

CENTER for AMERICAN PROGRESS



**Lagging Investment**

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**The Cost of the Upside-Down Economy**

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## **INTRODUCTION**

The current economic recovery has been unique in many respects. It was the first “job loss” recovery since World War II. For most of the first two years of the recovery, total employment was below the levels at the start of the recovery. Total compensation growth was the lowest in any post-war recovery. After eight quarters of recovery, total compensation was less than 3 percent higher than at either the start of the recovery or the recession. Simultaneously, after-tax profit rates rose to record highs, marking this as an ‘upside-down’ economy, whereby corporate gains soared and labor’s gains reached new lows.

Another distinct and not unrelated facet of this recovery was the prolonged decline in business investment that lasted longer than any prior decline well into the second year of the recovery.

Only in recent quarters has investment begun to grow again. Yet, it will take years before investment reaches again the economic importance of the late 1990s. And much of the recent investment growth has benefited only a few industries. For example, industrial capacity in the manufacturing sector outside some information-technology (IT) sectors has not changed compared to the start of the recession.

The decline in investment was not due to a lack of corporate profits. On the contrary, companies were more profitable than ever before. Instead, firms saw no real reason to invest more due to large overcapacities.

Consequently, firms put their resources to other uses. Dividend pay-outs and share repurchases remained popular uses of corporate funds after 2000. Thus, firms prioritized speculative investments over productive ones because demand growth was low. In other words, faster demand growth would provide companies an incentive to prioritize productive investments over speculative ones, thereby stabilizing the recovery. Because investment is the only economic sector that still has room to grow, unlike consumption or government spending, its increase will be critical to making the recovery sustainable. More capital expenditures will also boost the country’s capital base and thus lay the foundation for future productivity growth.

## **INVESTMENT GROWTH IN PERSPECTIVE**

After declining for most of the 1980s, investment saw a robust recovery for most of the 1990s (figure 1).<sup>1</sup> It rose from a low of 9.5 percent of gross domestic product (GDP) in early 1992 to a high of 12.7 percent in the second half of 2000.

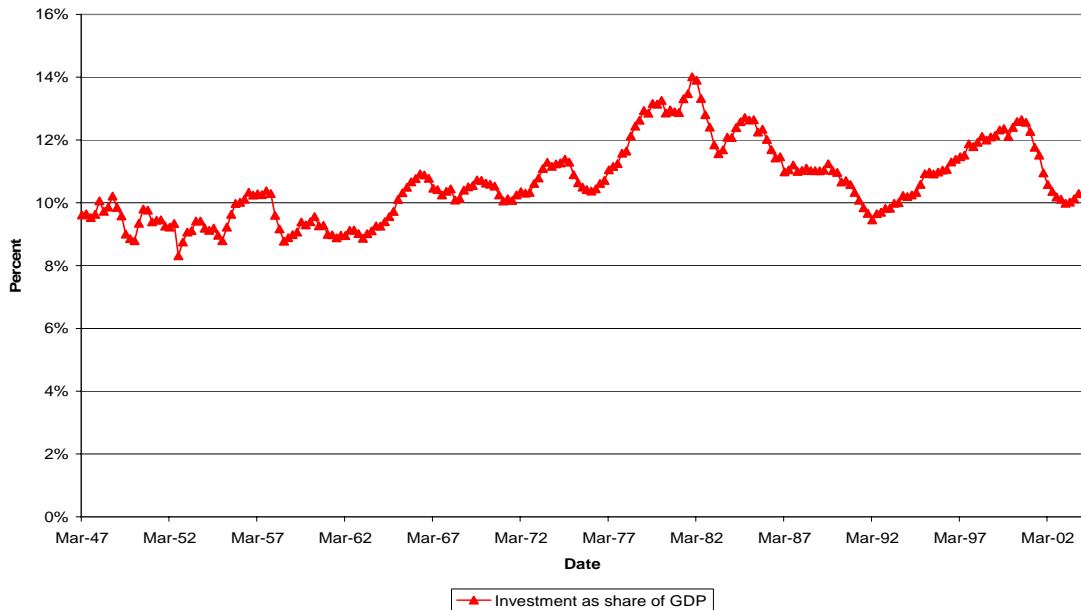
But the gains made throughout the last business cycle were quickly erased in the recession and the recovery. After adjusting for inflation, investment declined for nine

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<sup>1</sup> Investment refers to nonresidential fixed investment.

quarters in a row, starting with the first quarter of 2001, marking its longest decline since the Second World War. As a result of this prolonged decline, investment fell to 10 percent of GDP in the first quarter of 2003, erasing more than 80 percent of the gains in investment relative to GDP in the 1990s.

