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The Need for Better Profits

Address by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

at Gonzaga University's 1977 Founder's Day

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It is a pleasure for me to be here on the campus of Gonzaga University to participate in this celebration of Founder's Day. I am also pleased to be able to join you in honoring a great teacher of economics, Dr. Graue. It is eminently fitting that Dr. Graue's contribution to economic understanding should be noted today not only by festivity but also by serious economic discussion.

In consonance with that, I would like to address a feature of our current economic environment which, as long as it persists, could well prove an insurmountable barrier to the achievement of full employment in our country. I refer to the fact that the profits being earned by American business are at an unsatisfactory level.

It is both striking and disturbing, I believe, that profits get relatively little attention these days from economists. I have the impression that the economics profession has almost forgotten that ours is still predominantly a profit-motivated economy in which, to a very large extent, whatever happens -- or doesn't happen -- depends on perceived profit opportunities. Certainly, the preoccupation in the Nation's capital tends to be with other matters. The slightest hint, for example, of emerging trouble for the economy will promptly unloose a flood of fiscal and monetary proposals, virtually all predicated on the notion that what is crucial is governmental manipulation of aggregate demand. Seldom does anyone pause to ask what should be a compellingly obvious question -- namely, whether lack of confidence in profit opportunities on the part of our profit-oriented businessmen and investors may not be the essential cause of difficulty.

My own judgment is that a deep-rooted concern about prospective profits has in fact become a critical conditioner of economic performance in our country. If I am right in thinking so, actions taken in Washington to enlarge the already huge budget deficit in the interest of more consumer spending are likely to be of little sustained benefit in reducing the level of unemployment. That was a principal reason why I felt no lasting benefit could flow from the $50 rebate that was under consideration early this year.

If poor profitability is adversely affecting economic performance, we should expect business firms to exercise great caution in embarking on capital-investment projects. No businessman is likely to add to his plant or equipment if the promise of a decent return is not present. The current expansion of the over-all economy, while otherwise generally satisfactory, has been marked by notably weaker investment spending than was characteristic of previous recoveries. In the two-and-a-half years of this expansion, real capital outlays have increased only half as much as they did, on average, over like periods in the previous five expansions. The shortfall has been especially marked in the case of major long-lived industrial construction projects, and it has occurred even in industries -- such as paper and basic chemicals -- in which the rate of utilization of industrial capacity is well advanced.

Unless the willingness of businessmen to invest in new plant and equipment increases decisively, the expansion of economic activity now under way will continue to lack balance. And that, I need hardly add, will make it more uncertain whether the expansion is going to continue at a sufficient pace to bring unemployment down significantly, or -- for that matter -- whether the expansion itself will long continue.

The weakness of profits in recent years is not the only cause of investment hesitancy, but it is unquestionably a very important cause. To be sure, many people have a contrary impression about the general level or the trend of profits. In fact, the most commonly cited profits figures --

the so-called book profits that businesses report to their stockholders -- have risen spectacularly in the last few years, and in total are currently running just about double their level a decade ago. But these raw profit figures are misleading and they should never be taken at face value.

In actuality -- as the more sophisticated observers of corporate finances know -- raw profit numbers have become virtually meaningless as a guide to corporate affairs because of the way in which inflation distorts the calculation of profits. Under historical cost accounting -- the method used widely for inventory valuation and universally for capital-asset valuation -- the true costs of producing goods in an on-going business are far from fully captured. Rather, they are significantly understated with respect to both the drawdown of materials from inventory and the consumption of capital assets. And when costs are understated on an accounting basis, profits of course are overstated; that is to say, the reported total of profits contains an element of inflationary fluff that in no sense enlarges a firm's ability to pay dividends or add to retained earnings.

The practical consequence of the inflationary fluff on a company's fortunes is decidedly negative, since taxes have to be paid on the "phantom" portion of profits. Quite obviously, this has lessened the ability of corporations to add to their capital investment without borrowing. The tax drain has become very large in recent years because of the enormous understatement of costs. For 1976, for example, the Commerce Department estimates that the replacement cost of inventories used up by nonfinancial corporations exceeded by $14 billion the materials expenses claimed for tax purposes. More striking still is the Department's estimate for last year of the amount by which depreciation charges based on historical cost fell short of the replacement cost of the capital assets consumed. That estimate came to nearly $36 billion, making the combined understatement of costs from these two sources $50 billion in 1976.

The huge understatement of costs that arises because of inflation cannot be ignored by anyone seriously concerned with corporate earnings. Once account is taken of the distortions wrought by inflation -- and when an offsetting adjustment is also made to allow for the changes over time in Treasury depreciation rules -- we find that the level of corporate profits was overstated in 1976 by about $30 billion, and that this resulted in an overpayment of some 10 to 12 billion dollars in income taxes. True economic profits of corporations are thus very different from reported book profits.

