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THE ROLE OF PROFITS

Remarks by
Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at

The John Diebold Lectures
"New Challenges to the Role of Profit"

Harvard University

Cambridge, Massachusetts

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An effective society is a functional society. Institutions, including the institution of profit, must justify their existence by performing a function. A society cluttered up with obsolete remnants of history, or burdened by special privilege, is not effective.

Profits have been denounced by some as relics of the past and as a privilege for a few. I regard profits as functional. Fundamentally, I see them performing three functions. They allocate resources, by stimulating production of what is profitable and discouraging what is not. Profits also serve as a standard of performance, by rewarding the efficient and weeding out the inefficient. Finally, profits serve as a source of financing. Today, I believe, we are witnessing a change in the relative weight accorded to these functions. Profits as a source of financing are becoming more important. Profits as a means for allocating resources seem to be losing some of their effectiveness. The first part of my observations will be concerned with this shift.

For the first time in a generation, American corporate business has been facing serious problems in financing its continued growth. Grow we must, if we are to have more jobs and higher living standards. But until recently, corporations had financed this growth by shifting away from internal and toward external sources of funds, away from equity financing and toward debt, and from long-term debt to short-term debt. These trends in financing have produced financial structures that make additional financing difficult.

Now the process must be reversed. We need more internal financing, a larger equity component in external financing, and also consolidation of short-term into long-term debt. Profits play a role in all of these adjustments.

It is useless to argue that if internal cash flow is inadequate, and if the stock market is not receptive to equity issues, business should just continue to borrow. This advice is like Queen Marie Antoinette's "Let them eat cake." Where there is not enough profit, there will be no equity financing, and where there is not enough equity, there will not be much debt money available. An adequate flow of profits is the basis for debt financing, equity financing, and, of course, internal financing.

A year or two of good profits, to be sure, will not immediately change corporate balance sheets. This would be true even if, as I expect, corporations will be prudent in raising dividends and will allow most of their growing profits to remain in the business. But though, over a short span, book value of equity may not be greatly enhanced even by good earnings and cautious dividend policies, market value may well be. In judging the debt capacity of a firm, it is the market value of the equity rather than its book value that counts primarily. Financing was relatively easy during the middle 1960's because the market value of equity exceeded book value by an average of almost 50 per cent. New financing became more difficult when, in the course of 1974, the market value of equity, for the first time in more than 20 years, fell well below book.

I am aware of the argument that corporate restraint in dividend payments contributes little to aggregate saving because stockholders, receiving a smaller share of the earnings in the form of cash than they might like, can sell stock, and thus consume as much as they would have had dividends been higher. I see the logic but I doubt the importance. The concept of total return, which would prompt stockholders to treat capital gains like dividends, has suffered a serious setback in the wake of market developments in the last few years. Lower dividends probably would mean less stockholder consumption and more aggregate saving. In short, it seems to me that profits, both directly as a source of funds and indirectly as a basis for equity and debt financing, are acquiring an increasingly important role.

Meanwhile, however, the role of profits in allocating resources is threatened by some recent developments. The reason lies both in factors that limit the profits which market forces otherwise produce, and in other factors that enhance business risk.

Profits in particular industries today are affected by quasi-political decisions, such as requirements for environmental protection and controls affecting the price of oil, natural gas, and electric power. Whatever the merits of these decisions, their consequence is that profits are lower and that less investment is flowing into these areas than might be the case if resources were allocated according to a market determined return on these investments.

A few years ago, new techniques of institutional investment within the stock market threatened to produce adverse allocational effects. I refer to the practice of "tiering," which bestowed upon a small number of seemingly fast-growing corporations a special status, giving them very high price/earnings multiples and hence a very low cost of capital. Meanwhile, the great majority of American equities were neglected by portfolio managers, raising the cost of capital to those firms. In the last year or two, the forces of the market have tended to bring about their own correction, leading to significant changes in investment philosophy. There is hope, therefore, that defective resource allocation resulting from these unbalanced portfolio policies may be a thing of the past.

Floating exchange rates may have a distorting effect on investment decisions in situations where such movements are larger than justified by underlying fundamentals. Moreover, the risk of investing for sale to foreign markets may rise under such conditions. Business may find it safer to invest in the market for which it is producing, in order to be assured of reasonably stable cost-price relationships. In a world, however, in which movements of exchange rates do reflect fundamentals, resource allocation should be improved as contrasted with a world of unrealistically fixed rates.

