six quarters than in the same period of past expansions. Larger depreciation allowances increased reported expenses and reduced reported profits, which, in turn, lowered corporate taxes and boosted economic profits on an after-tax basis. The effective average corporate tax rate—that is, the ratio of tax payments to before-tax economic profits—fell sharply from over 40 percent to 20 percent in this expansion. The recent effective tax rates have been at the lowest levels in the postwar period.\(^9\) In contrast to economic profits, reported profits have been relatively weak since mid-1984. Chart 3 shows that in the last five quarters, after-tax reported profits have lagged behind the annual growth rates registered in past expansions. From the beginning of this expansion in November 1982, nominal after-tax reported profits have risen by an annual pace of only 14 percent, compared to 23 percent recorded in the 1975 expansion and to 20 percent, on average, registered in the four previous expansions. After-tax reported profits in constant dollars also rose at a slower annual rate in the current expansion. After-tax reported profits have been held down by accelerated depreciation allowances and slower price increases, which have enhanced reported expenses and reduced profits generated from holding inventories.\(^9\)

The disparity between reported and economic profits has expanded in recent years. Depreciation charges under the tax code were substantially below the replacement cost of capital in the early years of the 1981 tax changes and disinfation, depreciation allowances have increasingly exceeded the estimated replacement cost of capital. While there was a similar movement between the 1950s and 1960s, the magnitude of that shift was insignificant compared to the one of the past decade.

Conclusion

Recent corporate profits from current production could be viewed as weak or strong, depending on how they are measured. On the one hand, after-tax reported profits of nonfinancial corporations have indeed been sluggish, increasing at a 14 percent annual pace over the current expansion. This is substantially below the 20 percent annual rate of growth, on average, for reported profits in post-Korean War recoveries. On the other hand, numbers can be deceiving, and reported profits are not the most accurate indicator of earnings from current production.\(^1\) Reported profits are simply the difference between total receipts and total expenses, which include "depreciation," as reported for tax purposes. Economic profits, which adjust reported profits for price changes and depreciation allowances, are generally thought to be a better gauge of corporate performance. In contrast to reported profits, after-tax economic profits of nonfinancial corporations have been strong in the current expansion, growing at a 25 percent annual pace, which far exceeds their average annual rate of 19 percent in previous expansions. An examination of after-tax reported and economic profits of nonfinancial corporations over the last three decades shows that reported profits were not much different from economic profits until the inflationary 1970s, when reported profits surpassed economic profits. That trend has reversed, and economic profits have surged ahead of reported profits. The slowing in the pace of inflation and 1981 changes in tax laws account for much of the reduction in reported profit growth over the last few years.

After-tax economic profits have been bolstered by the expansion in economic activity and slower increases in costs and taxes. Modest gains in wages and salaries helped firms keep the lid on operating costs in recent years. Moreover, since taxes are based on reported profits, corporate taxes have not risen in proportion to economic profits. Reported profits have grown more slowly because of the greater use of accelerated depreciation, and because gains are not the most accurate measure of price increase.

Profit Measures

The fundamental difference between reported and economic profits is on the cost side: measuring expenses is problematic when prices are not stable. Cost changes distort business performance. In contrast to reported profits, after-tax economic profits have been strong in the current expansion, growing at a 25 percent annual pace, which far exceeds their average annual rate of 19 percent in previous expansions.

Address Correction Requested: Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department. P.O. Box 6387, Cleveland, OH 44101.

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Differing from economic depreciation inventory valuation adjustment (IVA),


Because of the actual depreciation consistent straight-line, historical-cost at replacement cost. This adjustment accounting gains, since inventory must inventory valuation adjustment negates for inventory gains or losses is made in under the tax code and the funds accounting procedures from a historical-cost to a replacement-cost basis. The inventory valuation adjustment creates accounting gains, since inventory must be replaced at current prices.

The capital consumption adjustment (CCAdj) in the NIPAs estimates the difference between depreciation allowable under the tax code and the funds required to maintain fixed capital stock at replacement cost. This adjustment has two components. The first component shifts depreciation expenses reported on accelerated schedules to a consistent straight-line, historical-cost basis. The second component is the adjustment made for price changes in fixed nonresidential investment. This is done by converting straight-line depreciation from historical cost to replacement cost. The capital consumption adjustment recognizes that tax-based depreciation may differ from economic depreciation because the actual depreciation schedules used and the rate of inflation.

Chart 1 shows the relationship among after-tax reported profits, the inventory valuation adjustment (IVA), the CCAdj, and after-tax economic profits. The divergence between reported and economic profits was relatively small in the 1950s and 1960s, but the reported profits exceeded economic profits by a large margin in the 1970s, as inflation accelerated. Reported profits were inflated by inventory gains between 1973 and 1981. Consequently, a large negative inventory valuation adjustment was applied to reported profits in the calculation of economic profits. Since 1981, as inflation has slowed, this negative IVA has become smaller and has even turned positive in the first three quarters of 1985.

