

# RESEARCH BUZZ

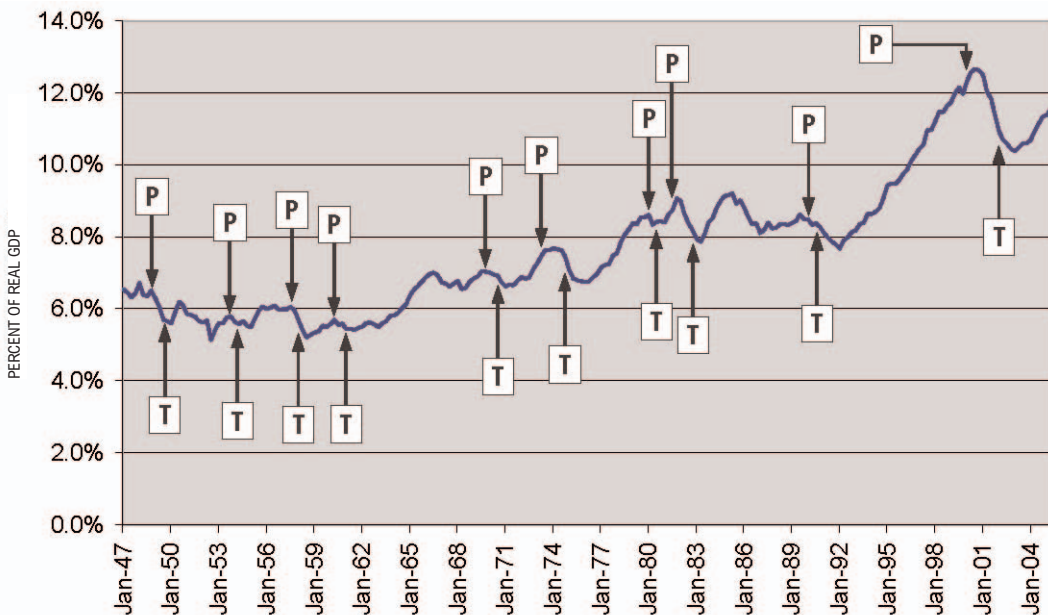
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## Business investment, cycles and tax policy: Are we investing too little too late?

BY DR. JOHN TATOM  
john.tatom@isunetworks.org

### Business investment cyclical but currently high, rising

Real non-residential private fixed investment as a percentage of real GDP:



Some analysts have argued that bubble excesses of the late-1990s led to excessive real investment, a process sometimes referred to as gold-plating, and that an important consequence was that capital formation has been depressed since then as firms have let production catch up with the excessive capital stock. While this description broadly fits the pattern of business fixed investment from the mid-1990s at least until 2003, it may be overstated. The business cycle and tax policy have played more important roles in explaining the pattern of investment activity. The resumption of investment, so long as tax policy changes in 2003 are maintained, suggests the excess capacity argument is no longer valid if it ever was.

The graphic at right shows the strength of real non-residential fixed investment, a measure of the quantity of investment in business structures, equipment and software, relative to real GDP, by measuring such investment as a percentage of real GDP. What stands out is that business investment surged up after the mid-1990s and, despite a sharp decline in 2000-03, has remained relatively high and has rebounded since 2003. In the latest quarter shown, the investment ratio equaled its average since 1997 (11.4 percent) and this was more than 50 percent above its previous 50-year average of 7 percent. Even at its lowest point in 2003, business investment was higher than at any time from 1947 through 1996. A cyclical expansion together with tax policy changes that lowered the cost of capital for business, by lowering the personal tax rates on dividend income and on capital gains and in turn raised stock

prices and lowered the real rate of interest, led to a rapid increase in business investment, though not yet by enough to raise investment back to the record pace of late-2000.

