Chapter Five
Three Approaches to Fostering Economic Competitiveness

By Jason J. Fichtner

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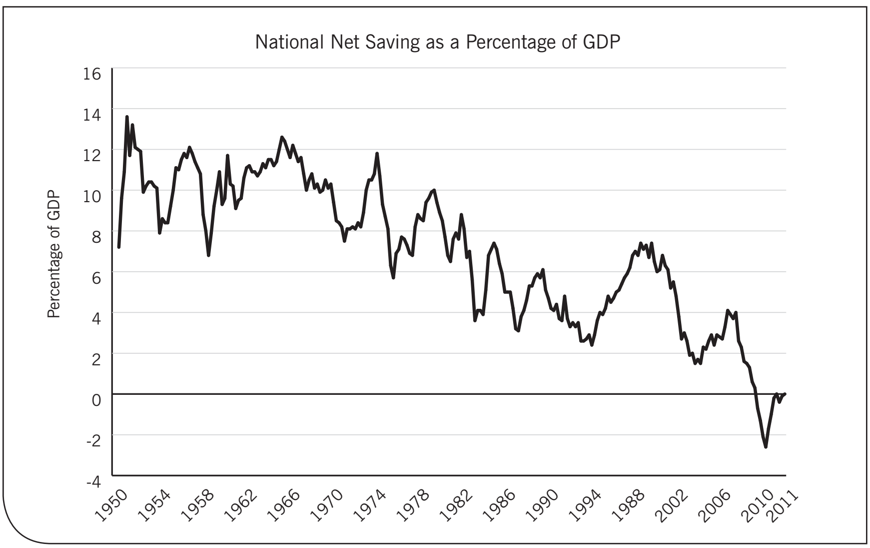
As a society, the United States has moved from being a nation of creditors to a nation of debtors; from a nation of savers to a nation of consumers. Nowhere is the consequence of this debtor mentality more profound than in the federal debt. In the wake of two recessions, national savings have taken a slight upturn as some consumers seek to protect themselves and their retirement (Figure 5.1). Whether this recent return to saving results in a long-term shift, or is just a short-term blip that quickly reverts to a downward slide, remains to be seen. But the federal government has yet to follow suit. Although greater attention is now focused on the national deficit, the country continues to live beyond its means and the national debt continues to soar.

As noted by Gail Fosler in Chapter Four, competitiveness demands that a nation's producers contend within a global marketplace. A nation's ability to compete successfully depends on its ability to employ its resources productively. While some debt-financed spending can be conducive to economic growth, if a nation's debt becomes so large that servicing that debt redirects resources away from productive activity, debt generally undermines competitiveness.

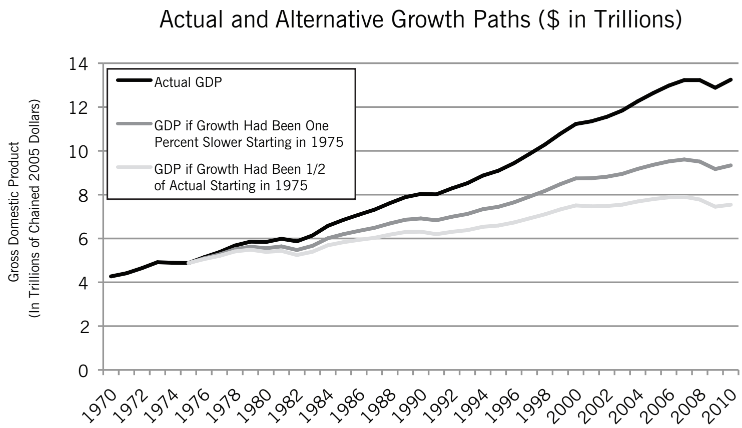
Like most nations, the United States finances its sovereign debt by issuing securities. Therefore, when government borrows to finance its spending, it

