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DID REAGAN'S 1981 TAX INCENTIVES WORK?; AFTER 1982, CAPITAL SPENDING SET RECORDS

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IT has become fashionable in certain quarters to deny either that there has been a significant increase in capital investment under the Reagan Administration's tax policies or that current investment levels are significantly greater than those that prevailed earlier.

The argument is that the Reagan tax changes in 1981 (the Economic Recovery Tax Act) had no significant effect in loosening the constraints on capital formation. Thus, we need not be concerned that capital formation would be adversely affected by the severely restrictive changes in depreciation rules and the repeal of the investment tax credit proposed in many of the current tax-reform plans. The data do not support this position.

In the eight quarters following the recessionary trough of 1982, outlays for "producers' durable equipment" increased by $44.7 billion in constant 1972 dollars, or by 40.8 percent. This was an annual growth rate of 18.7 percent. Of this $44.7 billion increase, $30 billion has been in facilities other than "office computing and accounting machinery," an increase in this type of investment of 36.2 percent overall, or 16.7 percent annually, Investment in office machinery increased by $14.8 billion, a 65 percent rise (24.5 percent annually), reflecting the growing use of computer technology in machinery and equipment. These growth rates far exceed the average rates of growth in these three categories in the years 1947 to 1984: 4.3 percent for durable equipment, 11.1 percent for office computing machinery and 3.5 percent for durable equipment other than computers.

The recession of 1982 was particularly severe, and critics of the 1981 tax act are fond of claiming that the investment boom of the post-recession 1980's has only brought us back to where we would have been without a recession. Indeed, some claim that we remain below the levels we otherwise would have achieved. A comparison between this recession and previous ones shows that this assertion is without substance.

We don't know how quickly investment would have grown without the 1981 act. Thus, we have to be careful in attributing vigorous expansion of capital formation in the recovery to any one factor. Nevertheless, it is certainly reasonable to conclude that the provisions in the 1981 act that reduced tax impediments to savings and investments, even with the restrictions imposed by the Tax Equity and Fiscal Responsibility Act of 1982, made a major contribution to that expansion. Comparison of the data for the period from the last quarter of 1982 to the last quarter of 1984 with previous recoveries strongly supports that conclusion. T HE 18.7 percent rate of growth of investment in producers' durable equipment in constant 1972 dollars during the period was far faster than the 7.9 percent growth rate in a similar period after the recession of 1975. In fact, it far exceeds the investment growth rate for comparable periods following the recessions ending in 1970 (10.7 percent), 1961 (6.6 percent) and 1958 (10.3 percent).

Some skeptics have attributed the strength of the recent expansion to the surge in outlays for office computer and accounting machinery. Investment in these facilities has been spectacular, but even excluding those outlays, the remaining expenditures increased at a much faster rate in the two years after the end of 1982 than they did in any comparable prior period.

It is precisely with respect to producers' durable equipment that the 1981 tax changes were most pronounced and most beneficial. Cost recovery periods were reduced sharply with the adoption of the Accelerated Cost Recovery System of depreciation and the investment tax credit was significantly liberalized.

Growth in private purchases of non-residential structures typically lags behind capital investment during recoveries. This has been true in the recent pick-up, but the recent growth in these purchases has been much stronger than in the same period after prior recessions. The 1981 tax changes were not as helpful for structures as for machinery and equipment, but they did afford some positive incentive for such outlays.

The record tells us that tax policy can provide strong and effective incentives for businesses to add to the stock of the nation's productive capital. We must hope that tax reform efforts do not weaken the incentives which were provided in President Reagan's first tax act.