May 18, 2021

Restore, rebuild, reshape

Biden's three-pronged push aims at redesigning the US economy

The biggest fiscal spending program in decades has the potential to reshape the US economy. While increased social spending and income redistribution aim at reducing the growing income gap, the proposed investments to modernise the infrastructure are long overdue and should help to lift the economy's growth potential. However, higher corporate taxes would weigh on profitability and could be a drag on business investment.

Source: iStock

Biden's fiscal proposals have the potential to significantly reshape the US economy
The American Families Plan is the third pillar of President Biden's massive fiscal push to stimulate and reshape the US economy following his announcements of the American Rescue Plan and the American Jobs Plan.

The American Rescue Plan provided crucial, though untargeted, fiscal support to bridge the gap until the economy reopened, leading to a very swift recovery following the deepest recession in decades. The interaction between fiscal and monetary support could serve as a template for future crises, helping to avoid some of the long-term scars that usually follow a severe recession.

The American Jobs Plan includes some important and long overdue proposals to renew and modernise crucial parts of the American infrastructure. While several measures are politically motivated and would tend to raise the cost of producing in the US, the benefits of investing in core infrastructure are expected to outweigh the cost, particularly given the historically low yield on government debt, and should help to lift productivity and the longer-term growth potential of the US economy.

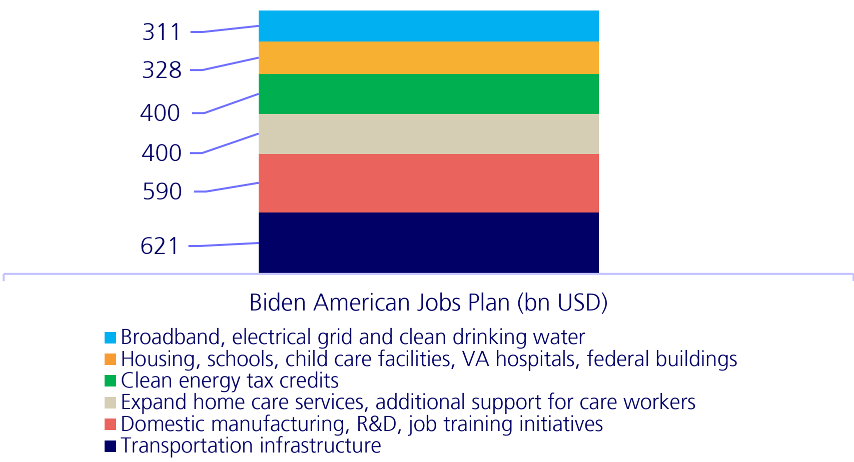
Finally, the American Families Plan is likely to be the politically most contested proposal though it is still possible that the Democrats could successfully use the reconciliation process to pass at least some of the plan.

Given the lack of details and progress in the political process it is difficult to judge the potential impact of these measures. Nevertheless, a moderate income redistribution is likely to have a positive impact on economic growth as lower-income households usually have a higher propensity to spend.

Build back better with a geopolitical touch
The American Jobs Plan is presented as an investment in Americas' future intended to create millions of jobs, rebuild the country's infrastructure and position the US to out-compete China, the latter adding a geopolitical aspect to the proposal.

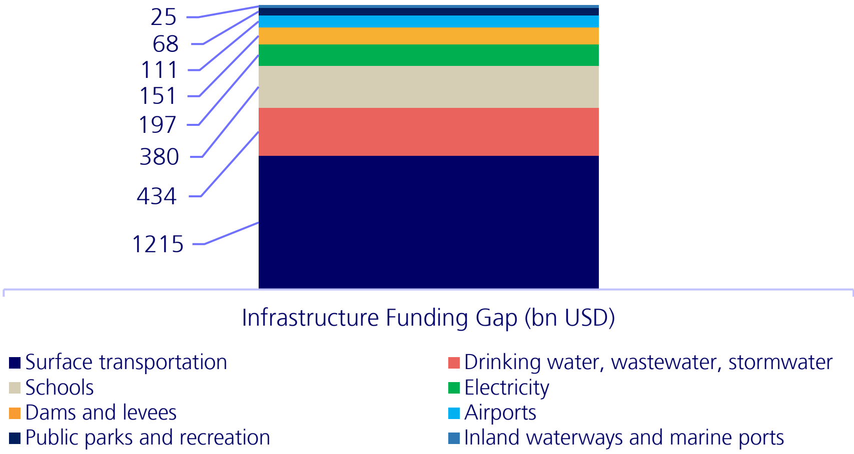
For years the deteriorating state of America's infrastructure due to chronic underinvestment has been the topic of political discussions. While in principle a broad consensus exists that additional investments in infrastructure

