

## **Objectives for Chapter 15: Explanations of Business Investment Spending**

At the end of Chapter 15, you will be able to answer the following questions:

1. Define "*gross private investment spending*".
2. Define "*net private investment spending*".
3. Describe the performance of net investment spending in the United States over the past 30 years. Why is this important?
4. What are the main factors that affect business investment spending?
5. From your answers question #4, what reasons can you give for the poor performance of American business investment spending for most of the past three decades?
6. Why did the performance of American business investment spending improve so much from 1995 to 2000?

## Chapter 15: Business Investment Spending (latest revision September 2004)

We have encountered business investment spending several times already in the course. *Business investment spending has been defined as the buying of capital goods by private businesses.* While not the largest form of spending, business investment spending may be the most important. It is important for two reasons. **First, the new capital goods that businesses buy increase their ability to produce goods and services.** The growth in the standard of living, discussed in Chapter 2, depends in large part on the amount of business investment spending. **Second, business investment spending is very volatile.** This means that the amount of business investment spending can change greatly from year to year. Much of the business cycle is explained by changes in business investment spending. The economic boom from 1995 to 2000 was largely an “investment boom”. And the recession that began in March of 2001 was largely caused by a decline in business investment spending.

In order to understand the effects of business investment spending, we need to distinguish between *“gross private investment spending”* and *“net private investment spending”*. Gross private investment spending is the total amount of spending by American businesses on capital goods. *Net private investment spending is the amount of gross private investment spending minus depreciation. Depreciation means that certain capital goods are used up or become obsolete during the year.* (The word “private” is used here to remind us that we are talking about private businesses, not the government.) Businesses buy new capital goods to replace the ones that have depreciated. In doing so, the businesses are merely making up for what has been lost; they are not able to increase their production. Suppose I have one computer and it becomes unable to function. I replace it for \$1000. I have bought a new computer but I am not able to do more than I could when my original computer was working. We would say that my gross private investment spending was \$1000 while my net private investment spending was zero. Now suppose I replace it and also buy a second computer for \$1000. The second computer increases my ability to produce. So we would say that my gross private investment spending was \$2000 but that my net private investment spending was \$1000. **The increase in net private investment spending is a major factor in increasing the ability to produce goods and services.**

Examine the table on the next page. **In the official statistics, gross private investment spending includes the purchases of capital goods (called non-residential structures and producers’ durable equipment), purchases of new homes, and changes in inventories. (Items produced in one year and sold in another are counted in the year in which they are produced and are counted as part of investment).** Since we are interested in the effect of business investment spending on economic growth, the table excludes the spending on new homes and on inventories.

Year	Private Investment Spending on Structures and Equipment	Depreciation	Net Investment Spending on Structures and Equipment	% of GDP
1959	46.5	40.2	6.3	1.2
1960	49.4	41.8	7.6	1.4
1961	48.8	42.8	6	1.1
1962	53.1	44.3	8.8	1.5
1963	56.1	46	10.1	1.6
1964	63.1	48.4	14.7	2.2
1965	74.8	51.7	23.1	3.2
1966	85.4	56.3	29.1	3.7
1967	86.4	61.4	25	3
1968	93.4	67.4	26	2.9
1969	104.7	74.5	30.2	3.1
1970	109.1	81.8	27.3	2.6
1971	114.1	89.8	24.3	2.2
1972	128.8	99.4	29.4	2.4
1973	153.3	109.1	44.2	3.2
1974	169.5	126.9	42.6	2.8
1975	173.7	149.1	24.6	1.5
1976	192.4	164.5	27.9	1.5
1977	228.7	184.4	44.3	2.2
1978	278.6	210.7	67.9	2.9
1979	331.6	244.9	81.7	3.2
1980	360.9	282.6	78.3	2.8
1981	418.4	323.9	94.5	3
1982	425.3	357.5	67.8	2.1
1983	417.4	372.7	44.7	1.3
1984	490.3	393.5	96.8	2.5
1985	527.6	422.5	105.1	2.5
1986	522.5	450.8	71.7	1.6
1987	526.7	478.2	48.5	1
1988	568.4	512.4	56	1.1
1989	613.4	554	59.4	1.1
1990	630.3	579.5	50.8	0.8
1991	608.9	608.1	0.8	0
1992	626.1	642.2	-16.1	0
1993	682.2	660.1	22.1	0.3
1994	748.6	714.6	34	0.5
1995	825.2	743.6	81.6	1.1
1996	899.4	781.9	117.5	1.5
1997	999.4	832.4	167	2
1998	1017.5	889.4	128.1	1.5
1999	1203.1	961.4	241.7	2.6
2000	1390.6	1053.3	337.3	3.4
2001	1174.1	1061	13.1	0
2002	1080.2	1077.8	2.6	0
2003	1124.4	1089.9	34.4	0.3

