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IN FOCUS

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Introduction to U.S. Economy: Business Investment

What Is Business Investment?

Business investment is spending by private businesses and nonprofits on *physical capital*—long-lasting assets used to produce goods and services. Physical capital is generally grouped into three categories: equipment (e.g., machinery or computers), structures (e.g., offices or warehouses), and intellectual property (e.g., software development or research and development).

Through investment, businesses can build up their stock of physical capital, which increases their capacity to produce goods and services. For example, when a restaurant purchases an additional grill, it increases its capacity to prepare food over any given time period. However, physical capital tends to become less productive over time due to wear and tear and must eventually be replaced as it breaks down, a process known as depreciation. For a firm to continually increase its stock of physical capital, and therefore its productive capacity, it must invest in new physical capital faster than its current physical capital is depreciating. The same is true for the economy as a whole: For the economy's stock of physical capital to increase, the investment rate must exceed the rate at which physical capital depreciates.

Economic Considerations

Business investment can affect the economy's short-term and long-term growth. In the short term, an increase in business investment directly increases the current level of gross domestic product (GDP), because physical capital is itself produced and sold. Business investment is one of the more volatile components of GDP and tends to fluctuate significantly from quarter to quarter.

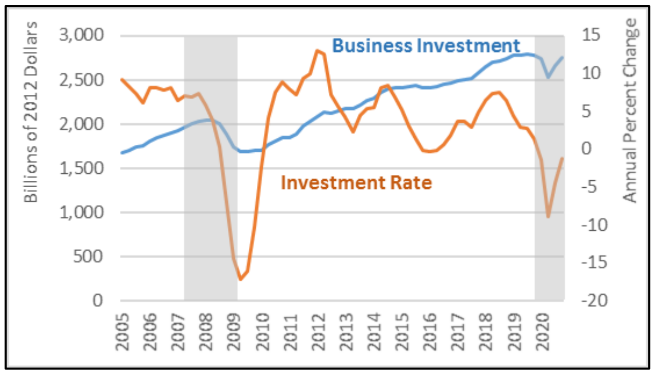
In the long term, a larger physical capital stock increases the economy's overall productive capacity, allowing more goods and services to be produced with the same level of labor and other resources. Long-term economic growth generally depends on growth in the economy's productive capacity rather than swings in supply and demand. In turn, faster economic growth generally translates into faster income growth and improved living standards. For additional discussion of the long-term drivers of economic growth, see CRS In Focus IF10557, *Introduction to U.S. Economy: Productivity*, by Marc Labonte.

Drivers of Business Investment

The main determinants of business investment are broader economic conditions, business confidence and expectations, and long-term interest rates.

The business cycle is one of the largest drivers of business investment. As a recession occurs, businesses tend to see a decline in demand for their products, which leads them to reduce investment spending. Alternatively, during a healthy economic expansion, businesses tend to see rising demand for their products, which leads them to increase investment in order to increase production to accommodate the increased demand. **Figure 1** illustrates this phenomenon—both business investment and the investment rate fell in the beginning of the 2007-2009 recession and the recession caused by COVID-19. For more information regarding the business cycle, see CRS In Focus IF10411, *Introduction to U.S. Economy: The Business Cycle and Growth*, by Lida R. Weinstock.

Figure 1. Recent Business Investment Trends
2005-2020



Source: Bureau of Economic Analysis.

Notes: The investment rate is measured as the year-over-year change in real business investment. Gray bar indicates recession.

Business confidence and future expectations for the economy are also expected to influence business investment. If business owners expect rising sales and improving economic conditions, they are more likely to invest in their businesses, because they anticipate increased demand for their goods and services. Business confidence and future expectations can be unpredictable and difficult to influence through public policy.

Business investment is typically financed through loans and other debt. As such, interest rates influence business investment decisions by either increasing or decreasing the cost for a business to borrow funds, thus affecting the profitability of making additional investments. All else equal, when the interest rate rises, the cost of investing—the interest the business will pay—rises, resulting in less investment overall. This type of interest-sensitive behavior is what allows monetary policy to function. The Federal Reserve changes the short-term federal funds rate, which in turn affects other interest rates, in an effort to affect business investment (and interest-sensitive consumer spending). For additional discussion of monetary policy and the Federal Reserve, see CRS Report RL30354, *Monetary*

Policy and the Federal Reserve: Current Policy and Conditions, by Marc Labonte.