Just how poor the trend of profits has recently been is clearly indicated by the fact that in each year from 1968 through 1975 the after-tax "economic profits" of nonfinancial corporations from domestic operations were, in the aggregate, consistently below the levels reached during 1965-1967. A new high level of these profits was indeed reached during 1976, but even that achievement is decidedly unimpressive when profits are expressed as a rate of return on the amount of equity capital in use. So far in the inflation-riddled 1970's, the after-tax rate of return on stockholders' equity has averaged only about 3-1/4 per cent when the tangible assets portion of equity capital is valued, as it should be, on a replacement cost basis. That figure is lower by two percentage points than the average rate of return for the 1950's and 1960's. Despite a sizable recovery from the recent recession, the rate of return on the equity investment in our corporations appears to be running currently at a level not significantly different from the depressed average so far this decade.

Anyone who wonders why capital spending has been so halting or why stock prices have behaved so poorly for so long would be well advised to study this dismal record of what American business has been earning. Historically, there has been an impressively close correlation between the rate of return on stockholders' equity and the rate of real investment. The linkage between the rate of return on equity and the behavior of equity prices is looser, but it still suggests that professional investment managers are no longer being deceived by the inflationary fluff in profit numbers. The stock market, by and large, has not been behaving capriciously; instead it has been telegraphing us a message of fundamental importance.

At any given point in time, investment activity and stock market behavior are conditioned, of course, by much more than current profit readings. What is ultimately decisive in determining the behavior of investors and businessmen is not the rate of return currently earned on past investments but rather expectations about future earnings. Very often current earnings are an excellent proxy for expectations about future earnings; sometimes they are not. My judgment is that businessmen and investors at present have a sense of doubt and concern about the future that is even greater than would be justified by the low level of true economic profits.

One telling piece of evidence that this is so is the pronounced hesitancy of businessmen in going forward with capital-spending projects that involve the acquisition of long-lived assets. The investment recovery that we have experienced so far in this cyclical expansion has been heavily concentrated in relatively short-lived capital goods that promise quick returns -- trucks, office equipment, and light machinery, for example. Major investment projects that cannot be expected to provide payback for many years encounter serious delays in getting management's approval. Indeed, the decline of industrial construction that set in during the recent recession continued through the first quarter of this year -- two years after general economic recovery got under way -- and has not yet turned around decisively enough to establish a clear trend.

Many businessmen have a deep sense of uncertainty about what the longer future holds and, as a consequence, are discounting expected future earnings more heavily than they ordinarily would in their investment calculations. The special degree of risk that businessmen see overhanging new undertakings means that they often will not proceed with a project unless the prospect exists for a higher-than-normal rate of return. This is not only skewing investment toward short-lived assets; it is also fostering an interest in mergers and acquisitions -- something that does not require waiting out new construction undertakings. There has been a noticeable pickup in merger activity recently, but such activity generates neither additional jobs nor additional capacity for our Nation's economy.

The reasons why businessmen appear to be assigning special risk premiums to major investment undertakings are complex, and I certainly cannot deal with them exhaustively today. But I would like at least to touch on the conditioning influences that seem most important -- beyond, of course, the critical fact that current corporate earnings, properly reckoned, are discouragingly low.

My frequent discussions with businessmen leave little doubt in my mind that a strong residue of caution in businessmen's thinking has carried over from the recession of 1974-75. I think it is fair to say that the present generation of business managers had developed an inordinate degree of faith in government's ability to manage and sustain economic expansion. When they discovered that that faith was not justified, the experience was sobering -- particularly for the not inconsiderable number of businessmen who had imprudently expanded debt in the froth of the earlier prosperity. Moreover, the lingering sense of unease produced by the severity of the recession has been deepened by the sluggishness of the subsequent recovery in much of the world economy outside the United States. In contrast to the widely-shared conviction of just a few years ago that the business cycle had been mastered, a surprising number of businessmen are now seized by concern that the world economy may have entered a downphase of some long cycle. One factor sparking such speculation is apprehension that the quantum jump in energy prices may be affecting the world's growth potential to a more serious extent than was originally thought likely.

More troublesome still, the specter of serious inflation continues to haunt the entire business community. The fear that inflation will not be effectively controlled is indeed a key reason for the high risk premiums that businessmen nowadays typically assign to major investment undertakings. Increasingly, businessmen understand the severity of the burden they are carrying on account of the taxation of "phantom" profits. They also have learned the hard way -- from the frenetic conditions of 1973-74 -- that inflation is totally inimical to a healthy business environment. Having little basis for projecting how inflation will affect their enterprises and fearful that government may in time resort to direct controls once again, they feel bewildered in attempting to judge their future costs or their future selling prices. Because of that, they yearn for some solid piece of evidence that inflation will be tamed. They are troubled because no such evidence is yet at hand.