Figure 5.1: National Savings Decline, 1950–2011



Source: Bureau of Economic Analysis, Table 5.1 (updated on September 29, 2011)

Debt and Potential Economic Growth



Source: Bureau of Economic Analysis; author's calculations. Created by Matthew Mitchell, Mercatus Center at George Mason University

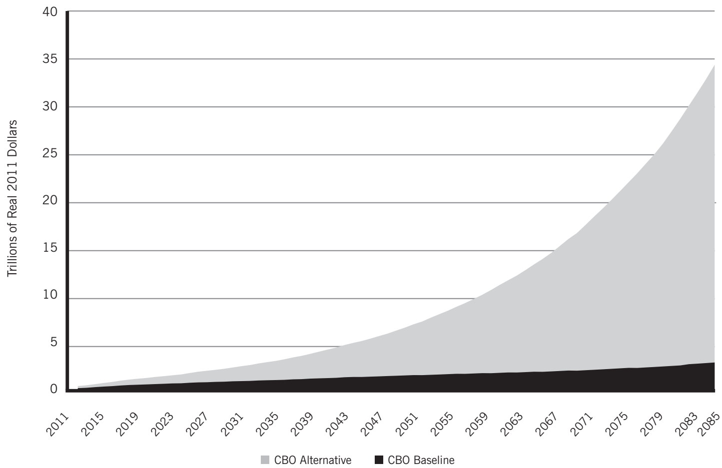
Matt Mitchell of the Mercatus Center at George Mason University illustrates the impact of slower growth by imagining what our economy would look like if—starting in 1975—we had accumulated the sort of debt that we have now accumulated. The graph shows the path of actual (inflation-adjusted) GDP, along with two hypothetical GDP paths: one in which the nation had grown one percentage point more slowly, and one in which it had grown at half of its actual pace.

competes with private entrepreneurs who are borrowing to finance their own activities. Capital used by government is capital that cannot be used by private business. Moreover, when government borrows, demand for funds increases, thus raising the price of borrowing, or the interest rate, for private investors.[1]

For firms requiring capital, this means an increase in the cost of doing business. Projects are less profitable than they would have otherwise been. At the margin, some producers may make the decision not to produce at all.[2] For the nation, this means a decrease in the level of capital it accumulates. Since capital accumulation is at the core of economic development,[3] this in turn means a decrease in the level of goods it produces.[4]

But the effect of a large government debt burden on the economy extends beyond its interaction with interest rates. Debt also undermines our nation's competitiveness by contributing to our real and perceived macroeconomic instability.[5] With high and growing levels of debt, firms and individuals must operate under the uncertainty that taxes might need to be increased to pay

Projected Long-Term Interest Costs



Source: Congressional Budget Office, *Long-Term Budget Outlook,* June 2011

The Congressional Budget Office's (CBO's) two long-term projections of the annual costs of servicing the federal debt are shown for the years 2011 through 2085.[6] The black area represent CBO's baseline estimate of interest costs if current law continues. Under this scenario, a number of tax cuts expire. The grey area represents the CBO alternative, which estimates increased interest costs if several provisions under current law do not expire as planned, including the Bush-era tax reductions, an Alternative Minimum Tax patch, and increased payments to Medicare physicians.

debt servicing costs and/or that inflation is possible; this uncertainty is a detriment to overall productivity. For this reason, fiscal consolidation as well as structural reforms will be needed to increase American competitiveness and growth in the long term.[7]

Empirical examinations of debt's impact on economic growth bear out Mitchell's illustration of the data as presented in the box *Debt and Potential Economic Growth*. Most notably, economists Carmen Reinhart and Kenneth Rogoff examine historical data from 40 countries over 200 years and find that when a nation's gross debt exceeds 90 percent of GDP, real growth slows by one percentage point in some cases, and in the most extreme cases, real growth is cut in half.[8] This result is true for developing and advanced economies alike. Likewise, economists at the Bank for International Settlements find that when government gross debt in the Organisation for Economic Co-operation and Development (OECD) countries exceeds a threshold of about 85 percent of GDP, economic growth slows.[9]

The United States gross debt has already exceeded both of these empirical thresholds.[10] While there remains some question as to the generalizability of international experiences to the United States, there is no reason to believe that the United States occupies a sufficiently unique position to allow it to accumulate high levels of debt without consequence.