Figure 1: Nonresidential Fixed Investment as Share of GDP



Source: BEA, 2004a.

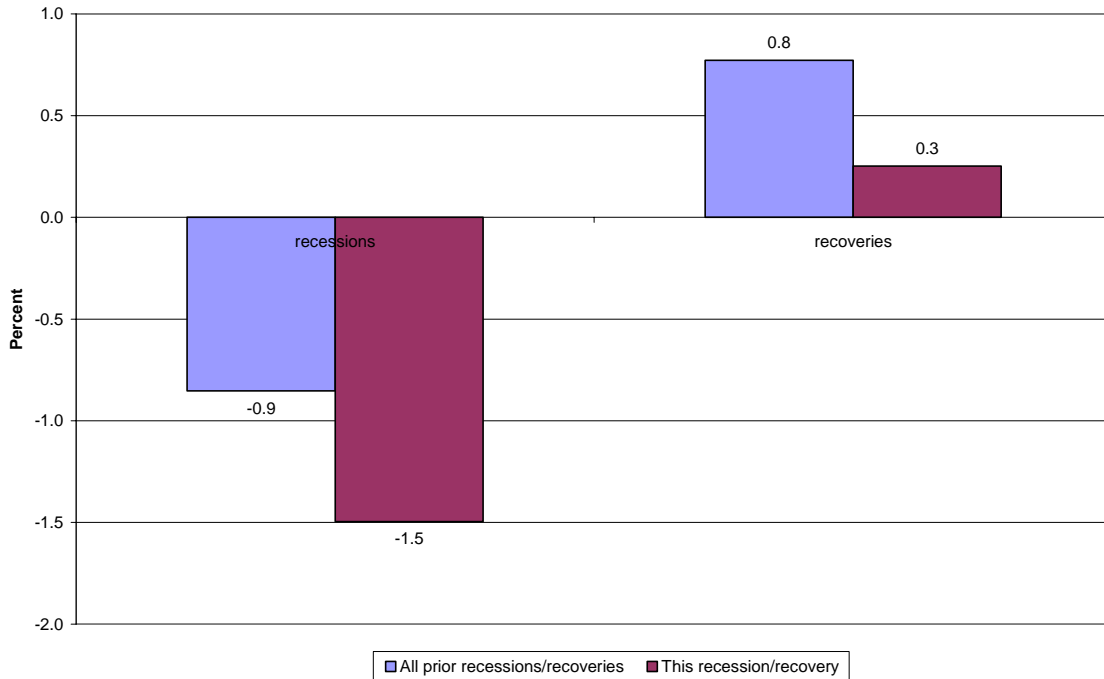
Even with strong investment growth, it will likely take years before investment plays the same economic role as in the 1990s. If we assumed that GDP and investment will grow at the average growth rates of the entire last business cycle – from 1990 to 2001, it would take until early 2020 before investment reached 12.7 percent of GDP again. If investment and GDP grew instead at the rates of the last investment recovery – in the late 1990s – it would still take until 2011 before investment grew again to 1999 levels. And if investment and GDP continued to grow at the rates of the last four quarters, it would also take until early 2011 before the last investment peak was reached again.

The investment decline in this recession constituted an above average drag on economic growth. While on average investment decreased economic growth by 0.9 percentage points in a recession, it reduced it by 1.5 percentage points in this recession (figure 2). In other words, had investment declined at similar rates as in past recessions, economic growth would have been 0.6 percentage points faster each year, thus making the recession much milder than it actually was.

Similarly, investment also made a well below average contribution to economic growth in the first eight quarters of the recovery. While investment growth raised economic growth on average by 0.8 percentage points in all prior recoveries, it only added 0.2 percentage points in this recovery (figure 2). Thus, low demand for investment goods,

following slow growth of demand elsewhere – consumption, exports and government spending – explains part of the first “job loss” recovery since the WWII.