Added to these concerns is the fact that businessmen have had great difficulty in evaluating the implications of the major policy initiatives that are being considered this year. Businessmen cannot at this juncture confidently judge what kinds of energy will be available in the years ahead. Nor do they yet have any firm basis for assessing what kinds of tax incentives or disincentives may apply to particular energy uses. They are concerned that innovations in Social Security financing now under consideration may end the traditional rule under which employer and employee taxes have been the same and, as a consequence, lead to multi-billion dollar increases in the Social Security levies they have to pay. They suspect, moreover -- as do many others -- that the revamping of welfare programs will prove much more expensive than is now being estimated and that still additional taxes on businesses will be imposed as a means of financing reform. And the daily rumors about impending tax reform, among which ending of preferential treatment of capital gains is frequently emphasized, have contributed to a mood of unease in both corporate board rooms and the stock exchanges. So too has the expectation that a serious campaign for a costly undertaking in national health insurance may start next year.

I strongly suspect that the ability of businessmen to assimilate new policy proposals into their planning framework has now been stretched pretty far. In fact, I seldom talk with a businessman these days who does not, in one way or another, voice concern about his inability to make meaningful projections of corporate costs and earnings for the years immediately ahead.

The implications of the matters on which I have been dwelling -- the behavior of profits and the state of mind of the business community -- appear to have escaped a good many people. Economic analysts who insist, for instance, that capital spending will automatically catch fire as capacity margins diminish are, in my judgment, thinking too mechanically. Much will depend on the process by which the economy reaches more intensive utilization of resources -- especially on government's role in that process.

I also think that analysts endeavoring to assess capital-spending prospects -- and indeed prospects for the economy generally -- may be neglecting a sensitive cyclical development. I refer to the fact that, whereas prices charged by business generally advanced more rapidly than did the costs incurred by business in the early stages of this expansion, that is no longer the case. This, of course, means that profits per unit of output have stopped rising and may indeed have begun to fall -- a development typical of the more advanced stage of business-cycle expansions and one that is certainly not conducive to vigorous capital-investment activity. I know enough about business-cycle behavior to avoid at this time the inference that a sustained profits squeeze is emerging. We have here, nevertheless, an incipient imbalance in the economic situation that ought to concern us. And it is one more compelling reason to ask if national policy does not need to be more explicitly oriented to the strengthening of profitability and the encouragement of capital formation.

The last time business investment in fixed capital was as weak as it has been since 1973 was in the late 1950's and early 1960's. I believe there are some policy lessons we can profitably draw from that period. There was a great deal of concern at that time that a phase of deep-seated economic malaise had set in, with worry voiced that sluggishness in business investment might well prevent the economy from attaining full employment. The parallels with today -- both in objective fact and in assessment -- are close in many respects, the major differences being that profit rates were not as low then, nor was inflation comparably troublesome.

A bold policy approach -- predicated on the need for stimulation of capital investment -- was then developed, with one of President Kennedy's early messages to Congress calling for enactment of an innovative tax device, namely, the investment tax credit. The Revenue Act of 1962 brought the tax credit into being. That same year witnessed a reinforcement of investment incentives in the form of significant liberalization of Treasury depreciation rules. This investment-oriented thrust of policy was followed, moreover, by recommendations for broadly based income tax reductions for both businesses and individuals, and they ultimately were embodied in the Revenue Act of 1964. Taken together, those actions of the early 1960's were sensitively responsive to conditions that have many similarities to the situation in which we now find ourselves. And what is particularly worth recalling, those actions soon had the consequence of strengthening dramatically both investment activity and the general economy.

If we were able to launch a policy response now that was just as unambiguously positive in its implications for profitability, I for one would have little doubt about our economy's capacity to shake off its malaise. As every recent study of our Nation's investment needs has emphasized, we are confronted with an enormous capital-formation challenge for the years ahead. If we have the good sense to create hospitable conditions for saving and investing, I truly believe ours could become an age of sustained progress in employment and well-being.

The doubts and uncertainties that now prevail in the business and investing community reflect, in large part, irritation or annoyance at what is viewed as governmental myopia. They must not be interpreted as being indicative of business timidity. That enormous vitality and dynamism still exist in our business system is attested by the extraordinary fact that, despite the weakness of profits in recent years and the cumulating anxieties about the future, our economy has actually generated nearly seven million jobs since the spring of 1975 -- nearly all of them, I should add, in private industry.

