

# The Return to Capital and the Business Cycle\*

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May 16, 2007

## Abstract

We measure the return to capital directly from the NIPA and BEA data and examine the return implications of the real business cycle model. We construct a quarterly time series of the after-tax return to business capital. Its volatility is considerably smaller than that of S&P 500 returns. The standard business cycle model captures almost 50% of the volatility in the return to capital (relative to the volatility of output). We consider several departures from the benchmark model; the most promising is one with stochastic taxes which captures nearly 80% of the relative volatility in the return to capital.

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\*For helpful comments we thank David Andolfatto, Michele Boldrin, Gian Luca Clementi, Aubhik Khan, Ellen McGrattan, Richard Rogerson, Jian Wang, and seminar participants at University of North Carolina–Greensboro, Seoul National University, the Federal Reserve Banks of Cleveland, Minneapolis and Philadelphia, and the conference participants at 2006 Midwest Macro, 2006 SED, 2006 CMSG and 2007 Texas Monetary conference. The data set used in this paper is available at <http://www.clevelandfed.org/Research/Models/>. The views expressed herein do not necessarily reflect those of the Federal Reserve Bank of Cleveland or of the Federal Reserve System.

# 1 Introduction

There has been considerable progress in accounting for business cycle fluctuations in aggregate quantities. Using the real business cycle (RBC) framework developed by [Kydland and Prescott \(1982\)](#), many studies have replicated the observed comovements and volatilities of aggregate variables such as output, consumption, investment and hours. In the basic RBC model, changes in total factor productivity alter the real rate of return on a representative unit of capital which, in turn, affects the temporal profiles of consumption, investment, hours, etc. We examine whether the successes in accounting for the aggregate quantities are achieved at the cost of being unable to replicate the time series properties of the return on capital.

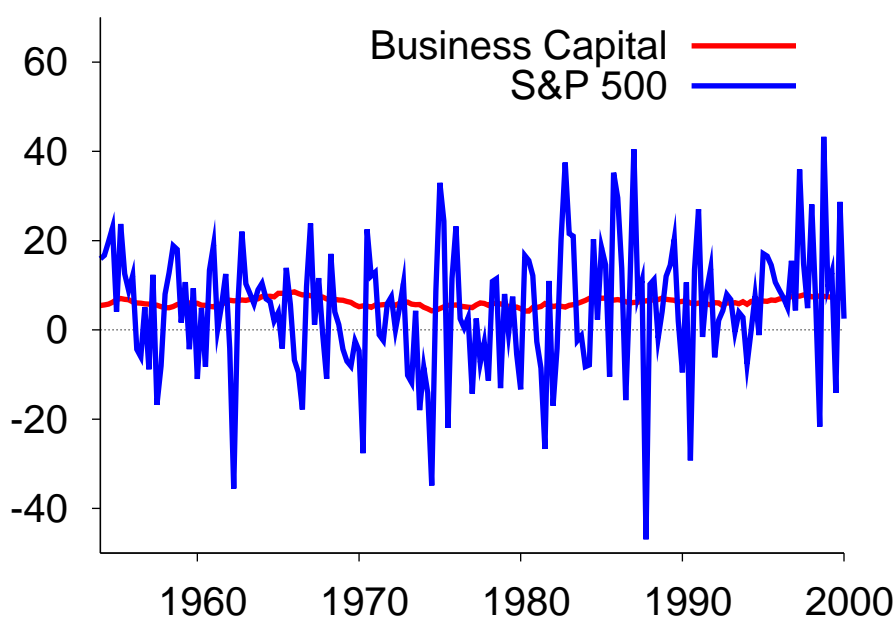
In the standard RBC model, one can think of the representative firm as an entity that maximizes the present value of dividends (defined as output minus investment and factor payments to labor). The rate of return to a financial claim to the sequence of the firm's dividends is the same as the rate of return to capital in the RBC model. With this equivalence, [Rouwenhorst \(1995\)](#) used the S&P 500 returns to measure the return on capital. An alternative approach is to follow [Poterba \(1998\)](#), [Mulligan \(2002\)](#) and ? and construct the return by summing all of the relevant income generated by capital and dividing by the stock of capital that generated the income. We follow the latter approach and construct a *quarterly* time series for the after-tax return to business capital. Using our measurement, we reexamine the return implications of the standard RBC model. Specifically, we examine whether the RBC model can account for the fluctuations in the after-tax return to capital measured by the flow of income accruing to owners of capital.

Our measure of business capital is the sum of private nonresidential structures, private nonresidential equipment and software, and private inventories. Our calculations for the return to capital, described in [Section 3](#), take into account all taxes paid by the owners of *all* business capital over the period 1954:1–2003:4. A number of authors have made conceptually similar calculations for specific sectors and for specific types of capital. [Poterba \(1998\)](#) computes annual returns for the *nonfinancial corporate* sector; [Mulligan \(2002\)](#) calculates the annual return to capital including residential structures; ? compute annual after-tax returns for the *noncorporate* sector. All of these

previous studies computed *annual* returns; we compute *quarterly* returns since that is the frequency typically used in the RBC literature.

There are two findings of note. First, the return to capital is very smooth relative to the S&P 500 returns; see Figure 1. The *percent standard deviation* of the S&P 500 quarterly returns over the 1954:1–2003:4 sample period is 360.03% while the volatility of our constructed return to capital is only about 14.08%.<sup>1</sup>

Figure 1: After-tax return to the S&P 500 and Capital



The difference in the properties of the returns can be traced back to the difference in the two approaches to measurement noted earlier. The return to the S&P 500 is measured as  $\frac{p_{t+1}+d_{t+1}}{p_t} - 1$  where  $p_s$  denotes the price of equity and  $d_s$  denotes the dividend in period  $s$ . It is well known that the volatility in the S&P 500 return is largely due to the volatility in equity prices. Our measurement, however, includes only the flow income per unit of capital, not the variations in the price of capital. Since the price of capital is assumed to be constant in the basic one-sector

<sup>1</sup>These figures are in the spirit of “deviations from trend” calculations of other business cycle variables. That is, if  $\bar{R}$  is the mean after-tax return in the sample and  $\hat{R}_t = \frac{R_t - \bar{R}}{\bar{R}}$  is the deviation at time  $t$  from the mean, then the percent standard deviation of the return we report is 100 times the standard deviation of  $\hat{R}_t$ . The corresponding figures for “raw” standard deviations (i.e.,  $\text{std}(R_t)$ ) are 0.89 and 14.13.

RBC model, both theory and our measurement ignore capital gains and take into account only the fluctuations in the flow income generated by capital.

The second finding is that the basic RBC model with logarithmic preferences accounts for about 40% of the volatility in the return to capital. Relative to output volatility, the model accounts for nearly 50% of the volatility in the return to capital. To contrast, [Rouwenhorst \(1995\)](#) showed that the intertemporal marginal rate of substitution (IMRS) or the stochastic discount factor in the basic RBC model is too smooth to account for the volatility in the return to equity. It is not a surprise, given [Figure 1](#), that the basic RBC model fares better under our measure of the return to capital. However, the magnitude – whether the model accounts for little or most of the volatility in our measure of the return to capital – is not obvious.

We study a few well known variations of the basic RBC model to examine whether they perform better. A model with indivisible labor generates roughly the same volatility relative to output as the basic RBC model, whereas a model with home production generates only 30% of the relative volatility. Instead of logarithmic preferences, a risk aversion of 5 accounts for more than 75% of the relative volatility. The last variant we consider is an environment with stochastic taxes. This variant accounts for nearly 80% of the relative volatility.

To summarize, the basic RBC model accounts for a large part of volatility in the flow income component of the return to capital. However, under the assumption that stock prices reflect the price of the income flow to capital owners, the basic RBC model cannot account for the volatility in the price of equity.

The rest of the paper is organized as follows. In the next section we set up the economic environment. Our model is essentially the same as the basic RBC model in [Prescott \(1986\)](#). In [Section 3](#), we describe our measurement of tax rates and return to capital. In [Section 4](#), we study the quantitative implications of the model. [Section 5](#) concludes.

