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# BUSINESS INVESTMENT IS RIPE FOR A REBOUND AND WASHINGTON CAN LEND A HAND

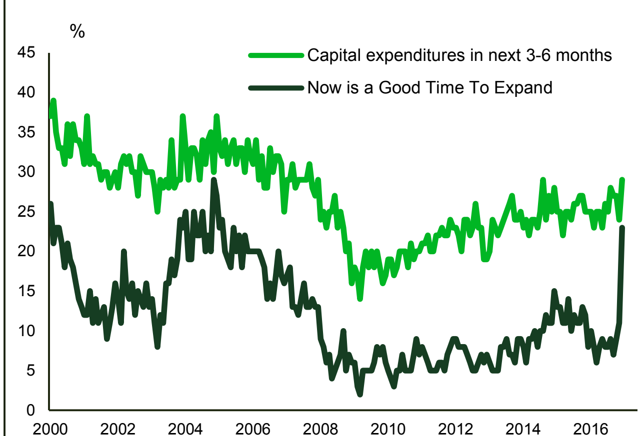
## Highlights

- A variety of factors suggest that after a period of weakness, conditions are ripe for U.S. business investment to accelerate. These include better corporate profits, improved business sentiment and leading indicators from the construction sector,
- Trends in the capital to labor ratio also suggest that there may be a degree of "pent up" demand in business investment that has the potential to be unleashed.
- Several aspects of Republican policy proposals could help to further unlock investment and boost economic growth. Chief among them is corporate tax reforms that include a lower statutory rate.
- Success depends on how tax cuts are paid for, since an increased debt burden raises interest rates and crowds out private investment over the longer run. Reforms funded by reduced government spending have the potential to reduce distortions in the current tax system, enhance productivity and raise potential growth over the long run.
- The details of these policies will be hashed out over the coming months. As initiatives become more concrete, we will incorporate any upward revisions into our economic forecast.

Business investment has been stymied over the past two years by a sharp drop in oil prices and rapidly rising dollar (see report), but conditions are increasingly ripe for a turnaround. In addition to rebounding corporate profits, measures of business confidence and investment intentions have perked up meaningfully since the election, suggesting that business' "animal spirits" have been reignited.

Against this already favorable backdrop, several policy proposals of the new Congress and administration in Washington could provide the key to unlock pent-up demand among American businesses. While it remains to be seen what specific measures will be implemented and there are a lot of moving parts, the risk to the investment outlook appears skewed to the upside. As these measures become more concrete, we will incorporate any upward revisions into our economic forecast.

CHART 1: SMALL BUSINESS READY TO SPEND




Source: NFIB/HAver Analytics, TD Economics.

### Stars align for business investment uptick

The causes of the recent downturn in business investment are not hard to identify: a rapid drop in oil prices and sharp rise in the dollar drained corporate coffers. After-tax corporate profits were down a whopping 18% year-on-year through the fourth quarter of 2015 and only moved into positive territory in the third quarter of 2016.

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There are several factors that suggest that businesses are poised to spend once again. First and foremost is the upturn in profits. Corporate profits staged a sizeable rebound in the third quarter, after declining in five of the prior six quarters. We expect these gains to be sustained as the downturn in the oil and gas sector has troughed, and the worst of the impact from a stronger U.S. dollar on corporate earnings overseas is in the rearview mirror. That will put businesses in a stronger financial position to undertake new spending.

And, many firms agree. A variety of sentiment surveys indicate that American businesses have become more optimistic about their prospects since the election. Most notably the National Federation of Independent Business (NFIB) survey of small business optimism index skyrocketed following the election. Encouragingly, the percent of businesses saying that "now is a good time to expand" jumped to its highest level since 2005 (Chart 1). Moreover, 29% of respondents expect to make capital expenditures in the next 3-6 months, the highest reading since before the downturn in oil prices.

Two leading indicators of activity in nonresidential construction have also seen notable improvement in recent months. The Dodge Momentum Index, which is a monthly measure of initial nonresidential building projects in planning and has been shown to lead construction spending, has accelerated since mid-2016 and reached an eight-year high in December. Another leading indicator for nonresidential construction, The Architectural Billings Index, jumped up in December, and reached a post-recession high.

All told, our baseline forecast is for overall business investment to accelerate to 3.4% over the course of this year, from an estimated decline of 0.2% in 2016. But, that does not include the upside potential if policy shifts in Washington are able to ignite a hotter pace of spending. There is also upside risk to investment from a stronger-than-expected bounce back in oil and gas spending, that has nothign to do with policies in Washington or renewed confidence among business leaders. This seems to be materializing as U.S.shale producers are proving very responsive to even small upticks in the price of oil.

