Non-US groups reaped fruits of Bush tax cuts

By Richard Bernstein

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Continuation of the Bush tax cuts has been the subject of much discussion in US political and economic circles.

Those on the right object to most forms of increasing government revenue, while the left wants to narrow disparities of income and wealth.

The tax cuts' two bills, in 2001 and 2003 – changed laws so that personal income tax rates were reduced, exemptions for the Alternative Minimum Tax increased, and dividend and capital gains taxes also cut.

Yet in the debate, it seems of no moment to either side whether the tax cuts were effective in achieving their goal of spurring business investment and making the US economy more competitive.

Our own examination of US non-residential investment indicates that the reduction in capital gains tax rates failed to spur US business investment and failed to improve US economic competitiveness.

The 2000s – that is, the period immediately following the Bush tax cuts – were the weakest decade in US postwar history for real non-residential capital investment.

Not only were the 2000s by far the weakest period, but the tax cuts did not even curtail the secular slowdown in the growth of business structures.

Rather, the slowdown accelerated into a full decline.

During each decade from the 1950s to the 1990s, growth in real gross non-residential investment averaged between 3.5 per cent and 7.4 per cent per decade. During the 2000s, it averaged a mere 1 per cent.

Similarly, the growth rate for investment in equipment and software ranged from 5.7 per cent to 9.9 per cent in these earlier decades. It averaged 1.9 per cent during the 2000s.

Average growth in non-residential structures ranged from 1.3 per cent to 5.7 per cent from the 1950s to the 1990s. During the 2000s, it declined by 0.8 per cent.

The stated goal of cutting taxes to spur US capital investment was not achieved.

Where did the benefit of the tax cuts go?

We have maintained that an increasing proportion of the benefits of US monetary and fiscal policy are leaking outside the US.

Washington sets policy as if the US were a closed economic system and rarely considers ramifications outside the country.

The consensus regarding the negative effects of rising tax rates on US stocks suggests that investors also might not adequately consider policy leakage when formulating strategies.

The Bush tax cuts may have encouraged capital flight from the US because the dollar was weak and capital – including incremental funds in taxpayers' pockets – tends to flow to stronger currencies.

In a weak dollar environment, US policymakers must consider whether a tax cut's positive effects on the US economy might be muted relative to its collaterally positive effects on stronger-currency economies.

Record flows to emerging market debt and equity funds, coupled with anaemic US investment spending, suggest that this might be an issue.

If we are correct about the growing extraterritorial leakage of US monetary and fiscal policies, then an increase in the capital gains tax rate might have a larger negative effect on non-US investments such as emerging market funds and exchange-traded funds than on US investments.

There probably are greater long-term capital gains to be made in non-US investments than in US investments simply because of the outperformance of non-US markets since the tax cuts were enacted.

From December 2003 to August 2010, the MSCI Emerging Market Index appreciated 120 per cent versus a decline of 6 per cent for the S&P 500.

Speculative assets that have appreciated, such as gold, might also suffer if the tax cuts were allowed to expire and investors rushed to cash in gains before the lower tax rate expires.

Business investment data demonstrate that the Bush tax cuts failed to achieve their goal of spurring productive US investment and that this failure has contributed to the poor performance of US stocks.

In a strong dollar environment, the cuts might have encouraged incremental taxpayer savings to flow into US companies, reducing their cost of capital, boosting their return on capital and driving their stock values higher.

Instead, in the weak dollar environment of the times, the cuts leaked abroad and boosted return on capital outside the US.

By so boosting non-US companies' return on capital relative to that of US companies, the tax cuts made US companies that much less attractive and had the opposite of their intended effect.

It is possible that allowing the Bush tax cuts to expire might damage non-US investment prospects more than those of the US.

Richard Bernstein is chief executive of Richard Bernstein Advisors