Figure 2: Growth Contribution from Investment, avg. During First 9 Quarters



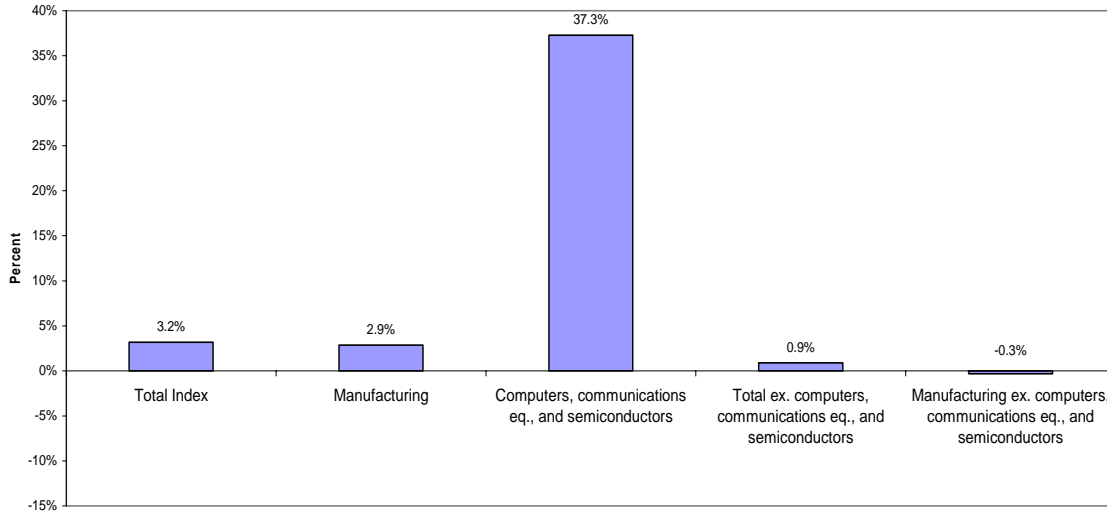
Source: BEA, 2004a.

In recent quarters, investment growth has begun to rebound. However, the available data suggest that this constitutes a somewhat limited resurgence of investment, rather than a broad investment boom. Compared to the start of the recovery in November 2001, industrial capacity in the entire economy had risen by 3.2 percent and in manufacturing by 2.9 percent by March 2004. Much of this growth is attributable to strong growth in IT-related industries: computers, communications equipment and semiconductors. Industrial capacity in these sectors grew by 37.3 percent. Outside of these sectors, industrial capacity in the economy rose by 0.9 percent and actually declined by 0.3 percent in manufacturing (figure 3).

### HIGH PROFITS AND HIGH CAPACITY

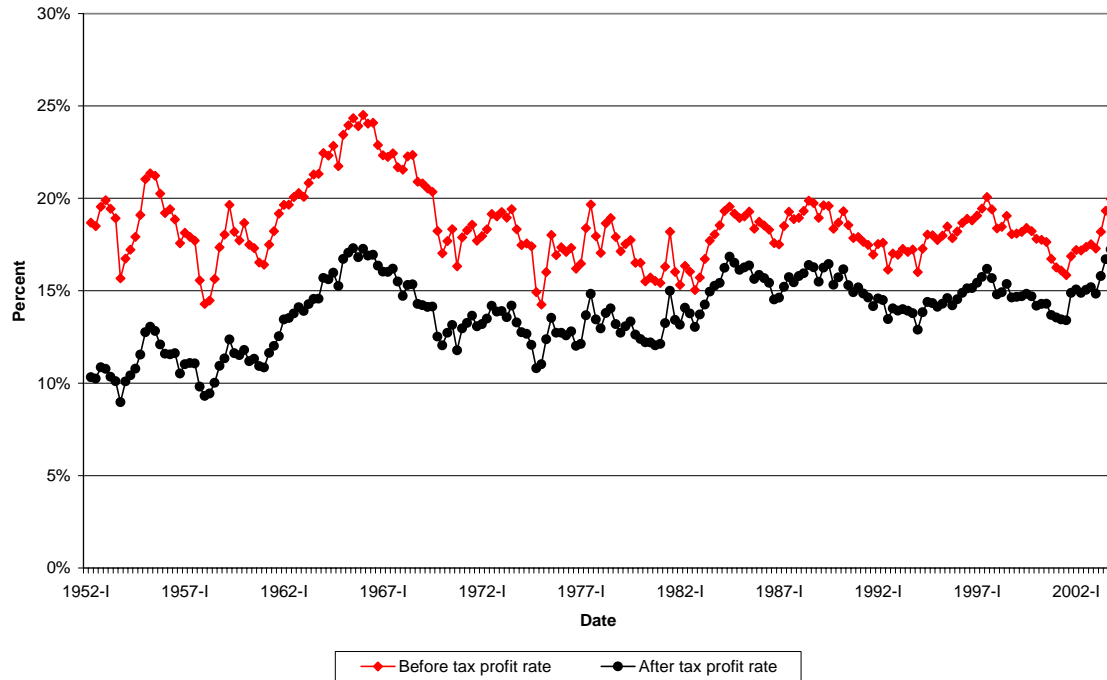
The lack of strong investment growth did not result from low profit opportunities. On the contrary, profit rates neared record highs as corporations had more resources available at any point in time since the 1950s. The most instructive measure for the performance of corporations is a corporate profit rate that relates the broadest measure of corporate income to its asset base. This measure is the sum of corporate profit and net interest income minus corporate tax payments. Relative to corporate assets, this measure reached never before recorded highs by the end of 2003 (figure 4).