In Billions of Current Dollars

### Test Your Understanding

1. Examine the table above. Did depreciation represent a higher percent of Gross Private Investment Spending, a lower percent, or a constant percent over time? If you answered higher or lower, try to explain why this might have occurred.
2. Examine the table above. Based on the last two columns, which years do you believe were recession years? Why?
3. Examine the table above. Briefly describe the overall performance of the American economy in terms of Net Investment Spending (especially as a percent of GDP). In which years was the performance good and in which years was it poor?
4. Examine the table below. How much of the “investment boom” of the 1990s can be attributed to Information Processing Equipment and Software?

Year	Private Investment Spending on Structures and Equipment	Information Processing Equipment and Software
1980	360.9	69.6
1981	418.4	82.4
1982	425.3	88.9
1983	417.4	100.8
1984	490.3	121.7
1985	527.6	130.8
1986	522.5	137.6
1987	526.7	141.9
1988	568.4	155.9
1989	613.4	173.1
1990	630.3	176.1
1991	608.9	181.4
1992	626.1	197.5
1993	682.2	215.1
1994	748.6	233.7
1995	825.2	262.1
1996	899.4	287.3
1997	999.4	325.2
1998	1017.5	367.4
1999	1203.1	433.1
2000	1390.6	548.6
2001	1174.1	436.4
2002	1080.2	421.3
2003	1124.4	477.0

### 1. Factors Affecting Business Investment Spending

In order to understand those factors that affect business investment spending, let us make up a hypothetical example. Assume that General Motors is considering the building of a new automobile assembly plant. Just for numbers, let us say that it will cost General Motors \$1 billion to pay for the land, the construction of the building, and all of the machines and equipment needed. Part of this \$1 billion will be obtained by borrowing (either from a financial institution or by selling bonds). The other part of the \$1 billion will be obtained from the retained part of the company’s profits. (This is called *retained earnings or corporate savings*. It is the part of the profits not paid as dividends.) The plant has an expected lifetime of twenty years after which it will need a complete

renovation. The plant will be able to produce up to 10,000 new automobiles each year. Each of these automobiles is expected to sell for a certain price, say \$20,000. The production of these automobiles will require a certain amount of raw materials (for example, steel) and a certain amount of parts (for example, tires). General Motors would need to estimate the costs of these items. Also, the production of the automobiles will require certain number of workers. General Motors would need to estimate the costs of the wages and benefits it will pay for its workers. There are other costs as well, such as advertising, insurance, salaries of executives, and so forth. Once it makes these estimates, General Motors can determine whether it is profitable to build the plant.

A. From this hypothetical example, we can highlight the factors that affect the investment decisions of businesses. **First, there is the cost of the capital goods** (\$1 billion in the example). One would expect that, *if the prices of capital goods rise (fall), other things equal, business investment spending would fall (rise)*. From 1980 to 1988, the prices of capital goods rose only 18%. This is very low (the GDP Deflator rose 41% of the same period). Thus, changes in the prices of capital goods do not explain the poor investment performance of that period. The same conclusion holds for the decade of the 1970s. However, in the second half of the 1990s, business investment spending boomed. **About half of this boom was caused by falling capital goods prices**, especially in the area of data processing and data communications equipment.

B. **Second, there is the cost of borrowing money --- the real interest rate.** Since the days of the Classical economists, it has been accepted that *as real interest rates rise (fall), business investment spending falls (rises)*. The real rate of interest affects spending on housing in the same way (remember that spending on housing is treated as part of investment spending). In fact, the effect of changes in the real interest rate is greater for housing than for the buying of capital goods, but it is significant for all forms of business investment spending. **An examination of historical data shows that real interest rates were very low (even negative) for much of the 1970s and were usually high in the 1980s and early 1990s.** Therefore, high real interest rates could explain part of the poor investment performance of the 1980s and early 1990s, but not that of the 1970s.