Most of the declines in this ratio in the graphic have been due to either recession or to tax policy changes that lowered the rate of return on investment. For example, periods of recession are indicated by P and T, which stand for peak and trough, respectively. In every recession the business cycle peak was accompanied by a peak in the share of business investment in real GDP. And business investment did not recover until the business cycle trough was reached or passed. Following the last three recessions the recovery began about two years after the business cycle trough. The effects

of the 1981 tax cuts in boosting investment and the 1986 tax hikes on business income are the most striking for their impact on the share of real business investment in real GDP. Another period of examples includes the suspension of the investment tax credit in 1966-67, its restoration from 1968-69 and suspension in 1970-71. In each case suspension led to declines in the ratio and restorations led to increases in the ratio. The only major decline in the ratio since 1946 that was not due to a cyclical downturn or tax hike raising the cost of capital was a slight decline from III/1950 to II/1951 and that had to do with the wartime transition in the start of the Korean War.

At least judged by the performance of more than 50 years, the U.S. business investment in new

plant, equipment and software has remained exceptionally high in this decade despite the recession in 2000 and subsequent expansion. It is not obvious that any excessive investment in the late-1990s has depressed the pace of capital formation since then.

As long as the 2003 tax policy changes remain in place and the economic expansion continues to be robust, business investment is likely to continue to grow faster than real GDP, boosting the share of such investment in GDP back toward its 2000 peak. Indeed, this is a major factor in most forecasts for continuing economic expansion in 2006.


















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# RESEARCHBUZZ



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## MISSION

Networks Financial Institute at Indiana State University was founded in 2003 through a grant from Lilly Endowment Inc. and strives to facilitate broad, collaborative thinking, dialogue and progress in the evolving financial services marketplace by focusing on the areas of education, outreach and research. NFI is a leader in preparing students to excel in careers in the financial services industry. NFI connects Indiana State University's financial, business and educational expertise and resources with community needs. NFI is a primary source for objective and applied research within the financial services industry.

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networksfinancialinstitute.org

# NFI seeks research papers, proposals for prospective fellows

Networks Financial Institute at Indiana State University invites the submission of research papers and proposals for prospective fellows.

Papers and proposals should be in one of the following four areas: 1) Social Security reform and/or retirement income security, 2) financial literacy, 3) financial sector regulatory reform, including banking, insurance or other areas, and 4) the link between the financial sector and economic development.

Within these broad areas of interest, there are no restrictions on desired subject matter. For example, NFI will consider proposals in the area of the link between the financial ser-

vice industry and economic development that look more narrowly at particular sectors of the financial services industry or that look at the issue in the context of U.S. cities, counties, states or the nation as a whole.

NFI is also interested in proposals examining experience abroad, especially in emerging markets.

Non-residential fellows will participate in occasional programs at NFI or elsewhere. Compensation for research projects is competitive. NFI anticipates limited full-time research openings in Indianapolis for up to one year. Please indicate your interest in and availability for such a position in your proposal.

Ideal candidates will have

a Ph.D. in economics or finance, demonstrated academic and/or research experience, and, for full-time appointments, a sabbatical leave for up to one year.

Please send letters of interest, a curriculum vita and details of proposed papers and/or proposals to:

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FAX materials to 317.536.2269.

Appointments will be made on an ongoing basis.

For more information, visit NFI online at networksfinancialinstitute.org.



## 5 fellows busy on NFI research projects

This year, NFI and Indiana State University welcomed back returning fellows Jay Page and Kyle Plesniak and accepted Jason Dean, Elizabeth Illyes and Rebecca Shorter into the graduate fellows program.

Plesniak is primarily assisting NFI staff with research and data collection including Indiana life sciences and regional higher education issues.

Page is enrolled in the Public Administration program through the Political Science department while Dean, Illyes, Plesniak and Shorter are pursuing

MBAs.

As new fellows, Dean, Illyes and Shorter are defining their areas of focus.

Dean has signed on to work with Indiana State University College of Business professor Dr. Art Sherwood on a project to discover if small banks make a difference to the economic development of local communities in Indiana. The study will probe whether these banks provide any unique services to small businesses that large banks don't and if local and state governments should support them.

Illyes is pursuing an accounting major in the MBA program and hopes to investigate the accounting considerations of charitable giving plans as integral components of retirement and estate planning.