Figure 3: Industrial Capacity Growth, March 2001 to March 2004



Source: BOG, 2004a.

Figure 4: Before and After Tax Profit Rates, 1952 to 2003



Source: BEA, 2004a, 2004b.

Yet, corporations had no strong incentive to invest their additional financial resources. Generally, changes in capacity utilization are a good indicator for future investment

increases. The more capacity is used, the stronger the incentive is for firms to invest more (Weller et al., 2004). That is, if demand growth outpaces productivity gains, firms have good reason to build up more capacity since they expect more customers in the future. However, changes in capacity utilization were low or even negative. It was not until the fourth quarter of 2003, or almost two years into the recovery, that capacity utilization increased markedly (BOG, 2004). With lackluster changes in capacity utilization, there was no reason for firms to invest more, since their capacity gains due to productivity gains allowed them to meet any demand increases.

The fact that changes in capacity utilization remained comparatively low for most of the recovery reflects the large divergence between productivity growth and demand growth. If firms learn to generate more output with a set of given inputs, their productivity is rising. Firms can supply more goods and services without hiring more workers or investing in more capital. To ensure that employment grows, too, demand for new products has to grow faster than the supply of new goods.

At no point in past recoveries have supply and demand growth drifted apart as much as in the most recent recovery. In this recovery, the supply of new goods rose relatively rapidly thanks to increasing productivity growth. At the same time, demand growth remained fairly subdued. Households managed to increase their demand for consumption items only by borrowing more money, particularly since wage growth was nearly flat (Weller, 2004a). Similarly, the federal government incurred large deficits to finance its consumption amid several rounds of large tax cuts. And foreign demand for U.S.-made products was hampered by a comparatively high value of the dollar (Weller, 2004b). There was simply not enough demand to absorb the rising supply, which reflected low demand growth rather than rapid supply growth (Weller, 2004a).