**The real interest rate depends in part on the amount of personal savings. If personal savings are high (low), banks will need to lower (raise) interest rates to persuade businesses to borrow.** Savings were covered in the previous chapter.

C. **Third, there is the amount of profits of the business.** As was discussed in Chapter 7, a corporation earns profits on which it pays taxes. Some of the after-tax profits are paid to the owners in cash. These are called *dividends*. The rest of the after-tax profits are retained in the company and can be used to pay for capital goods. **The greater (lower) the retained after-tax profits, the greater (lower) will be the amount of business investment spending.** In 2003, corporate profits totaled \$1,124 billion. Of this, approximately \$230 billion (21%) was used to pay the corporate profits tax, \$310 billion (28%) was sent to the owners as dividends, and \$459 billion (41%) was retained by the companies. **Retained profits were generally low through much of the 1970s and 1980s; this is one of the reasons that business investment spending was relatively low**

**in that period. Retained profits were generally high from 1993 to 2000; this is one of the reasons that business investment spending was relatively high in that period.**

Additional evidence on this point can be gained by examining **stock market prices**. Stock market prices should reflect corporate profits, among other things. *The higher (lower) are stock market prices, the greater (lower) business investment spending should be.* Adjusting for inflation, stock market prices peaked in the late 1960s, then collapsed from 1969 to 1985, before rising until the late 1980s. They then fell in the late 1980s and early 1990s, before rising greatly from 1992 to 2000. They fell in 2001 and 2002 and then were up and down in 2003 and 2004. Nobel laureate James Tobin theorized that *aggregate investment spending is related to the ratio of the total stock market value of companies to the replacement cost of their capital goods (this ratio is called Tobin's Q).* The change in stock prices does seem to correlate well with the investment performance of the American economy.

### Test Your Understanding

Examine the data on the next page and answer the following questions:

1. Is there any trend in the percent of corporate profits paid as corporate taxes?
2. Is there any trend in the percent of after-tax corporate profits paid as dividends?
3. How well does the trend in after-tax profits explain the trend in business investment spending shown in the first table above?
4. How well does the change in stock market prices explain the trend in business investment spending shown in the first table above?
5. Go to the following site: <http://www.bea.doc.gov/bea/dn/saverate.xls> Examine the personal savings rates in the United States. We know that savings are used to finance business investment spending. Do the data on the personal savings as a percent of disposable income correlate well with the investment performance? (That is, are personal savings rates high when investment spending is high and vice versa?). Explain.

Year	Corporate Profits	Profits Tax	Dividends	Retained Earnings	Stock Prices*
1970	81.6	34.4	24.3	23	45.72
1971	95.1	37.7	25.1	34.3	54.22
1972	109.8	41.9	26.8	41.1	60.29
1973	123.9	49.3	29.9	44.8	57.42
1974	114.5	51.8	33.2	29.5	43.84
1975	133.1	50.9	33	49.1	45.73
1976	160.6	64.2	39	57.3	54.46
1977	190.9	73.1	44.8	73.1	53.69
1978	217.2	83.5	50.8	82.9	53.7
1979	222.5	88.1	57.5	77	58.32
1980	198.5	84.8	64.1	49.6	68.1
1981	219.1	81.1	73.8	64.1	74.02
1982	201.2	63.1	76.2	61.9	68.93
1983	254.1	77.2	83.6	93.2	92.63
1984	309.8	94.1	91	124.7	92.46
1985	322.4	96.5	97.7	128.3	108.09
1986	300.7	106.5	106.3	88	136
1987	346.6	127.1	112.2	107.3	161.7
1988	405.1	137.2	129.6	138.3	149.91

1989	395.7	141.5	155	99.2	180.02
1990	408.6	140.6	165.6	102.4	183.46
1991	431.2	133.6	178.4	119.2	206.33
1992	453.1	143.1	185.5	124.4	229.01
1993	510.5	165.4	203.1	142	249.58
1994	573.2	186.7	234.9	151.6	254.12
1995	668.8	211.1	254.2	203.6	291.15
1996	754.1	223.6	297.7	232.7	358.17
1997	833.8	237.2	335.2	261.3	456.54
1998	815.1	244.6	351.5	218.9	550.26
1999	856.1	255.9	370.7	229.4	619.16
2000	782.3	265.2	377.9	174.8	
2001	770.4	260.2	398.3	434.3	
2002	904.2	230.6	434.3	459.3	
2003	1124.2				

\*NYSE Index 1965 = 50

D. The first three factors affecting business investment spending have involved the costs of the capital goods. Review the description of the investment decision by General Motors above. The next factor that must be considered is **the expected lifetime of the capital goods**. *One would expect that the shorter (longer) is the expected lifetime of the capital goods, the lower (greater) the amount of investment spending there will be.* This is so because, if the expected lifetime is shorter, there is less time for the capital goods to earn profits. This point was central to two of the prominent explanations for the poor investment performance of the 1970s and 1980s.