## 2 Economic Environment

Since the economic environment should be easily recognizable to those familiar with the macroeconomics literature of the past two decades, the model's description is fairly brief. The competitive equilibrium for this model is standard.

### 2.1 Firms

Taking as given the real wage rate,  $w_t$  and the rental rate for capital,  $r_t$ , the typical firm rents capital,  $k_t$ , and hires labor,  $h_t$ , to maximize profits,

$$y_t - w_t h_t - r_t k_t.$$

Output is produced according to a constant-returns-to-scale, Cobb-Douglas production function,

$$y_t = z_t k_t^\alpha (g^t h_t)^{1-\alpha}$$

where  $g$  is the growth rate of labor-augmenting technological change, and  $z_t$  is a random shock to production that follows the stochastic process,

$$\ln z_t = \rho \ln z_{t-1} + \varepsilon_t$$

where  $\varepsilon_t \sim N(0, \sigma_\varepsilon^2)$ .

The firm's output can be converted into either consumption,  $c_t$ , or investment goods,  $i_t$ :

$$c_t + i_t = y_t.$$

### 2.2 Households

The representative household has preferences over streams of consumption,  $c_t$ , and leisure,  $\ell_t$ , summarized by

$$E_0 \sum_{t=0}^{\infty} \beta^t U(c_t, \ell_t). \quad (1)$$

The period utility function has the functional form,

$$U(c, \ell) = \begin{cases} \frac{[c\ell^\omega]^{1-\gamma}}{1-\gamma} & \text{if } 0 < \gamma < 1 \text{ or } \gamma > 1, \\ \ln c + \omega \ln \ell & \text{if } \gamma = 1. \end{cases}$$

The household allocates its one unit of time between leisure,  $\ell_t$ , and work,  $h_t$ :

$$\ell_t + h_t = 1. \quad (2)$$

The household faces a budget constraint,

$$c_t + i_t = (1 - \tau_\ell)w_t h_t + (1 - \tau_k)r_t k_t + \tau_k \delta k_t + T_t, \quad (3)$$

where  $\tau_\ell$  is the tax rate on labor income,  $\tau_k$  is the tax rate on gross capital income, and  $T_t$  is a lump-sum transfer received from the government.  $\tau_k \delta k_t$  is a capital depreciation allowance term.

The household's capital stock evolves according to

$$k_{t+1} = (1 - \delta)k_t + i_t \quad (4)$$

where  $\delta$  is the depreciation rate of capital.

The household's problem is to choose contingent sequences for consumption,  $c_t$ , leisure,  $\ell_t$ , work,  $h_t$ , investment,  $i_t$ , and capital,  $k_{t+1}$ , so as to maximize lifetime utility, (1), subject to the constraints, (2)–(4), taking as given the wage rate,  $w_t$ , rental rate,  $r_t$ , taxes,  $\tau_\ell$  and  $\tau_k$  and transfers,  $T_t$ .

## 2.3 Government

The government levies time-invariant taxes on capital income,  $\tau_k$ , and on labor income,  $\tau_\ell$ . It also makes a lump-sum rebate to households,  $T_t$ . Government does not directly consume resources; the government sector is included because capital income taxes distort the return to capital, and the focus of this paper is on the after-tax return on capital. The government's budget constraint, then, is

$$T_t = \tau_k r_t k_t - \tau_k \delta k_t + \tau_\ell w_t h_t.$$

## 2.4 The Return to Capital

Factor market competition and firm profit maximization imply that the rental price of capital satisfies

$$r_t = \alpha z_t k_t^{\alpha-1} (g^t h_t)^{1-\alpha}$$

The net after-tax *return* to capital, then, is given by

$$R_t = (1 - \tau_k) \left[ \alpha z_t k_t^{\alpha-1} (g^t h_t)^{1-\alpha} - \delta \right].$$

In other words, the after-tax return to capital is given by the after-tax marginal product of capital less the depreciation rate.

## 3 Measurement

In this section we describe the empirical counterparts to our theory in the previous section. As part of this description, we construct a time series for the rate of return to capital. The sample period for the returns data is 1954:1–2003:4.

Construction of the empirical counterparts to the model's variables follows standard procedures in the literature such as those in [Cooley and Prescott \(1995\)](#) and [Gomme and Rupert \(2003\)](#). The National Income and Product Accounts (NIPA) are the source for much of the derivations. Variables are converted to per capita values using the civilian noninstitutionalized population aged 16 and over. Nominal variables are converted to real ones using a deflator for consumption (non-durables and services), which was constructed from nominal and real consumption so as to conform to our measure of market consumption; on this point, see [Greenwood, Hercowitz, and Krusell \(1997\)](#).

In the U.S. economy, the real after-tax rate of return on a representative unit of business capital can be calculated by summing all of the income generated by business capital, subtracting the relevant taxes, and dividing by the stock of capital that generated the income. The income and tax data are found in the NIPA, while the capital stock data is obtained from the Bureau of Economic

Analysis (BEA).

There are several issues complicating such a calculation, however. We are interested in obtaining cyclical properties of the return at a quarterly frequency. Unfortunately not all of the necessary data are available quarterly. After presenting the calculations, we will describe the data that is not available at a quarterly frequency, then explain our imputation procedure to construct a quarterly series.

Since we are interested in the return generated from business capital, we must include the income earned from both the corporate and noncorporate sectors. One concern is the income accruing to proprietors. Evidently, this income is partly generated from capital and partly from labor. The generally accepted practice is to allocate proprietors' income to capital and labor in the same proportion as calculated for the economy as a whole; see, for example, [Cooley and Prescott \(1995\)](#) and [Gomme and Rupert \(2003\)](#). That is, if labor's share of national income is  $1 - \alpha$  and capital's share is  $\alpha$ , we attribute the fraction  $1 - \alpha$  of proprietor's income to labor and the fraction  $\alpha$  to capital.

We remove income associated with the housing sector because we are interested in the return to business capital. Our measure of the capital stock will, then, include only those parts that are used in producing market output, and so will exclude residential structures and consumer durables.

While most of the taxes levied against capital income can be obtained fairly directly from the data, those paid by households must be imputed. To obtain the tax rate on general *household income*, we follow the basic methodology of [Mendoza, Razin, and Tesar \(1994\)](#) and [Carey and Tchilinguirian \(2000\)](#). This tax rate,  $\tau_h$ , is computed as:

$$\tau_h = \frac{\text{PERSONAL CURRENT TAXES}}{\text{NET INTEREST} + \text{PROPRIETORS' INCOME} + \text{RENTAL INCOME} + \text{WAGES AND SALARIES}}.$$

The tax rate  $\tau_h$  – distinct from  $\tau_\ell$  and  $\tau_k$  – is an intermediate input into subsequent calculations of the rate of return to capital.

After-tax capital income can be written as:

$$\begin{aligned}
 Y_{AT} = & \text{NET OPERATING SURPLUS} - \text{HOUSING NET OPERATING SURPLUS} \\
 & - (1 - \alpha)(\text{PROPRIETOR'S INCOME} - \text{HOUSING PROPRIETOR'S INCOME}) \\
 & - \tau_h(\text{NET INTEREST} - \text{HOUSING NET INTEREST}) \\
 & - \alpha\tau_h(\text{PROPRIETOR'S INCOME} - \text{HOUSING PROPRIETOR'S INCOME}) \\
 & - \tau_h(\text{RENTAL INCOME} - \text{HOUSING RENTAL INCOME}) \\
 & - \text{TAXES ON CORPORATE INCOME} \\
 & - \text{BUSINESS PROPERTY TAXES} \\
 & - \text{STATE AND LOCAL OTHER TAXES.}
 \end{aligned}$$

Net operating surplus is defined as value added minus depreciation and payments to labor. As discussed above, the income flows and tax rates have been modified to subtract out the income generated from the housing sector.