The practicality of so many initiatives in this Administration's first year is arguable, but the President's leadership also bespeaks a seriousness of purpose that in the end may bring lasting benefits to our Nation. We have been through a year of animated policy debates -- a year, I think, of useful growth in the perception of how plausible but divergent objectives can be practically blended. The basic reform this country now needs is the creation of an environment with many new job opportunities for our people. I expect the dust of controversy to settle and that constructive legislation will follow.

I do not mean to suggest that encouragement of investment through a bold tax policy is all that is needed. Such encouragement is vital, to be sure, and it will undoubtedly make a difference in the willingness of businessmen to invest in new plant and equipment. But the effort at eliminating the high risk that now attaches to investment must be of broader reach. It must go to the array of concerns of the business community about energy policy, about environmental codes, about governmental regulations at large, and -- above all -- about inflation.

I cannot overstate the importance of unwinding the inflation that is continuing to plague our economy. There is a paramount need for avoiding new cost-raising measures by government, of which the recently legislated increase of the minimum wage is only the most recent very troublesome example. Fiscal and monetary policies need to be conducted in ways that will quiet rather than heighten inflationary expectations. On the fiscal side, this means that great caution will have to be observed both in giving up tax revenues and in program initiatives entailing new expenditures. As a practical matter, expenditures on some existing programs may therefore have to give way. We simply dare not take steps that would result in any appreciable enlargement of our already swollen budget deficit. That could only excite unease in the business and financial community.

On the monetary side, I want to assure you that we at the Federal Reserve fully appreciate the critical linkage between money creation and inflation. We have no intention of letting the money supply grow at a rate that will add fuel to the fires of inflation. On the contrary, we are determined to bring about a gradual reduction in the rate of money expansion to a pace compatible with reasonable price stability. That cannot be done quickly because of the powerful inflationary pressures that have become embedded in our economic life over so many years; but I assure you that it will be done if the Federal Reserve retains -- as I expect it will -- the independence from political pressures on which the Congress has so wisely insisted across the decades. That does not mean that the Federal Reserve is preoccupied with the objective of monetary firmness. Our obligation to foster financial conditions that favor the expansion of job opportunities is clear and I assure you this is very much on our minds. We constantly keep probing for that delicate balance between too much and too little money.

The increase of short-term interest rates that has occurred since late April has served to check what would otherwise have been an explosion of the money supply. By taking measures to check the growth of money, we have demonstrated that we remain alert to the dangers of inflation. As a consequence, long-term interest rates, which nowadays are extremely sensitive to expectations of inflation, have remained substantially stable. Had we not taken steps to bring the money supply under control, I have little doubt that fears of inflation would now be running stronger, and that long-term interest rates, which play such a significant role in shaping investment decisions, would therefore now be higher than they in fact are. In that event, of course, the continuance of economic expansion would be less secure.

We at the Federal Reserve always welcome advice on how best to proceed. Ours, however, is the responsibility to act in the monetary area, and we intend to exercise that responsibility in ways that promote the long-run as well as the immediate interests of this Nation.

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SUPPORTING CHARTS

KEY TO CHARTS

Business Outlays for Plant and Equipment, Constant Dollars

Outlays are current dollar expenditures for new plant and equipment by U.S. businesses, divided by the implicit price deflator for nonresidential fixed investment. Excludes outlays by agricultural business; real estate; medical, legal, educational, and cultural services; and nonprofit organizations. Data source: Department of Commerce, Bureau of Economic Analysis.

Domestic Profits After Tax, Nonfinancial Corporations

Reported profits are after-tax profits from domestic operations of U.S. nonfinancial corporations as derived by the Department of Commerce primarily from Internal Revenue income tax reports. Economic profits are "reported profits" adjusted to exclude inventory profits and to compensate for the difference between depreciation reported for tax purposes and the estimated replacement cost of fixed assets used in production. Data source: Department of Commerce, Bureau of Economic Analysis.

Economic Profits, Nonfinancial Corporations

Economic profits on a current dollar basis are measured as above. The constant dollar series is generated by dividing current dollar economic profits by the implicit price deflator for gross domestic business product. Data source: Department of Commerce, Bureau of Economic Analysis.