**One of those explanations focused on the energy crisis of the 1970s.** All capital equipment requires energy for its use. In the time when energy was cheap, companies were likely to buy machines that used a great amount of energy. When energy prices rose significantly, these companies had to scrap machines that were otherwise productive because they used so much of the now expensive energy. Whatever validity this explanation had for the 1970s, it could not have much validity after that. Between 1979 and 2000, energy prices actually fell. (However, energy prices rose greatly in 2000 before falling back in 2001 and then rising greatly in 2003.) So rising energy prices could not have caused the poor performance of business investment spending from 1979 to 1994 and in 2000-2001.)

**The second prominent explanation involves the role of foreign competition facing American companies.** Especially because of competition from Japan, companies now require **continuous product development and change**. This means that companies now require capital goods that can be changed more easily. This new type of competition, it is argued, has shortened the expected lifetime of capital goods, since needed changes in products are likely to render today's capital goods obsolete. As just one example, think of personal computers and how quickly each generation of personal computers is replaced by one that is more advanced.

### Test Your Understanding

1. Examine the data again. If the expected duration of capital goods has become shorter, one would expect that depreciation would represent a higher percent of gross private business investment spending. Has this been happening?
  2. Now, examine the same data in more detail. Was depreciation a higher percent of gross private business investment spending in the years when the investment performance was especially poor?
- E. While the factors above focus on the cost of the capital goods and the expected lifetime, the next factors focus on the reasons for buying the capital goods in the first place. The main reason for building a new automobile assembly plant is to produce automobiles. So the company must estimate just how many automobiles it expects to sell. *One major theory of business investment spending, called the **accelerator theory**, says basically that the more businesses expect to sell in the future, in relation to the amount that they can produce at present, the greater business investment spending will be.* In most interpretations of this theory, **businesses assume that sales in the future will be similar to those of the present and recent past.** So if companies are selling a large amount of their product today and have been doing so recently, they will assume that sales will continue to be high in the near future. (These kinds of expectations are called *adaptive expectations*.) The most common measure of the present level of production is called *capacity utilization – the quantity of the product produced and sold as a percent of that quantity that can be produced with the existing capital.* Other things equal, we would expect that *when capacity utilization is rising (falling), business investment spending would rise (fall).* During recessions, as in 2001-2003, sales are low. Businesses expect sales to continue to be low. This expectation reduces their business investment spending. The reduction in business investment spending makes the recession even worse (that is, the economic downturn **accelerates** --- hence the name accelerator theory).

### Test Your Understanding

The table below gives the data for Capacity Utilization in Manufacturing. Examine the years for which the investment performance was poor. Was Capacity Utilization falling and particularly low in those years.

Year	Capacity Utilization in Manufacturing (%)
1967	87.2
1968	87.1
1969	86.8
1970	79.4
1971	77.9
1972	83.4
1973	87.7
1974	83.4
1975	72.9
1976	78.2
1977	82.6
1978	85.2
1979	85.3
1980	79.5
1981	78.3

1982	71.8
1983	74.4
1984	79.8
1985	78.8
1986	78.7
1987	81.3
1988	83.8
1989	83.6
1990	81.4
1991	77.9
1992	79.4
1993	80.4
1994	82.5
1995	82.5
1996	81.6
1997	82.7
1998	81.3
1999	80.5
2000	80.6
2001	77.4
2002	75.6
2003	74.9

F. Once the company has determined how many automobiles (or other product) it expects to sell, it must determine how profitable these sales will be. This requires the company to examine three variables. One is **the expected price of the product**. If the automobiles will sell for \$50,000, it will be more profitable to produce them than if they were to sell for \$10,000. So we would expect that *if the companies expect the prices of their products to be greater (lower), business investment spending would be greater (lower)*.