## **SPECULATIVE INVESTMENTS OVER PRODUCTIVE INVESTMENTS**

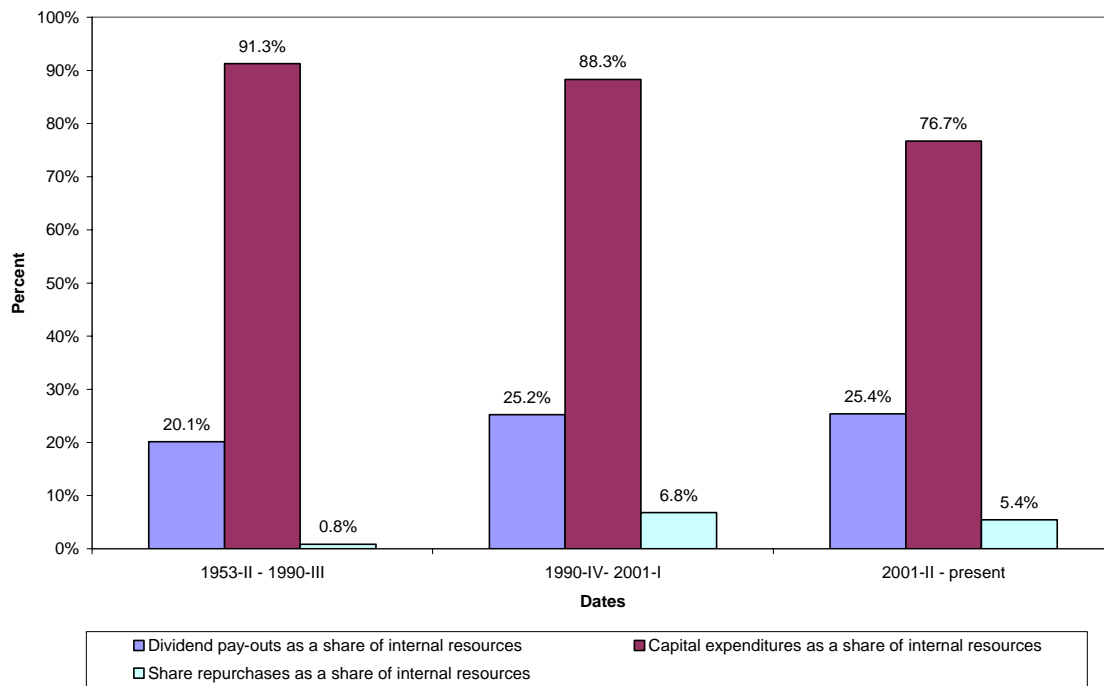
What did corporations use their record profits for if not for investments? A number of possibilities arose. Among them were dividend pay-outs and share repurchases. Neither use of corporate funds increases a company's productive capacity. The intent of either dividend pay-outs or stock repurchases was to maintain high levels of stock prices. Demand for more valuable stocks raised their price.

Share repurchases are also the flip side of stock grants and stock options as part of employee compensation, especially for executives. If corporations were just to grant stock options and stock grants to their employees without any offsetting actions, the number of stocks in circulation would ultimately rise, thereby diluting share prices. To avoid this dilution effect, companies typically repurchase their own shares. Nellie Liang and Stephen Sharpe (1999), two researchers at the Federal Reserve, estimated in 1999 that if corporations continued their share repurchases and dividend pay-outs at the pace of the late 1990s, they would have to dedicate all future profits to these uses. In other words, the research suggested that firms either would have had to forego investments in productive capital or that demand for stocks and thus their price would have had to fall.

In fact, the numbers suggest that firms did both: invest less in productive capital and accept a drop in stock prices.

The numbers show that the trend of using corporate resources increasingly for speculative investments did not stop with the end of the stock market boom in the late 1990s. Although capital expenditures - mainly investments in productive capital - are still the largest use of corporate internal resources, their respective shares have declined.<sup>2</sup> Since the start of the recession, corporations have been using less than 80 percent of their resources for capital expenditures, compared to close to 90 percent in the 1990s (figure 5). In comparison, the use of corporate resources for dividend pay-outs and share repurchases rose over time. Dividend pay-outs amounted to a record 25.4 percent of corporate resources since March 2001, surpassing the already high levels of the 1990s (figure 5).<sup>3</sup> Also, share repurchases remained high with more than 5 percent of corporate resources, albeit below the levels of the 1990s.<sup>4</sup> America's corporate sector has continued to emphasize more speculative than productive uses of corporate resources in this recession and recovery, in light of largely unchanged and occasionally rising overcapacities.

Figure 5: Selected Uses of Corporate Resources



Source: BOG, 2004b

<sup>2</sup> Internal corporate resources are defined as profits minus taxes plus depreciation plus inventory valuation adjustments (BOG, 2004b: Table F.102).

