Fiscal Stimulus: Missing the Big Picture?

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The Bush Administration and Congress are reportedly crafting a fiscal stimulus plan to boost the economy after recent signs of economic weakness.[1] This means either short-term tax cuts or rebates or an increase in government spending. The specific proposals that have surfaced on the spending side include increasing unemployment insurance or food stamps, while on the tax side they include bonus depreciation (i.e., faster write-off of investment), a tax rebate or credit, or a payroll tax holiday.

All of these policies are intended to address the potential economic weakness by putting more money into the economy in the near term, but they do little to address issues that face the U.S. economy over the longer term. Rather than debate short-term policies that are likely to be ill-timed and ineffectual, policymakers ought to address broader issues, such as the competitiveness of the U.S. business tax system, to improve the nation's longer-term economic health.

Unless fiscal stimulus is well-timed and well-crafted, it is doubtful that it would be effective for addressing the economy's current woes. Disagreement over the "best" approach usually translates into an actual stimulus package that is enacted long after it might have been useful. Moreover, stimulus packages often become bloated with profligate spending and tax provisions, which may be needed to move a package through the political process but do little to address the economic weakness.

Monetary policy is typically viewed by economists as the better approach for providing short-run stimulus. The Federal Reserve Board can act quickly, lowering the federal funds rate to provide broad support to the economy without propping up one particular sector. Indeed, fiscal stimulus enacted by the Congress is likely to be taken into account by the

Federal Reserve Board as it adjusts monetary policy to changing economic conditions and may well result in less-aggressive interest rate reductions than would otherwise occur.

The recent focus on near-term fiscal stimulus also takes the focus away from the broader challenges faced by our economy. A more fundamental problem, for example, is a U.S. business tax system that is increasingly outdated and is causing the United States to lose ground against its major competitors. A decade and a half ago the United States was a low-tax rate country, but with the decline in corporate tax rates among its major trading partners, the United States has now become a high-tax rate country. Among OECD member nations, the United States now has the second highest statutory corporate tax rate (see Table 1). Moreover, the United States continues to fall further behind as other countries like Germany, France, Italy and the United Kingdom plan or seriously consider further rate cuts.

The emphasis on business taxation by our major trading partners coincides with recent research that draws a firm link between business taxes and wages. In particular, this research suggests that lower corporate tax rates translate into higher wages. The reasoning is that lower corporate rates allow countries to attract more capital investment. Greater capital formation boosts labor productivity, ultimately raising the standard of living. One study by Kevin Hassett and Aparna Mathur (2006) reports that raising the corporate tax rate by one percent results in a 0.8 percent decrease in manufacturing wages.[2]

Table 1
Statutory Corporate Income Tax Rates for OECD Countries
Calendar Year 2007

Country	**Statutory Corporate Income Tax Rate**
Australia	30.0%
Austria	25.0%
Belgium	33.99%
Canada	36.1%
Czech Republic	24.0%
Denmark	25.0%
Finland	26.0%
France	34.4%
Germany	38.9%
Greece	25.0%
Hungary	20.0%
Iceland	18.0%
Ireland	12.5%
Italy	33.0%
Japan	39.54%
Korea	27.5%
Luxembourg	30.4%

Mexico	28.0%
Netherlands	25.5%
New Zealand	33.0%
Norway	28.0%
Poland	19.0%
Portugal	26.5%
Slovak Republic	19.0%
Spain	32.5%
Sweden	28.0%
Switzerland	21.32%
Turkey	20.0%
United Kingdom	30.0%
United States	**39.3%**
Average (Unweighted)	**27.6%**
Source: Organisation for Economic Co-operation and Development, http://www.oecd.org/dataoecd/26/56/33717459.xls.	

The recent trends abroad may also signal a recognition that among the various ways for the government to raise revenue, business taxes are very costly per dollar of revenue raised. They distort a variety of economic decisions whereby resources get allocated based in part on tax considerations rather than on economic merit. For example, high business taxes discourage investment, resulting in lower capital formation. They also discourage investment in the corporate sector, resulting in underutilization of the corporate form; discourage equity-over-debt finance, resulting in too much leverage; and discourage the dividend payments; possibly resulting in poor signaling to investors of a company's financial health. All of these distortions allocate resources away from their most productive use and ultimately reduce living standards.

The Treasury Department recently released a report that laid out broad approaches for reform of the business tax system.[3] One approach was lowering the business tax rate, one was allowing faster write-off of business investment, and, finally and more fundamentally, one would completely replace current business income taxes with a business activities tax (a type of value-added/consumption tax). While there are pros and cons associated with each approach, virtually all of the approaches would increase economic output and living standards in the long run (see Table 2).

Table 2 Increase in U.S. Long-Run Economic Output Under Revenue-Neutral Business Tax Reforms	
Reform	**Increase in Long-Run Output**
Lower corporate tax rate to 31%, eliminate special business tax provisions, but retain accelerated depreciation	0.5%
Lower corporate tax rate to 28%, eliminate special business tax provisions, including accelerated depreciation	negligible
Allow 35% expensing of all business investment coupled with elimination of special business tax provisions	1.5%
Replace corporate tax with a business activities tax	2.0% to 2.5%
Source: U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007.	

An important issue for the U.S. is the risk of inaction—that is, of falling further behind. Not only might an unfavorable investment climate make it harder for the U.S. to attract investment, a key ingredient for higher living standards, but it might also slow the pace of technological innovation in the United States. The incorporation of new technologies in production often occurs through new investment whereby the new, more productive technologies are brought directly into the production process. Less capital formation due to an investment climate that is not keeping pace with other nations means that new technologies might not be integrated as quickly and as intensively as in other nations, which could have detrimental effects on labor productivity and living standards in the longer term.

Notes

1. Sheryl Gay Stolberg and David M. Herszenhorn, "Bush Admits Economy Faces Challenges," *The New York Times* (1/08/08); Michael Phillips, "Bush Looks to Reprise Tax-Relief," *The Wall Street Journal* (1/8/08).

2. Kevin Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute for Public Policy Research, Working Paper Number 128, June 2006.

3. U.S. Department of the Treasury, Approaches to Reform the U.S. Business Tax System for the 21st Century, December 20, 2007.

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