Dividing after-tax capital income,  $Y_{AT}$ , by the stock of business capital (inventories, market structures and equipment & software) gives the return to capital. After-tax capital income and the stock of inventories are converted to real terms by dividing by the price deflator for personal consumption expenditures while market structures and equipment & software are expressed in real terms (see the quarterly conversion procedure in the next subsection). Thus, the real return can be determined by

$$R_{AT} = \frac{Y_{AT}}{\text{INVENTORIES} + \text{STRUCTURES} + \text{EQUIPMENT AND SOFTWARE}}.$$

### 3.1 Annual to Quarterly Conversions

Several series are not available quarterly. Different methods are used to convert the annual series to quarterly. To start, the series STATE AND LOCAL OTHER TAXES covers such things as licensing fees. It seems reasonable, then, to divide this figure equally across the four quarters. Property taxes (paid by businesses and households) are available quarterly from 1958:1. Prior to this date, the annual observation is repeated for each quarter. Property taxes are not reported separately for businesses and households. It is assumed that the fraction of property taxes paid for by businesses

is the same as the fraction of structures owned by businesses.

Quarterly values for all of the housing flows are imputed with the exception of GROSS HOUSING VALUE ADDED (GHVA), which is available quarterly. To understand the approach taken here, we will explain the calculation for NET OPERATING SURPLUS as an example. Take the observation for GHVA (quarterly), multiply by NET OPERATING SURPLUS (annual) divided by GHVA (annual), for the relevant year. That is, apportion the quarterly GHVA to its constituent components using the annual ratios for the appropriate year. This strategy is also used to impute NET INTEREST, PROPRIETORS' INCOME and RENTAL INCOME for the housing sector.

Quarterly capital stocks are constructed from annual capital stocks and quarterly investment flows (both of which are converted to real by dividing by the consumption deflator for nondurables and services). This procedure requires solving for the depreciation rate that makes the annual capital stocks line up with Q4 of our quarterly capital stock, and be consistent with the quarterly investment flows. For example:

$$K_{1949Q4} = K_{1949} \text{ (the annual observation)}$$

$$K_{1950Q1} = (1 - \delta_{1950})K_{1949Q4} + I_{1950Q1}$$

$$K_{1950Q2} = (1 - \delta_{1950})K_{1950Q1} + I_{1950Q2}$$

$$K_{1950Q3} = (1 - \delta_{1950})K_{1950Q2} + I_{1950Q3}$$

$$K_{1950Q4} = (1 - \delta_{1950})K_{1950Q3} + I_{1950Q4}$$

$$K_{1950Q4} = K_{1950} \text{ (the annual observation).}$$

In effect, there are 4 equations (the middle 4) in 4 unknowns:  $K_{1950Q1}$ ,  $K_{1950Q2}$ ,  $K_{1950Q3}$  and  $\delta_{1950}$ .

### 3.2 The Real Return to Capital

The standard deviation of the rate of return to capital is 14.08% over the period 1954:1–2003:4 (see [Table 1](#)). As documented in this table (and visually in [Figure 1](#)) the rate of return to capital is very smooth relative to the S&P 500 return—the latter is nearly 22 times as volatile.

The quarterly time series for the tax rate on household income,  $\tau_h$  and the real after-tax return

Table 1: After-tax Returns Data: Selected Moments

	Mean (%)	% Standard Deviation
Business capital	6.29	14.08
S&P 500	4.15	360.03

to capital are shown in [Table 2](#). The mean after-tax return to capital, 6.29%, is on the high side of other estimates found in the literature; see, for example, [Poterba \(1998\)](#), [Mulligan \(2002\)](#) and [? \(1998\)](#). [Poterba \(1998\)](#) used data from 1959 to 1996 for the nonfinancial corporate sector and found a mean after-tax return of 3.9%. [Mulligan \(2002\)](#) excludes inventories but includes residential structures and finds the mean after-tax return on capital to be roughly 6%. [?](#) used data from 1880 to 2002 for the noncorporate sector and found a mean after-tax return of 4%. As we report later (in [Subsection 4.5](#)), inclusion or exclusion of specific sectors affects the return properties.

## 4 Quantitative Implications

### 4.1 Parameters

As has become standard in much of macroeconomics, the calibration procedure involves choosing functional forms for the utility and production functions, and assigning values to the parameters of the model based on either micro-evidence or long run growth facts. [Cooley and Prescott \(1995\)](#) provide an overview of the general strategy. A more detailed description of the calibration procedure can be found in [Gomme and Rupert \(2003\)](#).

In particular, capital's share of income,  $\alpha$ , is set to match NIPA data. The parameters governing the stochastic technology shock,  $\rho$  and  $\sigma_\varepsilon$ , are estimated from regressions using U.S. Solow residuals. The coefficient of relative risk aversion,  $\gamma$ , is set to 1. The growth rate,  $g$ , is chosen so that the average growth rate of real per capita output matches that in the U.S. data. The depreciation rate,  $\delta$ , is set based on BEA data on depreciation and capital stocks. The remaining parameters,  $\omega$  and  $\beta$ , are chosen so that in steady state, hours of work,  $h$ , and the investment-output ratio,  $i/y$ ,

Table 2: U.S. Return to Capital and Tax Rate on Household Income

Year	Return to Capital				Tax Rate, $\tau_h$			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1954	5.47	5.59	5.78	6.20	11.74	11.69	11.64	11.64
1955	6.79	7.00	6.85	6.75	11.74	11.80	11.95	12.03
1956	6.27	6.02	5.97	5.81	12.26	12.33	12.41	12.47
1957	5.77	5.62	5.55	5.18	12.56	12.59	12.52	12.46
1958	4.95	4.95	5.25	5.68	12.26	12.09	12.24	12.17
1959	5.90	6.48	5.90	5.92	12.42	12.47	12.65	12.80
1960	5.95	5.52	5.49	5.24	13.01	13.09	13.19	13.15
1961	5.17	5.68	5.84	6.16	13.09	13.04	12.95	12.85
1962	6.63	6.52	6.54	6.68	13.00	13.18	13.43	13.62
1963	6.61	6.82	6.86	6.96	13.61	13.50	13.40	13.31
1964	7.49	7.49	7.56	7.41	12.75	11.56	11.78	11.96
1965	8.18	8.19	8.22	8.34	12.57	12.66	12.13	12.07
1966	8.54	8.11	7.82	7.87	12.39	12.98	13.14	13.42
1967	7.65	7.49	7.41	7.35	13.35	13.16	13.43	13.59
1968	6.94	7.08	6.85	6.68	13.71	13.92	15.28	15.63
1969	6.65	6.37	6.16	5.59	16.37	16.46	15.77	15.74
1970	5.21	5.37	5.36	5.04	15.36	15.38	14.44	14.50
1971	5.57	5.55	5.64	5.71	13.71	13.79	13.80	13.97
1972	5.70	5.53	5.98	6.26	15.44	15.61	15.28	14.99
1973	6.22	5.78	5.64	5.69	14.58	14.50	14.68	14.82
1974	5.10	4.74	4.28	4.40	14.95	15.37	15.58	15.59
1975	4.79	5.20	5.50	5.49	15.61	11.85	14.54	14.68
1976	5.60	5.33	5.20	5.08	14.68	15.00	15.29	15.50
1977	5.00	5.65	6.10	5.94	15.68	15.75	15.55	15.70
1978	5.49	5.94	5.91	5.85	15.62	15.81	16.30	16.55
1979	5.57	5.26	4.98	5.10	16.43	16.65	16.98	17.04
1980	4.77	4.21	4.21	5.02	16.54	16.96	17.12	17.10
1981	5.01	5.21	5.88	5.51	17.38	17.66	17.77	17.37
1982	5.24	5.41	5.29	5.11	17.21	17.34	16.76	16.93
1983	5.49	5.67	5.92	6.27	16.45	16.60	15.59	15.52
1984	6.61	7.03	7.26	7.35	15.26	15.16	15.30	15.50
1985	7.08	7.12	6.95	6.68	16.57	14.74	15.85	15.79
1986	6.79	6.62	6.32	6.01	15.43	15.37	15.52	15.91
1987	6.15	6.18	6.45	6.50	15.43	17.26	16.17	16.32
1988	6.71	6.68	6.80	7.10	15.86	15.44	15.39	15.42
1989	6.86	6.71	6.61	6.26	16.06	16.35	16.37	16.40
1990	6.39	6.51	6.01	5.79	16.13	16.20	16.17	16.17
1991	6.02	5.90	5.83	5.62	15.70	15.74	15.74	15.85
1992	6.10	6.04	5.39	6.16	15.30	15.56	15.71	16.06
1993	5.91	6.09	5.86	6.32	15.44	15.89	16.19	16.40
1994	5.74	6.37	6.60	6.78	16.14	16.44	16.18	16.16
1995	6.45	6.39	6.68	6.60	16.35	16.73	16.67	16.82
1996	6.92	7.07	7.16	7.47	17.30	17.72	17.55	17.68
1997	7.55	7.57	7.85	7.78	18.08	18.17	18.35	18.49
1998	7.40	7.40	7.60	7.49	18.51	18.63	18.63	18.75
1999	7.43	7.30	7.16	7.25	18.64	18.76	18.93	19.06
2000	7.02	7.03	6.89	6.55	19.26	19.49	19.40	19.44
2001	6.68	6.65	6.19	6.64	19.74	19.96	16.89	18.75
2002	7.12	7.01	6.83	6.96	16.19	16.00	16.09	16.02
2003	7.02	7.25	7.59	7.61	15.56	15.46	14.02	14.82