Finally, and perhaps most obviously, the direct financial burden of large and indefinite interest payments will interfere with the nation's ability to provide essential services and make needed investments to improve national productivity and competitiveness.[11] To some extent, this interference has already begun.

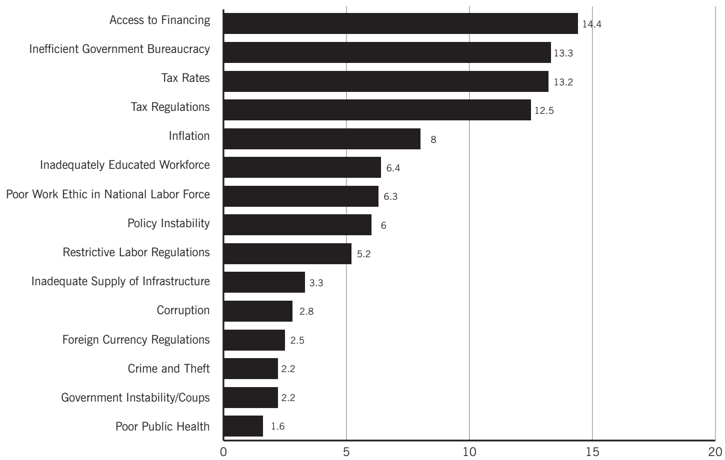
In the long term, lowering the debt burden will enhance U.S. competitiveness by contributing to lower costs, because interest rates would be lower and fewer resources would be devoted to servicing the debt as opposed to being invested in more productive pursuits. But there is room for debate about the merits of aggressively lowering the debt through fiscal austerity during a time of slow economic growth or recession. Though efforts to reign in our nation's debt must begin sooner rather than later, how quickly and aggressively to reduce the national debt is open to debate, especially since the nation's economy continues to lag. From the perspective of an economist, there are solutions to enhance United States competitiveness now, regardless of the state of today's economic business cycle. These steps should be taken, in addition to those that need to be taken to reduce the national debt, in order to improve national competitiveness.

Approach One: Corporate Tax Reform[12]

The United States corporate income tax system is riddled with agglomerated attempts to increase fairness, encourage economic growth, and promote favored industries. This system of taxation places domestic producers on an uneven playing field with each other and at a competitive disadvantage abroad. In fact, according to business executives surveyed by the World Economic Forum in 2011, one of the most problematic factors business owners are concerned with is taxes (see box *Business Owners' Stated Concerns*).

The current tax code discriminates between producers according to size and industry. Favored industries receive special deductions and benefits. Smaller companies may deduct their capital expenses all at once, while larger companies deduct their expenses gradually, thus facing an increased cost of investment. On the other hand, larger companies, with greater access to financial markets, are advantaged under a tax code that favors using debt

Business Owners' Stated Concerns



Source: World Economic Forum, *The Global Competitiveness Report 2011–2012* (September 7, 2011)

The survey data presented above were compiled by the World Economic Forum (WEF). According to the WEF, "From a list of 15 factors, respondents (437 United States business executives) were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings." Note that "access to financing," "inefficient government bureaucracy," and tax-related concerns are cited as the most problematic factors.

rather than equity-financed investments.[13] Such a complex system of corporate income taxes imposes a hefty compliance cost on American businesses, one not borne by many of their competitors in other countries.