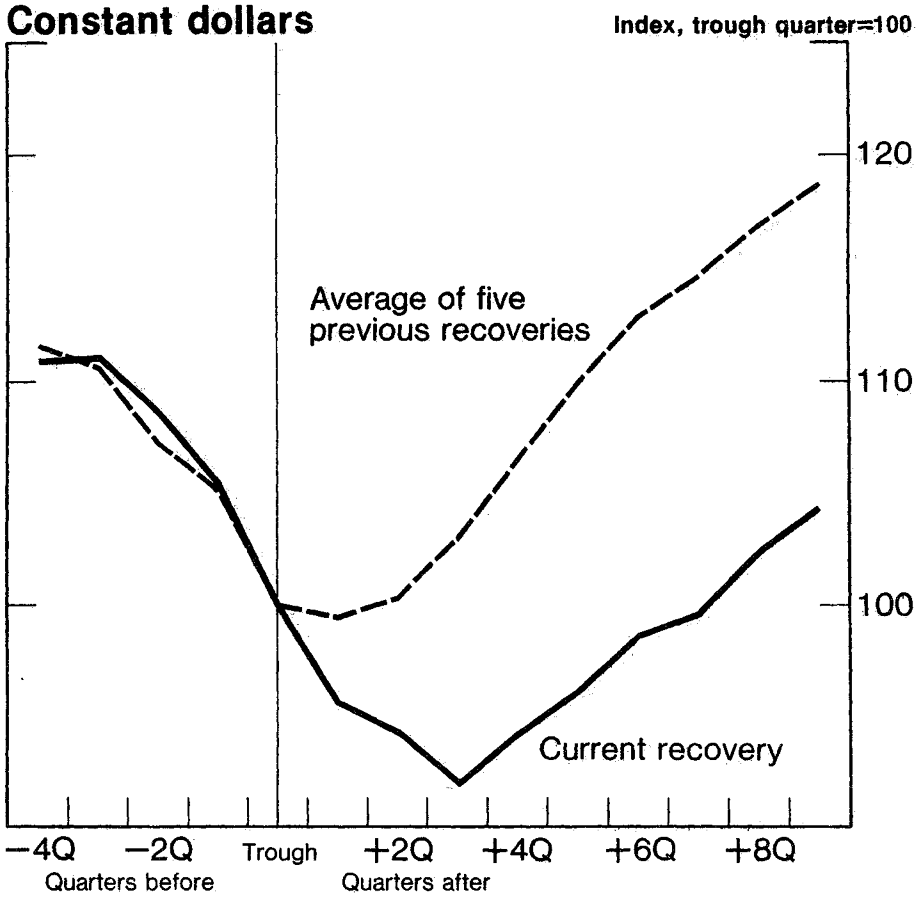
Rate of Return on Stockholders' Equity, Nonfinancial Corporations

The rate of return is measured as economic profits divided by net worth (with tangible assets valued at replacement cost). Net worth for each year is tne average of beginning and end-of-year levels. Data sources: Department of Commerce, Bureau of Economic Analysis; Federal Reserve Flow-of-Funds Accounts.

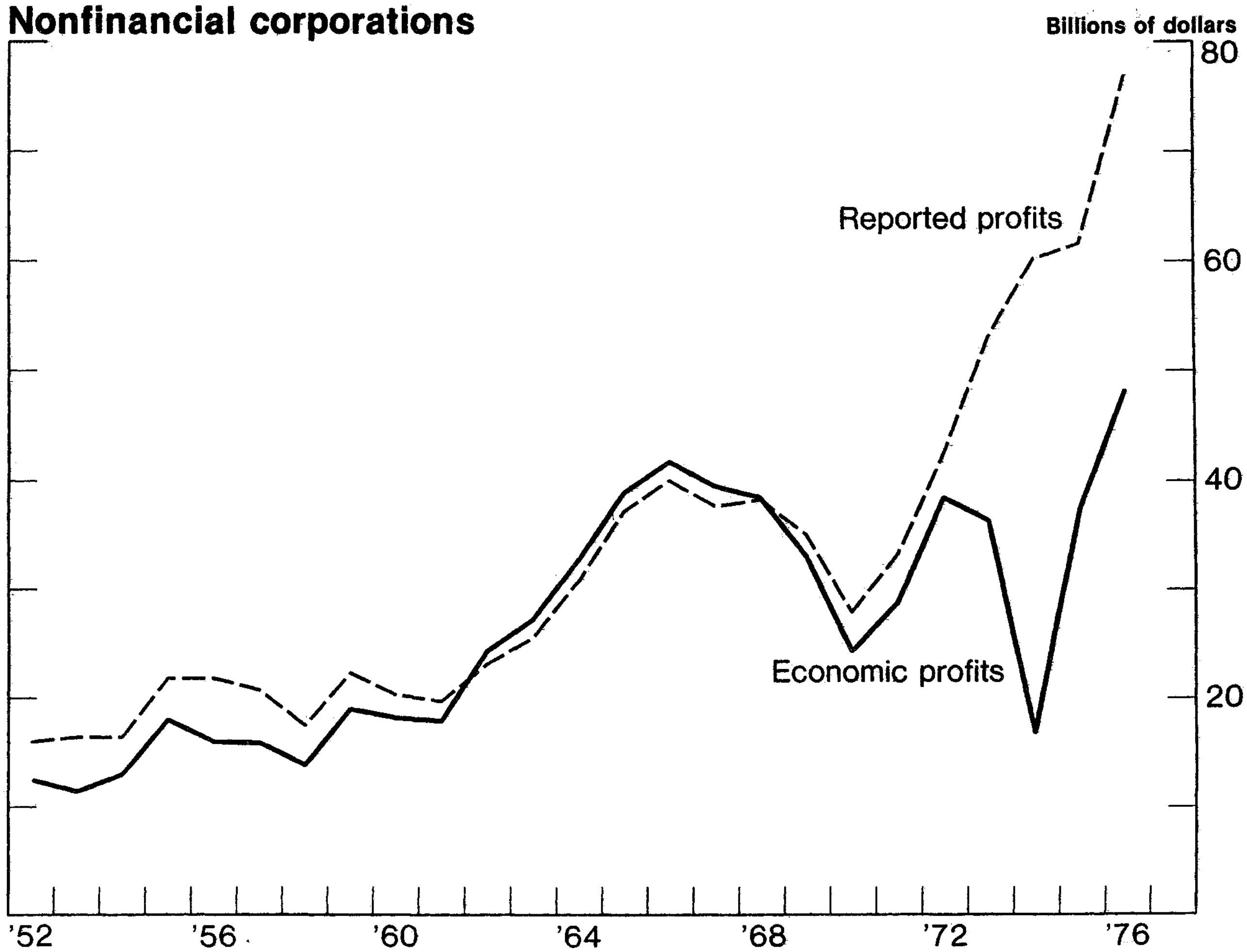
Profitability and Investment, Nonfinancial Corporations