Table 3: Parameter Values and Steady State

Parameter	Value	Variable	Value
$\beta$	0.9907	Hours	0.255
$\gamma$	1.0000	Consumption	0.448
$\omega$	1.8643	Output	0.516
$\alpha$	0.2830	Capital-output ratio	5.951
$\delta$	0.0177	Investment-output ratio	0.131
$\tau_k$	0.5437	Growth rate of output	0.42%
$\tau_\ell$	0.2263	Average return to capital	5.55%
$\rho$	0.96405		
$\sigma_\varepsilon$	0.00818		

are equal to what is observed in the data. The benchmark parameter values of our model are in [Table 3](#). The tax rates on capital income,  $\tau_k$ , and on labor income,  $\tau_\ell$ , are averages over the years 1954:1–2003:4 and are based on calculations in [Gomme and Rupert \(2003\)](#). For completeness, data on  $\tau_\ell$  and  $\tau_k$  are reported in [Table 4](#).

The steady state of the model for the benchmark parameters are summarized in [Table 3](#). The model is solved by applying a generalized Schur technique to a first-order log approximation of the decision rules around steady state; see [Klein \(2000\)](#).

## 4.2 Findings

The business cycle moments for the United States covering the period 1954:1–2003:4 are presented in [Table 5](#). With the exception of the returns data, the underlying data has been detrended by taking the logarithm and applying the Hodrick-Prescott filter with a smoothing parameter of 1600. As shown in [Figure 1](#), the returns to the S&P 500 are occasionally negative and so the usual business cycle detrending procedure cannot be applied. Instead, returns are expressed as a percentage deviation from their sample averages, a procedure that is in the same spirit as the Hodrick-Prescott filter.

On the real side, the benchmark economy shares many of the successes (and failures) of other RBC models. Models calibrated to the observed Solow residual process typically underpredict the volatility of output; so does our model. In the data, consumption varies less than output while

Table 4: U.S. Tax Rates on Labor and Capital Income

Year	Tax Rate, $\tau_\ell$				Tax Rate, $\tau_k$			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1951	14.14	14.68	14.99	15.57	67.46	60.20	55.60	56.90
1952	15.96	16.10	16.00	16.02	58.86	58.83	58.34	57.72
1953	15.85	15.68	15.64	15.58	60.25	61.33	61.65	60.78
1954	15.00	14.92	14.91	14.85	58.97	58.55	58.35	57.20
1955	15.20	15.19	15.36	15.41	56.84	55.91	56.46	56.87
1956	15.79	15.83	15.87	15.88	59.22	59.87	58.40	59.37
1957	16.37	16.37	16.29	16.21	60.41	60.02	59.51	60.12
1958	16.02	15.86	15.97	15.86	59.46	59.51	59.55	59.07
1959	16.69	16.70	16.88	16.98	58.31	56.78	58.33	58.22
1960	17.82	17.87	17.96	17.91	59.52	60.73	60.76	61.95
1961	17.91	17.85	17.75	17.61	62.68	60.78	60.65	60.05
1962	18.08	18.22	18.46	18.61	56.82	57.33	57.84	57.21
1963	19.06	18.94	18.84	18.71	57.64	57.39	57.60	57.35
1964	18.09	16.91	17.07	17.21	55.11	55.09	55.18	55.62
1965	17.76	17.83	17.30	17.18	53.10	53.07	52.72	52.78
1966	18.66	19.20	19.43	19.65	52.20	53.37	53.98	53.28
1967	19.78	19.74	19.97	20.14	53.93	54.47	54.74	55.62
1968	20.36	20.54	21.80	22.09	58.79	58.07	58.98	59.80
1969	23.19	23.24	22.53	22.49	60.19	60.85	61.12	64.10
1970	22.15	22.16	21.23	21.25	64.95	63.89	64.08	65.63
1971	20.88	20.89	20.84	20.96	63.15	63.20	62.10	61.52
1972	22.93	23.03	22.65	22.19	62.04	62.78	60.27	59.49
1973	23.09	22.93	23.06	23.09	59.97	61.68	61.25	60.59
1974	23.70	24.14	24.30	24.23	62.63	64.56	67.84	64.55
1975	24.36	20.73	23.22	23.28	59.48	56.26	56.71	56.80
1976	23.65	23.91	24.14	24.28	57.55	59.09	59.37	59.73
1977	24.70	24.72	24.48	24.50	60.77	57.76	55.19	55.67
1978	24.89	24.97	25.38	25.56	56.81	55.53	53.77	54.14
1979	25.99	26.15	26.41	26.41	54.59	55.35	56.08	54.35
1980	26.12	26.48	26.61	26.50	56.81	57.17	57.48	53.07
1981	27.54	27.80	27.87	27.49	52.45	50.11	47.08	47.54
1982	27.65	27.74	27.17	27.26	47.53	46.81	47.12	47.47
1983	27.14	27.24	26.25	26.10	45.52	46.43	46.13	45.11
1984	26.25	26.07	26.16	26.31	45.16	43.46	41.60	41.41
1985	27.60	25.87	26.90	26.86	43.45	42.51	43.78	44.79
1986	26.74	26.69	26.80	27.15	45.03	46.10	47.62	50.18
1987	26.72	28.38	27.31	27.39	49.07	50.48	49.62	49.57
1988	27.42	26.99	26.92	26.97	47.49	47.95	47.67	46.90
1989	27.66	27.96	27.97	27.96	48.79	48.68	48.38	50.22
1990	27.83	27.81	27.82	27.82	49.02	48.95	51.75	52.31
1991	27.69	27.72	27.74	27.80	50.38	51.37	52.27	53.58
1992	27.37	27.57	27.68	27.92	51.62	52.43	54.59	51.53
1993	27.45	27.92	28.21	28.43	52.87	52.62	53.44	52.23
1994	28.29	28.59	28.34	28.29	54.69	52.39	51.63	51.03
1995	28.48	28.81	28.72	28.82	51.99	52.09	50.84	50.83
1996	29.21	29.54	29.36	29.44	49.68	49.31	48.84	47.63
1997	29.82	29.88	29.99	30.09	47.54	47.61	46.96	47.08
1998	30.07	30.13	30.09	30.15	48.62	48.52	47.82	47.73
1999	30.10	30.17	30.28	30.33	47.96	48.45	49.04	48.83
2000	30.50	30.65	30.55	30.58	50.27	49.79	49.76	50.53
2001	30.97	31.22	28.37	30.15	48.81	48.68	49.51	47.01
2002	27.92	27.73	27.81	27.74	44.36	45.17	46.20	46.08
2003	27.43	27.30	25.92	26.63	46.39	45.27	44.24	44.79