Unlike most industrialized countries and all other members of the G7, the United States taxes all corporate income, regardless of where in the world it is generated.[14] Importantly, since foreign-source income is only subject to United States corporate income tax when it is repatriated,[15] this provides a strong incentive for corporations to retain earnings overseas instead of paying them out as dividends to shareholders or reinvesting them in America.[16] Evidence suggests that this is precisely what corporations do.[17]

The most obvious reforms are to move the statutory rate closer to the Organisation for Economic Co-operation and Development (OECD) statutory average of 26 percent[18] and to eliminate preferential subsidies and credits from the income tax code. This, however, is insufficient, as it leaves many of the structural inefficiencies of the current system in place.

Another pro-growth reform would be to permanently transition the United States corporate tax code to a territorial basis, with corporations taxed only on income generated in the United States, consistent with the tax policies of other G7 members.[19] The effect of such a proposal on tax revenues is unclear—it would discourage tax avoidance while decreasing the volume of eligible revenue. But the effect of removing this barrier to American producers' competitiveness *is* clear—firms will be able to invest their profits in the United States without being penalized for doing so and American producers will face more equal costs when operating abroad.

Approach Two: Regulatory Reform

The United States' regulatory framework was developed and drastically expanded during the 1970s to suit a manufacturing-based economy with relatively homogenous industries and little international movement of capital and goods.[20] Hence, today's regulatory mindset is ill-suited to guide the internationally fluid, knowledge-based economy American competes in today.

The cost of this antiquated regulatory framework is decreased economic growth[21] and domestic producers who are biased toward existing technologies and placed at a competitive disadvantage relative to their freer foreign counterparts.

At their core, regulations serve to enforce some social or economic constraint on producers for the good of consumers. However, within the United States' current regulatory framework, this goal must coexist with regulators' dependence on those with the greatest knowledge of industry—the current producers in that industry and the interest groups who seek to influence it. Without sufficient oversight from elected officials, these groups have historically biased regulation toward existing technologies, increased the regulatory burden on new entrants to the sector, and consequently consigned consumers to higher prices.[22]

Despite their far-reaching effects, regulations are currently assessed simply on a direct cost-benefit basis. A better regulatory framework would introduce an auxiliary criterion asking regulators to evaluate the impact of a potential regulation on domestic and global competition.

In addition, the structure of regulations themselves should be modified to address the challenges of a global economy without impeding domestic producers' ability to globally compete. As Bruce Yandle of the Mercatus Center notes, "Congress could pass performance-standard legislation that specifies different standards for particular products or sectors and, in so doing, induce anti-competitive effects."[23] The simplest and least anti-competitive tool available to

Congress is the performance standard approach. This approach specifies the goal to be reached instead of specifying how to accomplish that goal, thereby mitigating the impact of industry and interest groups on regulatory outcomes.

Sufficiently flexible regulation would allow firms to comply with the desired mandate of regulators while allowing them to continue to innovate, find low-cost ways to comply, and implement new technologies.

Approach Three: Product Liability Reform

The code and decentralized structure of United States product liability laws place domestic business at a competitive disadvantage. Businesses are liable without bound within a complex system that varies from state to state. As the law stands, United States manufacturers, distributors, and vendors are responsible[24] for the compensation of damages suffered as a result of using a product, regardless of fault or negligence. Businesses are responsible for these damages—which are determined by juries of laypersons and can reach into the tens of millions of dollars—regardless of where the product was produced or sold. In many states, business responsibility for the safety of a good extends until that good is decades old and sometimes even beyond.

Fearing the monetary consequences of potential lawsuits, some manufacturers may be deterred from introducing new and untested technologies; domestic producers doing business abroad therefore lose out to foreign producers who face no such litigation threat and are therefore freer to experiment. United States global competitiveness suffers as litigation threats bar innovation. In fact, some argue that this has been one force behind the relative decline of the American car industry.[25]

Product testing and safety measures come at a cost, and companies must weigh this cost against potential benefits to consumers. A competitive firm will then decide to include precisely as much safety as the consumer is willing to demand—no more and no less. American consumers demand an exacting amount of safety from their products, and to a certain extent, this preference is represented in our product liability system. However, for the American companies selling abroad who must still operate within this system, the constant specter of litigation imposes an economically inefficient safety standard beyond that demanded by consumers. As a consequence, American companies face an additional cost of production.