Let me turn now to the general behavior of businessmen with respect to profit. Students of economics are informed by their instructors that economic analysis is facilitated and the prospect of reaching determinate conclusions enhanced if it is assumed that firms try to maximize profits, even though they probably do not. There are, indeed, several other decision guides that firms may follow. They may, for instance, prefer to maximize sales or market share because this enhances the prestige of the firm and perhaps of the executives, while striving for profits that are merely satisfactory. Alternatively, businesses may maximize utility, in which case they may sacrifice some profit while aiming at greater safety which partly may take the form of high precautionary profit margins. Sometimes such differences in behavior are said to be associated with the difference between owner management and professional management.

The empirical evidence is slim. But to a casual observer a great change seems to have come upon the corporate scene, from the attitudes of the late 1960's and early 1970's, to those induced by the subsequent recession, and still visible today. This observable change in attitude seems consistent with the hypothesis that during the earlier years the dominant corporate style was to maximize sales at the expense of profits, while now it has become the style to stress safety and high margins. Corporate inventory policy, fixed investment policy, hiring policy, policy with regard to financial structure and profit margins all seem to point in that direction.

Such a shift, aside from its theoretical interest, could have far-reaching consequences. Maximizing sales and market share in the short- and intermediate-run means investment with comparatively lower capital intensity, capable of providing large numbers of jobs. Maximizing utility, in the form of accent on safety, may mean investment for cost reduction rather than expansion, as well as perhaps less investment in the aggregate. Less job creation would be the consequence probably of the first and certainly of the second of these factors. For the longer run, of course, such fashions in corporate style are apt to alternate and to be mutually self-correcting.

For our present situation, I would draw the conclusion that there are latent expansionary forces that could be released as business styles change once more in a direction of diminished risk aversion.

To be sure, the ability of business to move from the attenuated profit margins of some recent years to the better margins currently experienced raises questions concerning competitive structure. Before jumping to the conclusion, however, that a shift to higher profit margins represents a massive display of market power I would like to note that the widening of margins appears to be a very general phenomenon. No great market power may in fact be required to expand margins when large numbers of firms are acting simultaneously in response to a re-evaluation of risk.

Having said a number of things about profits and how they have moved down or up, let me pause for a moment to inquire how well we are able to measure profits at all. The Department of Commerce has made the computation of economic profits one of the principal features of its long-awaited comprehensive revision of the national income and product accounts. The major conceptual change has been to put depreciation on a consistent and replacement cost basis. Restated in this form, and excluding as before inventory profits, economic profits turn out to have been lower than previously believed, with the exception of a few years during the early 1960's. This is especially true of the last few years.

Contrasting with this approach of the Department of Commerce, which I regard as very constructive, is a proposal made by the Financial Accounting Standards Board. Where the Department of Commerce aims by implication but not exclusively at a restatement of profits that eliminates the effects of inflation, all-inclusive inflation accounting is the principal objective of the FASB approach. The FASB approach includes, in effect, the inflationary upward adjustments on inventory and fixed assets, i.e., the inflation-induced net capital gains, whereas the Department of Commerce ignores these, since capital gains do not constitute part of the GNP with which the Department is concerned.

There is still a third form of profit accounting, stressing book value profits -- which is that of the business which treats inventories on a FIFO basis and makes no adjustment for underdepreciation. The proportion of firms that abandoned FIFO during the last couple of years seems to have been substantial, but an informed guess is that it is still the predominant corporate accounting technique.

During a period of inflation, differences between the three methods can be large. The highest profits typically, although not always, are given by the approach which involves FIFO inventory accounting. The FASB technique frequently -- by no means always, since it depends on the net monetary position of the firm, i.e., essentially the degree of leverage -- seems to produce a somewhat lower value. The most conservative valuation tends to be that which is produced by the Department of Commerce method.

Which of the three techniques -- and, of course, there are still others -- is most nearly "right"? I have no special competence to answer such a question, but I can refer you to the answer given by the market when inflation was at its peak. During the period of high inflation, stock market values were low. The market put little store, apparently, in the gains that many corporations had from their net debtor position (or, inversely, from the excess of their nonmonetary assets over their equity). Inventory gains, moreover, accruing as they did in illiquid form, were of little use to corporations and produced tax liabilities to boot. Thus, the stock market's answer was that the techniques producing the higher profit values are not the right ones. It is remarkable, under the circumstances, that the shift to LIFO was not much more general than apparently it has been. It is remarkable also that many corporations apparently believed that the stock market would react negatively to a LIFO-induced reduction in profits despite the indisputable benefits of tax saving.