Shorter, who has an insurance bachelor's degree from Indiana State University, is excited to assist the Insurance Industry Working Group of the Indiana Economic Development Corporation in compiling a database of insurance employers in the state.

# Military personnel often targets of financial scams

## Are payday lenders preying on our troops?

BY OZER ERDEM  
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Financial literacy skills are indispensable requirements of daily life.

This is especially true for military service men and women because they are more mobile, often separated from families and must perform in alien environments despite continuing financial responsibilities elsewhere.

Because of the unique challenges they face, military service personnel are often the targets of financial scams.

Military service personnel, even those from a low-income background, do have a steady income to pay the bills but often are young and possess comparatively fewer financial literacy skills; this combination of characteristics makes them more attractive to payday lending and other types of potentially predatory activities.

Some common scams or financial opportunism commonly aimed at the military includes abuses of:

- Payday lenders, cash advance and other “fast cash” businesses;
- Automobile-related scams;
- Catalog, Internet and phone card “sales”; and
- Benefits buyouts aimed specifically at veterans.<sup>1</sup>

The Servicemembers Civil Relief Act of 2003 (SCRA), which updated the Soldiers’ and Sailors’ Civil Relief Act of 1940 (SSCRA), can help military service members by providing temporary relief, but the need for financial education for military service personnel remains an important issue. The important fact is that SCRA only provides temporary relief; a service person’s obligations will not be protected beyond the term of military service. The act protects at least temporary relief against these types of situations:

- Default Judgments
- Stay of Proceedings
- Evictions
- Private life insurance termination due to nonpayment of premiums

COMPARING THE TRANSACTIONS		
Paying a credit card balance late is a lot cheaper than getting a payday loan, in terms of APR. A cost comparison of payday loans and some other alternatives prepared by the Center for Responsible Lending.		
TRANSACTION	FEES/MONTH	APR
\$255 payday loan	90	391
Late fee on \$255 credit card bill	30	141
Late fee on \$800 mortgage (homeowner)	32	48
Late fee on \$600 rent payment (renter)	30	60
Late fee on \$300 car payment	15	60

SOURCE: Alternatives to Payday Lending, Center for Responsible Lending, Jan. 09, 2006, [www.responsiblelending.org/payday/alternatives.cfm](http://www.responsiblelending.org/payday/alternatives.cfm)

The recent Defense Authorization bill, approved by the Congress on Dec. 21, 2005, contains a pair of amendments authored by U.S. Sen. Evan Bayh, D-Ind. His amendments improve current protections by requiring the Pentagon to educate families about their rights and mandate the inclusion of language explaining these rights in foreclosure paperwork.

Despite many legal safeguards available to service members to protect their rights against consumer abuses, certain issues are still causing a lot of concern in the military community.

Payday lending is certainly an example. Payday lenders argue they are providing an important service by offering payday loans for occasional emergencies. There are others arguing that payday lending services are designed to trap borrowers in a cycle of repeated transactions that generate huge fees for the lenders.

Payday loans are advertised as a way for borrowers who need short-term cash to make it to their next pay check. Generally, payday loans are made in amounts of \$500 or less.

According to the “Survey of State Payday Loan Laws” prepared by the National Consumer Law Center, the maximum fee or interest rate schedule in Indiana is:

- 15 percent for up to \$250, which

equates to a 391 percent Annual Percentage Rate.

- 13 percent for the next \$251-\$400 plus \$37.50 (15 percent of the first \$250)
- 10 percent for the next \$401-\$500 plus \$57 (15 percent of the first \$250 and 13 percent of the next \$150)<sup>2</sup>

Although when converted to APR, a one-time fee charged by payday lenders may seem very high, it should be noted that those are one-time fees for a short-term loan.

The Community Financial Services Association of America (CFSA), the payday advance industry’s national trade association, publishes on its website that payday advance services are economical and convenient when used for short-term cash needs. But they are inappropriate to use for long-term or continuing cash needs.<sup>3</sup> Moreover, a recent study presents evidence that fixed operating costs and loan loss rates do justify a large part of the high APRs charged on payday advance loans and that a store’s loan volume is a key determinant of its profitability.<sup>4</sup>

There are some organizations, such as the Army, Navy, Marine Corps and Air Force Relief Societies, that provide financial counseling and financial assistance to military service members. Services by these types of organizations offer the best loan terms —

such as extended payment plans and zero interest rates.

