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CORPORATE TAX RATE CUT LIKELY TO BE INEFFECTIVE AS STIMULUS

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Numerous government and independent studies agree that corporate tax rate cuts provide relatively little "bang-for-the-buck" as stimulus. The Congressional Budget Office (CBO), for example, has concluded that a corporate rate cut "is not a particularly cost-effective method of stimulating business spending."[1] The Congressional Research Service (CRS) has found that in terms of stimulating aggregate demand, the "effect of corporate rate cuts is likely small."[2] And Mark Zandi, chief economist of Moody's Economy.com, has rated a corporate tax rate cut as one of the least effective of all tax and spending options in stimulating the economy, estimating that it would generate only 30 cents in economic demand for every dollar spent on the tax cut.[3]

Nevertheless, some policymakers and business groups — many of them longstanding proponents of corporate tax cuts *regardless* of economic conditions — now advocate cutting corporate tax rates as a stimulus measure.[4] There is a serious debate to be had about whether cutting corporate rates, especially if done in tandem with measures to close corporate tax loopholes, would strengthen the economy over the long run.[5] But corporate rate cuts simply are not credible as short-term economic stimulus in a recession.

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[1] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, p. 13 http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

[2] Jane G. Gravelle, "Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?" Congressional Research Service, December 5, 2008, p. 2.

[3] Mark Zandi, "The Economic Impact of a $750 Billion Fiscal Stimulus Package," January 6, 2009. Testimony before the Democratic Steering and Policy Committee Forum: http://edlabor.house.gov/SteeringPolicyForumInformationPacket.pdf

[4] Rep. Tom Price and Paul Teller, "The Economic Recovery and Middle-Class Tax Relief Act of 2009," Republican Study Committee, January 14, 2009. http://rsc.price.house.gov/UploadedFiles/Econ_Recovery_Act_Highlights_Jan_14_2009.pdf

[5] See Aviva Aron-Dine, "Well-Designed, Fiscally Responsible Corporate Tax Reform Could Benefit the Economy," Center on Budget and Policy Priorities, June 4, 2008, http://www.cbpp.org/6-4-08tax.htm.

Corporate Rate Cut Would Not Reward New Investments

Explaining why a corporate tax rate cut is relatively ineffective as stimulus, CRS noted that "Increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more, because production depends on the ability to sell output."[6]

The primary problem employers face in a recession is a shortage of *demand* for their products, not a shortage of cash.[7] When firms face a shortage of demand, they will find it more attractive to retain — or pass to shareholders — any new cash they receive from a tax cut, rather than invest in increased production of goods and services for which no customers exist.

But passing the tax benefits to shareholders and business owners would not stimulate the economy much. Shareholders and business owners are two groups that tend to have higher incomes — and thus to save, rather than spend, much of any additional income they receive. As CRS concluded, such a tax cut "is more likely to be spent on reducing debt, or paying out dividends. Both choices would not expand aggregate demand."[8]

In the short run, therefore "a substantial effect of reducing current corporate tax rates is to increase the returns from *past* investments rather than increase the attractiveness of *new* investments," according to CBO.[9] Only new investments are stimulative.

Temporary Rate Cut Might Actually *Discourage* Investment

Cutting corporate tax rates on a temporary basis, as some have suggested, could even discourage investment. Cutting tax rates reduces the value of deductions that companies claim when they invest, make other purchases, pay wages, or depreciate equipment; for example, a $1,000 deduction is worth $350 at the current 35 percent corporate tax rate but would be worth only $250 at a 25 percent rate. If tax rates were cut on a temporary basis, companies would have an incentive to *delay* investments until the rate returned to 35 percent and deductions regained their lost value.[10]

A permanent corporate rate cut would not have this disincentive effect. But neither would it provide timely stimulus, because it would provide *no* incentive for businesses to speed up investments. Firms could keep investments on the timeline already planned — or even delay investments until the economy recovered — and still get the benefits of the rate cut. Furthermore, a permanent rate cut, if deficit financed, would worsen the long-run budget outlook, which could hurt the economy over the long term.

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[6] Gravelle.

[7] As CRS stated, "whether an increase in cash flow would induce a firm to make new investments during periods of excess demand is doubtful." Gravelle, p. 5.

[8] Gravelle, p. 5.

[9] CBO. Emphasis added.

[10] CBO, p. 14.

Broad-Based Tax Cut an Inappropriate Response to Liquidity Constraints

The current lack of liquidity in credit markets could make an infusion of cash more valuable to some companies that, in past recessions, would have been able to borrow to meet payrolls and make needed investments to maintain their capital stock. But this raises a question — how can a tax cut be focused on businesses that would actually spend an infusion of cash? Without an effective targeting mechanism, too much of the benefits of a corporate rate cut would be retained by corporations or pass to shareholders rather than spent, and hence not have much stimulative effect.

Such targeting mechanisms are not easy to design, but an across-the-board corporate rate cut clearly would not constitute an effective or well-targeted way of addressing the liquidity concern. Indeed, a corporate tax cut would likely target relief *away* from firms that are most likely credit-constrained. A firm would only benefit from the corporate rate reduction if it was profitable: firms struggling to break even — the firms most likely to be cash-constrained — would not.

Mechanisms such as business tax incentives tied to new investments or business purchases would at least attempt to deliver liquidity in a targeted way.[11] Other possibilities are zero-fee loans administered by the Small Business Administration or loans via the Troubled Asset Relief Program or a similar mechanism. All of these should be more effective than a corporate rate cut in targeting assistance so it is more likely to generate spending that firms would not otherwise undertake. Moreover, the public would ultimately be able to recoup a portion of the value of any such loans.

Some previous tax cuts intended as stimulus measures — accelerated depreciation for new investments, for example — have attempted to target tax relief to new investments. Yet even those targeted tax cuts have had relatively low effectiveness as stimulus. An untargeted, across-the-board corporate rate cut would almost certainly have an *even lower* stimulus effect and thus deliver very little bang-for-the-buck. As CRS stated, "[general] corporate rate cuts are less likely to be effective than investment subsidies. . . . Since even temporary investment subsidies do not appear to have worked effectively, a corporate rate cut would be expected to have a small effect."[12]

[11] No perfect measure would exist for such a tax credit; there inevitably will be some expanding firms that would have made the new investment even without the credit and some contracting firms that would have cut back less on investment if they had been eligible for the credit.

[12] Gravelle, p. 5.