well the tax system conforms to different concepts of neutrality, such as capital export neutrality, capital import neutrality, national neutrality, and capital ownership neutrality.[5] But despite the fact that the relative importance of each type of neutrality is a topic of considerable academic debate, as a practical matter, it is difficult to draw tight links between the various neutrality concepts and economic outcomes that are in the nation's best interests. Therefore, we do not view those concepts as a particularly useful guide for policy analysis.

A second set of evaluative criteria involves the effects of the tax treatment of multinational corporations on firms' behavior. In its report, CBO focused on two types of behavioral responses for which, in the agency's judgment, there is fairly clear empirical evidence of economically meaningful effects of the tax treatment of multinational corporations: The first is the choice between investing in the United

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[3] Edward Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes* (September 5, 2011), pp. 1021–1042.

[4] Robert Carroll, *The Importance of Tax Deferral and a Lower Corporate Tax Rate*, Tax Foundation Special Report 174 (February 2010), p. 2, http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr174.pdf

[5] For definitions of those terms, see U.S. Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007, p. 56.

States or in another country, and the second concerns the choice between reporting profits in the United States or in another country. There is a growing body of evidence from academic studies that there has been a substantial increase in recent years in profit shifting between countries and that firms appear to be more likely to shift reported profits than to move physical investments. Those behavioral responses to the tax system also have significant consequences for federal revenues—the third criterion addressed in the report.

The behavioral responses examined in the report have implications for the allocation of resources to their most productive uses, a standard economic definition of efficiency. To the extent that taxes influence firms' decisions regarding the location of investment, those decisions may lead to the misallocation of resources away from activities that would be more productive, thus reducing efficiency. And to the extent that firms use resources to find ways to reduce U.S. taxation, those resources are diverted from more productive uses as well.

A number of other considerations can affect choices about the taxation of multinational corporations—for example, the effects of such taxation on the competitiveness of U.S. multinational corporations, on repatriation decisions, on the complexity of administering and complying with tax rules, on the location of headquarters of multinational corporations, and on the portfolio adjustments those corporations make. All of those issues are potentially important, and it was not the intent of the report to suggest otherwise. However, those issues were not featured in the report because CBO found only limited empirical evidence to date regarding the effect of the taxation of multinational corporations on overall economic outcomes through those channels.

Choice of Policy Options

You also expressed concern about CBO's selection of policy options to analyze in the report. CBO recognizes that there have been many specific proposals (including your own) that would move the U.S. tax system closer to a territorial approach and that there are other proposals that would take the opposite approach of moving further toward a worldwide tax system. Rather than scrutinize those specific and often complex proposals, the agency chose to analyze very broad options that would highlight the major issues raised by those two approaches. Each of those broad options had previously been described in past biennial CBO reports on budget options—including the most recent volume, *Reducing the Deficit: Spending and Revenue Options* (March 2011), which included the revenue estimates by the staff of the Joint Committee on Taxation that are cited in the report on multinational corporations.

In addition to the two broad approaches, the report discusses seven other policy options. Three of those were substantial variations of the broad approaches. The remaining four options were chosen to illustrate ways to reduce incentives for income shifting under the current tax system, but not fundamentally to move closer to either a territorial or a worldwide tax system. Two of those four options—one that would determine foreign tax credits on a pooling basis and another that would defer interest deductions related to deferred income—were drawn from the President's budget. Because the staff of the Joint Committee on Taxation regularly estimates the effects of the President's budgetary proposals on revenues, estimates of the savings attributable to those proposals were available to be included in the report.

Requests for CBO Reports

You also questioned how CBO determines what reports to prepare. CBO's chief responsibility under the Congressional Budget and Impoundment Control Act of 1974 is to assist the House and Senate Budget Committees with matters under their jurisdiction. CBO also supports other Congressional committees and the Congressional leadership.

Some of the reports the agency produces are specified in statute, of which the best known is the annual report *The Budget and Economic Outlook*. Other publications are required by law or have become regular products of the agency because of high and sustained interest of the Congress (a list of such publications is available at www.cbo.gov/about/our-products). CBO also is required by law to produce a formal cost estimate for nearly every bill that is approved by a full committee of either House.

In addition to regular reports and cost estimates, CBO prepares analytical reports at the request of the Congressional leadership or the Chairmen or Ranking Members of committees or subcommittees. Such reports, which cover a wide range of budgetary and economic issues, are an important aspect of the agency's work for the Congress. CBO's analysts consult with leadership and committee staff to identify the types of analysis that would be most useful to the Congress, recognizing the analytic resources that CBO can bring to bear in a given subject area. In this instance, the request came from the then-Chairman of the Senate Budget Committee after discussions between CBO analysts and the Budget Committee staff.

I hope that you find this information helpful. If you have any further questions, please contact me or my staff. The primary staff contact is Jennifer Gravelle.

Sincerely,

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

cc: Honorable Sander Levin
Ranking Member

Honorable Max Baucus
Chairman, Senate Finance Committee

Honorable Orrin G. Hatch
Ranking Member, Senate Finance Committee

Honorable Paul Ryan
Chairman, House Budget Committee

Honorable Chris Van Hollen
Ranking Member, House Budget Committee

Honorable Patty Murray
Chairman, Senate Budget Committee

Honorable Jeff Sessions
Ranking Member, Senate Budget Committee

Honorable John Boehner
Speaker of the House

Honorable Eric Cantor
House Majority Leader

Honorable Kevin McCarthy
House Majority Whip

Honorable Cathy McMorris Rodgers

Honorable Greg Walden

Honorable James Lankford

Honorable Lynn Jenkins

Honorable Virginia Foxx

Honorable Steve Southerland

Honorable Ann Wagner

Honorable Pete Sessions

Honorable Peter Roskam