These uncertainties about how to compute corporate profits should make us cautious about any general statements concerning such broad matters as the rate of return on capital or the share of corporate profits in the GNP. These matters are further complicated by the fact that of late a larger share of corporate financing has taken the form of debt. A larger share of the return to capital has therefore tended to take the form of interest. This tends to reduce the share of profits in the GNP. Fairly impressive evidence has been produced, for instance by William Nordhaus, that during the late 1960's the return on capital declined severely. This, then, would have been the main cause of the drop in the GNP share of profits. This may well be a more fundamental view of the matter than my hypothesis that during this period firms tended to engage in maximization of sales rather than of profits. But we shall have to await further evidence in order to see whether the decline in the rate of return on capital will turn out to be a lasting phenomenon. Conceivably, the rate of return on capital may turn up again, in line with my hypothesis that corporate style has changed once more to emphasize profits and safety. The much debated emergence of a capital shortage -- which I see as a possibility as the economy approaches full employment -- could also work to raise the return of capital.

With respect to the past meanwhile I would like to introduce two sets of data. Table 1 shows profits of nonfinancial corporations adjusted by the Department of Commerce method for inventory valuation and underdepreciation. It relates these adjusted profits to the equity of nonfinancial corporations which in turn is adjusted for, i.e., revalued in proportion to, the rate of inflation. These data show a sharp decline in the rate of return on equity from the middle 1960's to the middle 1970's. In contrast to the series of book value profits of nonfinancial corporations as a percentage of that sector's GNP, also shown in Table 1, however, the data on economic profits as a percentage of adjusted (average) equity do not indicate a declining trend for most of the period since World War II.

Instead of looking at corporate profits in terms of the return on corporate equity, we can also look at them in terms of the rate of return to the stockholder on the value of his stocks as displayed in Table 2. This approach has been made famous by the finding of Lawrence Fisher and James Lorie, recently updated, showing the return on common stock from 1926 to 1975 to have been about 8.5 per cent. This return includes, of course, capital gains as well as dividends during the period. When this calculation is adjusted for inflation, the rate of return drops to something like two-thirds of its nominal value. For the last 10 years, moreover, the real rate of return to the stockholder has been negative. By whichever approach, we always reach the same comclusion: profits of late have not been good.

Proposals abound for remedying this state of affairs through the tax system. Integrating corporate and personal taxation to end the double taxation of dividends, tax deductibility of dividends and, on the side of the investor, tax-free reinvestment of dividends are among the more prominent proposals. If the nation is of a mind to recognize the functional importance of corporate profits by insisting on legislation of this type, I believe the economy would benefit. But all these proposals have negative distributional effects -- they make income distribution more unequal. I should be surprised if much tax legislation improving the position of corporations and their stockholders were passed so long as the average person responding to surveys believes that profit margins on sales are 33 per cent.

But, as I have repeatedly noted, the tax law could be restructured to favor corporate profits and improve corporate financial structure without increasing the share of capital in the aggregate. This could be done by reducing the tax deductibility of interest, which would increase the corporate tax base, and lowering the tax rate on corporate profits, so as to leave the over-all corporate tax burden unchanged. The problems of shifting from our present system to that described could, I think, be dealt with by appropriate phasing-in measures.

A tax reform of this kind would, I think, be helpful. Evem more important would be a change in national attitudes toward profits. At the present time, there still is widespread public misunderstanding of the relative share of profits. There is little understanding also of how large a part of the profit share goes for corporate and individual taxes, for corporate and individual saving and investment, and how small a part contributes to inequality of living standards. But a more constructive national attitude is in the making, I believe, thanks in part to evidence that profits are not only the life blood of trade but more particularly also of corporate financing. To this more constructive attitude, I hope, our meeting is making a contribution.

Table 1

Profits of Nonfinancial Corporations
(billions of dollars)