G. The other two variables involve the other costs of making the product (in addition to the costs of the capital goods). **One cost is the cost of the raw materials (natural resources), parts, and energy**. Between 1951 and 1964, the prices of food, raw materials, and energy were low. Relative to the prices of the products the companies produced, these raw materials' and energy prices actually fell. The fall in the relative prices of raw materials and energy surely contributed to the good investment performance of that period. Beginning in the late 1960s and especially in the 1970s, raw materials' prices rose – faster than the prices of the final products. Especially important was the large increase in the price of oil. By making production less profitable, these rising prices surely contributed to the poor investment performance of the 1970s.

H. The other major cost is that of wages, salaries, and fringe benefits (called **“compensation”**). But the compensation must be measured against labor productivity. If the compensation rises 10% but the productivity of the workers also rises 10%, then the cost of making the product does not change. The measure of compensation compared to labor productivity is called **“unit labor costs”**. *An increase (decrease) in unit labor costs should decrease (increase) business investment spending*. The history of unit

labor costs is similar to that of raw materials prices. Throughout the 1950s, unit labor costs rose slowly. In the early 1960s, they barely rose at all. This contributed to the good investment performance of that period. Then, in 1966, unit labor costs began to rise considerably, reaching very high growth rates from 1973 to 1982. These high growth rates were the result of workers obtaining COLAs so that they could keep up with the high rates of inflation. The rise in unit labor costs contributed to the poor investment performance of that period.

### Test Your Understanding

On the next page, there is a table of data concerning raw materials' prices and unit labor costs. Raw materials' prices and unit labor costs should be rising slowly (if at all) during the years of good investment performance and should be rising greatly in the years of poor investment performance. Does the data support this hypothesis? Explain.

Year	Raw Materials Prices	Unit Labor Costs
1974	52.5	43.2
1975	58	46.1
1976	60.9	48.4
1977	64.9	51.4
1978	69.5	55.3
1979	78.4	60.7
1980	90.3	67.4
1981	98.6	72.4
1982	100	78.2
1983	100.6	78.6
1984	103.1	79.8
1985	102.7	82.1
1986	99.1	83.9
1987	101.5	86.7
1988	107.1	89.8
1989	112	91.3
1990	114.5	95.3
1991	114.4	98.7
1992	114.7	100
1993	116.2	101.9
1994	118.5	102.6
1995	124.9	104.1
1996	125.7	104.5
1997	125.6	105.3
1998	123	107.9
1999	123.2	109.9
2000	130.5	110.8
2001		116.7
2002		113.9
2003		111.3
	1982 = 100	1992=100

I. There is one more factor to consider. In explaining the other factors that affect business investment spending, we have used the word "expected" many times. Investment decisions are made with consideration as to what will result in the future.

Since we don't know what will be in the future, there is an element of uncertainty in making these decisions. *But companies are more likely to go ahead with the investment spending plans if they are reasonably certain that their expectations of the future are likely to actually come about. And they are less likely to go ahead with their investments in they are very uncertain as to whether their expectations of the future will come about.* We saw this point in Chapter 3. There it was argued that inflation (and the fight against inflation) generates uncertainty. When there is inflation (and the government is trying to stop it), companies cannot reasonably predict the future prices of the products they sell nor the future costs of raw materials and labor. In this period of uncertainty, business investment spending is likely to decline. When inflation is very low and stable over a long time period, companies can feel more certain of their expectations and business investment spending is likely to rise. Therefore, it should not be a surprise that business investment spending was low during the high inflation period of the 1970s and was high during the period of low and stable inflation during the 1990s.

### Summary

*In summary, business investment spending is likely to rise if:*

- (1) the prices of capital goods are low and falling,*
- (2) real interest rates are low and falling,*
- (3) corporate profits after taxes are high,*
- (4) stock market prices are high and rising,*
- (5) the expected lifetime of the capital goods is longer,*
- (6) expected production (measured by Capacity Utilization) is rising,*
- (7) the costs of raw materials are low and stable,*
- (8) unit labor costs are low and stable, and*
- (9) businesses are more certain of their expectations of the future (because, for example, inflation rates are low and stable).*

*The opposite will cause business investment spending to fall.*

### Test Your Understanding

1. Question 3 on Page 3 asked you to characterize the overall investment performance of the United States --- stating in which years that performance was good and in which years it was bad. Other questions have asked you to relate these periods to other data. Now, it is time to summarize. Go back to your answers to the Test Your Understanding questions. Write a one-page essay on the following question: when the investment performance of the American economy was poor, what factors can explain this poor performance? And when the investment performance of the American economy was good, what factors can explain this good performance?