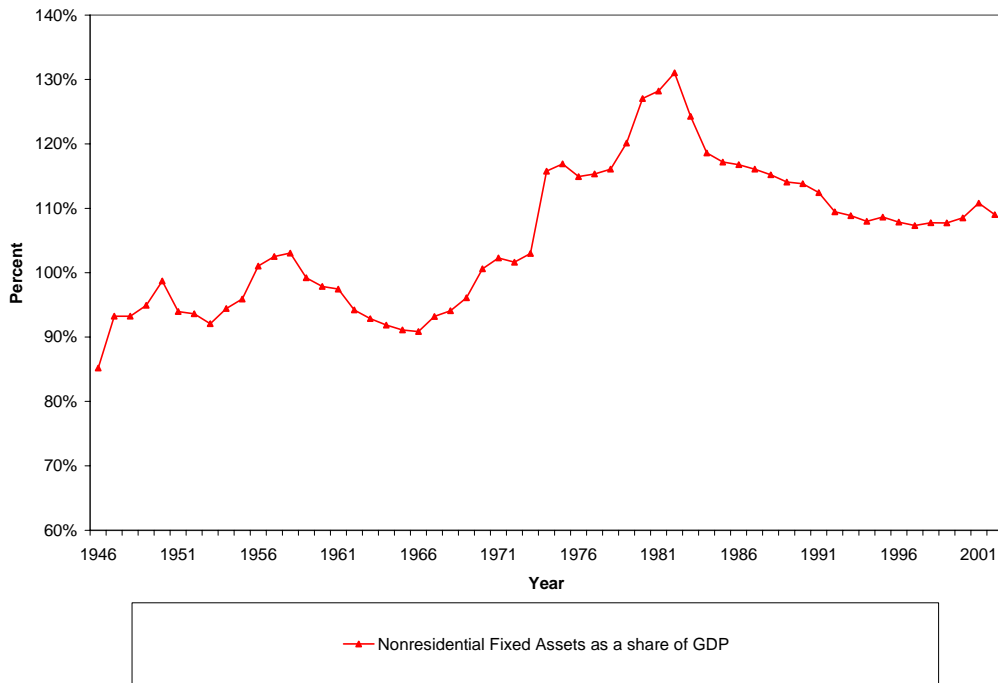
<sup>3</sup> The shares do not add to 100% since increases in corporate debt as well as purchases of financial assets are not included.

<sup>4</sup> Net share repurchases are the opposite of net new equity issues. They are calculated by multiplying net new equity issues by minus one (BOG, 2004b: Table F.102).

## THE EROSION OF AMERICA’S CAPITAL BASE

The obvious question is whether the growing prioritization of speculative over productive investments is necessarily bad. The data indicate that the lackluster investment growth in this recovery contributed to slow demand growth in the short-run and raised worries about the country’s future capital base. A solid capital base is the foundation for future productivity growth. A better capital stock can help to grow the economy more efficiently in the future. Since the early 1980s, the capital stock of businesses relative to the size of the economy has steadily declined (figure 6).<sup>5</sup> While total fixed assets, such as buildings and machinery, amounted to more than 130 percent of GDP in 1982, they have fallen to less than 110 percent since 1992, with the exception of 2001, when it amounted to 110.8 percent of GDP.

Figure 6: Nonresidential Fixed Assets as a Share of GDP



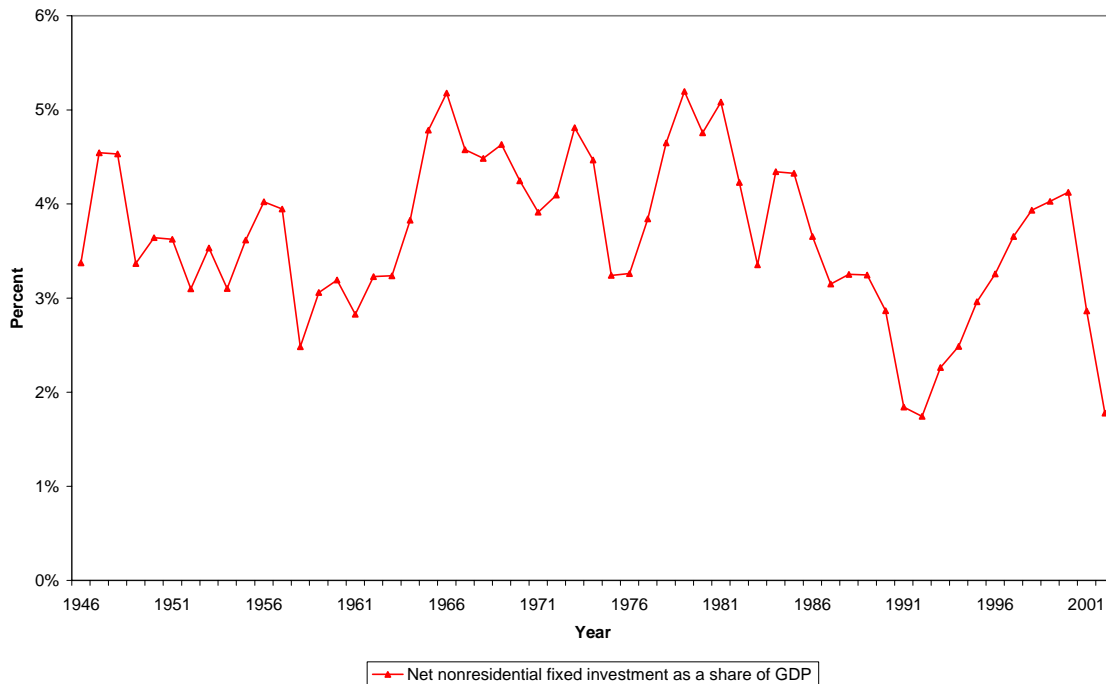
Source: BEA, 2004a, 2004b.

