Business Income and Investment

BUSINESS OUTLAYS for plant and equipment have increased sharply this year and are expected to rise further in 1965. By late 1964 such outlays were more than a third larger than at the 1961 cyclical low. Most of this increase has taken place since mid-1963.

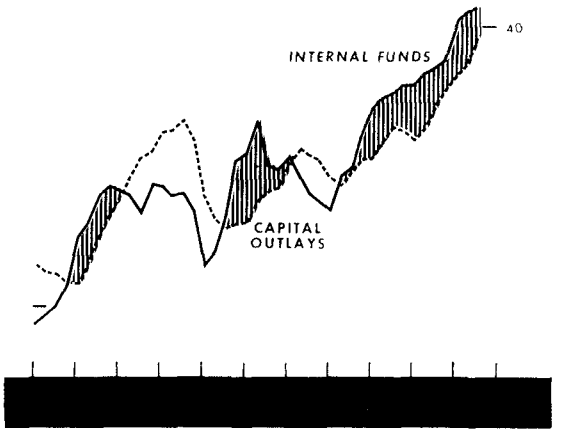
The rising trend in plant and equipment expenditures has persisted longer in this upswing than it did in the large expansion of 1955-57. Growth in the dollar value of such spending has not matched that in the earlier period, but prices of equipment have increased much less this time. However, if advances in outlays anticipated through mid-1965 are realized, the aggregate percentage increase in the dollar value of these expenditures in the 4 years since early 1961 will be a little larger, even without adjustment for differences in price trends, than in the shorter and steeper 1955-57 expansion.

Plant and equipment outlays tend to respond slowly to cyclical upturns in general economic activity. This is due in part to the time required to implement spending decisions once they are made. In addition, the decisions themselves may be delayed until a combination of factors becomes strong enough to stimulate a general upward adjustment in business spending plans. Such a development may have accounted for the more rapid rise in capital expenditures since mid-1963, as a number of factors have remained or have become unusually favorable to investment.

Profit margins have risen much longer than in earlier expansion periods and this year have been at the highest levels since the mid-1950's. The rate of capacity use in manufacturing has remained high for an unusually long period, at close to the level prevailing in late 1956. Other stimulants to capital spending have included the availability of improved technological processes, domestic and foreign competition for markets, and Governmental actions taken in part to encourage both earlier retirement and greater expansion of fixed assets.

Moreover, alternative needs for funds, especially for additions to inventories, have been more moderate than in previous upswings, and supplies of both internal and external funds have been ample.

CORPORATE INTERNAL FUNDS still growing in 4th year of economic expansion



NOTE.—Seasonally adjusted quarterly totals at annual rates for nonfinancial corporations. Based on Dept. of Commerce data for internal funds (retained earnings and depreciation allowances) and Dept. of Commerce–Securities and Exchange Commission data for capital outlays (expenditures for plant and equipment) in the United States. Amounts excluded—for banks, insurance companies, and investment companies from each series, and for unincorporated businesses from the outlays series—estimated by Federal Reserve from Dept. of Commerce annual data. Latest figures shown, third quarter 1964.

Corporate retained earnings and depreciation allowances have risen almost steadily for nearly 4 years. This long advance has reflected a number of developments, including substantial increases in sales, the upward trend in profit margins, a step-up in depreciation allowances, and a reduction in the proportion of profits paid out in income taxes.

Despite higher dividend payments, the total flow of internal funds in late 1964 was running one-third above the early 1961 low and one-fifth above the pre-recession peak reached in mid-1959.

At the same time, funds have been readily available in credit and capital markets and, in sharp contrast with earlier upswings, the cost of new borrowing has shown little increase as capital outlays have expanded.

INTERNAL FUNDS

Internal funds of nonfinancial corporations have been accumulating at a seasonally adjusted annual rate of more than $40 billion throughout this year. This compares with $27 billion at the 1961 cyclical low and a previous peak rate of $33 billion reached in the second quarter of 1959 just prior to the long strike in the steel industry.

In this as in other expansion periods, internal funds rose sharply in the first year of recovery. In previous expansions such funds leveled off or declined during the second year, but this time they continued to rise steadily until the beginning of 1964 when they spurted up again because of the tax cut. Since the first quarter of this year the total flow has increased a little further.