Rate of investment is measured as the percentage change in net fixed capital assets (i.e., equipment and structures) valued in 1972 dollars. Rate of return on stockholders' equity is measured as above. Data source for rate of investment: Department of Commerce, Bureau of Economic Analysis.

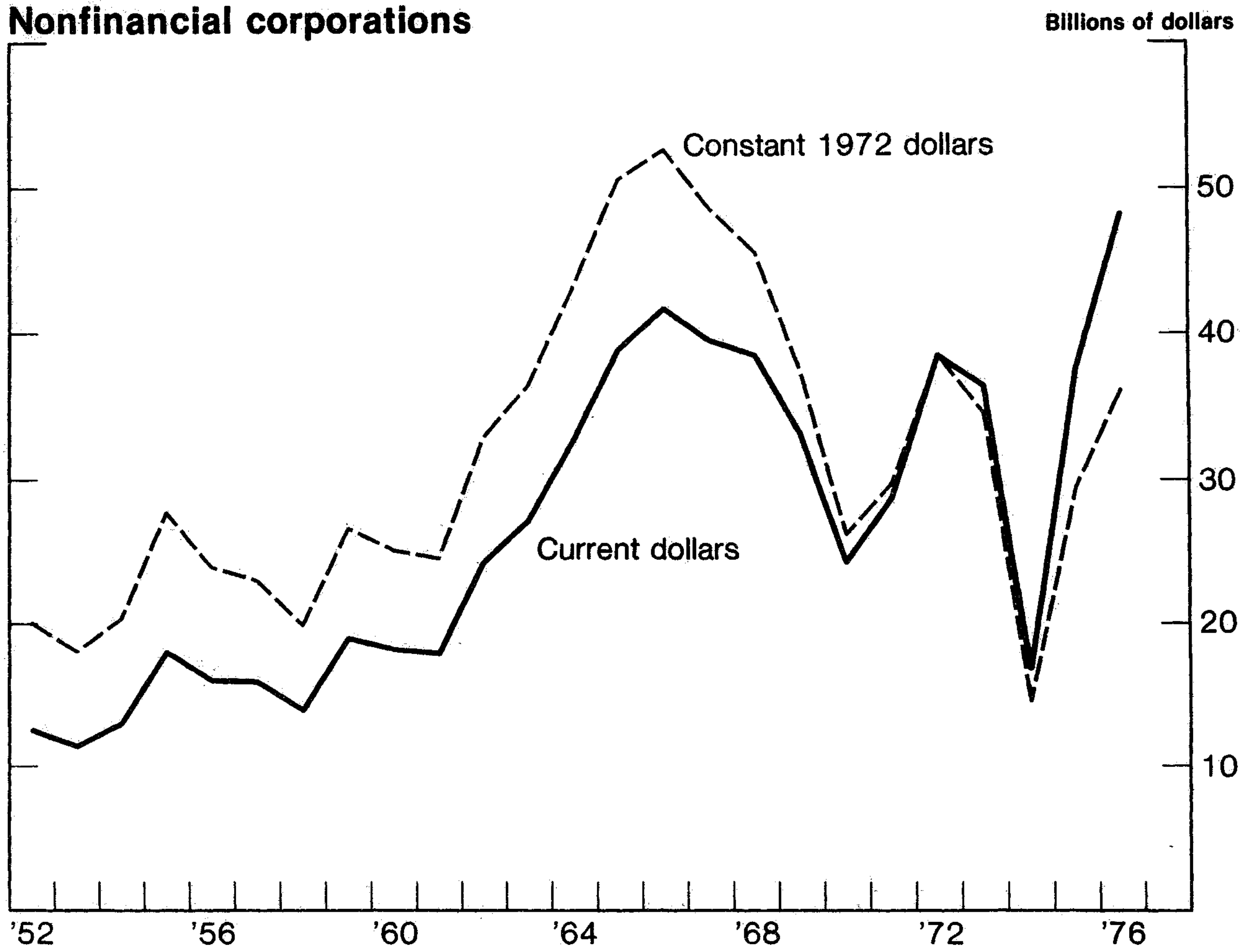
BUSINESS OUTLAYS FOR PLANT AND EQUIPMENT
Constant dollars