Table 5: Selected Business Cycle Moments

	Standard Deviation	Cross Correlation of Real Output With								
		$x_{t-4}$	$x_{t-3}$	$x_{t-2}$	$x_{t-1}$	$x_t$	$x_{t+1}$	$x_{t+2}$	$x_{t+3}$	$x_{t+4}$
<b>U.S. Data, 1954:1–2003:4</b>										
Output	1.74	0.11	0.35	0.61	0.84	1.00	0.84	0.61	0.35	0.11
Consumption	0.85	0.19	0.39	0.58	0.73	0.79	0.70	0.55	0.38	0.19
Investment	4.63	-0.20	-0.04	0.20	0.46	0.71	0.81	0.79	0.69	0.50
Hours	1.77	-0.13	0.09	0.34	0.61	0.83	0.89	0.80	0.64	0.43
Productivity	1.01	0.42	0.46	0.46	0.38	0.26	-0.11	-0.36	-0.51	-0.56
Capital	1.21	-0.43	-0.44	-0.41	-0.32	-0.18	0.01	0.19	0.35	0.46
<i>After-tax returns</i>										
Business capital	14.08	0.31	0.37	0.40	0.41	0.38	0.24	0.09	-0.05	-0.18
S&P 500	360.03	0.20	0.17	0.10	-0.07	-0.19	-0.22	-0.20	-0.14	-0.07
<b>Benchmark Model</b>										
Output	1.45	0.09	0.26	0.46	0.71	1.00	0.71	0.46	0.26	0.09
Consumption	0.72	0.00	0.17	0.39	0.65	0.98	0.75	0.55	0.37	0.22
Investment	6.68	0.16	0.31	0.50	0.72	0.98	0.65	0.38	0.16	0.00
Hours	0.56	0.18	0.33	0.51	0.73	0.98	0.64	0.36	0.14	-0.03
Productivity	0.90	0.04	0.21	0.42	0.68	0.99	0.74	0.51	0.33	0.17
Capital	0.50	-0.40	-0.30	-0.15	0.07	0.36	0.54	0.64	0.67	0.65
Return to capital	5.52	0.23	0.29	0.37	0.44	0.53	0.34	0.19	0.07	-0.03

**Data sources:** With the exception of hours, all variables have been converted from current dollars to real by deflating by the price deflator for consumer nondurables and services. All variables are expressed relative to the civilian noninstitutionalized population aged 16 and over. Output is measured by gross domestic product less gross housing product; consumption by personal consumption expenditures on nondurables and services less gross housing product; investment by private non-residential fixed investment; hours by private nonfarm payroll hours; productivity is output divided by hours; and capital and the returns series are as described in the text.

investment varies more; our model delivers this ranking, but underpredicts the volatility of consumption while exaggerating that of investment.

Next, consider the returns data. Recall that in the model, the net after-tax return on capital is given by the after-tax marginal product of capital less the depreciation rate. The model does reasonably well in terms of the average return to capital, predicting a value of 5.55% compared to 6.29% in the data. Keep in mind that the model is not calibrated to the average rate of return. In the U.S. economy, the return to capital is 8 times more volatile than output, is procyclical, and slightly leads the cycle. S&P 500 returns are far more volatile – 176 times that of output. These returns are also *countercyclical*. To the extent that stock market returns reflect the marginal product of capital, it is odd that its return is countercyclical, albeit weakly. These business cycle facts are not very sensitive to whether the returns are measured after-tax or pre-tax.

The model's prediction for the volatility of the return to capital is summarized in [Table 5](#). The rate of return in the benchmark model is about 40% as volatile as in the data. The model predicts that this return is 3.8 times more volatile than output and is strongly procyclical. In the data, the return to capital is 8 times as volatile as output, so the model captures almost 50% of the relative volatility in the return to capital. If the target was to match the volatility of S&P 500 returns, the model does quite poorly, capturing less than 4% of this relative variability.

### 4.3 Alternative Models and Parameterizations

Figure 2: Return to Capital and Marginal Product of Capital

A natural question at this stage is whether models in the RBC class could ever deliver the volatility in the rate of return to capital just by successfully delivering the aggregate quantities. One approach to answer this question is to examine the model's after-tax return to capital,  $(1 - \tau_k) [\alpha (y_t/k_t) - \delta]$ , using the time series data on output and capital stock ; i.e., hold fixed  $\tau_k$ ,  $\alpha$  and  $\delta$  as in the model and compute the model's after-tax marginal product of capital. [Figure 2](#) illustrates this time series along with the after-tax rate of return to capital. The volatility of the after-tax

marginal product of capital is only 13% less than the volatility of our measure of the rate of return to capital. A model that replicates the time series properties of output and capital stock could potentially generate sufficient volatility in the after-tax marginal product of capital to account for the volatility in the rate of return to capital.

In this subsection, we consider three variants on the benchmark model. The common theme is to explore the model's implications for the volatility of the return to capital. As motivation for these experiments, consider the intertemporal equation governing the accumulation of capital,

$$1 = E_t \left\{ \left( \beta \frac{U_{c,t+1}}{U_{c,t}} \right) \left[ 1 + (1 - \tau_k) \left( \alpha \left( \frac{y_{t+1}}{k_{t+1}} \right) - \delta \right) \right] \right\}. \quad (5)$$

The first term on the right-hand side is often referred to as the stochastic discount factor or the intertemporal marginal rate of substitution for consumption. The second term is the after-tax gross return to capital. [Table 6](#) summarizes the results for the U.S. data, the benchmark model, and the three variants considered in this subsection. The calibration procedure implies that the average rate of return across model variants are identical.

The first model variant increases the coefficient of relative risk aversion,  $\gamma$ , from 1 to 5. This change has two important implications. First, utility is no longer additively separable between consumption and leisure which implies that the intertemporal marginal rate of substitution now depends not only on consumption but also leisure (hours of work). Second, the representative household will have a stronger utility-smoothing motive as  $\gamma$  increases.<sup>2</sup> Increasing risk aversion raises the volatility of the return to capital both in absolute terms, and relative to the volatility of output. The model now captures over 75% of the relative volatility in the return to capital; the benchmark model just under 50%. For the most part, this improvement does not come at the cost of substantially worsening the model's predictions for the real side of the economy.

The second model variant considers [Hansen \(1985\)–Rogerson \(1988\)](#) indivisible labor. This variant operates more on the return to capital term in (5). In particular, [Hansen](#) showed that indivisible labor could substantially increase the volatility of hours worked. If the variability of capital

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<sup>2</sup>To the extent that introducing habit persistence has effects similar to increasing risk aversion, this experiment is suggestive of the likely effects of introducing habit.

Table 6: Alternative Models and Parameterizations

	U.S.		Benchmark		Risk Aversion: $\gamma = 5$		Indivisible Labor		Home Production	
	SD	Corr.	SD	Corr.	SD	Corr.	SD	Corr.	SD	Corr.
Output	1.74	1.00	1.45	1.00	1.31	1.00	1.72	1.00	2.05	1.00
Consumption	0.85	0.79	0.72	0.98	0.81	1.00	0.82	0.98	0.93	0.99
Investment	4.63	0.71	6.68	0.98	4.92	0.99	8.26	0.98	61.43	0.29
Hours	1.77	0.83	0.56	0.98	0.38	1.00	0.94	0.98	1.15	0.99
Productivity	1.01	0.26	0.90	0.99	0.93	1.00	0.82	0.98	0.91	0.99
Capital	1.21	-0.18	0.50	0.36	0.39	0.27	0.62	0.36	0.99	0.95
Return to capital	14.08	0.26	5.52	0.53	8.16	0.37	6.36	0.54	5.07	0.54

is not much affected by the introduction of indivisible labor, then we might expect to see more volatility in the marginal product of capital, and so the return to capital; to see this, rewrite (5) as

$$1 = E_t \left\{ \left( \beta \frac{U_{c,t+1}}{U_{c,t}} \right) \left[ 1 + (1 - \tau_k) \left( z_{t+1} \alpha \left( \frac{g^{t+1} h_{t+1}}{k_{t+1}} \right)^{1-\alpha} - \delta \right) \right] \right\}. \quad (6)$$

Relative to the benchmark model, introducing indivisible labor increases the volatility of macroaggregates – just as in Hansen. While the variability of the return to capital increases – from 5.52 to 6.36 – its volatility relative to output is essentially unchanged.