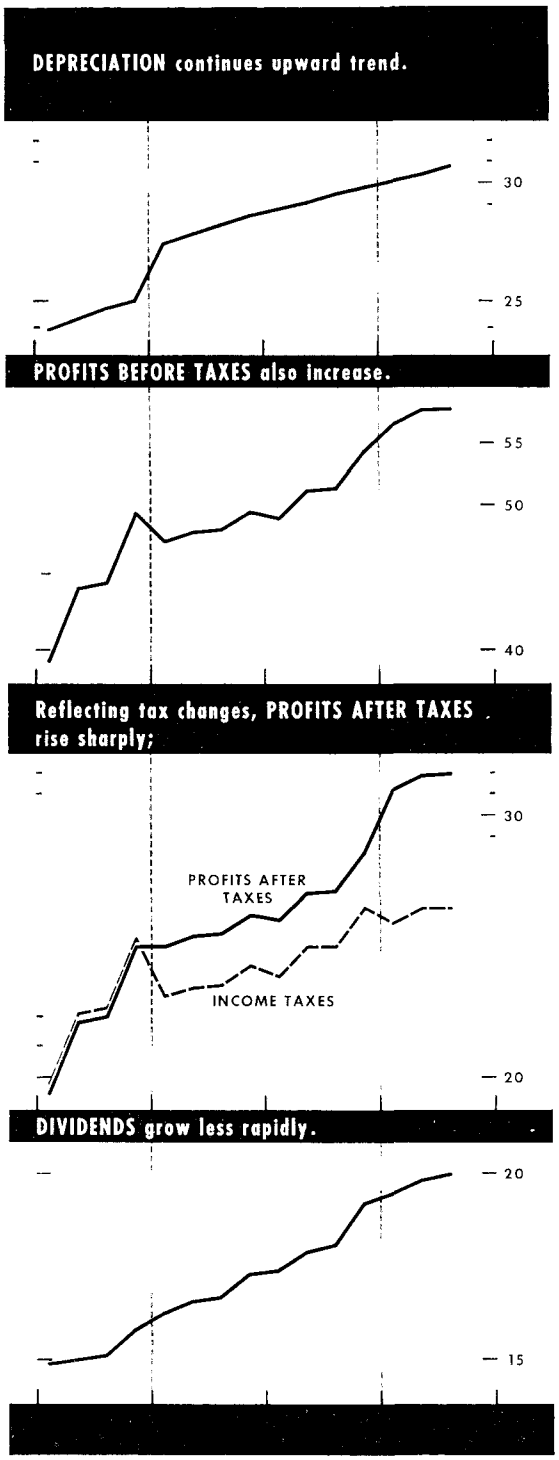
Depreciation allowances have accounted for about half of the rise in internal funds during this expansion period, and they now comprise about three-fourths of the total. The growth in depreciation, which has been substantial throughout the postwar period, is in large part a reflection of the expansion that has taken place in plant and equipment. But it also results from liberalization, in 1954 and again in 1962, of the rules for computing depreciation on such investment. Since the step-up at the beginning of 1962, the depreciation component of internal funds has grown at approximately the same steady pace as it had earlier.

The most striking features of the increase in corporate retained earnings in this expansion have been the long rise in profits before taxes and the significant easing of Federal income taxes.

In the first 9 months of 1964 corporate profits before taxes were at a seasonally adjusted annual rate of more than $57 billion. By the third quarter they were one-eighth above the 1963 average and nearly one-fourth above the level for the first quarter of 1962—which was the first quarter affected by the new depreciation guidelines and a year after the recession low. Almost all major industries have shared in the rise in profits this year.

Profits after taxes have risen much faster than profits before taxes over the expansion period, as three actions by the U.S. Government have significantly reduced the proportion of corporate receipts paid out in Federal income taxes.

Two of these actions—adoption of the new guidelines for depreciation and of the tax credit for investment outlays—became effective at the beginning of 1962. Their impact on tax liabilities and after-tax earnings may be seen from Chart 2. While profits before taxes dropped with the step-up in depreciation allowances, the reduction in taxes resulting from the additional depreciation expense and from the investment tax credit offset all of the drop in before-tax profits, and profits after taxes in the first quarter of



NOTE.—Seasonally adjusted quarterly totals at annual rates for all corporations. Dept. of Commerce figures except for depreciation, which is estimated by Federal Reserve from Dept. of Commerce annual data. Latest figures, third quarter 1964.