Overarching federal legislation could introduce bounds and simplicity into the American product liability system. This legislation should cap the amount for which companies are liable at some predetermined level, and it should limit how long a company is liable for the safety of a good after it was produced. Indeed, such legislation was introduced with bipartisan support in the late 1990s, but ultimately vetoed by President Clinton.[26]

Conclusion

The United States is at a tipping point: the gross national debt is over $15 trillion, equal to or exceeding the gross national product; unemployment is high and job creation is low. Our nation's high levels of debt are crowding out private investment, raising costs to private business, and stifling economic growth. To help American businesses remain competitive in an increasingly globalized world, immediate action is required to improve their competitive position and to stabilize the macroeconomic climate in which they operate. While debt must ultimately be paid down, there are other competitiveness-enhancing reforms which can be implemented more quickly in addition to reducing the national debt: tax reform, regulatory reform, and tort reform.

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Notes

1. World Economic Forum, *The Global Competitiveness Report 2011–2012;* Matt Mitchell and Jakina Debnam, *In the Long Run, We're All Crowded Out,* Mercatus Working Paper, 2012. This is true even in the presence of international financial markets. The existence of fluctuating exchange rates introduces an additional risk into international lending and borrowing; therefore, international integration of financial markets remains incomplete.

2. Mankiw, Gregory, *Principles of Economics*. Mason, OH: South-Western Cengage Learning, 2008.

3. Schumpeter, J. (1942). *Capitalism, Socialism and Democracy.* New York: Harper. Solow, R. (1956). A Contribution to the Theory of Economic Growth. *Quarterly Journal of Economics,* pp. 65–94. Swan, T.W. (1956). Economic Growth and Capital Accumulation. *Economic Record,* pp. 334–361.

4. *New Palgrave Dictionary of Economics*: crowding out. The importance of capital accumulation for economic growth has been emphasized across the literature examining developed countries. Examples include Xavier Sala-i-Martin, Gernot Doppelhofer, Ronald I. Miller, *Determinants of Long-Term Growth: A Bayesian Averaging of Classical Estimates (BACE) Approach,* writing in the *American Economic Review,* and Horst Siebert in *Debt and Capital Accumulation,* Weltwirtschaftliches Archiv. Also, Urquhart finds a strong relationship between capital accumulation and economic growth in Canada in *Capital Accumulation, Technological Change, and Economic Growth, The Canadian Journal of Economics and Political Science / Revue canadienne d'Economique et de Science politique, Vol. 25, No. 4 (Nov., 1959), pp. 411–430.* See also Peter Howitt and Philippe Aghion, "Capital Accumulation and Innovation as Complementary Factors in Long-Run Growth," in the *Journal of Economic Growth* and Paul Davidson, "Portfolio Balance, Capital Accumulation, and Economic Growth," in *Econometrica,* who also notes that policymakers should facilitate producers' financing in order to encourage capital accumulation and move the economy toward full employment. In this case, when domestic

borrowed is primarily financed through international capital inflows, the federal demand for loanable funds may not compete with domestic demand for lending, therefore interest rates may not increase and domestic production may not decline in the short run. However, national income decreases nonetheless as the nation must eventually repay its foreign debts. (William Gale, "Budget Deficits," *The New Palgrave Dictionary of Economics)*.

5. The effect of macroeconomic stability on economic growth is documented in the World Economic Forum *Global Competitiveness Report*.

6. Congressional Budget Office (2011). *Long-Term Budget Outlook.* Washington, D.C.: Government Printing Office. The CBO alternative assumes that the 2001 tax cuts will continue to be extended (as they were most recently in 2010), and that the alternative minimum tax will continue to be revised so that middle-income taxpayers are not subject to it.