## Good case for pent-up demand for business investment

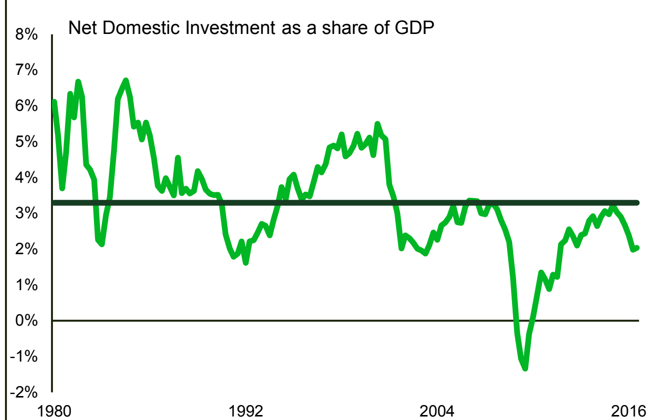
The risk to the outlook comes from the potential for a return to a more normal investment environment. Even before the shocks of the last two years, business investment had been one of the more disappointing elements of the economic recovery. Overall non-residential investment including structures, equipment, and intellectual property fell a whopping 20% during the Great Recession and did not regain its pre-recession peak for five years. This was by far the longest period of weakness on record.

Even more concerning, investment net of depreciation has been noticeably weak for roughly the past fifteen years. Through to the late 1990s, net-investment's share of GDP during expansions had regularly been above 5%, and even during recessions, typically did not fall below 2% of GDP (Chart 2). Since 2000 however, net-investment has not been much higher than 3% of GDP. Net investment fell negative for the first time on record during the Great Recession (implying an outright reduction in the net-stock of investment goods), but peaked at just 3.2% in the first quarter of 2015 before once again turning south.

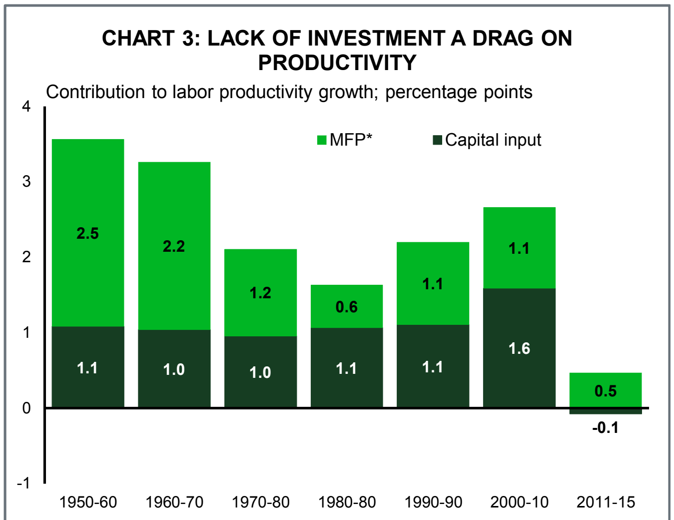
This relatively weak pace of investment growth has been an important factor weighing on labor productivity growth since the recovery. Typically over history, investment has not only kept pace with depreciation, but grown fast enough to raise the level of capital available per worker  This so-called "capital deepening" has allowed American workers to produce more output with the same amount of labor effort (thereby raising productivity). Over the past fifty years, additional capital per worker has explained slightly over half of the 2.0% increase in labor productivity. Importantly, while growth in capital per worker typically slows in the aftermath of recessions, it has, for the most part, not deviated far from its long run trend.

However, since the Great Recession, the level of capital relative to labor and output has been declining or flat. Instead

**CHART 2: NET DOMESTIC INVESTMENT BELOW LONG-RUN AVERAGE**



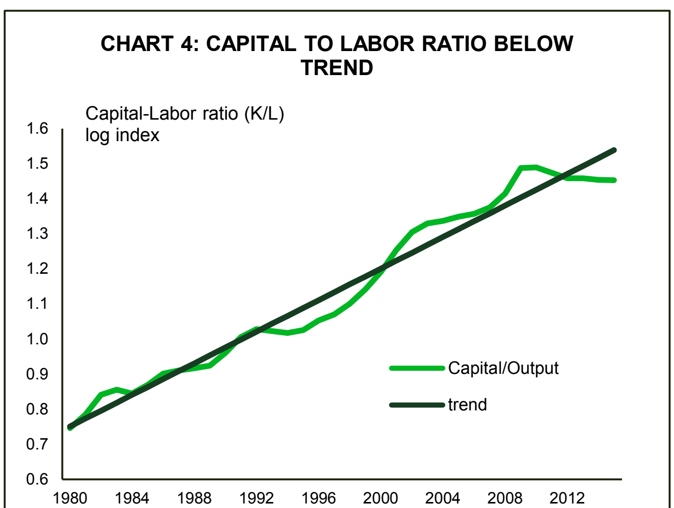

Source: BEA/Haver Analytics, TD Economics.



