JOINT ECONOMIC COMMITTEE

JIM SAXTON, CHAIRMAN

RESEARCH REPORT #109-45

September 2006

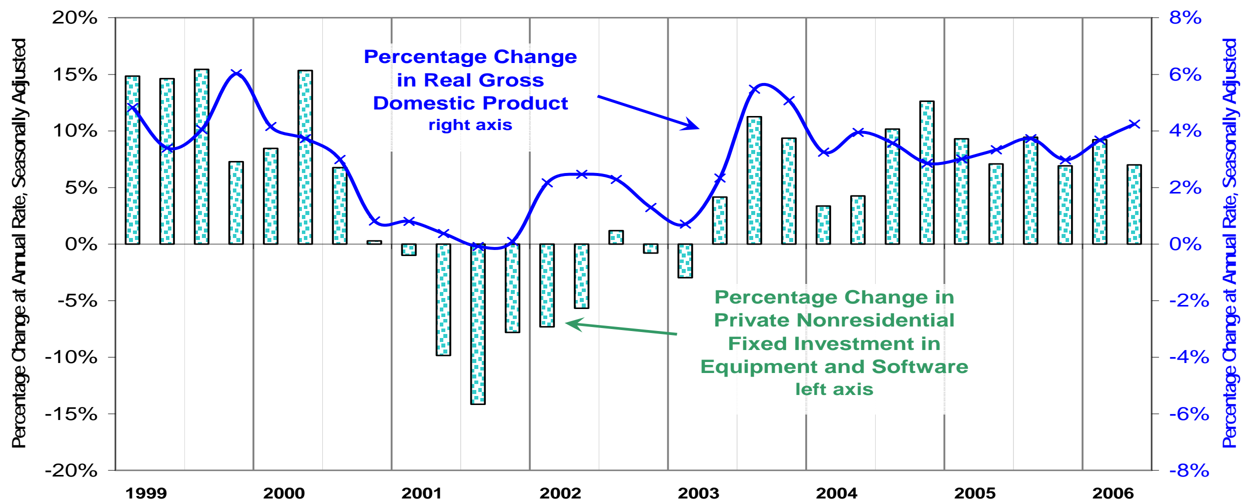
TAXES, INVESTMENT AND ECONOMIC EXPANSION: THE CASE FOR THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003

In 2000, the stock market bubble burst and investment spending collapsed. Shortly thereafter, economic growth came to a virtual standstill and the economy lost jobs.

The recovery that began in late 2001 lacked vigor because investment was still falling. Starting in 2003, however, a new policy mix was introduced that combined accommodative monetary policy with enhanced tax incentives for investment. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) contained several investment incentives and augmented the incentives in the 2002 tax bill. JGTRRA and the 2002 tax bill were designed to encourage balanced economic growth. The economic rebound that followed and the 5.7 million jobs created in the last three years demonstrate that JGTRRA was effective.

The figure below plots the impact that sagging investment had on economic growth. In the first half of 2000, investment was solidly positive, but in the third quarter of 2000, real investment in equipment and software started to slide, eventually heading into negative territory in 2001. Economic growth and employment fell.

Despite the economic slowdown in 2000 and 2001, consumer spending remained relatively buoyant. After dropping from a 5 percent annual growth rate in 1999, the growth rate of consumer spending returned to the average of the previous twenty-five years – around 3.3 percent per year. In addition to the economic stimulus of the 2001 and 2002 tax bills, consumer spending was propelled by low interest rates and rising real estate values. Even so, healthy consumer spending could only sustain anemic economic growth.



In early 2003, before JGTRRA was signed into law, investment spending was still in the doldrums. In addition to providing taxpayer relief, JGTRRA was designed to stimulate capital formation and long-term growth. As a result, JGTRRA was expected to reverse the loss of jobs as well as boost productivity and contribute to future wage growth.

DID JGTRRA WORK?

Economists cannot conduct controlled laboratory experiments comparing the results of no tax legislation with the economic outcome of JGTRRA. Instead, one must analyze the efficacy of JGTRRA, or any tax legislation for that matter, using economic theory and data. Tax incentives lower the cost of capital. According to economic theory, a decline in the cost of capital would spur an increase in the quantity of capital demanded. All other things equal, lowering the cost of an input induces businesses to use more of that input.

The empirical debate is not centered on *whether* the cost of capital influences investment. All economists agree that the cost of capital impacts investment. Rather, the debate is centered on how responsive investment is to changes in the cost of capital. A sizable body of research suggests that investment is sensitive to the cost of capital.[1]

Skeptics also argue that other factors dilute the simulative effects of tax legislation on investment and growth. Many argue that there is a considerable lag between the approval of tax legislation and the installation of new physical capital. While it may take several months for legislation to work its way through Congress, in today's economy there is no significant lag between capital goods orders and the delivery of equipment.[2]

Stimulating investment has additional benefits. Investment encourages economic expansion and reaps benefits well into the future, in much the same way that money spent on education rather than a vacation generates future financial returns. Recent research estimates that "capital deepening" – that is, increasing the ratio of capital inputs relative to labor inputs – accounts for about half of the marked productivity growth increase the economy has experienced since 1995.[3] Capital investment boosts productivity and, given that productivity growth is the pathway to increasing prosperity, it makes sense to encourage capital investment.

CONCLUSION

From 2000 to 2001, investment in equipment and software plummeted. In the three years before JGTRRA, the annual growth rate of real investment was, on average, *negative* 1 percent. After JGTRRA was signed into law in May of 2003, investment rebounded and has averaged an annual growth rate of 8 percent. The relationship between the turnaround in investment and the turnaround in the economy demonstrates that JGTRRA was effective. JGTRRA sparked a recovery in investment and has boosted economic growth.

---

[1] For example, see Hassett, Kevin A. and R. Glenn Hubbard. "Tax Policy and Business Investment." In *Handbook of Public Economics* Vol. III, edited by Auerback and Feldstein, 1293-343. Amsterdam: Elsevier Science B.V., 2002.

[2] This is not your father's economy. E-business, just in time delivery of supplies, production processes and expedited freight transportation have greatly compressed the time between orders and deliveries, even for industrial equipment. For a more detailed discussion of lags in capital equipment orders and shipments – or the lack thereof – see the forthcoming JEC study *Tax Incentives, Investment and Economic Growth.*

[3] See Jorgenson, Dale, W., Mun S. Ho and Kevin J. Stiroh. "Potential Growth of the U.S. Economy: Will the Productivity Resurgence Continue?", *Business Economics,* January 2006.