Investing in infrastructure – and more



Source: Committee for a Responsible Federal Budget (CRFB)

Huge infrastructure funding gaps have accumulated



Source: American Society of Civil Engineers (ASCE)

are needed, relatively little has actually happened.

The US' outdated infrastructure could cause huge economic losses

In its latest 2021 Report Card for America's Infrastructure, the American Society of Civil Engineers (ASCE) sees a modest overall improvement, but still considers 11 out of 17 individually graded infrastructure categories to be in a poor state, exhibiting significant deterioration or approaching the end of their service life.

According to the ASCE, the total investment gap has gone from USD 2.1tn to nearly USD 2.59tn. The potential economic impact of this chronic underinvestment is huge. Poor roads, airports, an aging electric grid, unreliable utility networks and other deficits in the infrastructure increase the cost of doing business for manufacturers and service providers alike. The ASCE estimates that the overall cost of continued underinvestment in America's infrastructure at the current rate would accumulate to USD 10tn, cost more than three million jobs and result in USD 2.4tn fewer exports by 2039.

The largest funding gaps exist in surface transportation, water systems, schools and electricity. A reminder of the latter was the recent power outage in a number of regions in Texas. A Department of Energy study found that power outages cost the US economy up to USD 70bn annually (representing roughly 0.3% of annual GDP).

To close the estimated investment gap and to meet future needs the ASCE recommends increasing investment at all levels of government and the private sector from 2.5% to 3.5% of GDP by 2025.

Biden's plan covers core infrastructure as well as education and digitalisation

The American Jobs Plan is intended not only to close the investment gap to lift America's aging infrastructure back up to the recommended standard. It also aims at raising the US' longer-term competitiveness with a particular focus on strategic challenges regarding China as well as meeting the Herculean task of addressing climate change by investing in a range of green initiatives.

President Biden's plan is an ambitious proposal to rebuild America's economy and contains many elements that cover more than basic infrastructure in a traditional sense. In addition to investments in transportation, utilities, water supply, sewage and waste disposal, the proposal would provide funds to what was defined by the Bureau of Economic Analysis (BEA) as digital infrastructure (like cell phone towers and assets that are needed to support the internet and cloud computing) and social infrastructure (schools, hospitals, and public safety facilities)

Biden intends to invest about 1% of GDP annually over eight years to upgrade the country's infrastructure, revitalize manufacturing, invest in basic research and science, shore up supply chains and solidify health care infrastructure. The intended new spending would raise total infrastructure investment to about 4.5% of GDP, the highest level since the early 1970s.

Infrastructure investment is expected to lift the long-term growth potential

In addition to the direct impact of increased fiscal spending on growth in the coming years an improved and modernized infrastructure is likely to raise America's longer-term growth potential. It is very difficult to estimate the overall impact, but studies show that public investment in core infrastructure like transportation or utilities tends to have higher economic returns than investment in non-core infrastructure.

On average, it is estimated that increasing the public capital stock by 1% will raise the level of long-run output by about 0.1%. As mentioned, the investment mix is relevant as investments in core infrastructure tend to have a greater impact than other initiatives. Based on a number of studies increasing infrastructure spending according to President Biden's proposal could lift the potential growth rate by 0.25% to 0.5%.