There are other alternatives to payday lending. The Department of Defense has launched several programs to improve financial education among the service members. Some of these include:

- The Financial Readiness Campaign<sup>5</sup>
- Military Sentinel<sup>6</sup>
- FDIC’s Money Smart financial education program<sup>7</sup>

Although these financial education programs and new laws are providing important protections for the military service members, there is still more to do to achieve desired results.

□ Erdem is a research associate at Networks Financial Institute.

<sup>1</sup> Tripoli, Steve and Mix, Amy. “In Harm’s Way — At Home: Consumer Scams and the Direct Targeting of America’s Military and Veterans,” May 2003, National Consumer Law Center, Jan. 10, 2006, [www.consumerlaw.org/action\\_agenda/military/index.shtml](http://www.consumerlaw.org/action_agenda/military/index.shtml)

<sup>2</sup> Survey of State Payday Loan Laws, November 2005. National Consumer Law Center, Jan. 09, 2006, [www.consumerlaw.org/action\\_agenda/payday\\_loans/content/PaydayLoanStatsbyState2005.pdf](http://www.consumerlaw.org/action_agenda/payday_loans/content/PaydayLoanStatsbyState2005.pdf)

<sup>3</sup> CFSA Consumer Information, Community Financial Services Association Of America, Jan. 12, 2006, [www.cfsa.net/custinf/acustinf.html](http://www.cfsa.net/custinf/acustinf.html)

<sup>4</sup> Flannery, Mark J. and Samolyk, Katherine, “Payday Lending: Do the Costs Justify the Price?” (June 2005). FDIC Center for Financial Research Working Paper No. 2005/09 <http://ssrn.com/abstract=771624>

<sup>5</sup> “DOD and Treasury announce financial readiness campaign,” May 8, 2003. Department of Defense, Jan. 17, 2006 [www.defenselink.mil/releases/2003/b05082003\\_bt308-03.html](http://www.defenselink.mil/releases/2003/b05082003_bt308-03.html)

<sup>6</sup> Welcome to Military Sentinel, Jan. 9, 2006, [www.consumer.gov/military/](http://www.consumer.gov/military/)

<sup>7</sup> Money Smart — An Adult Education Program, Jan. 10, 2006, [www.fdic.gov/consumers/consumer/moneysmart/](http://www.fdic.gov/consumers/consumer/moneysmart/)

# Online searching today: Far more complex than 'googling'

## Doing it right is an art form

BY MARTHA HENN McCORMICK  
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In his book "The Search: How Google and its Rivals Rewrote the Rules of Business and Transformed Our Culture" (2005), author Jonathan Battelle begins by describing the term "search" as an anthropological concept. He writes:

"Search has moved from a useful service on the edge of most Internet users' experience to the de facto interface for computing in the information age. ... In the past few years, search has become a universally understood method of navigating our information universe: much as the Windows interface defined our interactions with the personal computer, search defines our interactions with the Internet. Put a search box in front of just about anybody and he'll know what to do with it."

In the most basic sense, Battelle is probably right. "Put a search box in front of just about anybody and he'll know what to do with it."

Internet search maintains its elemental meaning — the activity of looking thoroughly to find something or someone. Among the Internet literati, however, search has become something more of an art form than it once was. It is an increasingly complex and arcane set of skills with an increasingly specialized skills set and lingo. For some of us, "googling" is still a cutting-edge verb. But it was in 2002 that the American Dialect Society chose "googling" as its most useful word. The Internet world has moved on and people are now using RSS, the blogosphere and the tagosphere to define and order their Internet searching and use experiences.