The final variant introduces home production; see Benhabib, Rogerson, and Wright (1991) and Greenwood and Hercowitz (1991). Home production is likely to operate primarily through the intertemporal marginal rate of substitution with general equilibrium effects on the marginal product of capital. Allowing agents another margin along which they can smooth utility – namely through home production – may make them more tolerant of fluctuations in market consumption, the object that appears in (5). Details of this model are left to the Appendix which also briefly discusses calibration of the home production model. In Table 6, market variables are reported for the home production model. The volatility of (market) investment is much higher than that observed in the data. Papers that have successfully addressed the investment volatility issue include Greenwood and Hercowitz (1991), Greenwood, Rogerson, and Wright (1995) and Gomme, Kydland, and Rupert (2001). Most pertinent to the focus of this paper, the home production model implies lower volatility (both absolute and relative to that of output) for the return to capital.

Table 7: SUR Estimation Results

$x_t$	$x_{t-1}$	$x_{t-2}$	time	constant	SD( $\varepsilon$ )
$\ln z_t$	0.9751381 (0.0117922)		0.0000362 (0.0000254)	0.0616098 (0.0271694)	0.0076912
$\tau_{\ell t}$	0.6636514 (0.0648272)	0.3079808 (0.0670264)	0.0000119 (0.0000234)	0.0059327 (0.0039333)	0.005693
$\tau_{kt}$	0.9435565 (0.0228361)		-0.0000438 (0.0000232)	0.0352314 (0.0146354)	0.0134531

#### 4.4 Stochastic Taxes

Figure 3: Return to Capital and Marginal Product of Capital

The “fit” between the return to capital and the after-tax marginal product of capital is rather poor in Figure 2. In the data, capital’s share of income, depreciation and tax rates all vary, and allowing all of these parameters to vary markedly improves the visual fit of the marginal product of capital. Most of the action, though, is due to changes in tax rates over time. Figure 3 illustrates the time series for  $(1 - \tau_{kt}) [\alpha (y_t/k_t) - \delta]$  where  $\alpha$  and  $\delta$  are fixed but the output, capital and tax rate are allowed to vary as in the data.

This subsection investigates how stochastic taxes contribute to the model’s prediction for the volatility in the return to capital. A preliminary step is to estimate the joint process of the technology shock and the tax rates on labor and capital income. The tax rates are as reported in Table 4. Estimation results are summarized in Table 7 over the sample period, 1954:1–2003:4. A time trend is included in each regression equation to absorb any secular trends in the variables. The Solow residual and tax rate on capital income only require one lag; the tax rate on labor income requires two. All three shock processes exhibit considerable persistence. The correlation matrix of the residuals (ordered as  $\varepsilon_{z_t}$ ,  $\varepsilon_{\ell t}$  and  $\varepsilon_{kt}$ ) is :

$$\begin{bmatrix} 1.0000 & & \\ -0.1796 & 1.0000 & \\ -0.1117 & 0.2240 & 1.0000 \end{bmatrix} \quad (7)$$

The stochastic processes are given by the autocorrelation coefficients and standard deviations of

Table 8: Results for Model with Stochastic Taxes

	Standard Deviation	Cross Correlation of Real Output With									
		$x_{t-4}$	$x_{t-3}$	$x_{t-2}$	$x_{t-1}$	$x_t$	$x_{t+1}$	$x_{t+2}$	$x_{t+3}$	$x_{t+4}$	
<b>U.S. Data, 1954:1–2003:4</b>											
Output	1.74	0.11	0.35	0.61	0.84	1.00	0.84	0.61	0.35	0.11	
Consumption	0.85	0.19	0.39	0.58	0.73	0.79	0.70	0.55	0.38	0.19	
Investment	4.63	-0.20	-0.04	0.20	0.46	0.71	0.81	0.79	0.69	0.50	
Hours	1.77	-0.13	0.09	0.34	0.61	0.83	0.89	0.80	0.64	0.43	
Productivity	1.01	0.42	0.46	0.46	0.38	0.26	-0.11	-0.36	-0.51	-0.56	
Capital	1.21	-0.43	-0.44	-0.41	-0.32	-0.18	0.01	0.19	0.35	0.46	
<i>After-tax returns</i>											
Business capital	14.08	0.31	0.37	0.40	0.41	0.38	0.24	0.09	-0.05	-0.18	
S&P 500	360.03	0.20	0.17	0.10	-0.07	-0.19	-0.22	-0.20	-0.14	-0.07	
<b>Stochastic Tax Model</b>											
Output	1.72	0.07	0.22	0.43	0.65	1.00	0.65	0.43	0.22	0.07	
Consumption	0.83	-0.05	0.09	0.29	0.51	0.83	0.65	0.49	0.34	0.22	
Investment	9.15	0.13	0.25	0.43	0.62	0.93	0.54	0.32	0.11	-0.03	
Hours	1.24	0.12	0.23	0.40	0.55	0.87	0.47	0.29	0.10	-0.02	
Productivity	0.89	-0.03	0.10	0.27	0.49	0.72	0.60	0.42	0.28	0.17	
Capital	0.64	-0.38	-0.30	-0.15	0.05	0.35	0.52	0.61	0.63	0.60	
Return to capital	10.04	0.17	0.22	0.29	0.36	0.49	0.30	0.17	0.06	-0.02	

the innovations (see Table 7) and the correlations of the innovations (see (7)).

As in Mendoza et al. (1994), we are measuring tax payments instead of statutory tax rates. First, our measurement accounts for subsidies and tax shelters. Second, even if the statutory tax rates change only at an annual frequency, stabilization policies over the cycle have the unintended effect of changing the effective tax rates at a much higher frequency. Third, as noted in Table 7, the autocorrelation in the capital income tax rate is high indicating that there is not much variation in the rate from one quarter to the next.

Table 8 repeats the U.S. observations, and adds model results when taxes are stochastic and preferences are logarithmic. Here, variation in tax rates makes the model's predictions for macroaggregates more volatile – particularly investment and the return to capital. Volatility in the return to capital is now just over 75% of that seen in the data (compared with about 40% for the benchmark model); relative to output, the model now accounts for nearly 80% of the volatility in the return to capital (compared with just under 50% for the benchmark model).

## 4.5 A More Traditional Calibration

One of the main points of [Gomme and Rupert \(2003\)](#) is that home production is important for measurement even if the model does not include home production. This approach stands in contrast to much of real business cycle theory that defines economic activity more broadly – at least at the measurement and calibration phase. This subsection investigates the implications of a more traditional calibration strategy that takes a broader view of economic activity. Specifically, we explore the implications of the oft cited [Cooley and Prescott \(1995\)](#) calibration strategy; the interested reader is directed to their paper for more details.

The [Cooley and Prescott \(1995\)](#) calibration proceeds as follows. Given a steady state investment-output ratio of 0.076, an annual capital-output ratio of 3.32, and real growth of 1.56%, the law of motion for capital implies an annual depreciation rate of 6.04% (1.477% quarterly).<sup>3</sup> [Cooley and Prescott](#) set the capital share parameter,  $\alpha$ , to 0.40 on the basis that since they have defined capital quite broadly, its share of income will correspondingly be higher. They set the risk aversion parameter,  $\gamma$ , to one implying logarithmic utility. Their target for the average fraction of time spent working is 0.31. This target, along with the steady state capital-output ratio, pins down the discount factor,  $\beta$ , and the utility parameter on leisure,  $\omega$ ; for a quarterly frequency, these values are  $\beta = 0.9887$  and  $\omega = 1.775$ . The technology shock process is  $\rho = 0.95$  and  $\sigma = 0.007$  – fairly close to the values estimated by [Gomme and Rupert \(2003\)](#).

Next, the data used to compare the model differs from that used in the rest of this paper. In particular, housing product and income flows are *not* netted out of any of the series; see the notes to [Table 10](#). The return to (all) capital is measured as

$$\tilde{R}_{AT} = \frac{\tilde{Y}_{AT}}{\text{INVENTORIES} + \text{PRIVATE FIXED ASSETS}}$$

where PRIVATE FIXED ASSETS is the sum of private nonresidential structures, the stock of private equipment & software, and private residential structures. Notice that government fixed assets as well as consumer durables are omitted from “all capital” since the NIPA do not provide any

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<sup>3</sup>[Cooley and Prescott \(1995\)](#) include population growth in their model; we do not, which implies a larger value for the depreciation rate.