1962 remained at the same level as in the fourth quarter of 1961.

The third Governmental action involved revision of Federal income tax rates. A major feature of the revision was a 4-point reduction in the maximum rate paid by corporations, to become effective in two equal steps—at the beginning of 1964 and at the beginning of 1965. As a result of the first step-down, tax liabilities declined in the first quarter of 1964 even though profits before taxes increased by 4 per cent. The net effect was a 10 per cent rise in income after taxes. Since the fourth quarter of 1961, profits before taxes have risen by a little more than one-sixth, and profits after taxes by nearly one-third.

This sharp rise in profits after taxes has been accompanied by a smaller, though substantial, increase in dividend payments. Although the proportion of after-tax earnings paid out in dividends has declined from about two-thirds in 1961-63 to five-eighths currently, total dividend disbursements have increased by one-fourth since late 1961.

Dividend payments rose sharply in the closing quarter of 1963, when year-end extras were considerably larger than usual, and payments have increased further during 1964. Many companies have raised their regular dividend rates this year. In addition, some companies that normally would have made payments in late 1963 delayed them until early 1964 in anticipation of lower individual income tax rates, and several large companies paid extra dividends in the early part of the year.

EXTERNAL FINANCING

For those businesses whose depreciation allowances and retained earnings were not adequate to meet their total financing requirements, the supply of funds available

for external financing has remained ample. Financing costs, while continuing at a relatively high level historically, have remained unusually stable throughout the expansion period.

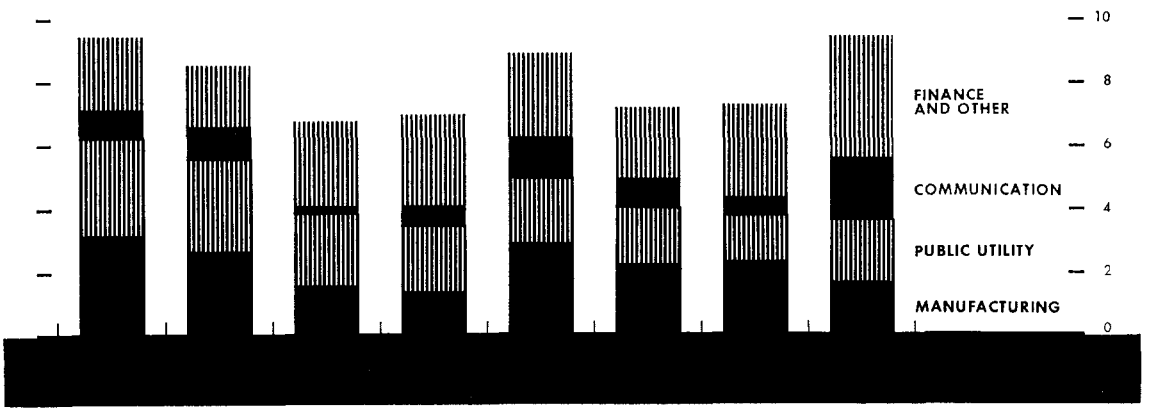
The persistent tendency for corporate internal funds to outrun plant and equipment spending, together with the generally moderate growth in inventories in recent years, might seem to indicate little need for expanded corporate financing from external sources. In practice, however, corporations in need of funds are not in all instances those that are experiencing the largest internal flows, and corporations in some industries customarily finance a large proportion of their outlays externally.

Substantial amounts of new security financing have therefore been undertaken in each year of the expansion, and business use of bank credit has increased steadily.

Corporate security issues for new capital totaled $9.5 billion during the first 9 months of 1964—30 per cent more than a year earlier and the largest January-September volume since the record year of 1957. But about two-thirds of the increase reflected two unusual equity issues in the communications industry, and most of the remaining one-third was accounted for by a rapid rise in commercial bank financing through sale of capital notes and debentures. Efforts of banks to expand their loanable funds by selling such issues began in the latter part of 1963. Securities issued by nonbank corporations in the real estate and financial group have also been unusually large this year.