The average slow growth of the past few years has not added much new capital to this stock. In 2002, net investment fell to 1.8 percent of GDP. Since World War II, there was only one year, 1992, when net investment was lower at 1.7 percent of GDP (figure 7). Consequently, the lack of investment growth also did not help to boost the low capital base of the United States.

<sup>5</sup> Some researchers thus argue that the productivity boom in recent years was to a large degree the result of large and long-standing investments made in prior decades (O’Sullivan, 2000).

The low levels of capital and net investment are particularly worrisome in light of the fact that a growing share of capital and of investment consists of equipment and not structures, such as office buildings and plants. Equipment, such as machinery, computers and software, tends to depreciate much quicker than buildings. Since World War II, the share of equipment out of the stock of nonresidential fixed assets has grown from 29 percent to 38.6 percent in 2002, the last year for which data are available (BEA, 2004a). At the same time, the share of equipment investment out of total investment grew from 65.4 percent in 1947 to 76.1 percent at the end of 2002 and to 77.3 percent by early 2004 (BEA, 2004b: Table 1.1.5). In other words, investment has to grow much faster nowadays than in the past just to keep the country’s capital base intact.

Figure 7: Net Investment as a Share of GDP



Source: BEA, 2004a.

## CONCLUSION

Although the economy appears to have found more solid ground in recent months, a number of problems still remain. Even though it may seem surprising given its recent surge, investment still deserves attention. After experiencing its longest decline since World War II, business investment has grown for the past four quarters. However, much of this growth appears to have been concentrated in a few IT-related sectors. Moreover, the economy needs faster investment growth to make the recovery more sustainable and to ensure that the U.S. capital stock does not reach unduly low levels. A low capital base may ultimately jeopardize future productivity growth.

Thanks to the ‘upside-down’ economy, whereby corporate profits have had their strongest showing on record and labor has seen its weakest performance in a recovery, corporations have been flush with money. Yet, because demand growth has been low in compared to strong productivity growth, firms have continued to use their additional resources for speculative purposes. For instance, dividend pay-outs in recent years have gone beyond the already high levels of the 1990s. And share repurchases have remained at comparatively high levels as well.

Reversing the unequal distribution of economic resources between capital and labor is likely to lead to a more durable recovery. Faster wage and employment growth should boost demand growth and thus provide firms with the much needed incentives to invest more. Investment growth follows a rise in capacity utilization. Such an increase in capacity utilization results from faster demand growth. Demand growth could come from more exports, more government spending, and more consumption. Exports are hampered by a high value of the dollar and low growth overseas and government expenditures are more likely to decline than to increase given large budget deficits. That leaves only consumption as a potential driver for more demand growth. Consumption growth in the recovery has been fuelled to a large degree by household debt. To make consumption growth, and thus demand growth more sustainable, household incomes have to rise as a result of higher employment and faster wage growth.

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Christian Weller is a senior economist at the Center for American Progress, where he specializes in Social Security and retirement income, macroeconomics, the Federal Reserve, and international finance. Prior to joining American Progress, he was on the research staff at the Economic Policy Institute, where he remains a research associate. Weller has also worked at the Center for European Integration Studies at the University of Bonn, Germany, in the Department of Public Policy of the AFL-CIO in Washington, D.C., and in universal banking in Germany, Belgium and Poland. His publications appear in publications ranging from the Cambridge Journal of Economics, the Journal of Policy Analysis and Management, the International Review of Applied Economics, the Journal of Development Studies, and the Journal of International Business Studies to the *Atlanta Journal Constitution*, *USA Today*, *Detroit News*, *Challenge*, and the American Prospect. Weller is often cited in the press and he has been a frequent guest on news programs on ABC, NBC, CNN, MSNBC, CNBC, Fox News and Bloomberg Television. He holds a Ph.D. in economics from the University of Massachusetts at Amherst.

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