JOINT ECONOMIC COMMITTEE

JIM SAXTON, CHAIRMAN

RESEARCH REPORT #109-6
May 4, 2005

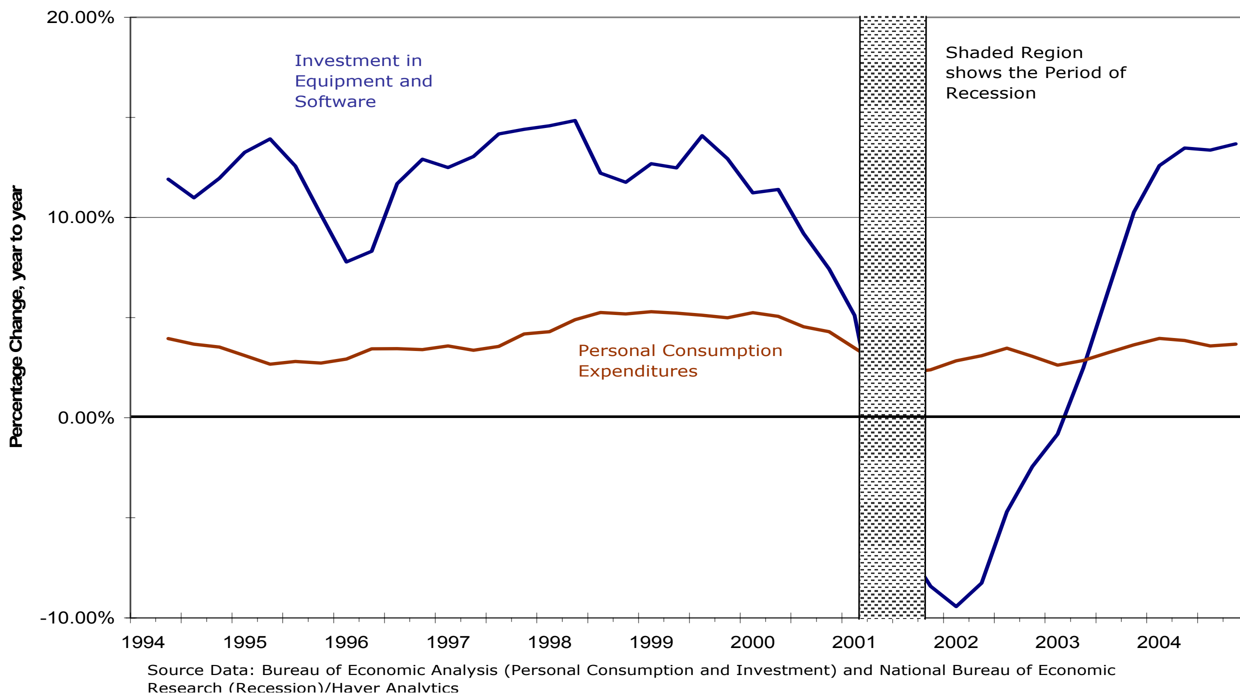
HOW EFFECTIVE WAS THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003?

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) was designed to encourage balanced economic growth. In addition to stimulating consumer spending and short-term economic growth, the JGTRRA was intended to promote investment, capital formation and long-term growth. The efficacy of the JGTRRA has been the subject of debate in recent policy disputes and in academic and popular publications. Many of the criticisms have questioned the adequacy of the economic stimulus to increase consumer spending. The key issue, however, is whether the JGTRRA stimulated investment.

As the JGTRRA was being drafted in early 2003, consumer spending only needed a nudge. As the economy began to deflate in the first quarter of 2000, the pace of consumer spending eased. But unlike the previous four recessions, consumer spending never declined. After dropping from a 5% annual growth rate in 1999, the growth rate of consumer spending returned to the average of the previous twenty-five years – around 3.3% per year. In addition to the economic stimulus of the 2001 and 2002 tax legislation, consumer spending was fueled by low interest rates, rising real estate values and mortgage refinancing. Consumer spending remained buoyant during the recession and recovery.

In contrast, the rate of investment spending started its free fall beginning in 2000. (Please see Figure 1.) As a result, even healthy consumer spending was inadequate to expand employment or stimulate anything but anemic economic growth.

Figure 1. Change in Consumer Spending and Investment



Source Data: Bureau of Economic Analysis (Personal Consumption and Investment) and National Bureau of Economic Research (Recession)/Haver Analytics

The collapse of investment following the bubble in the late 1990's had a devastating effect on the economy and may have been the primary cause for the recession. As a result, the JGTRRA was designed to stimulate capital formation. Through the mechanism of "bonus depreciation," whereby future tax benefits related to the depreciation of capital are brought forward into the current period, the JGTRRA stimulated investment in capital goods, notably computers and related equipment. (Expenditures for computers and related equipment account for 57% of capital investment in all non-structural capital.) This investment would reverse the loss of employment in this key sector and have the added benefit of boosting productivity and contributing to growth in the future.

MEASURING THE EFFECTS OF JGTRRA

Economists cannot conduct controlled macroeconomic experiments. Because of the inability to re-run history and compare the results of no tax legislation with the economic outcome of the JGTRRA, one must construct a case that the JGTRRA did perform as expected using economic theory and data. First, economic theory would state that a decline in the cost of capital would spur an increase the quantity of capital demanded because, all else equal, lowering the cost of any item increases the quantity demanded for that item. Second, using economic theory and real-world observations about how the economy behaves, economists build mathematical models to conduct "what if" analyses. What if tax rates were reduced, will economic growth increase? Several academic researchers have compared the results of economic models of the U.S. with and without the tax changes of the JGTRRA. While the results vary – each researcher or research team uses a different model with different strengths and weaknesses – the research has shown the JGTRRA as having a positive effect on economic growth.

The economic data of the last several years comport with the economic models. Investment in Equipment and Software (a category that includes all capital goods except structures) and employment in Durable Goods Manufacturing both declined sharply in early 2000. Economic activity – production, sales and employment – in the industries producing capital goods continued to decline into the beginning of 2003. The rate of investment became positive in the second quarter of 2003. Eventually, the investment returned to the historical rate of about 10% per year, as shown in Figure 1. As a result, the capital goods producing industries experienced an increase in production and an eventual return to employment growth. While the relationship of the turnaround in investment and employment in durable goods production does not prove that one event caused another, the trends in these economic data, combined with the results of the economic modeling, lead to the conclusion that the JGTRRA performed as designed.

In summary, investment collapsed in 2000 and, as a result, the pace of economic growth eased. By 2001, the economy grew by a disappointing 0.75%. Due to the balanced stimulus of the JGTRRA, the economy regained its footing in 2003 and GDP grew at 3%. As the benefits of JGTRRA took full force in 2004, the economy expanded at the healthy rate of 4.4%.