RSS is an acronym for Rich (or RDF) Site Summary — or sometimes Really Simple Syndication. RDF is a resource description framework. RSS is a way for users to stay up-to-date with their favorite news sources or topics of interest. RSS readers may be applications users download to their desktop or web-based aggregators. RSS uses XML to allow the syndication of lists of hyperlinks, along with other information, or metadata,

that helps viewers decide whether they want to follow the link. RSS allows a person's computer to fetch and understand the information (Bytown Internet Glossary). Some RSSs are pre-configured and some allow users to customize; they generally pull information from major news sites, community sites and even personal weblogs. The advantage of RSS feeds is the availability of constantly updated information on a topic or from a news source of interest to the user



without requiring the user to continually execute the same or similar searches or sift through general news to find topics of interest.

The Financial Times offers a series of RSSs that deal with a range of financial services topics, as does BizJournals. CNNMoney also offers a range of business and finance-related RSS feeds, including one on personal finance.

Online social networks are Internet applications that result from software designed to build and verify social networks — or a structure to bring individuals, businesses and organizations together. Social software allows people to connect or collaborate through the computer and to form online communities. These communities encompass well-established

mechanisms such as listservs and user groups — or usenets — and include newer mechanisms such as blogs, a website in which journal entries are posted on a regular basis and displayed in reverse chronological order; wikis, a type of website that allows users to easily add and edit content and is especially suited for collaborative authoring; or other virtual meeting spaces. A common type of online social network is a dating service but new uses include social bookmarking, services that

rather than content that has been indexed either by a web crawler or by a centralized authority, as is the case in most Internet directory sites.

The tagosphere is rather thin now but the belief is that it will grow quickly as tech-savvy, early adopting young people catch on. The central site for tagging is Wink. It includes user-submitted websites harvested from Slashdot, Digg and del.icio.us, for example, but when tagged results are hard to come by, Wink substitutes in non-tagged results from Google. Users of Wink can also build and publish their own set of links using a feature called Collections.

Blogsphere is a term coined to describe the collective online presence of blogs. As blogging has caught on, many blogs have become highly interconnected. An entire culture of blogging has developed on the Internet.

While blogging is really just a description of a format choice, that of entries posted and displayed in reverse chronological order, the notion of the blogosphere looks at blogging as a social phenomenon and transforms a loose assortment of blogs into a cultural phenomenon. There are even many sites that engage in blog-tracking to study the trend of interconnectedness among blogs and through hypertext technology can track a conversation as it leaps from blog to blog.

From RSS through social networks to the blogospheres and tagospheres, the trend is to see more individuals and organizations putting a personalized slant on the vast amalgam that is the Internet.

These technologies have been embraced by younger audiences and technologically advanced Internet users but they begin to move toward more widespread adoption, as is the usual trajectory with search innovations.

Sooner or later, all these special-interest and user-defined applications will begin to affect the more staid and traditional domains of business, finance and research.

□ McCormick is research coordinator at Networks Financial Institute.

# Do transparency and predictability improve economic policy outcomes?

One of the major advances of economic theory of public policy has been the notion that more transparency and predictability improves market performance, boosting out-

put and lessening the extent of shocks. Two recent studies outside the area of macroeconomic policy suggest that some qualifications of this new wisdom may be in order.

## Forced Information Disclosure and the Fallacy of Transparency in Markets

Timothy N. Cason  
and Charles R. Plott  
*Economic Inquiry* 2005  
43(4):699-714

Is more information always better?

The authors looked at this question in the light of a dispute between California's electric utilities and its suppliers. Independent power producers supply two-thirds of California's power needs.

Along with intervenors such as "The Utility Reform Network (TURN)," the suppliers argue that increased market transparency will benefit the public by lowering energy costs. Utilities strongly oppose this argument, saying that revealing

substantial amounts of data, including forecasts of price and availability of energy, will weaken considerably their bargaining positions with their suppliers.

The authors employed experimental market studies which involved decentralized, privately negotiated contracts to study the effect of forced disclosures.

They conclude that competitive equilibrium will occur under stable supply-demand conditions in a market involving bilateral contracts.

So, forced disclosures will not provide any benefit to consumers.

In addition, the authors also conclude that a disclos-

ing party will be in a worse condition by revealing strategically important data.

Moreover, in the California case, the authors argue that prices can actually increase because of the forced disclosures.