2. The data in this chapter are all taken from the Economic Report of the President and cover the period through the time this chapter was written. Go on to the Internet and get the most recent data available. Again write a one-page essay. First, describe the current investment performance of the American economy. Then, use the other data (points 1 to 9 above) to explain why the current performance is as it is. You can get some of the information you need at the following site: <http://www.bea.doc.gov/>. Then follow the path:

GDP and Related Data.

Selected Data from the Full Set.

List of Selected NIPA Tables.

Choose the data you need.

Other information can be found at other sites using as search engine.

## 2. Government Attempts to Increase Business Investment Spending

As has been pointed out, business investment spending is very important to the growth of production and the standard of living. In addition, declines in business investment spending often have contributed to economic recessions. Therefore, government has sometimes attempted to try to increase the amount of business investment spending. Let us examine two approaches to increasing business investment spending, that of Presidents Reagan (1981-1989) and President Clinton (1993-2001).

### The Reagan Approach

President Reagan followed an approach similar to that of President Kennedy in the early 1960s. His approach, created in 1981, was to try to increase the profits of corporations after taxes. This was to be accomplished by **lowering the taxes corporations would pay**. To illustrate this, let us make up a simple tax return for a corporation in 1980:

Sales Revenue	\$1,000,000
-Cost of Goods Sold	500,000
-Overhead	100,000
-Depreciation	<u>100,000</u>
= Corporate Profits	300,000

In this, **“cost of goods sold”** refers to the direct costs of making the produce --- materials, labor, and so forth. **“Overhead”** refers to indirect costs such as advertising, administrative salaries, and so forth. **“Depreciation”** refers to the reduction in value of the capital goods. Typically, this was done on a “straight line basis”; if the machine cost \$10,000 and was to last 10 years, then it would depreciate by \$1,000 each year. In 1980, the corporate profits tax rate was 48%. Therefore, the company would pay \$144,000 in taxes (48% of \$300,000), and have an after-tax profit of \$156,000. Part of this \$156,000 would be paid in cash as a dividend to the owners. The rest was available for business investment spending.

President Reagan proposed and achieved three changes to the corporation tax law. **(1) The first change was to lower the tax rate from 48% to 46%.** In our simple case, the tax would decline to \$138,000 (46% of \$300,000). The extra \$6,000 (\$144,000 minus \$138,000) would now be available for business investment spending. **(2) The second change was the creation of a system of *accelerated depreciation* known as the Accelerated Cost Recovery System.** We do not need the details here. Basically, this was a system to artificially increase the amount taken as depreciation. For tax purposes, the capital goods would depreciate more rapidly than they were doing in reality. In the above example, assume that the Depreciation could be artificially increased to \$150,000. The corporate profits for tax purposes would now be only \$250,000. At 46%, the corporation would now pay only \$115,000 in taxes (46% of \$250,000), instead of the original \$144,000. The \$29,000 that it did not have to pay in taxes would be available for

new investment spending. (And the fact that the benefit results from depreciation requires that the corporation buy capital goods in order to receive it. Only capital goods can be depreciated.) **(3) The third change was the increase in the investment tax credit. A tax credit is an amount deducted directly from one's taxes.** If I have a \$1 tax credit, I have \$1 less to pay in taxes. **Under the new rules, a certain percent of the purchase price of a new capital good could be taken as a credit off of the corporation's taxes.** The exact percent depended on the type of capital good being purchased. So if the company in our example purchased a machine for \$100,000 that was eligible for a 5% tax credit, the company would have \$5,000 less in taxes to pay. The tax the company would pay would now be only \$110,000 (\$115,000 - \$5,000).

In our made-up example, the company saved \$34,000 in taxes (\$144,000 to \$110,000). In reality, many companies saved much more than that. **In fact, many of the largest companies ended up paying no corporate profits tax at all.** The particular changes initiated by President Reagan benefited mostly those companies with large amounts of capital (automobile companies, steel companies, and so forth). They provided little benefit to those companies in high technology. High-technology companies have little capital. Their main asset is the intelligence and creativity of their employees.