Source: Bureau of Labor Statistics, TD Economics. *Multifactor productivity.

of adding to growth, it has subtracted from it (Chart 3). By 2015, the capital to labor ratio was about 9% below trend (Chart 4). With investment declining in 2016, this deviation likely worsened over the past year.

According to research by economists at the Chicago Fed, the trend has historically been re-achieved by an increase in capital accumulation (i.e. investment) rather than a reduction in labor force growth. This suggests there may be a degree of "pent-up" demand in business investment. As economic growth strengthens, a return to more historical patterns would imply a firm acceleration in business investment over the next several years. Businesses may just need the confidence to do it.



Source: Chicago Fed, BLS/Haver Analytics, TD Economics.

### Policy shifts could act as catalyst

Against this favorable backdrop, several priorities of the new administration in Washington could provide the key to unlock pent-up demand among American businesses. These priorities include corporate tax reform, lower marginal tax rates, and a reduced regulatory burden. In all likelihood, the recent surge in business confidence reflects optimism that these goals will be achieved.

One of the most potent catalysts to improve business investment could be a corporate tax rate cut as part of a larger tax reform. There has been bi-partisan agreement for quite some time that the current corporate tax code is overly complex and even contains perverse incentives. Nonetheless, Washington gridlock has stymied reform efforts for over ten years. There is widespread consensus that now is the best time to pass a major tax reform package. Indeed, Treasury Secretary-Nominee Steven Mnuchin has pledged to usher in the "largest tax change" since the Reagan administration. The details are currently being hashed out on Capitol Hill, and the final proposal may not be known for some time. But, it is likely that the corporate tax rate will fall, combined with reforms to broaden the tax base.

### Tax reform should support business investment

Both the Trump campaign and House Republicans (GOP) put forward corporate tax reform plans during the campaign. Their high level features are outlined in the following table, and are very much aligned. Congress appears likely to craft a tax reform package, which will also incorporate cuts to personal income taxes.

Both the House GOP and Trump plans call for significant reductions to the marginal tax rate on corporate income. This could help stimulate business investment in the U.S. economy in two ways. First, it would make U.S. tax rates more competitively internationally. Corporate income tax rates have been on a downtrend in recent years among OECD countries, and the U.S. stands out as an exception, with the highest statutory rate. Capital is mobile, and a higher tax rate hurts America's competitive position as a place for businesses to invest.

Second, a lower corporate tax rate could encourage American businesses to invest more. Firms' investment decisions are driven by the cost of capital and the expected return to the project. Corporate taxes reduce the after-tax return on an investment by increasing the tax-adjusted user cost of capital.

**Converting the corporate income tax to a "destination-based cash flow" tax**

The House GOP Blueprint proposal put forward during the election campaign would transform corporate income taxes into a cash-flow tax based on domestic cash flow, called a "destination-based cash-flow tax" (DBCFT). U.S. corporations would no longer pay tax on foreign-sourced income (either repatriated overseas earnings or income from exports), eliminating incentives to hoard cash overseas or engage in complicated transfer pricing to shift tax liability offshore. If the revenue is not generated by sales of goods and services in the U.S., it is not taxable.

This system of taxation would mean businesses could not deduct the cost of imported goods and services when calculating income for tax purposes. These "border adjustments" are a key aspect of the DBCFT, and have already proven quite controversial. They seemingly advantage companies with a high degree of export revenue, and disadvantage firms who import much of their inputs, like retailers or oil refiners. Since the U.S. imports more than it exports, border adjustments represent a significant broadening of the tax base. In fact, the revenue expected to be generated from border adjustments offsets over 60% of the cost of the rate reduction and eliminating the alternative minimum tax over the first ten years of the proposal.

Economists behind the proposal argue that the impact on import-intensive industries would be offset by an appreciation in the U.S. dollar. A stronger U.S. dollar would lower the cost of imports, and raise the price of exports, such that the after-tax income between a company that exports heavily versus one that imports heavily, would be equalized. The U.S. dollar would need to appreciate by 25% for this to strictly hold true. Few currency traders expect this to occur at least immediately, and so some of the increase in the price of imports would likely be passed on to consumers.

