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Summary: The Decline of U.S. Corporate Investment

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Summary: The Decline of U.S. Corporate Investment

Seminar by Professor Joao Gomes

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THE AMERICAN ECONOMY CONTEXTUALIZED

A historical view of the U.S. economy reveals a troubling phenomenon. In 2008, after the recession hit, GDP, investment, and consumption in the U.S. dropped (as one would expect during a recession). However, while the nation's GDP and consumption recovered by 2012, investment has continued to underperform. In light of this stagnation, Congress passed the Tax Cuts and Jobs Act in 2017, which included tax reductions for U.S. corporations aimed at stimulating corporate spending. However, based on the limited data available since then on private sector behavior, it appears these recent tax cuts may not lead to a significant increase in corporate capital expenditures. Why is that?

THREE MAJOR DRIVERS OF CORPORATE INVESTMENTS

There are three main drivers for corporate investment: exploitable profit opportunities, funding costs, and tax/regulatory policies. Let's take a closer look at the roles these three drivers have played in leading the U.S. to a place where corporate investment is severely depressed.

Profit opportunities are built on the expectation of future economic growth. However, the U.S. economy has not performed well over the past decade, and the consensus among economists is that it will not grow quickly over the next decade either. The U.S. is going through a period of dramatic economic slowdown triggered by a shrinking workforce and declining levels of productivity. During the period from 1950-2016, the U.S. economy grew at an average annual rate of around 3 percent. Approximately half of that growth came from an expanding labor force; the other half from increased labor productivity. Projections from the CBO for the next decade put average annual growth at just 2 percent. The U.S. population is aging and the labor force is growing much less quickly than in the past, and labor force productivity is increasing at a lower rate too. With fewer people in the labor market to produce goods and services, collective buying power has declined. Businesses see these lower projections and hesitate to make large, expensive investment decisions. It does not make sense to expand productive capacity when economic conditions do not promise a commensurate payoff.

While the slowdown in the economy is arguably the most important reason for the lag in corporate investment, some people point to the cost of finance as also playing a role. The data, however, tell a different story. After the start of the Great Recession, banks indeed became much more nervous about lending, particularly from 2008-2010. But since 2010, fewer banks have continued to be restrictive in their lending practices. And interest rates remain historically low, between 4-5 percent. It seems difficult, then, to argue that corporations are not making investments because they cannot raise capital.

> "It's not funding. It's not uncertainty. It's not regulations. It's that people don't look at the US economy and see the same growth potential as they did in the past."

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Another explanation for the decline in corporate investment is uncertainty, particularly uncertainty in the legislative and regulatory environment. It can be hard to measure the impact of such uncertainty. But one can look at behavior in purchasing insurance against stock market volatility--through the Chicago Board Options Exchange Volatility Index, for instance--to gauge how nervous investors are about risk. Those data indicate that perceived business risk spiked from 2008-2010, at the height of the Great Recession, but since then, the trend in the data does not show a heightened awareness of risk currently.

In all, then, the ongoing slump in investment does not appear to be due primarily to uncertainty, or to difficulties gaining access to capital, but rather to the lack of confidence in the future growth of the economy. Companies do not see the profit opportunity. Another term for this state of affairs is "secular stagnation."

A Case Study: The American Shale Industry

To see the primacy of profit opportunity in driving corporate investment decisions, one need look no further than shale. That industry, fueled by fracking, has been the one sector of the U.S. economy that has seen a tremendous boom in corporate investment over the past decade. What is fascinating is that this is a sector defined by many small firms with limited access to capital markets, and characterized by great uncertainty (including regulatory uncertainty), as it is tied to one thing—oil prices, which are notoriously volatile. Nevertheless, those firms have had no problem accessing money to make significant capital investments. Why? Because despite the volatility and uncertainty, they saw the growth potential in the industry and therefore the profit opportunity.

INTANGIBLE ASSETS

Quantitative economic models suggest that this secular stagnation explains between 1/3 and 2/3 of the decline in corporate investment over the past ten years. It is unclear what accounts for the rest, but there are two possible explanations that deserve exploration.

One possible argument goes like this: There has been an increase in industrial concentration in the U.S.—a result of increased merger activity, which has increased monopoly power in many sectors. Monopolies typically raise prices while restricting production and productive capacity. The common example is the airline industry: airline mergers have proliferated, leading to fewer airplanes in service, fewer flights, and higher prices for consumers. In scenarios such as this, where there is reduced competition and a scaling back of production, there simply is less need for investment.

Though logically plausible, this argument about industrial concentration has flaws. For one thing, if industrial concentration has increased so greatly, why aren't prices going up more generally? Why is inflation so low? Consumer prices do not currently suggest widespread concentration and monopoly power, which makes it harder to argue that industrial concentration has become so pervasive as to explain why businesses are not investing.

A second theory argues that maybe the U.S. simply is moving toward a less capital-intensive economy, from being a manufacturing based economy to a service based one, in which the private sector demands more "intangible" assets, as opposed to traditional physical capital investments.

There are three types of investments that firms can make. One is equipment: cars, trucks, machinery, and the like. The second is plants. And the last is intellectual capital—intangibles such as R&D and software. Looking at the data on the quantity of private capital used to produce each unit of GDP in the U.S., this is what we see: the number of physical units of equipment relative to GDP has gone up slightly, while physical plant has declined dramatically alongside an equally dramatic increase in the units of intellectual capital. This suggests that Americans now live in an economy where heavy, long-lived assets (such as plants, trucks, and physical property) are simply no longer needed in the same quantities as before. Instead, companies are becoming more reliant on the intangibles. That is where the private sector is putting its money.

In all, then, looking at all of the possible explanations for why companies are spending less and less on capital goods, two of them emerge as particularly compelling: secular stagnation, combined with technological changes that have allowed companies to spend less on physical capital. It is not that companies cannot purchase capital goods—interest rates are very low. It's that companies generally do not want to make such investments. In light of this trend, let's take a closer look at the future of infrastructure spending.

IMPLICATIONS ON INFRASTRUCTURE POLICY

If corporations are communicating, through their behavior, that they do not want to put money into capital assets, does it make sense for the government to build and refurbish airports, high-speed railways, and other major infrastructure projects? Many people regard infrastructure as the answer to weak economic growth, and point to China as an example of how infrastructure development can serve as a driver for a more dynamic economy. But Spain, Italy, and Greece are telling examples too. Those countries have invested in major infrastructure projects, but unlike China, have not seen concomitant economic growth, and instead have experienced great economic instability and insolvency.

The fact that America's infrastructure is old is not an **economic** rationale for new infrastructure investment. The private sector is signaling that they are not seeing the value of investing in that kind of physical capital, even though interest rates for making such investments are low. Given the reticence of the private sector to invest in capital goods, it is important that policymakers likewise consider whether putting money into public capital makes sense economically.