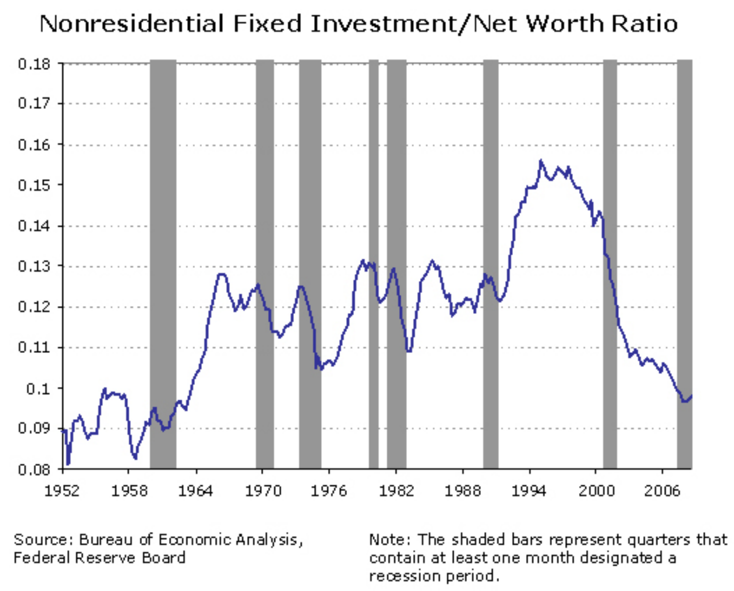
January 7, 2009

Will tax stimulus stimulate investment?

Update: Reader Doug Lee points out that the fixed investment series above is dominated by the extraordinary decline in residential investment over the past several years. For that sector, the questions posed above are in a bit sharper focus. Are firms in the residential investment sector pessimistic about future prospects? Absolutely. Are compromised credit markets behind the low investment levels? Quite possibly, though given the large inventory overhang in housing it is improbable that activity in the sector would be robust in any case. Is the low investment/net worth ratio symptomatic of a general deleveraging within the nonfinancial business sector? Not so clear, as it is pretty hard to see through the effect in residential category.

Here, then is a chart of the history of nonresidential fixed investment relative to corporate net worth:



The recent decline in the ratio, while still there, is much less dramatic and, in fact, seems to be part of a more persistent trend that commenced prior to the 2001 recession (and which may have been temporarily disguised by the housing boom that followed).

Was the nonfinancial nonresidential business sector ahead in the deleveraging game—ahead of residential construction businesses, financial firms, and consumers? And could this bode well for this sector when the recovery begins? Unfortunately, I have more questions than answers.

By David Altig, senior vice president and research director at the Atlanta Fed

Original post:

On Monday, the form of potential fiscal stimulus, 2009-style, took a step forward detail-wise. From the *Wall Street Journal*:

> "President-elect Barack Obama and congressional Democrats are crafting a plan to offer about $300 billion of tax cuts to individuals and businesses, a move aimed at attracting Republican support for an economic-stimulus package and prodding companies to create jobs.

> "The size of the proposed tax cuts—which would account for about 40% of a stimulus package that could reach $775 billion over two years—is greater than many on both sides of the aisle in Congress had anticipated."

The plan appears to make concessions to both economic theory—which suggests that consumers will save a relatively large fraction of temporary increases in disposable income—and recent experience—which seems to suggest that what works in theory sometimes works in practice. Again, from the *Wall Street Journal*:

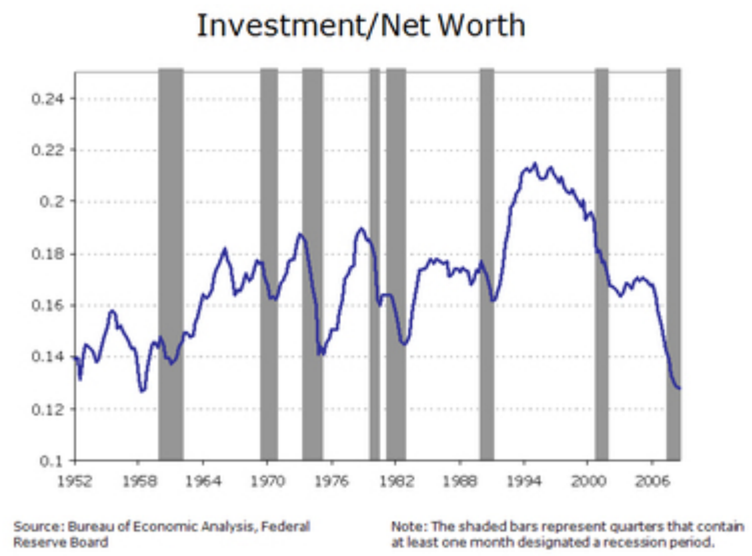
> “Economists of all political stripes widely agree the checks sent out last spring were ineffective in stemming the economic slide, partly because many strapped consumers paid bills or saved the cash rather than spend it. But Obama aides wanted a provision that could get money into consumers’ hands fast, and hope they will be persuaded to spend money this time if the credit is made a permanent feature of the tax code.”

As for the business tax package:

> “… a key provision would allow companies to write off huge losses incurred last year, as well as any losses from 2009, to retroactively reduce tax bills dating back five years. Obama aides note that businesses would have been able to claim most of the tax write-offs on future tax returns, and the proposal simply accelerates those write-offs to make them available in the current tax season, when a lack of available credit is leaving many companies short of cash.

> “A second provision would entice firms to plow that money back into new investment. The write-offs would be retroactive to expenditures made as of Jan. 1, 2009, to ensure that companies don’t sit on their money until after Congress passes the measure.”

A relevant question here is really quite similar to the one we ask when the tax cuts are aimed at households: Will the extra cash be spent? This graph provides some interesting perspective:



Relative to net worth (of nonfarm nonfinancial corporate businesses), private fixed investment has been in consistent decline since the second quarter of 2006. (The level of fixed investment has declined in each quarter, save one.) In fact, the investment/net worth ratio is currently at a postwar low.

Why? A couple of hypotheses come to mind. (1) Firms are extremely pessimistic about the outlook and see relatively few worthwhile projects in which to commit funds. (2) Credit markets are so impaired that the net worth of firms—a critical variable in mainstream models of the so-called “credit channel” of monetary policy—is supporting increasingly smaller levels of lending. (3) Nonfinancial firms, like financial firms, are deleveraging and hence not expanding.

Of course, even if one of these hypotheses is true, it need not be the case that marginal dollars sent in the direction of businesses will go uninvested. But it makes you wonder.

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