Despite the controversy caused by border adjustments, the GOP's tax reform proposal is appealing in that it removes many distortions in the current U.S. international tax system. It would no longer encourage overseas production by U.S. multinationals, because all production for US consumption would be taxable, no matter where production occurred. It would also eliminate any incentive for corporate inversion transactions, because the amount of US tax paid would not depend on where it was incorporated or where the product or service was produced, but where the good or service is consumed. In essence, the DBCFT is similar to a value-added tax (VAT), but with a deduction for wages.

However, this DBCFT system has been left out of previous tax reform proposals on concerns that it would run afoul of WTO rules. The WTO allows border adjustments in the context of VATs, but views border adjustments in income tax systems as export subsidies. The GOP plan argues its system is economically equivalent to a VAT. However, critics argue that wage deductibility makes it not equivalent to a VAT, and could trigger international challenges and potential retaliatory tariffs. Despite this, the policy is consistent with President-elect Trump's "America First" agenda, and therefore should not be completely discounted.

Overall there are pluses and minuses for business investment inherent in the base-broadening impact of border adjustments. For some firms, it could somewhat offset the stimulus provided by the lower marginal tax rate. But removing the incentive for businesses to shift production and or profits offshore would reduce costly distortions in the current tax system.

There is a substantial literature on the impact of corporate income taxes on economic growth. The OECD has found that corporate tax rates (along with the high top marginal personal rates) have an adverse impact on investment and productivity[1]. In fact, a study looking at a variety of taxes and economic growth[2] found that corporate taxes are the most harmful to growth, followed by personal incomes taxes.

One key study estimates that the impact of a 10% reduction in the corporate income tax rate would lift annual growth in GDP per capita between one to two percentage points[3]. A subsequent study substantiated this claim by applying similar methods to Canadian provinces and found that a 1% reduction in the CIT rate is associated with a 0.1-0.2%-point temporary increase in the annual GDP per capita growth rate . This was after controlling for personal income taxes, sales taxes and a variety of other economic variables. It also found that private investment as a share of the economy rises to approximately 0.34%-points in response[4].

Both plans also call for reductions to personal income tax rates, which would reduce the top marginal rate on capital gains, dividends and interest income. The House plan would also allow businesses to immediately deduct all investments in equipment, structures and inventories, rather than having to depreciate them over time. The net effect of all of these changes is a lower marginal effective tax rate (METR) on

| Key Features of Trump Campaign & House GOP Corporate Tax Plans | | | |
|---|---|---|---|
| | Current | Trump | House GOP |
| Corporate Tax rate | 35% | 15% | 20% |
| Pass-through business tax rate | 45% | 15% | 25% (max) |
| Tax on existing unrepatriated foreign earnings* | na | 10% , 4% | 8.75%, 3.5% |
| Treatment on investment spending | depreciate | choose | full expensing |
| Interest expense deduction | deductible | choose | eliminated |
| Corporate Alternative Minimum Tax | 20% | repeal | repeal |
| METR on new investment - corporate/pass-through | 22%, 18.9% | 9.5%, 2.6% | 8.8%, 2.5% |
| Revenue impact over 10 years | | -$2.63T | -$0.89T |
| Source: Tax Policy Center. * Cash, other earnings. | | | |

new investments. Under the House GOP Blueprint, the METR on new business investment would be reduced from 22% to 6.3%, according to the Tax Policy Center[5] (see summary table, next page).

Because the House GOP plan eliminates the deductibility of interest payments from taxable profits, business investments that are financed by debt would face higher effective tax rates than under current law. This would eliminate the tax advantage for debt over equity-financed investment, a long-standing distortion of the tax code. This could reduce corporate leverage. As the OECD points out, this distortion can affect total factor productivity (TFP) by distorting the allocation of investment between industries, favoring those that can more easily debt finance and disadvantaging those that have to rely on equity, such as knowledge-based industries that invest heavily in intangible property.

Finally, both the Trump and GOP proposals include a transitional tax on existing repatriated foreign earnings, at rates (see table) well below the statutory rate. Estimates of accumulated earnings offshore run as high as $2.9 trillion. In the case of the GOP plan, the TPC estimates that this would generate approximately $140 billion in revenues for the federal government over ten years, helping to offset the lower tax rate. While in theory this money could be invested domestically by U.S. corporations, past experience tells a different story. The U.S. implemented a similar one-time repatriation tax rate at 5.25% in 2004. On average, firms used the tax break to repurchase shares or pay dividends rather than investment. More importantly, a lower statutory rate would reduce the incentive for corporations to build up cash overseas in the first place, eliminating the need for these temporary repatriation amnesties.