The authors point to the fact that this situation is more likely to happen in the case in which demand and supply are both inelastic and demand is changing, which is expected to be the situation in California in the future.

Thus, disclosure of more information to enhance market transparency worsens outcomes for consumers and the regulated public utilities.

— Summary by Ozer Erdem

## Ambiguity about Audit Probability, Tax Compliance and Taxpayer Welfare

Arthur Snow  
and Ronald S. Warren Jr.  
*Economic Inquiry*  
Volume 43, No. 4  
October 2005, pp. 865-871(7)

The Internal Revenue Service (IRS) conducts strategic and random audits of taxpayers' returns. Both the randomness and strategic aspect of the IRS's audit policies play an important role in increasing taxpayer compliance.

The authors associate attitudes toward ambiguity with perceptions of the risk of being audited. In this method, taxpayers who are ambiguity-averse or ambiguity-loving have a different perceived probability of an audit, compared with the true probability.

The authors present

experimental evidence from various studies indicating that purely random audits lead taxpayers to overestimate the low probability of being audited.

This is evidence that individuals are generally "ambiguity averse."

Also, the authors present evidence indicating that these ambiguity-averse taxpayers, who are the biggest part of the general population, are very sensitive to the random audit policy of the IRS which leads to reduction in tax evasion. However, these same policies have no effect on an ambiguity-neutral population. In addition, for an ambiguity-loving population who constitutes a minority of the population, the same policies produce adverse effects which reduce the amount of

tax collection and increases tax evasion. The authors show that ambiguity has different effects on taxpayers depending on whether they are ambiguity-averse, ambiguity-neutral or ambiguity-lovers, but in the majority case and overall, use of random audits discourages tax evasion.

Mainstream theory on public policy, especially monetary policy, suggests that reducing ambiguity fosters superior policy outcomes, but this paper finds precisely the opposite. Transparency and predictability of policy actions may result in less desirable policy outcomes when taxpayers or investors are averse to ambiguity.

— Summary by Ozer Erdem

# Will the president's proposal solve the Social Security crisis?

Andrew J. Rettenmaier and Thomas R. Saving  
National Center for Policy  
Analysis, Policy Report No. 280  
November 2005

The Social Security program is facing long-term financial problems.

Changing demographics are making these problems more urgent to deal with. Life expectancy is increasing, the birth rate is slowing and the baby boomer generation is about to retire.

In 1950 the worker-to-beneficiary ratio was 16.5 to 1; today it is down to 3.3 to 1. It is expected to be 2 to 1 in 40 years.

In this paper, the authors examine a combination of progressive price indexing with personal retirement accounts similar in size to those suggested by President Bush. What makes this proposal different than the one that they proposed in December 2004<sup>1</sup> is that in this proposal the authors rely on additional government borrowing rather than higher taxes to finance the loss to social security of funds diverted to contributions to personal retirement accounts.<sup>2</sup>

Major features of this proposal include:

- A worker earning more than the ceiling for Social Security and born in 2000 will only be paid 56 percent of benefits promised under current law with the progressive price index formula.
- Low-income workers will not have lower social security benefits because of the protection from progressive price-indexing.
- High income workers will receive about same amount of their promised benefits during their retirement with an increasing percentage of their income coming from private annuities and the rest from government paid benefits.
- The proportion of retirement income coming from personal retirement account annuities will increase.

### High income

This proposal will reduce unfunded obligations to \$4.6 trillion compared to \$4.8 trillion under the current law. Reduction in unfunded obligations is not significant by itself; however, according to the proposal, the Social Security Administration will begin to take in more than it pays out in 2055, which will improve the solvency of the program.

— Summary by Ozer Erdem

<sup>1</sup> Andrew J. Rettenmaier and Thomas R. Saving, "Social Security Reform Without Illusion: The Five Percent Solution," National Center for Policy Analysis, Policy Report No. 272, December 2004.

<sup>2</sup> Andrew J. Rettenmaier and Thomas R. Saving, "Will the President's Proposal Solve Social Security's Crisis?" National Center for Policy Analysis, Policy Report No. 280, November 2005.

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