

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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*CAN TAX POLICY IMPROVE ECONOMIC
COMPETITIVENESS?*

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Abstract. Perspectives on international competitiveness differ, so it's not surprising that tax proposals for improving competitiveness vary also. But economics is famous for being "the dismal science," and its reputation is well-deserved in this case: regardless of how competitiveness is defined, economic analysis suggests that most tax measures can do little to enhance it. Indeed, many of the tax provisions designed to improve U.S. performance in the world economy could actually reduce U.S. economic welfare.

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Can Tax Policy Improve Economic Competitiveness?

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Summary

Perspectives on international competitiveness differ, so it's not surprising that tax proposals for improving competitiveness vary also. But economics is famous for being "the dismal science," and its reputation is well-deserved in this case: regardless of how competitiveness is defined, economic analysis suggests that most tax measures can do little to enhance it. Indeed, many of the tax provisions designed to improve U.S. performance in the world economy could actually reduce U.S. economic welfare. This report will not be updated.

The Firm-level Perspective. The effects of foreign competition are probably most visible and are doubtless felt most directly at the individual-firm level. For example, imagine the case of a U.S. manufacturing corporation whose market share is rapidly shrinking because of competition from low-priced imports. The company's owners, managers, and employees probably define competitiveness as their ability to withstand the threat of foreign competition. And if asked, they would probably recommend some sort of tax benefit targeted at their industry: measures such as favorable depreciation rules for the types of machines the industry uses; or tax credits for consumers who buy the industry's product. Indeed, economic analysis predicts that such measures might well improve the position of the U.S. companies in the targeted industry: their costs would fall because their taxes have, introducing the possibility of reduced prices, larger market shares, and more jobs.

But here is one place that economic theory earns its sobriquet: it predicts that the effects of a targeted tax benefit will ripple through the economy and ultimately confound the policy's competitiveness goals. The reason is this: because the Nation's resources are limited, a narrowly available tax benefit will, to a large extent, simply reshuffle the way in which the Nation's limited resources are employed. Resources that taxes draw into the favored sector of the economy must be pulled out of some other use. And while exports in the favored industry may rise (or competing imports fall), exports in other sectors of the economy will fall. While jobs may be saved (or even grow) in the targeted sector, they probably will ultimately be lost elsewhere.

Economic theory goes even further. Not only are targeted tax benefits of limited use when the whole economy is considered; they also reduce the Nation's economic welfare in a number of ways. First, economics predicts that with few exceptions, the interference of taxes in how the economy's resources are deployed diminish the Nation's economic vitality: market forces, not tax rules, are usually the best way to guarantee that resources are used efficiently. For example, a tax benefit for the company in the preceding example might boost that company's output. But that increased output would be produced by resources diverted from sectors of the economy where they were more productive. Second, if some or all of the tax benefit is passed on to foreign consumers in the form of lower prices for U.S. goods, the United States registers a worsening of its "terms of trade": it obtains fewer foreign goods for the American products it sells.

The National Level. Moving beyond the individual-firm level, policymakers and others may have a different perspective and view competitiveness as the international performance of the economy as a whole. From this vantage point, a more widely-available tax benefit may seem more promising than a narrowly-targeted tax incentive. For example, it is sometimes argued that U.S. firms in general have a higher cost of capital than do competing companies from Japan and other developed countries. U.S. businesses, it is argued, must pay more for the use of investment funds than foreign firms -- perhaps because of the relatively low U.S. savings rate. Tax incentives for saving and investment -- measures such as a tax cut for capital gains, expanded Individual Retirement Accounts (IRAs), and investment tax credits -- have thus been proposed partly as a way to reduce the U.S. cost of capital and improve the competitive position of U.S. firms in general.

Economists are generally skeptical of the results. The principal reason is that both theory and evidence suggest that tax policy is relatively powerless to affect saving. And since the cost of capital is heavily dependent on the availability of savings, tax incentives apparently can do little to reduce the cost of capital for the economy in general.