The policies of President Reagan were designed to increase business investment spending. And indeed, they did so. But the kind of investment spending that resulted was not the kind that was desired. **Instead of factory buildings and equipment, there was a large increase in spending on office buildings and shopping malls.** So much building was done that the office buildings and shopping malls in many cities had vacancies for many years. So, in 1986, President Reagan offered a new tax proposal that undid his earlier one. **In 1986, the Accelerated Cost Recovery System was eliminated. The investment tax credit was also eliminated. And to compensate, the profits tax rate, which had been 46%, was reduced to 34%, where it is today.** This policy had an effect opposite to that of the original one: it hurts companies that were very capital-intensive and aided companies in high-technology. As we shall see later, these two tax policies also provided the origin of the collapse of the Savings and Loan Industry.

### **The Clinton Approach**

President Clinton was elected in 1992 mainly to "grow the economy". He believed that an increase in business investment spending was needed. When he first became President, he proposed to re-instate the investment tax credit. His proposal was never enacted. So he went to a different strategy.

**The heart of the Clinton strategy was to eliminate the budget deficit of the federal government.** The budget deficit, as you know, is the difference between the spending and the tax revenues of the federal government. This difference is financed by borrowing. The budget deficit was to be eliminated first by holding down the growth of government spending. Government spending will be discussed in the next chapter. The budget deficit was also to be eliminated by an increase in taxes. The tax system, and the 1993 increase in taxes, will be discussed in Chapter 17. By eliminating the budget deficit of the federal government, the government would not have to borrow as much. **Reduced government borrowing would lower interest rates.** And as we will see later, the

Federal Reserve also acted to lower interest rates. **Lower interest rates would encourage business investment spending.**

As we will see in Chapter 18, the federal government's budget deficit was indeed eliminated by 1998. This occurred much earlier than had been expected. **From 1998 to 2001, the federal government incurred budget surpluses.** Partly as a result of the elimination of the budget deficits, interest rates fell in the 1990s to levels not seen since the 1960s. **The low interest rates of the 1990s certainly contributed to the increase in business investment spending that occurred between 1995 and 2000.** But the increase in business investment spending in this period was much greater than had been expected. One economist argued that the elimination of the federal government's budget deficit was responsible for about one-third of the growth in business investment spending.

### Test Your Understanding

Go to the following site: <http://www.whitehouse.gov> Examine the policies of President Bush that are designed to increase business investment spending. Write a one-page essay. In the first part of this essay, describe the proposals of President Bush. In the second part of the essay, provide an analysis of these proposals based on the material presented in this chapter.

### 3. Conclusion

In this chapter, we have examined the factors that are likely to affect the amount of business investment spending. We have looked at some of the recent history of business investment spending and of the factors that affect it. And we have examined two of the approaches of government to try to increase business investment spending. But in closing, it has to be admitted that our knowledge of business investment spending is very inadequate. No one predicted that the increase in business investment spending after 1995 would be as large as it turned out to be. And no one predicted that business investment spending would collapse in 2001 as much as it did. Perhaps our inability to predict results from the fact that business investment spending depends so much on expectations of the future, expectations that are very difficult to understand or predict? This chapter has tried to present what is known about business investment spending. But there is so much more to learn.

### Practice Quiz for Chapter 15

- Net private investment spending** equals gross private investment spending minus
  - inflation
  - consumer spending
  - taxes
  - depreciation
- through 9      Answer   a. rise   b. fall   c. stay the same
- Net private investment spending will rise if the prices of new capital goods \_\_\_\_\_
- Net private investment spending will rise if real interest rates \_\_\_\_\_
- Net private investment spending will rise if corporate profits taxes \_\_\_\_\_
- Net private investment spending will rise if stock market prices \_\_\_\_\_
- Net private investment spending will rise if capacity utilization rates \_\_\_\_\_

7. Net private investment spending will rise if the expected lifetimes of capital goods \_\_\_\_\_
8. Net private investment spending will rise if unit labor costs \_\_\_\_\_
9. Net private investment spending will rise if inflation rates \_\_\_\_\_
10. Which of the following was **NOT** used by President Reagan to try to increase business investment spending?
- a. lowering the corporate profits tax rate
  - b. increasing the investment tax credit
  - c. increasing accelerated depreciation
  - d. eliminating the federal budget deficit