7. Olivier Blanchard and Carlo Cottarelli, "Ten Commandments for Fiscal Adjustment in Advanced Economies," IMFdirect, comment posted June 24, 2010.

8. Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt," National Bureau of Economic Research, Working Paper 16827, February 2011.

9. Stephen Cecchetti, M.S. Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bank for International Settlements, September 2011.

10. Gross federal debt includes debt that the government owes to itself through various trust funds.

11. There is evidence to suggest that investments in health care and infrastructure could improve national producers' competitiveness by transferring costs onto the taxpayer which are analogously borne in competing nations (in the case of health care), by making production more efficient (in the case of infrastructure investment), or by increasing the productivity of the American worker (in the case of education investment). For suggested investments, see chapters 6 and 7 in this volume. I do not provide specific investment recommendations in this volume.

12. Note that in the United States, corporate taxes are imposed at more than one level of government. When the average rate of state and local corporate taxation is included, the corporate tax rate in the United States rises from 35% to 39% of profits. The discussion here is limited to the federal level, however, since that is the level at which international competition for business occurs.

13. This feature of the tax code undermines national economic stability, as companies are more prone to seek debt financing and be highly leveraged, thus increasing the risk of being unable to service debt during economic downturns (Cnossen, 1996; OECD 2007b).

14. However, to minimize double taxation, qualified income tax paid to the foreign country in which the income is derived is deductible from a corporation's liability under the United States tax code up to the domestic corporate tax rate of 35%. Internal Revenue Service. (2011). *Topic 856—Foreign Tax Credit.*

15. Active foreign-source income is subject to taxation only upon repatriation, while passive foreign-source income and royalties are subject to taxation during the tax year they are generated.

16. C. Fritz Foley, Jay C. Hartzell, Sheridan Titman, and Garry Twite, 2006. *Why do firms hold so much cash? A tax-based explanation,* NBER Working Papers 12649, National Bureau of Economic Research.

17. Kristin Forbes, comment on "The U.S. needs an overhaul of the corporate tax system, not a temporary tax break," MIT Sloan Experts, comment posted May 9, 2011.

18. OECD. (2011). *Tax Reform Trends in OECD Countries.* OECD Publishing.

19. R. De Mooij. and G. Nicodème (2008), "Corporate tax policy and incorporation in the EU," *International Tax and Public Finance*, Springer, Vol. 15(4), pp. 478–498.

20. Bruce Yandle, Henry Wray, Richard Williams, Scott Farrow, Andrew Perraut, and Gary E. Marchant, "21st Century Regulation: Discovering Better Solutions to Enduring Problems" Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2006.

21. Alesina, Alberto, Silvia Ardagna, Giuseppe Nicoletti, and Fabio Schiantarelli. "Regulation and Investment" *European Economic Association,* 2005: 791-825; Nicoletti, Giuseppe, Robert C. G. Haffner, Stephen Nickell, Stefano Scarpetta, and Gylfi Zoega (2001a), "European

Integration, Liberalization, and Labor Market Performance," in *Welfare and Employment in United Europe,* edited by Bertola Giuseppe, Tito Boeri, and Giuseppe Nicoletti, MIT Press.

22. Yandle et al. 2006.

23. Ibid.

24. These cases are litigated on the basis of *strict liability.* If businesses are found to have been negligent or malicious, then additional damages will be imposed. As civil matters, lay juries decide compensatory damages, which are awarded to recoup plaintiffs' pain, suffering, and economic losses; as well as punitive damages, which are awarded to punish businesses' wrongdoing.

25. Yelkur, Rama, Janet Morrison, Erwin H. Steiner, and Ian Schmehl. "Product Liability: Its Impact on the Auto Industry, Consumers, and Global Competitiveness." *Business Horizons,* 2001: 61–66.

26. *Product Liability Fairness Act of 1995,* HR 956, 104th Congress, 2nd session, Congressional Record H2239-2247.