Table 9: Rates of Return for Different Measures of Capital, 1954:1–2003:4

	Pre-tax	After-tax	Implied $\tau_k$
Business Capital	10.62%	6.29%	41.2%
All Capital	7.75	5.03	35.12
Housing Capital	4.24	3.54	18.

estimates of the income flows to these assets. After-tax income of all capital is

$$\begin{aligned} \tilde{Y}_{AT} = & \text{NET OPERATING SURPLUS} - (1 - \alpha)\text{PROPRIETOR'S INCOME} \\ & - \tau_h(\text{NET INTEREST} + \alpha\text{PROPRIETOR'S INCOME} + \text{RENTAL INCOME}) \\ & - \text{TAXES ON CORPORATE INCOME} - \text{BUSINESS PROPERTY TAXES} \\ & - \text{HOUSEHOLD PROPERTY TAXES} - \text{STATE AND LOCAL OTHER TAXES.} \end{aligned}$$

Figure 4: After-tax Returns on Capital

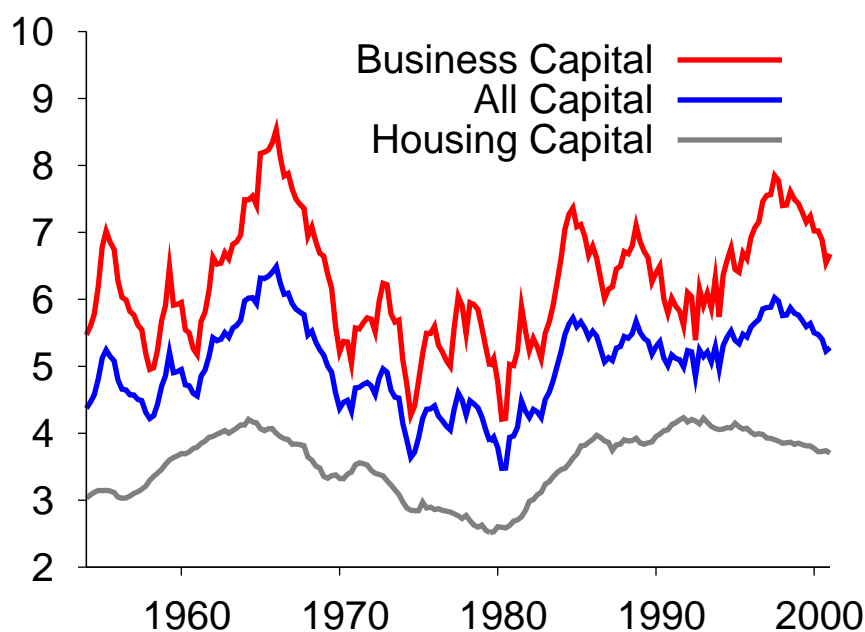


Table 9 summarizes the average rates of return to our measure of business capital as well as all capital and the implied tax rate on capital income. Figure 4 displays the after-tax returns on business capital, all capital, and housing capital. The return to all capital is a weighted average of the returns to business and housing capital where the weights are given by the relative sizes of the capital stocks. We should note that the “all capital” rate of return calculations embody

Table 10: Alternative Calibration Strategy

	Standard Deviation	Cross Correlation of Real Output With									
		$x_{t-4}$	$x_{t-3}$	$x_{t-2}$	$x_{t-1}$	$x_t$	$x_{t+1}$	$x_{t+2}$	$x_{t+3}$	$x_{t+4}$	
<b>U.S. Data, 1954:1–2003:4</b>											
Output	1.66	0.11	0.36	0.62	0.85	1.00	0.85	0.62	0.36	0.11	
Consumption	0.79	0.22	0.43	0.63	0.78	0.83	0.74	0.58	0.40	0.19	
Investment	4.66	0.19	0.38	0.61	0.81	0.92	0.83	0.64	0.39	0.13	
Hours	1.78	−0.15	0.07	0.34	0.61	0.83	0.88	0.79	0.63	0.41	
Productivity	1.00	0.44	0.46	0.43	0.32	0.18	−0.17	−0.40	−0.53	−0.55	
Capital	1.17	−0.42	−0.32	−0.18	−0.02	0.16	0.34	0.49	0.60	0.66	
<i>Return to all capital</i>											
After-tax	12.80	0.26	0.32	0.36	0.38	0.36	0.24	0.11	−0.01	−0.13	
<b>Model</b>											
Output	1.31	0.08	0.25	0.45	0.70	1.00	0.70	0.45	0.25	0.08	
Consumption	0.35	−0.15	0.02	0.24	0.53	0.89	0.76	0.62	0.49	0.37	
Investment	4.45	0.14	0.29	0.48	0.72	0.99	0.66	0.39	0.18	0.01	
Hours	0.70	0.16	0.31	0.50	0.72	0.99	0.64	0.37	0.15	−0.02	
Productivity	0.63	0.00	0.16	0.38	0.65	0.98	0.74	0.53	0.35	0.20	
Capital	0.29	−0.44	−0.34	−0.19	0.02	0.32	0.50	0.61	0.65	0.64	
Return to capital	5.16	0.23	0.31	0.41	0.52	0.64	0.44	0.28	0.14	0.04	

**Data sources:** With the exception of hours, all variables have been converted from current dollars to real by deflating by the price deflator for consumer nondurables and services. All variables are expressed relative to the civilian noninstitutionalized population aged 16 and over. Output is measured by gross domestic product; consumption by personal consumption expenditures on non-durables and services; investment by private fixed investment plus purchases of consumer durables; hours by private nonfarm payroll hours; productivity is output divided by hours; capital by the sum of private fixed assets, the stock of consumer durables, and the stock of inventories (with conversions to quarterly as in [Subsection 3.1](#)); and the returns series are as described in the text.

capital stocks with very different rates of returns. In particular, the pre-tax return to business capital is almost 2.5 times the return to housing capital. (The return to housing capital can be obtained by subtracting business capital income from all capital income, then dividing by the stock of residential structures.) The after-tax returns, however, differ by a factor of only 1.8. In general, these rates of return and the implied capital income tax rate are related by

$$R^{\text{after-tax}} = (1 - \tau_k)R^{\text{pre-tax}}. \quad (8)$$

As shown in [Table 9](#), the implied tax rate on housing capital is roughly 40% of that associated with business capital. Thus, aggregating these capital stocks into “all capital” may be problematic.

Business cycle moments for both the U.S. economy (new measurement) and the model ([Cooley](#)

and Prescott calibration) are summarized in [Table 10](#). Apart from the rate of return on capital, the U.S. business cycle properties are quite similar to those reported in [Table 5](#). The percentage standard deviation of the return to all capital is roughly 90% that of business capital. The smaller variability of the return to all capital can be largely attributed to the fact that the return to housing capital is considerably smoother than that earned on business capital. While the model's prediction for the variability of the return to capital is slightly lower than that of the benchmark model (5.16% versus 5.52%), the model can account for a similar fraction – around 40% – of the volatility in the return to (all) capital. In terms of volatility relative to output variability, the model accounts for roughly 50% of the variability in the return to all capital.

## 5 Conclusions

We constructed a time series for the after-tax return to capital and showed that its behavior is substantially different from the S&P500 returns. Our measure of the return to capital is considerably smoother (by a factor of 22) and has a higher mean. The standard real business cycle model accounts for nearly 50% of the volatility in the return to capital relative to that of output. We considered three variants of the standard model – high risk aversion, indivisible labor and home production. The high risk aversion model delivers over 75% of the relative volatility in the return to capital, the indivisible labor model delivers almost 50%, while the home production model about 30%.