Year	Profits After Tax 1/3/	I.V.A. 1/	Capital Consump. Allow. Adjustment 1/	Adjusted Profits 1/	Average Equity 2/	Return on Average Equity (per cent)	After Tax Profits 1/ / Gross Nonfinancial Corporate Product 1/3/
1946	13.4	-5.3	-2.7	5.4	105.3	5.1	13.5
1947	18.3	-5.9	-3.3	9.1	123.6	7.4	15.3
1948	20.0	-2.2	-3.9	13.9	141.4	9.8	14.6
1949	15.6	1.9	-3.8	13.7	152.3	9.0	11.7
1950	21.6	-5.0	-3.9	12.7	164.8	7.7	14.2
1951	17.9	-1.2	-4.5	12.2	183.0	6.7	10.3
1952	16.0	1.0	-4.4	12.6	197.1	6.4	8.8
1953	16.4	-1.0	-4.0	11.4	208.5	5.5	8.4
1954	16.4	-.3	-3.2	12.9	218.7	5.9	8.5
1955	21.8	-1.7	-2.1	18.0	233.9	7.7	10.1
1956	21.8	-2.7	-3.0	16.1	257.2	6.3	9.4
1957	20.7	-1.5	-3.3	15.9	277.8	5.7	8.5
1958	17.5	-.3	-3.4	13.8	291.9	4.7	7.4
1959	22.3	-.5	-2.9	18.9	305.2	6.2	8.4
1960	20.3	.3	-2.3	18.3	316.6	5.8	7.3
1961	19.7	.1	-1.8	18.0	324.8	5.5	6.9
1962	23.1	.1	1.0	24.2	336.6	7.2	7.4
1963	25.5	-.2	1.9	27.2	351.4	7.7	7.7
1964	30.7	-.5	2.6	32.8	369.9	8.9	8.6
1965	37.2	-1.9	3.6	38.9	393.2	9.9	9.5
1966	40.0	-2.1	3.8	41.7	422.6	9.9	9.3
1967	37.7	-1.7	3.6	39.6	456.5	8.7	8.3
1968	38.3	-3.4	3.6	38.5	491.0	7.8	7.7
1969	35.1	-5.5	3.5	33.1	530.8	6.2	6.5
1970	27.9	-5.1	1.5	24.3	574.5	4.2	5.0
1971	33.3	-5.0	.5	28.8	619.4	4.6	5.5
1972	42.4	-6.6	2.7	38.5	672.3	5.7	6.3
1973	53.7	-18.4	1.6	36.9	740.7	5.0	7.1
1974	61.1	-38.5	-2.1	20.5	851.1	2.4	7.6
1975	59.6e	-10.6e	-5.1e	43.9e	968.6e	4.5e	6.7

1/ Source: Department of Commerce.
2/ Source: FRB Flows of Funds.
3/ Excludes repatriated profits earned by foreign subsidiaries.

Five Year Period	Mean Return on Average Equity	After Tax Profits / Gross Nonfinancial Corporate Product
1946-1950	7.8%	13.9%
1951-1955	6.4	9.2
1956-1960	5.7	8.2
1961-1965	7.8	8.0
1966-1970	7.4	7.4
1971-1975	4.4	6.6

Table 2

Average Annual Nominal and Real Rates of Return
(10-year holding periods, 1926-1975)

10-Year Period	Average Annual Rate of Return 1/ Nominal	Real	10-Year Period	Average Annual Rate of Return 1/ Nominal	Real
	(per cent)			(per cent)	
1926-1935	5.9	10.4	1946-1955	16.2	8.3
1927-1936	7.9	12.2	1947-1956	17.9	14.4
1928-1937	0.3	3.9	1948-1957	15.9	13.4
1929-1938	-0.6	3.3	1949-1958	19.4	17.5
1930-1939	0.1	4.6	1950-1959	18.8	16.7
1931-1940	1.8	4.4	1951-1960	15.8	13.6
1932-1941	6.2	4.0	1952-1961	16.1	14.5
1933-1942	9.1	3.5	1953-1962	13.1	11.7
1934-1943	7.0	1.7	1954-1963	15.6	14.1
1935-1944	9.1	4.6	1955-1964	12.6	8.8
1936-1945	8.2	4.1	1956-1965	10.9	9.2
1937-1946	4.3	-3.8	1957-1966	9.0	7.2
1938-1947	9.3	-0.2	1958-1967	12.6	10.9
1939-1948	7.0	-3.4	1959-1968	9.8	7.9
1940-1949	8.9	-1.9	1960-1969	7.7	5.3
1941-1950	13.0	2.1	1961-1970	8.0	5.1
1942-1951	16.8	6.9	1962-1971	6.9	3.7
1943-1952	16.6	8.3	1963-1972	8.1	6.3
1944-1953	13.9	5.9	1964-1973	5.9	1.9
1945-1954	16.6	8.4	1965-1974	1.2	-4.1
			1966-1975	3.7	-2.9

	Nominal	Real
Mean	9.9	6.4
Standard deviation	5.4	5.4
Maximum	19.4	17.5
Minimum	-0.6	-4.1

1/ Rates of return estimated using Standard and Poor's 500 stock index. Dividends assumed to be reinvested at year-end.