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How to Make Business Want to Invest Again

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DURING the last week, the nation has witnessed much partisan wrangling over the economy. So it might be worth stepping back and assessing what we know and what we don't. Let's start with five propositions about which there is little doubt:

• *The economy is in bad shape.* Technically, the recession ended in June 2009, and since then the economy has been recovering. But it doesn't feel that way to many Americans. Things have stopped getting worse, but they have not gotten much better. The recovery has been so meager that unemployment lingers at historically high levels.

• *The disappointing news about job creation is closely linked to lackluster growth in G.D.P.* Economists call the relationship between growth and unemployment "Okun's Law," after Arthur Okun, who studied it in the 1960s. In essence, Okun's Law says that to reduce the unemployment rate, we need for gross domestic product to grow by more than its long-run average rate of about 3 percent. So far in 2011, the growth rate has been less than 1 percent.

• *The most volatile component of G.D.P. over the business cycle is spending on investment goods.* This spending category includes equipment, software, inventory accumulation, and residential and nonresidential construction. And the recent economic downturn offers this case in point about the problem: From the economy's peak in the fourth quarter of 2007 to the recession's official end, G.D.P. fell by only 5.1 percent, while investment spending fell by a whopping 34 percent.

• *The subpar recovery has coincided with a historically weak investment recovery.* Compare our recent experience with that of the early 1980s, when the nation last experienced a deep economic downturn in which unemployment topped 10 percent. That recession ended in the fourth quarter of 1982. In the subsequent two years, investment spending grew by a total of 54 percent. By contrast, in the first two years of this recovery, it grew by half that amount.

• *While the sluggish housing market can explain the slow pace of residential investment, it is not the whole story*. Business investment has also been weak. Over the last two years, nonresidential fixed investment has grown by only 12 percent, whereas during the two years after the 1982 recession, it grew by 27 percent. Similarly, the narrow category of spending on business equipment and software fell more than twice as much in this recession as it did in the 1982 recession, and it has been slower to recover.

So much for what we know for sure. Now comes the hard part: what to make of these facts.

Advocates of traditional fiscal stimulus often view low levels of investment as a symptom, rather than a cause, of the weak recovery. Businesses are reluctant to invest, they argue, because they lack customers eager to spend. If the government can goose demand by handing out dollars to households short on cash, or by buying goods and services directly, businesses will respond by expanding their own spending as well.

Yet fluctuations in investment spending, rather than being only a passive response, are also one of the driving forces of the booms and busts of the business cycle. The great economist John Maynard Keynes suggested that investment spending is in part determined by the "animal spirits" of investors, which he described as "a spontaneous urge to action rather than inaction." Recessions occur when optimism turns to pessimism, and businesses are reluctant to place bets on a prosperous future. Recovery occurs when investor confidence returns.

To be sure, both points of view may well be true. The relationship between investment and the overall economy is what an engineer would call a positive feedback loop. Greater business investment would increase hiring, both by those who produce the investment goods and those who buy them. Greater employment would mean more workers taking home paychecks, which in turn would increase the overall demand for goods and services. When businesses saw more customers coming through their doors, they would then increase investment spending yet again.

WHAT can policy makers do to stoke animal spirits and encourage businesses to invest?

One obvious step would be a cut in the taxation of income from corporate capital. According to a 2008 study by the Organization for Economic Cooperation and Development, “Corporate taxes are found to be most harmful for growth.” Tax reform that reduced the burden on capital income and shifted it toward consumption would improve prospects for long-run growth and, in so doing, encourage greater investment today.

Yet it would be overly optimistic to think that any single public policy, by itself, could lead to the kind of robust investment spending seen in previous recoveries. Myriad government actions influence the expected future profitability of capital. These include not only policies concerning taxation but also those concerning trade and regulation.

For example, passing the free trade agreement with South Korea, which has languished in Congress more than four years after first being negotiated, would be a step in the right direction. So would reining in the National Labor Relations Board; its decision to block Boeing from opening a nonunion plant in South Carolina may have been hailed by organized labor, but it surely did not hearten investors.

Economists often rely on the convenient shortcut of separating long-run and short-run issues. Recessions are then viewed as short-run problems that require short-run solutions. That approach, however, may be simplistic. Lack of investment spending is a large part of the economy’s current difficulties, but capital investments are always made with an eye toward the future.

The best fix for our short-run problems may be to focus on policies that will foster long-run growth as well.