Saving and Investment

One of the long-term determinants of business investment is the level of savings available to the economy. When individuals deposit their savings with financial institutions, those funds are then available to be loaned out to businesses to invest. Because of the global nature of the U.S. economy, firms in the United States have access to savings from within the United States and from abroad. Thus, interest rates in the United States are influenced by the supply of global, in addition to national, savings. A higher supply of savings results in lower interest rates, and a lower supply of savings results in higher interest rates, all else equal. As such, an increase in the supply of savings should lead to an increase in business investment due to declining interest rates. For additional discussion of the supply of savings, see CRS In Focus IF10963, *Introduction to U.S. Economy: Personal Saving,* by Lida R. Weinstock.

Trends in Business Investment

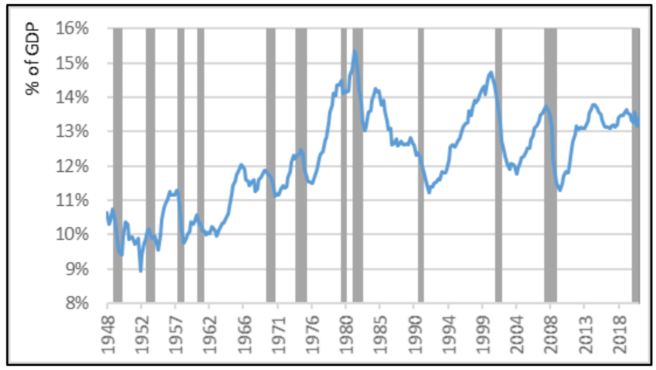
As shown in **Figure 1**, business investment declined sharply during the 2007-2009 recession. Deteriorating economic conditions during the recession reduced business revenues and confidence. The decline in business investment persisted through the third quarter of 2009 despite the Federal Reserve's previously unprecedented move of lowering its benchmark interest rate to zero beginning in late 2008. Following the 2007-2009 recession, business investment began rising again, with the year-over-year investment rate peaking around 13% in the first half of 2012. This rise in business investment coincided with historically low interest rates, improving business confidence, and broadly improving economic conditions.

Business investment began to slow considerably by mid-2014, remaining relatively flat between 2014 Q4 and 2016 Q2. This decline in investment coincided with a decline in business confidence as measured by the Organisation for Economic Co-operation and Development (OECD) business confidence index. Beginning in mid-2016, business investment began increasing again, peaking in mid-2018. Since this peak, investment slowed though the rest of 2018 and 2019. The temporary acceleration in business investment was potentially due to increased business confidence and changes to the tax code that made physical capital investment more attractive. For further discussion of the effect of the 2017 tax revision, see CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples.

In general, beginning in the late 1970s, business investment as a percentage of GDP increased and has remained elevated, increasing from an average of around 10.8% between 1948 and 1975 to around 13.0% between 1976 and 2020. As shown in **Figure 2**, after falling to about 11.3% by the end of 2009, business investment, as a percentage of GDP, rose back to pre-recession levels of around 13.5% and has stayed fairly constant since. Despite the effects of COVID-19, business investment as a percentage of GDP remained at 13.4% as of October 2020.

Figure 2. Historical Business Investment as a Share of GDP

1948-2020



Source: Bureau of Economic Analysis.

Notes: Gray bars indicate recessions.

COVID-19 and Investment

Business investment decreased during the initial months of COVID-19 but has since recovered somewhat. Investment did not decrease by as large a percentage as it did during the 2007-2009 recession. This could be the case for a few reasons. First, in contrast to the 2007-2009 recession, financial markets rebounded very quickly after the initial COVID-19 shock and continue to perform well. Second, COVID-19 did not hit all businesses the same. While certain industries, such as hospitality, were hard-hit by the pandemic, other industries remained unscathed or in some cases grew. For more information on the industries most affected by COVID-19, see CRS Insight IN11564, *COVID-19: Employment Across Industries*, by Lida R. Weinstock.

Foreign Investment

Business investment in the United States is made by both domestic and foreign individuals. Foreign investment can take the form of investment in U.S. financial assets, which indirectly funds business investment, or foreign direct investment, which directly funds business investment. The United States receives significant foreign direct investment from abroad, amounting to about $331.2 billion in 2019, according to the Bureau of Economic Analysis. By this measure, the largest foreign investors in 2019 were Japan, the United Kingdom, and Canada.

Foreign direct investment in the United States has decreased over the past several years, declining from its post-recession peak of about $439.5 billion in 2015. However, the United States is not alone in experiencing a decline in foreign direct investment. According to the OECD, global foreign direct investment declined about 50% in the first half of 2020 compared to the second half of 2019, the lowest half-year level since 2013.

(*Note*: This In Focus was originally authored by Jeffrey Stupak, former CRS Analyst in Macroeconomic Policy.)

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