Biden's tax plan would have a significant impact on corporate profits…

Unlike the USD 1.9tn American Rescue Plan approved by Congress earlier this year the increased spending on infrastructure proposed in the American Jobs Plan will have to be paid for by tax increases. The proposed changes were presented in the Made in America Tax Plan, a proposal with potentially profound impacts on the tax system and corporate profitability.

Major goals of Biden's tax plan are to make American companies and workers more competitive by eliminating incentives to invest offshore, substantially reducing profit shifting, countering tax competition on corporate rates and providing tax preferences for clean energy production.

…reversing the trend of falling revenues from corporate taxes

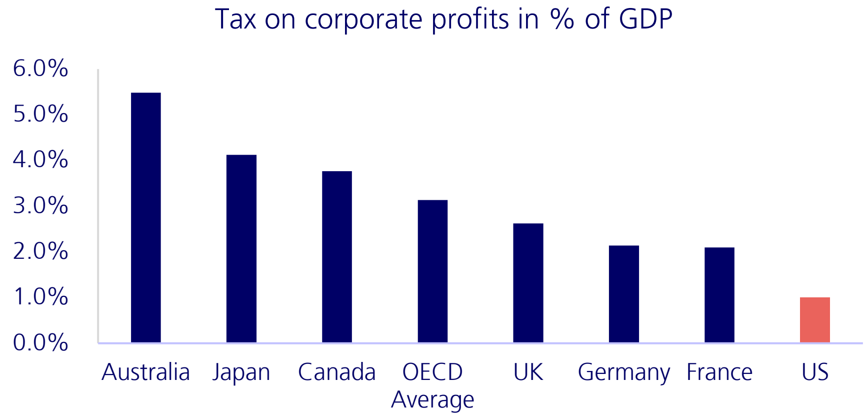
A clearly stated intention behind the plan is the Biden administration's goal of reversing the longer-term trend of falling revenues from corporate taxes relative to GDP. In 2019, the latest data available, taxes on corporate profits fell below 1% of GDP, down from about 2.5% twenty years ago. By now, the US has one of the lowest shares of revenues collected from corporate taxes relative to GDP of all OECD countries.

We expect Biden's proposal to be watered down in Congress, but a substantial rise in corporate taxes is still likely. The proposed tax increases would significantly raise the effective tax rate and basically reverse the entire 2017 corporate tax cut.

Corporate taxes relative to GDP fell to the lowest on record in 2019

Source: OECD

US corporate tax revenue is low in an international context



Source: OECD

Should firms decide to compensate higher taxes with lower business investment, a part of the positive long-term effect of higher infrastructure investment could be eroded.

Investors seem too complacent about higher corporate taxes

Interestingly, stock markets have hardly reacted to the announcement of these significant increases in corporate taxes. So far, investors have mostly focused on the proposed raise in the corporate income tax to 28% from the current 21% (implemented under the Trump administration). However, this represents only about 40% of the proposed increase in the overall corporate tax burden. Roughly 60% of the proposed gross tax increases result from more heavily taxing the foreign profits of multinationals at rates similar to the current domestic tax rate.

A number of measures have been presented to achieve this. The Global Intangible Low-Tax Income (GILTI), introduced in 2017, was put into place to ensure companies paid taxes on their intangible income overseas. Under Biden's proposal taxes paid under GILTI would significantly increase as a greater share of US companies' intangible income would be taxed, and the tax would be applied on a country-by-country basis rather than on a worldwide basis as is the case under current law. Under the new rules companies would not be able to offset higher taxes paid in one country by lower rates in another.

Other measures relate to intra-company transactions that are used to lower tax liabilities across different jurisdictions. The overall tax rate would rise as the new proposal reduces or denies deductions for payments made to related parties in low-tax jurisdictions. Finally, repealing a tax deduction for US companies' foreign profits that come from intangible assets held in the US and implementing a minimum book tax would further push up the effective corporate tax rate.