Taxes and saving are the key to a number of controversies in tax economics, so it is worth taking a brief closer look at the relationship between the two. Economic theory provides no clear answer about whether individuals reduce or increase their saving in response to various tax benefits. They may increase their saving because the tax benefit increases the aftertax rate of return on saving, or they may reduce it because they have more money and need to save less. Given the ambiguity of theory, the empirical evidence is of paramount importance. And most analyses of the data show little or no response by private savers to tax benefits. Thus, tax benefits probably do little to promote capital formation and probably do not reduce the cost of capital. Further, if tax incentives for saving and investment are financed by a reduction in the Federal budget surplus (or an increase in the deficit), the impact on total national saving -- government saving plus private saving -- is unambiguous: national saving is reduced.

But what if one looks beyond exports and imports and adopts a broader definition of competitiveness, defining it as how U.S. economic growth compares to that of other developed countries? Can tax incentives for saving and investment lead to a permanent increase in economic growth? For example, one study compared growth rates across different countries, and found that the nations with higher growth rates tend to have higher levels of investment in equipment. However, a large part of the correlation may well be

caused by only a few countries. And the theoretical reasons such a relationship might exist are not well understood. Thus, the results of the study must be viewed with caution.¹

Standard economic growth theory holds that an increase in saving cannot lead to a permanent increase in the economy's growth rate, although it can increase the level of output. Briefly, the reasoning is this: increased saving expands the capital stock, which initially leads to a higher growth rate. However, as the capital stock grows, more and more of the resulting increases in output must be devoted to simply ensuring that the larger capital stock grows at its old rate. At the same time, a fundamental principal of economics is that the product of additional capital declines as more capital is combined with a given amount of labor. Ultimately, these two trends collide at the point where any increase in saving must be entirely devoted to ensuring that the new, larger capital stock grows at its old rate -- the rate at which it grew before the increase in saving. As a result, in the long run, the economy's growth rate returns to the steady state that existed before saving increased.

In sum, economic analysis suggests that the nation's economic welfare is maximized if tax policy distorts market choices as little as possible, not attempting to direct resources into the export sector or into import-competing sectors. And it predicts that generally available savings and investment incentives probably do little to improve competitiveness.

But economic theory is not completely negative on the ability of tax policy to improve economic competitiveness in the U.S. context. First, it suggests that in certain exceptional cases tax incentives that interfere with resource allocation may improve rather than reduce economic efficiency; part of the enhanced efficiency may be registered in the international trade sectors of the economy. For example, theory suggests that the market mechanism may not work smoothly in the case of research and development (R&D); if left to their own devices, firms would probably underinvest in research and development compared to the amount of investment that is warranted by its benefit to society. Thus, a tax incentive for R&D investment may enhance U.S. economic welfare. Part of the improvement may consist of higher productivity in the export or import-competing sectors.

A second way tax policy might enhance competitiveness is by its impact on the budget surplus or deficit. First, there is a firm link between the size of the budget surplus (or of the budget deficit, in years when spending is greater than revenues), on the one hand, and the size of the trade deficit, on the other. It works like this: a reduction in the budget surplus puts upwards pressure on U.S. real interest rates compared to rates elsewhere in the world. The resulting inflow of foreign capital drives up the exchange rate, which reduces exports, increases imports, and expands the trade deficit. Second, while private saving is generally unresponsive to changes in taxes, an increase in the budget surplus increases national saving and the amount of capital available for private investment. While it is true that an increase in saving cannot permanently increase long-term growth, it can increase growth in the near-term, as well as the level of output. Thus, the one unambiguous contribution tax policy could make toward improving U.S. competitiveness

¹ The study is summarized in: DeLong, Bradford, and Lawrence Summers. Equipment Investment and Economic Growth. Quarterly Journal of Economics. v. 106. May, 1991. p. 445-502.

is probably by increasing the budget surplus (or reducing the budget deficit, during years of budget deficits).