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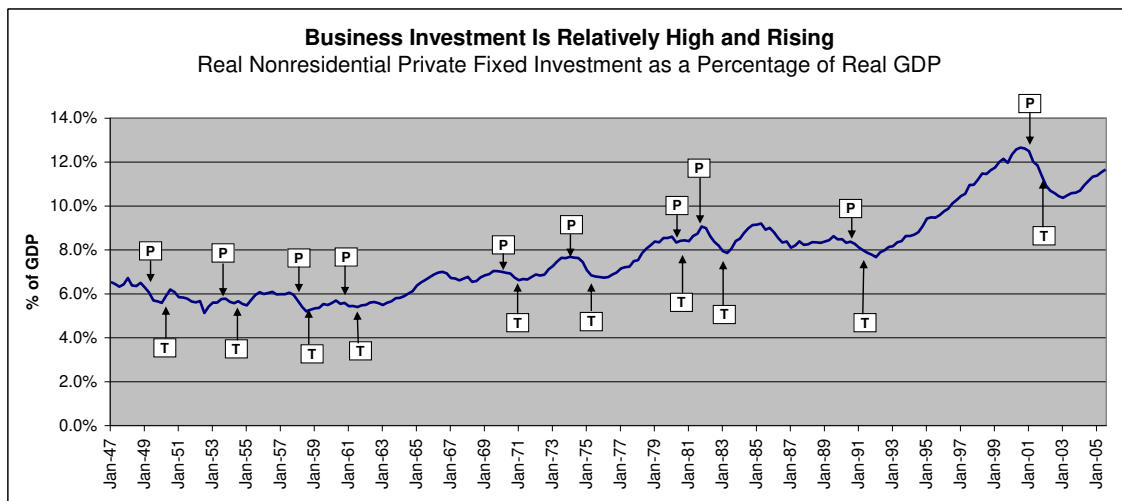
Business Investment, Cycles and Tax Policy: Are We Investing Too Little?

John A. Tatom

Some analysts have argued that bubble excesses of the late-1990s led to excessive real investment, a process sometimes referred to as gold-plating, and that an important consequence was that capital formation has been depressed since then as firms have let production catch up with the excessive capital stock. While this description broadly fits the pattern of business fixed investment from the mid-1990s at least until 2003, it may be overstated. The business cycle and tax policy have played more important roles in explaining the pattern of investment activity. The resumption of investment, so long as tax policy changes in 2003 are maintained, suggests the excess capacity argument is no longer valid, if it ever was.

Chart 1 shows the strength of real non-residential fixed investment, a measure of the quantity of investment in business structures, equipment and software, relative to real GDP by measuring such investment as a percentage of real GDP. What stands out is that business investment surged up after the mid-1990s and, despite a sharp decline in 2000-03, has remained relatively high and has rebounded since 2003. In the latest quarter shown, the investment ratio equaled its average since 1997 (11.4 percent) and this was slightly more than double its previous 50-year average of 5.8 percent. Even at its lowest point in 2003, business investment was higher than at any time from 1947 through 1996. A cyclical expansion together with tax policy changes that lowered the cost of capital for business, by lowering the personal tax rates on dividend income and on capital gains and in turn raised stock prices and lowered the real rate of interest, led to a rapid increase in business investment, though not yet by enough to raise business investment back to the record pace of late-2000.

Chart 1
Business investment is cyclical, but currently high and rising



Most of the declines in this ratio in the chart have been due to either recession or to tax policy changes that lowered the rate of return on investment. For example, periods of recession are indicated by P and T, which stand for peak and trough, respectively. In every recession the business cycle peak was accompanied by a peak in the share of business investment in real GDP. Moreover, business investment did not recover until the business cycle trough was reached or passed. Following the last three recessions the recovery began about two years after the business cycle trough. The effects of the 1981 tax cuts in boosting investment and the 1986 tax hikes on business income are the most striking for their impact on the share of real business investment in real GDP. Another period of examples include, the suspension of the investment tax credit in 1966-67, its restoration on 1968-69 and suspension in 1970-71. In each case suspension led to declines in the ratio and restorations led to increases in the ratio. The only major decline in the ratio since 1946 that was not due to a cyclical downturn or a tax hike raising the cost of capital was a slight decline from III/1950 to II/1951 and that had to do with the wartime transition in the beginning of the Korean War.

At least judged by the performance of more than 50 years, the US business investment in new plant, equipment and software has remained exceptionally high in this decade despite the recession in 2000 and subsequent expansion. It is not obvious that any excessive investment in the late-1990s has depressed the pace of capital formation since then. As long as the 2003 tax policy changes remain in place and the economic expansion continues to be robust, business investment is likely to continue to grow faster than real GDP, boosting the share of such investment in GDP back toward its 2000 peak. Indeed, this is a major factor in most forecasts for continuing economic expansion in 2006.