Aside from the two large issues of communications stock, nonfinancial corporations as a group issued a smaller volume of new securities in the first 9 months of this year than in the same period of any other year since 1960. Manufacturing companies accounted for this further decline. Their offerings in the period were off more than 25 per cent from 1963. In addition, new issues by foreign corporations in U.S. capital markets were sharply below their heavy 1963 volume. The reduction reflected first anticipation, and then enactment, of the interest equalization tax.

NEW CAPITAL issues rise sharply in 1964, reflecting finance and communication offerings



NOTE.—Based on Securities and Exchange Commission quarterly data.

The ability of corporations to place this year's expanded volume of new security offerings without any appreciable rise in interest cost has reflected the continued growth in saving seeking long-term investment as well as the continued general availability of bank credit. Individuals have provided some of these increased funds to corporations by their direct purchases—especially of the two large issues of communications stock. But the bulk of the expanded flow into corporate securities has continued to come from life insurance companies and pension funds.

In addition to the increase in security issues, other forms of external business financing—including mortgages, bank loans, and commercial paper—also expanded somewhat more rapidly up to late 1964 than in 1963. From January through November business loans at commercial banks rose at an annual rate of 10 per cent, compared with 9 per cent in 1963 and 8 per cent in 1962. The growth in business loans over the whole expansion period has been less vigorous but more sustained than in earlier upswings. Since the end of 1961 the amount of such loans outstanding has risen by about one-fourth.

PROFITABILITY

One of the factors contributing to the increasing flow of corporate internal funds throughout this expansion period has been a prolonged rise in profit margins. Profitability, as measured by over-all ratios of after-tax earnings to sales and to net worth in manufacturing industries, trended upward from early 1961 through early 1964, as Chart 4 shows. These ratios appear to have increased somewhat less than usual in the second quarter of this year, and they may have declined by a little more than the usual seasonal amount in the third, but their levels

NOTE.—Net worth proportions (lower grid) relate annual rate of profits after taxes for each quarter to stockholders' equity at the end of the quarter. All data are from Federal Trade Commission–Securities and Exchange Commission and are not adjusted for seasonal variation. Latest figures shown, third quarter 1964.

are still high relative to those of other recent years.

Over this expansion period, profitability has improved for almost every manufacturing industry as well as for manufacturing as a whole. Increases have tended to be relatively larger for durable goods than for nondurable goods groups, but the latter generally show greater stability in profit rates over the cycle. In part because of the tax cut, however, increases in early 1964 were about as large among nondurable as among durable goods groups.

For manufacturing corporations as a whole, profits after taxes in the first half of 1964 were equal to 5.2 per cent of sales. This compared with a ratio of 4 per cent in early 1961, and it was the highest for any January-June period since 1956. If one adds back depreciation allowances before com-

puting the ratio, the recent level has been the highest since the early postwar years, when inventory profits were substantial.

This latter ratio is a useful supplement to the more usual measures of profitability. Since part of the sharp postwar rise in depreciation reflects tax-law changes that have moderated the growth in corporate profits, totals of profits and depreciation are more comparable over time than the figures for either alone. Ratios based on such totals are particularly useful in assessing the influence of profitability on capital investment, because depreciation charges represent funds that are retained by corporations and thus are available for financing outlays.

The ratio of manufacturers' profits after taxes to stockholders' equity has also trended upward during the expansion period. At an annual rate of nearly 11.5 per cent in the first half of 1964, it was higher than for any similar period since 1957.

Many observers believe that ratios of earnings to stockholders' equity are a more meaningful indicator of profitability—to lenders, to owners, and to managers—than earnings per dollar of sales. Such ratios may also be more meaningful for comparisons of profitability among different industries. However, comparisons of present rates with those for earlier years are affected by changes in the valuation of net worth.

In the late 1940's and even into the 1950's, ratios of profits to net worth related earnings that were stated in postwar prices to net worth that was stated largely or partly in much lower prewar prices. This understatement of net worth relative to earnings gradually disappeared after prices stabilized, and such ratios now probably relate quantities measured in roughly the same prices.

