JOINT ECONOMIC COMMITTEE

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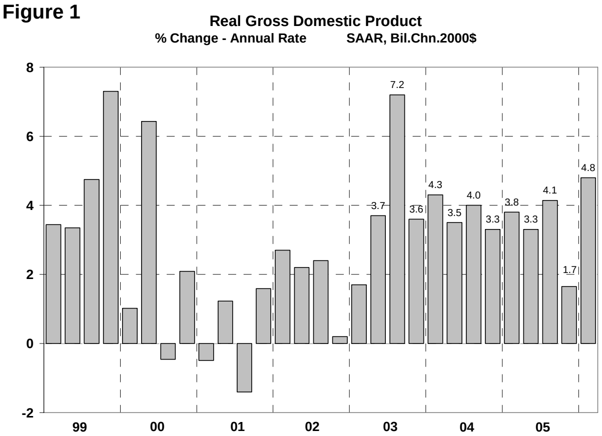
Investment Tax Incentives Boost Economic Growth

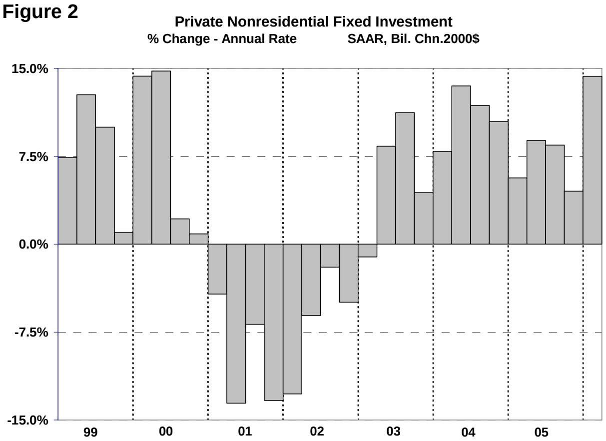
In recent years, the U.S. macroeconomy has staged a remarkable recovery from earlier sluggishness, due in part to numerous headwinds or macroeconomic supply-side shocks affecting the economy. Recent GDP growth, for example, has been persistent and robust, trending well above 3 percent (See figure 1). The movements in the economy have reflected movements in investment, as investment growth was the key contributor to recent GDP growth (See figure 2). Employment gains have been healthy (over 5 million since August 2003). Unemployment recently has fallen to 4.7%. Core inflation has been contained and, consequently, interest rates have been remarkably low.

Figure 1



Source: Bureau of Economic Analysis/Haver Analytics/ *Blue Chip Consensus

Figure 2



Source: Bureau of Economic Analysis / Haver Analytics

This report assesses the post-2003 period and spells out the key reasons, causes, and economic policies fostering these desirable results. **First**, monetary policy certainly played a significant role in containing inflation, inflationary expectations, and risk premiums: i.e., monetary policy helped to create and maintain the low interest rate environment in which the economy and especially interest rate sensitive sectors such as investment, real estate, and durable goods spending thrived. Monetary policy's focus on (implicit) inflation targeting helped call attention to this objective.

A **second** characteristic of this period fostering healthy economic growth was the remarkable degree of resiliency displayed by the U.S. economy. The economy experienced the lingering effects of asset price bubbles, terrorist attacks, several severe hurricanes, two wars, executive scandals, and a sharp increase in the price of oil. Remarkably, these shocks were, for the most part, absorbed promptly by the U.S. economy. In short, the U.S. macroeconomy displayed a great deal of flexibility and resiliency during this period.

This resiliency, however, is not "just luck." Rather, it is the product of long-term commitments to policies conducive to resiliency. It is a reflection of both a long-term exposure to the competitive pressures of an open economy as well as the explicit promotion of public policies promoting flexibility of prices and wages, mobility of resources and factors of production, and the avoidance of regulations and taxes that serve to constrain and to rigidify the economy.

Tax Policy

A **third** and critically important aspect of policy creating positive economic results relates to tax policy. More specifically, the tax incentives for investment that were included in the 2003 tax bill played a crucial role in bolstering economic growth.

Tax policy can play a major role in promoting investment or capital formation and consequently, economic growth. Accordingly, the tax policy endorsed by the Administration is, for the most part, focused on those objectives most related to economic growth.

In assessing initial economic conditions during the current expansion, it became obvious that investment and capital formation were weaker than desirable following the bursting of the stock market bubble. This weakness in investment was exacerbated by the structure of the income tax, which subjects saving, investment, and capital formation to over- and multiple taxation.[1] Accordingly, a tax program was proposed which lowered the tax rates on investment. In May of 2003, the “Jobs and Growth Tax Relief Act of 2003” was passed. The Act contained a number of provisions, most notably, a reduction in both dividend and capital gains tax rates, and expanded expensing for business investment.[2]

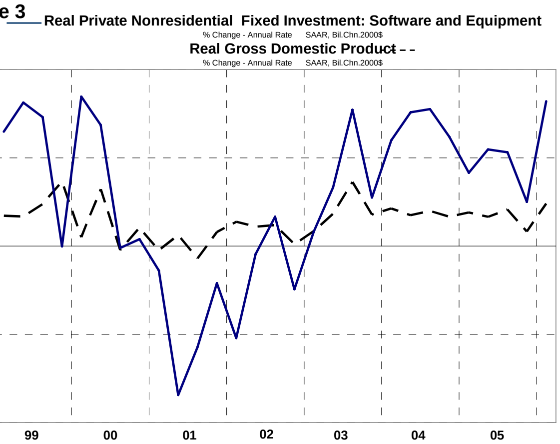
There were a number of reasons to lower these tax rates on capital in 2003, including:

- Removing some of the bias toward the multiple taxation of capital and investment.
- Lowering tax **rates** so as to affect behavior and promote additional incentives to save and invest.
- Removing some of the tax burden’s deadweight loss.
- Maintaining the U.S. as an attractive investment outlet for international capital flows and investors.
- And, most importantly, fostering capital formation so as to promote economic growth.[3]

As the data suggest, these tax cuts are associated with higher-trend growth in business investment spending (See figure 3) and increases in the value of the stock market (not shown). The NIPA data, for example, suggest that after the 2003 tax cuts, various categories of real nonresidential fixed investment began trending up at more rapid rates (See figure 2). The advances in real equipment and software investment are especially noteworthy. For example, from the third quarter of 2000 to the first quarter of 2003, real nonresidential fixed investment fell at a 5.6% annual rate. From the second quarter of 2003 to the first quarter of 2006, this measure of investment increased at a 9.2% annual rate. The analogous changes and the real equipment and software component are negative 4.2%, followed by an advance of 11.2%. Similarly, most common measures

[1] A number of JEC studies have underscored that capital is multiple-taxed under income taxation.
[2] The highest capital gains rate of 20 percent was lowered to 15 percent while the highest rate on dividend income was reduced from 35 percent to 15 percent. See Alan Auerbach and Kevin Hassett, “The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study,” NBER working paper 11449, June 2005, p.1.
[3] The argument for additional investment is provided by several JEC studies. See, for example: Robert O’Quinn, “Near-Term Stimulus and Long-Term Growth,” Joint Economic Committee, May 2003.

Figure 3



Source: Bureau of Economic Analysis / Haver Analytics

of stock market value (e.g., Dow Jones, Nasdaq, or S&P) began advancing at a faster pace. Since such tax cuts lower the cost of capital, they foster capital formation and investment. Consequently, since the tax cuts were implemented, the country has experienced higher economic growth, more rapid advances in payroll employment, significantly lower unemployment (with the unemployment rate falling to 4.7% from 6.2%), and higher than projected tax revenues. These advances can be explained by a rebound in investment activity. In short, the timing of investment and stock market activity indicates that the incentives of the tax cuts worked as designed.

A similar view was outlined by Ben Bernanke (then CEA Chairman):

"…tax legislation passed in 2003 provided incentives for businesses to expand their capital investments and reduce the cost of capital by lowering tax rates on dividends and capital gains…the effects are evident in the investment and employment data. From its trough in the first quarter of 2003, business fixed investment has increased over 21 percent, with the biggest gains coming in equipment and software."[4]

Furthermore, careful research (and empirical evidence) explicitly supports this contention. The findings of several studies tend to support the view that changes in the tax law can have significant impacts on investment, economic activity, and economic growth.

For example, a reexamination of the problems caused by high dividend taxes suggests that since the U.S. has relatively higher dividend tax rates than other countries, cutting the dividend tax rate in the U.S. may be more potent than otherwise.

Additionally, Auerbach and Hassett (2005) find strong evidence that the 2003 change in the dividend tax law had a significant impact on U.S. equity markets. Therefore, by reducing the tax rates of those forms of taxation working to double-tax capital, a more rational system can result.

In sum, the macroeconomy has advanced sharply in recent years in part because of the contribution of a tax relief effort which lowered taxation on capital, promoted economic growth, and provided potent tax relief.

Conclusion

Recent economic data indicate that the economy is quite robust and advancing at a healthy pace. Our economy has weathered a barrage of negative supply shocks (including a bursting stock market bubble, a terrorist attack, severe hurricanes, two wars, corporate scandals, and a sharp increase in the price of oil). Given this array of significant hurdles, the economy's performance is remarkable. Part of the reason for this performance relates to the contributions of monetary policy's focus on price stability, which leads to a lowering of inflation, the volatility of inflation, and the volatility of economic activity, thereby

[4] Ben S. Bernanke, Chairman, President's Council of Economic Advisers, "The Economic Outlook," testimony before the Joint Economic Committee, October 20, 2005, pp. 3-4.

fostering economic growth. Another very important reason for the strength of the economy in recent years is the pro-growth tax cuts that have lowered the cost of capital. These tax cuts helped to foster a rebound in investment, converting a key weakness of the economy into a significant source of strength. The subsequent increases in investment in equipment also boosted manufacturing output. A further contribution relates to our flexible price system, which has enhanced the economic resiliency we enjoy.

Consequently, the economic outlook remains positive. According to Federal Reserve and private economic forecasts, the economy is expected to grow at a healthy pace through 2006. The positive economic outlook, however, depends on the prompt extension and ultimate permanence of these pro-growth tax cuts.

This Research Report is based in part on the Joint Economic Committee study, *The Case for Incrementally Lowering Capital Taxation*, (February 2006). For a copy of this study, contact the JEC at (202) 226-3234 or visit the website **www.house.gov/jec.**

Additional JEC Reports on taxation are also available on the website and include:

- *How Effective was the Jobs and Growth Tax Relief Reconciliation Act of 2003?* (May 2005)
- *Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness* (May 2005)
- *A Brief Explanation of the Economic Burden Imposed by Federal Taxes* (April 2005)
- *How Competitive is the U.S. Tax System?* (April 2004)
- *Near-Term Stimulus and Long-term Growth* (May 2003)
- *Federal Tax Policy, Near-Term Stimulus and Long-Term Growth* (March 2003)
- *Tax Reduction and Economic Welfare* (April 1999)
- *Some Underlying Principles of Tax Policy* (September 1998)