Richard Bernstein Advisors

The Bush Tax Cuts: Investment Implications

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There has been considerable discussion recently regarding the continuation of the Bush tax cuts. Much of that discussion seems to be based on philosophical differences, not on economic facts. Those on the right object to most forms of increasing government revenue; those on the left want to narrow disparities of income and wealth. It seems of no moment to either side whether the tax cuts were actually effective in achieving their stated goal of spurring business investment and making the US economy more competitive globally.

Although an extension of the Bush tax cuts would likely benefit our clients in the very near-term, that is probably not the best criterion for evaluating the effects of public policy on long-term investment strategies. As investors, the key question must be the efficacy (or not) of the cuts, the answer to which can imply vastly different investment strategies.

Reviewing numerous articles in search of an unbiased perspective on this question of efficacy, we found little in the way of either objective discussion or reference to empirical data from reliable sources.

Our own examination of US non-residential investment indicates that the Bush tax cuts indisputably failed to spur US business investment and, accordingly, failed to significantly improve the global competitiveness of the US economy. In drawing this conclusion, we made no potentially biasing assumptions. The data are so dramatic that our conclusion was ineluctable.

The decade of the 2000s (*i.e.*, the period after the Bush tax cuts) was the weakest decade in US post-war history for real non-residential capital investment. The table below shows the average growth rate in real private non-residential investment by decade, broken down into Equipment & Software and Structures. 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 decline accelerated.

Gross Private Non-Residential Investment

(Average growth rate by decade)

	Total	Equipment & Software	Structures
1950s	5.1%	5.7%	5.1%
1960s	7.3%	8.6%	5.7%
1970s	5.8%	7.2%	3.7%
1980s	3.5%	5.0%	1.4%
1990s	7.4%	9.9%	1.3%
2000s	1.0%	1.9%	-0.8%

Source: BEA, Bloomberg LP

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It is hard to determine what sectors did benefit from the Bush tax cuts, but we believe that two sectors deserve further study. The first is US residential real estate. To our knowledge, there has been no serious discussion regarding those tax cuts' contribution to the housing bubble. Claims that the cuts led to job creation ignore that real-estate construction and sales were major contributors to job growth.

Second, we have maintained for many years that an increasing proportion of the benefits of US monetary and fiscal policy are leaking outside the US. We first wrote about this in 2002/03 and suggested that the Fed's ultra-accommodative monetary policy would effectively "give free money to China." It seems to us that Washington still sets policy as if the US was a closed economic system, and rarely considers to what extent their policies might ramify outside the country.

For example, the Bush tax cuts may have encouraged capital flight out of the US through a combination of a weak US dollar and the tendency of capital to flow to stronger currencies. US policymakers must consider whether tax cuts' positive effects on the US economy might be muted relative to their collaterally positive effects on non-US economies when the US dollar is weak. Record inflows to emerging-market debt and equity funds, coupled with anemic US investment spending, imply that this may already be a significant issue.

Because the Bush tax cuts did little to spur US business investment, and because real-estate-related jobs have already been lost, allowing the tax cuts to expire might have a much less pronounced effect on US stocks than many assert. If we are correct about the increasing "leakage" of US monetary and fiscal policies, then an increase in the capital gains tax rate might actually have a negative effect on non-US markets. After all, there probably are greater long-term capital gains to be harvested in non-US investments than in US investments, because of the significant outperformance of non-US markets.

US business investment data clearly demonstrate that the Bush tax cuts failed to achieve their stated goal. The period after the tax cuts was the weakest period of real business investment in US history. This fact, buried in the political rhetoric, once again highlights that investment strategies based on Washington oratory rather than on empirical data may miss important investment themes and opportunities.

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