Biden's proposals are aimed at raising labour income's share of GDP

While revenues from corporate taxes in percentage of GDP fell to the lowest on record in 2019, corporate profits as a share of GDP almost doubled over the last few decades. At the same time labour income as a share of GDP fell several percentage points reflecting the shift from labour income to return on capital fuelled by globalisation, national legislation and tax reforms. Labour income relative to GDP is close to the lowest level in half a century. This trend is one aspect behind the growing weariness regarding the effects of globalisation observable in large parts of the population.

The US government's push for a global minimum tax could provide a headwind for corporate profitability

The Biden administration is aware that unilaterally raising corporate taxes would lead to companies relocating to avoid higher tax rates and could result in the loss of tax revenues. Therefore, the US government is pushing for a global minimum tax. It is unlikely that all the proposed measures will be approved internationally. However, the tide for ever lower global corporate taxes seems to have turned and corporate profits could face more headwinds going forward. This trend could be supported by many nations striving to repair their fiscal situation following large fiscal stimulus programs during the pandemic.

Increased social spending is to be financed by higher taxes for wealthier households and capital owners

The American Families Plan would provide about USD 1.8tn over ten years in new benefit spending and tax credits. The proposal includes spending on child care, universal pre-school, paid leave, free community college as well as a number of extensions for temporary measures implemented under the American Rescue Plan (e.g. the child tax credit, health insurance premium tax credits and the earned income tax credit).

Most of the additional spending is to be financed by raising taxes on higher incomes, including a major capital gains tax hike. A significant part of the cost is intended to be covered by closing tax loopholes and strengthening Internal Revenue Service (IRS) enforcement.

Biggest tax rise in decades

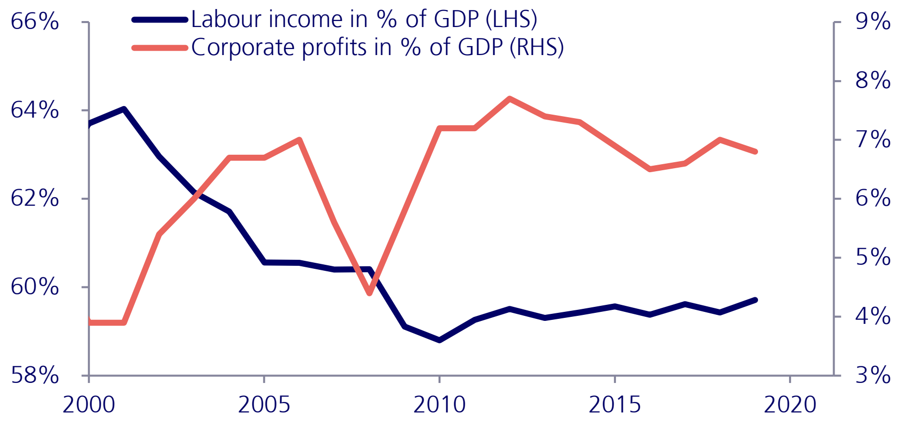
The proposed increase in personal taxes combined with the intended corporate tax hike discussed above would lead to the biggest tax rise in the US in decades. It is unlikely, however, that Biden's proposals will be fully implemented as major parts of the package face resistance from both Republicans and moderate Democrats.

The exact timing and structure of the process are still open. While it is possible that the measures related to traditional infrastructure spending will receive bipartisan support in Congress, it seems more likely that the Democrats will again try to pass the bill through the reconciliation process as they did with the American Rescue Plan at the beginning of the year.

Biden's plans have the potential to reshape the US economy

Biden's three-pronged push is a broad move aimed at reshaping the way the US economy functions that would have a significant and lasting impact. If well executed, the long overdue modernisation of America's infrastructure as well as addressing the issue of increasing inequality would benefit the long-term growth potential of the economy. Higher productivity would help to moderate inflationary pressures and support real wage growth in the long run. Meanwhile, the proposed tax measures would provide a significant headwind for corporate profitability, particularly in the short term, which could negatively affect business investment and erode part of the expected benefits.

Workers' share of GDP is close to the lowest in half a century



Source: Federal Reserve Bank of St. Louis

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