**Taking away the punch bowl**

Overall, a corporate tax reform plan that includes a reduced top marginal rate has the potential to raise business investment in the coming years. The sustainability of this growth will depend on how the tax cuts are financed and how much additional slack remains in the economy.

First, the U.S. economy is arguably operating relatively close to full capacity. There is a risk that faster economic growth inspired by these measures will simply stoke inflationary pressures and see the Fed hike rates faster than we currently expect, dampening the near-term boost. Still, to the extent that reforms boost the economy's capital stock, they could raise productivity growth, and mean the economy could grow at a faster pace without generating inflation. A boost to potential growth would be a welcome development given the pressures the United States will face in the coming years due to an aging population.

More critical is how the reductions in revenue are paid for. If they are financed through larger deficits, they risk raising the risk premium imbedded in long-term interest rates, ultimately crowding out future private investment. If they are financed through spending cuts, the impact may be less negative, but could still depend on where the cuts take place – cuts to government support for primary research for example could prove counterproductive.

Even accounting for the growth enhancing (and therefore revenue enhancing) nature of the tax reform, the scope of cuts to government necessary to pay for them could still prove to be significant. The Tax Policy Center (TPC) estimates that even when including the positive growth effects on the economy, the entire House GOP tax proposal would reduce federal revenue by about $2.5 trillion over the next 10 years. The TPC estimates the entirety of the House GOP

**Other potential policies which could improve the business investment backdrop**

Other aspects of Trump and the GOP's campaign platform could help provide a more favorable climate for business investment in the U.S. The first is reducing government regulation. Small businesses surveyed by the NFIB have increasingly cited "government requirements" and their single most important problem facing their business, now nearly tied with "taxes" as number one. Both the GOP plan and the Trump campaign emphasized cutting down on government red tape and streamlining regulations. This could help facilitate greater investment in the U.S. economy, although it is difficult to quantify precisely.

The new administration has clearly prioritized using its influence to encourage companies, particularly within the manufacturing sector, to make investments in the U.S. rather than overseas. This moral suasion has already resulted in on-shoring decisions by several multi-national corporations, and could result in more firms following suit. No doubt the promise of lower taxes was part of the inducement to invest in the U.S., but this moral suasion element could have a real impact on high profile investment decisions.

Finally, the new administration has indicated infrastructure spending is a priority. While it remains to be seen how much new spending will actually occur, and increase in the federal government's investment in infrastructure, which has lagged in the current economic cycle. That would have knock-on effects in sectors like construction, which may need to ramp up spending to service potential public sector projects.

tax plan (including personal tax cuts) would boost GDP by a maximum of 1.4% in 2018, relative to its baseline projection, but by only 1.0% by 2026. By 2036 the tax plan would reduce GDP by 0.2% relative to a baseline forecast due to crowding out, and lead to higher debt-to-GDP over the long run.

This analysis acknowledges that the models used are sensitive to assumption about how individuals respond to incentives and other government policies. It shows that a more "optimistic" scenario could occur where investment and output are permanently raised by the GOP plan. The necessary conditions for this outcome is that U.S. deficits do not affect the interest rates facing investors, which are determined on world markets, and that labor supply and savings are very responsive to wages and interest rates. These assumptions, however, are unlikely to hold for the U.S. given its weight in world capital markets and supply of global bond issuance.

**The Bottom Line**

A variety of factors suggest that after a period of weakness, conditions are ripe for U.S. business investment to accelerate on its own volition. And now, there are several aspects of Republican policy proposals that could help to further unlock investment and boost economic growth. This is likely the sentiment reflected by financial markets and business confidence surveys since the election. However, the impact depends critically on how these measures are paid for, since an increased debt burden raises interest rates and crowds out private investment over the longer run.

Moreover, given the U.S. economy is arguably close to full-employment, stimulative measures at this time could put upward pressure on inflation and lead to a faster pace of rate hikes by the Federal Reserve. However, if productivity-enhancing reforms are funded by cuts in government spending (that do not hurt incentives to investment) they have the potential to reduce distortions in the current tax system, enhance productivity and raise potential growth over the long run.

It is very early days for the Trump administration and the details of these policies will be hashed out for some time to come. As initiatives become more concrete, we will incorporate any upward revisions into our economic forecast.

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## ENDNOTES

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5 http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full