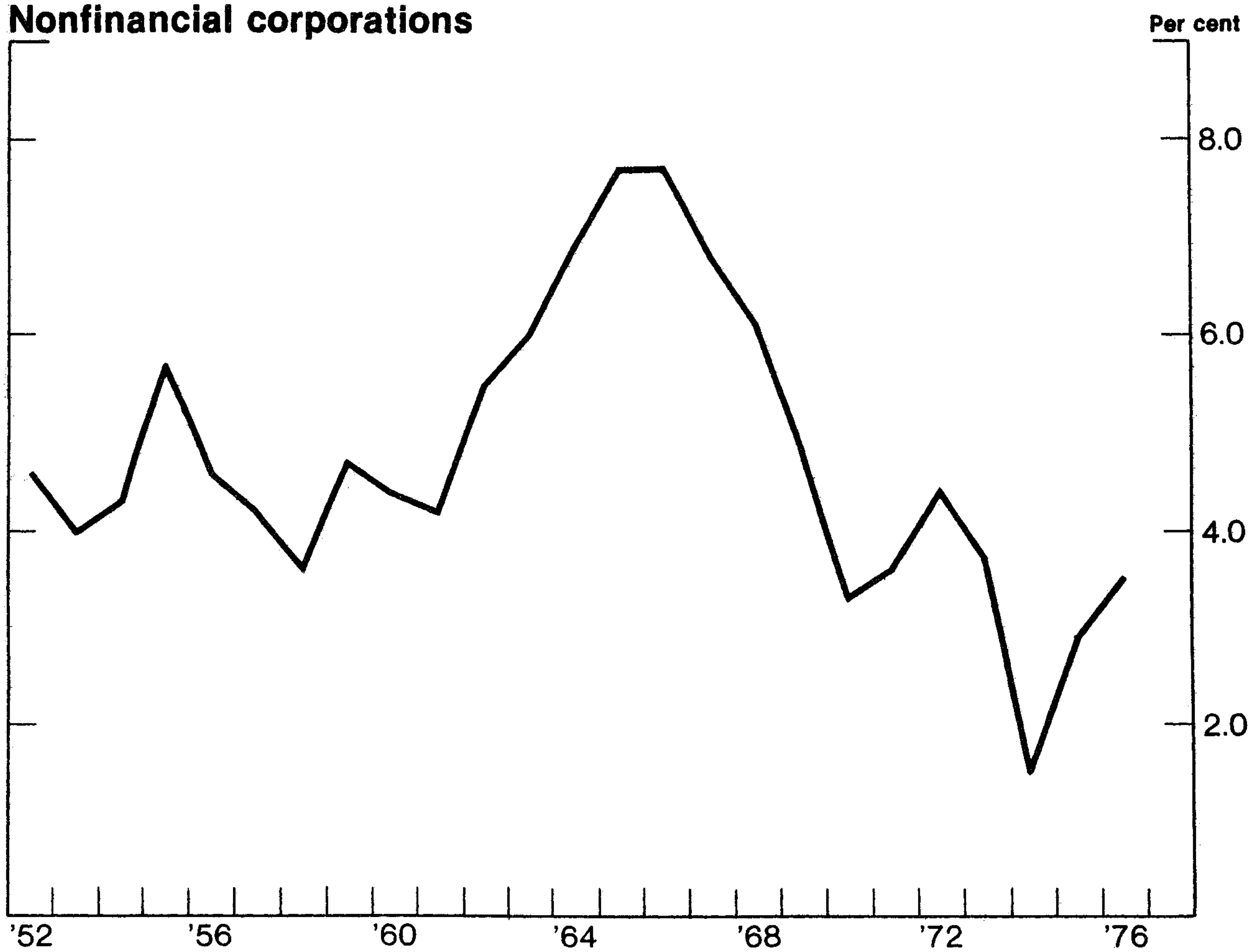
DOMESTIC PROFITS AFTER TAX
Nonfinancial corporations