[Table 6](#) provides some insight into factors that are important for accounting for the volatility of the return to capital. Increasing the volatility of output and/or capital increases the variability of the return to capital as seen by comparing the benchmark and indivisible labor models. However, increasing the volatility of these macroaggregates is not sufficient; the home production model has much higher output and market capital stock variability, yet the volatility of the return to capital is lower than in the benchmark model. In the case of home production, the model also generates a very strong positive correlation between output and market capital, a factor that works against

generating high volatility in the return to capital. By way of contrast, the data exhibits a small negative correlation between output and capital. To drive this point home, consider the high risk aversion model. In this case, the volatilities of output and capital are lower than in the benchmark model (factors that would tend to reduce the variability of the return to capital), but the correlation between output and capital is also lower (which tends to raise the volatility of the return to capital); the net result is higher variability in the return to capital.

Allowing taxes to vary over time also produces very promising results. The joint stochastic process for total factor productivity, the capital income tax, and the labor income tax were estimated from the data. The addition of stochastic taxes allows the model to capture almost 80% of the volatility of the return to capital (relative to the variability of output), up from the roughly 50% for the baseline model.

As noted in the Introduction, the return to capital and the return to equity are the same in the basic RBC model. The high risk aversion variant of the RBC model delivers more than 75% of the relative volatility in the return to capital, but delivers less than 4% of the relative volatility in the return to the S&P 500.<sup>4</sup> As is evident from [Figure 1](#), in order to simultaneously account for the volatilities of the return to capital and the S&P 500 return, we have to break the equivalence in the model between the return to capital and the return to equity. To the extent that the S&P 500 return does not reflect the return on a representative unit of capital in aggregate models (see [Mulligan \(2002\)](#), for instance), it might be useful to construct a general equilibrium theory of publicly traded firms and of “non-traded” firms.<sup>5</sup> Another approach to break the equivalence might be to introduce limited participation in equity markets. Such theories might deliver a smooth return to capital and a volatile return to equity via volatile stochastic discount factors that price equity.

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<sup>4</sup>Jermann (1998) examines an RBC model with habit persistence and adjustment costs to capital while Boldrin, Christiano, and Fisher (2001) examine a two-sector growth model with habit persistence and restrictions on factor mobility across sectors. Both papers account for almost the entire observed volatility in S&P 500 returns.

<sup>5</sup>The S&P 500 capital is less than 40% of the total private fixed capital in the U.S. economy.

## Appendix: Home Production

The market sector, denoted by the subscript  $M$ , produces output according to the technology

$$y_{Mt} = z_{Mt} k_{Mt}^\alpha (g^t h_{Mt})^{1-\alpha}, \quad (\text{A.1})$$

where  $y_M$  is the amount of output,  $k_M$  denotes the beginning of period capital stock,  $h_M$  denotes hours worked,  $g$  is the growth rate of labor-augmenting technical change, and  $z_M$  denotes the state of disembodied technical progress. Output in the market sector can be allocated between consumption goods and investment goods such that

$$c_{Mt} + i_{Mt} + i_{Ht} = y_{Mt},$$

where  $c_M$  denotes market consumption,  $i_M$  market investment, and  $i_H$  home investment.

The representative firm's problem is to choose  $k_{Mt}$  and  $h_{Mt}$  in order to

$$\max z_{Mt} k_{Mt}^\alpha (g^t h_{Mt})^{1-\alpha} - w_t h_{Mt} - r_t k_{Mt}$$

where  $w_t$  is the real wage rate, and  $r_t$  is the real rental rate on market capital.

Consumption goods in the home sector (denoted by  $H$  subscripts) use labor and home capital according to the technology

$$c_{Ht} = k_{Ht}^\theta (g^t h_{Ht})^{1-\theta}. \quad (\text{A.2})$$

Market and home capital evolve according to

$$k_{Mt+1} = (1 - \delta_M) k_{Mt} + i_{Mt} \quad (\text{A.3})$$

$$k_{Ht+1} = (1 - \delta_H) k_{Ht} + i_{Ht}. \quad (\text{A.4})$$

The representative household has preferences over market consumption,  $c_{Mt}$ , home consumption,  $c_{Ht}$ , market hours,  $h_{Mt}$ , and home hours,  $h_{Ht}$ , summarized by

$$E_0 \sum_{t=0}^{\infty} \beta^t U(c_{Mt}, c_{Ht}, h_{Mt}, h_{Ht}), \quad 0 < \beta < 1, \quad (\text{A.5})$$

where

$$U(c_M, c_H, h_M, h_H) = \begin{cases} \frac{[C(c_M, c_H)(1 - h_M - h_H)^\omega]^{1-\gamma}}{1-\gamma} & \text{if } 0 < \gamma < 1 \text{ or } \gamma > 1, \\ \ln C(c_M, c_H) + \omega \ln(1 - h_M - h_H) & \text{if } \gamma = 1, \end{cases} \quad (\text{A.6})$$

Table 11: Long Run Averages for the Home Production Model

Observation	Value
Capital's share of market income	0.283
Depreciation of market capital (annual)	0.069113
Depreciation of home capital (annual)	0.059981
Market investment as a share of market output	0.1306
Home investment as a share of market output	0.1571
Market hours	0.255
Home hours	0.24

where  $C$  is the “aggregate” of market and home consumption, described by:

$$C(c_m, c_h) = \begin{cases} \left[ \psi c_m^\xi + (1 - \psi) c_h^\xi \right]^{1/\xi} & \text{if } \xi \in (-\infty, 0) \cup (0, 1) \\ c_m^\psi c_h^{1-\psi} & \text{if } \xi = 0. \end{cases} \quad (\text{A.7})$$

Implicit in (A.6) is an assumption that the individual's time endowment is equal to one.

Given the initial conditions  $k_{M0}$  and  $k_{H0}$ , the representative agent's problem is to choose  $\{c_{Mt}, c_{Ht}, h_{Mt}, h_{Ht}, k_{Mt+1}, k_{Ht+1}\}_{t=0}^\infty$  in order to maximize (A.5) subject to (A.2)–(A.4), and

$$c_{Mt} + i_{Mt} + i_{Ht} = (1 - \tau_\ell) w_t h_{Mt} + (1 - \tau_k) r_t k_{Mt} + \tau_k \delta_M k_{Mt} + T_t.$$

where  $T_t$  is the transfer from the government in period  $t$ .

The government satisfies its budget constraint,

$$\tau_\ell w_t h_{Mt} + \tau_k r_t k_{Mt} - \tau_k \delta_M k_{Mt} = T_t$$

In steady state, the model must be consistent with long run averages observed in the U.S. data; for data details, see [Gomme and Rupert \(2003\)](#). These long run averages are summarized in [Table 11](#). The first three of these long run averages directly determine the parameters  $\alpha$ ,  $\delta_M$  and  $\delta_H$ . The coefficient of relative risk aversion,  $\gamma$ , is set to one which implies logarithmic utility. The curvature parameter in the consumption aggregator,  $\xi$ , is set to 0.4 based on estimates by [McGrattan, Rogerson, and Wright \(199\)](#) and [Rupert, Rogerson, and Wright \(1995\)](#). The remaining parameters,  $\beta$ ,  $\omega$ ,  $\psi$  and  $\theta$ , are set to match the remaining four long run averages in [Table 11](#). The parameter values are summarized in [Table 12](#). Finally, the properties of the stochastic technology process are as for the benchmark model.

Table 12: Home Production Model Parameter Values

Parameter	Description	Value
$\alpha$	Capital's share of market income	0.283
$\delta_M$	Depreciation of market capital (quarterly)	0.0177
$\delta_H$	Depreciation of home capital (quarterly)	0.0153
$\gamma$	Coefficient of relative risk aversion	1
$\xi$	Curvature parameter in consumption aggregator	0.4
$\tau_k$	Capital income tax rate	0.3014
$\tau_\ell$	Labor income tax rate	0.2263
$\beta$	Discount factor	0.9907
$\omega$	Utility weight on leisure	0.7489
$\psi$	Parameter on market consumption in consumption aggregator	0.5307
$\theta$	Capital's share in home production	0.3083
$\rho$	Autoregressive parameter of technology shock	0.96405
$\sigma$	Standard deviation of innovation to technology shock	0.00818

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