Regardless of the over-all ratio used to measure profitability, its relation to capital spending is difficult to evaluate. For example, declines in profit rates may discourage spending, or on the other hand they may stimulate outlays that are designed to cut costs. Increases in profitability may stimulate outlays to increase capacity, or they may simply represent the benefits gained from a preceding wave of major investment programs.

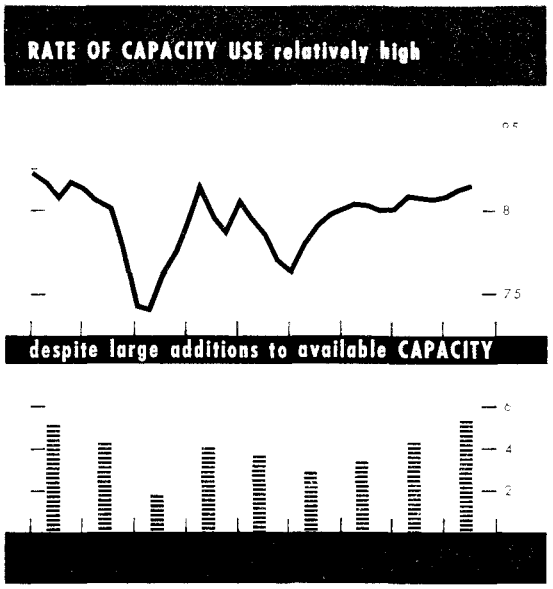
Moreover, the relationship between profitability and spending presumably is determined by the actual or expected rate of return on a particular product or a particular investment and not by the ratio of total profits to either total sales or total net worth.

Nevertheless, generally rising margins based on aggregate data, when they occur in most industries and in conjunction with other favorable developments, certainly constitute a plus factor for capital spending.

CAPACITY UTILIZATION

Among the nonfinancial considerations influencing business plans for investment, a major one is the extent to which existing capacity is being utilized. As with measures of profitability, the influence of capacity use on capital spending relates to specific product lines or specific production processes. Although available estimates of capacity use —and of spending—are necessarily more inclusive than this, they provide a rough indication of the degree of pressure on capacity.

In the third quarter of 1964, according to Federal Reserve estimates, manufacturers were operating at 88 per cent of capacity, as Chart 5 shows. This is the highest rate of capacity utilization since 1956 except for the second quarter of 1959, which was affected by an inventory build-up in anticipation of a steel strike.



NOTE.—Rate of capacity relates production in manufacturing to Federal Reserve estimates of current capacity, which are interpolated from year-end estimates. The latter are derived principally from capacity utilization as reported by McGraw-Hill and December-January production as shown in the Board's index of industrial production. Latest capacity rates shown, third quarter 1964.

However, this rate is below the rates reached on a number of occasions in the early and mid-1950's. The reason for this is that output in industries producing durable goods has not been so high this time relative to capacity. For nondurable goods industries, on the other hand, the operating rate has been 90 per cent ever since early 1961, and it has never been much higher than this.

Even in the durable goods groups, the relatively moderate over-all utilization rate in late 1964 obscured significant differences, among and within particular industries, between the mix of product demands and the mix of capacity to meet them. In iron and steel and nonferrous metals, for example, output was quite close to capacity for some production processes but well below capacity for others.

The high operating rate for nondurable goods groups may have been exerting less pressure on existing capacity than the lower average rate for durable goods groups. Many nondurable goods industries do not experience wide shifts in demand, and nondurable goods industries as a group characteristically have operated nearer to capacity over long periods than those manufacturing durable goods.

Thus the same utilization rate may have different implications in different industries or at different times. For this reason it is not surprising that data for broad aggregates of industries and products provide little evidence of some critical capacity utilization rate that automatically triggers adoption of new spending plans.

On balance it appears that outlays to expand manufacturing capacity in recent years have been based on what have proved to be realistic appraisals of prospective demands. Percentage increases in capacity in 1961 and 1962 were less marked than those in 1954 and 1955, though increases in 1963 and 1964 have been fully as large as those in 1956 and 1957.

In the long expansion period since early 1961 increases in output and in new orders have been more gradual and have pressed against capacity less quickly than in some earlier periods. This less rapid advance may also have contributed to the more orderly and longer-sustained growth in plant and equipment outlays.