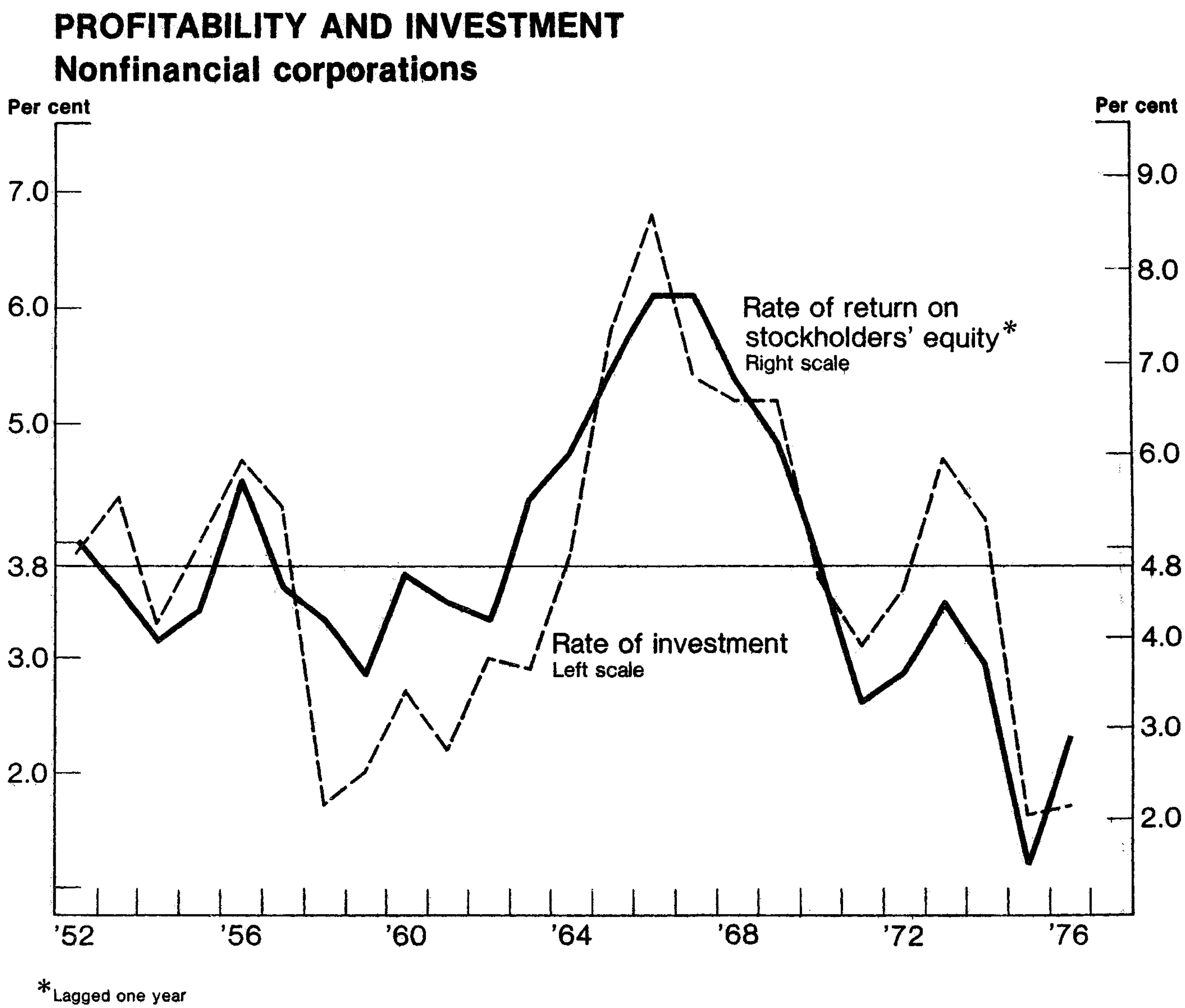


ECONOMIC PROFITS
Nonfinancial corporations



RATE OF RETURN ON STOCKHOLDERS' EQUITY
Nonfinancial corporations




PROFITABILITY AND INVESTMENT
Nonfinancial corporations
Per cent
Per cent
7.0
6.0
5.0
3.8
3.0
2.0
9.0
8.0
7.0
6.0
4.8
4.0
3.0
2.0
Rate of return on
stockholders' equity*
Right scale
Rate of investment
Left scale
'52
'56
'60
'64
'68
'72
'76
*Lagged one year