Similarly, reported profits during most of the 1970s were overstated, because firms were not able to adjust depreciation fully for the effects of inflation. A large negative CCAdj was added to reported profits in the computation of economic profits for NIPA purposes. More recently, this negative CCAdj has all but disappeared and has become progressively positive. As the IVA has become smaller, and CCAdj has become positive and quite large, profits reported by corporations for tax purposes have fallen below economic profits.

CCAdj’s swing to a large positive value is the primary explanation for the current divergence between reported and economic profits and reflects provisions in the Economic Recovery Tax Act of 1981 (ERTA). The Act shortened the period over which assets could be depreciated, which substantially increased depreciation allowances for the early years of most types of assets. The law was structured this way to restore the economic value of depreciation allowances in an inflationary environment. In the years just before the enactment of ERTA, inflation was at historically high levels. Between 1974 and 1981, depreciation allowances were significantly below the cost of replacing capital, as depicted by the negative CCAdj in chart 1. This trend was reversed by ERTA and by the rapid and dramatic drop in inflation since the early 1980s. Increased depreciation allowances have had the effect of augmenting reported expenses and sales, as well as profits. As firms depreciated larger amounts of fixed assets under more liberal depreciation schedules in a low-inflation environment, the offsetting adjustment to economic profits (the CCAdj) became increasingly important.

Economic profits are reported profits adjusted for capital consumption on a replacement-cost basis and for the inventory valuation adjustment (IVA), which was applied to reported profits plus CCAdj plus IVA.


4. Of course this discourages capital formation, but this article does not address the issue of depreciation allowances on investment decisions.

5. For a detailed description of the adjustments, see Bruce T. Grimm, "Domestic Nonfinancial Corporate Profits."

6. The implicit price deflator for fixed nonresidential investment in new plant and equipment rose by 5 percent between 1978 and 1981, compared to an average increase of less than 1 percent over the last three years.

7. The 1958 and 1980 expansions were excluded from the analysis because they lasted less than three years.

8. Constant dollars are at the 1982 value. Real or constant dollar after-tax economic profits are computed as the sum of after-tax economic profits and the implicit price deflator for fixed nonresidential investment in new plant and equipment.

The above-average gains in after-tax economic profits in this expansion have been attributed primarily to larger sales of the first half of the expansion and to slower increases in both operating costs and taxes throughout the recovery. This has implemented significant cost-cutting measures during the 1981-82 recession, which was one of the steepest and longest downturns in economic activity in the last four decades. Consequently, firms were in a better position at the beginning of the recovery than at previous recoveries. The 1980s expansion compared to past recoveries. Although profit margins are relatively thin from a historical standpoint, they have improved dramatically since 1982. The ratio of before-tax economic profits to gross domestic product of nonfinancial corporations, an approximate measure of profit margins, nearly doubled to 11 percent over this expansion. Unit labor costs have been held down by modest increases in wages and salaries, even though productivity gains were disappointing.

A slowdown in the pace of recovery and a shift in import competition has greatly curtailed the growth of sales and after-tax economic profits of nonfinancial corporations since mid-1984. By the early part of 1984, the value of the dollar rose to unprecedented levels, pricing out many domestic producers. Foreign competition became more intense and widespread, competing with domestic producers. Foreign competition became more intense and widespread, competing with domestic producers. Foreign competition became more intense and widespread, competing with domestic producers.

Nevertheless, after-tax economic profits have continued to grow at a faster pace than they did in previous expansions. In the last six quarters (ended fourth quarter, 1985), after-tax economic profits of nonfinancial corporations rose at an annual pace of 13 percent, compared to an average annual increase of 8 percent over the same period of time during previous expansions. A large decline in interest rates in the last six quarters has reduced net interest expenses of corporations. Perhaps the greatest contributing factor to better earnings has been the lower tax burden resulting from the 1981 tax law change, given that before-tax economic profits have grown at a slower pace in the last expansions.
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The capital consumption adjustment (CCAdj) in the NIPAs estimates the difference between depreciation allowable under the tax code and the actual depreciation required to maintain fixed capital stock at replacement cost. This adjustment has two components: the first component shifts depreciation expenses reported on accelerated schedules to a consistent straight-line, historical-cost basis. The second component is the adjustment made for price changes in fixed nonresidential investment. This is done by converting straight-line depreciation from historical cost to replacement cost. The capital consumption adjustment recognizes that tax-based depreciation may differ from economic depreciation because of the actual depreciation schedules used and the rate of inflation. The capital consumption adjustment (CCAdj) in the NIPAs estimates the difference between depreciation allowable under the tax code and the actual depreciation required to maintain fixed capital stock at replacement cost. This adjustment has two components: the first component shifts depreciation expenses reported on accelerated schedules to a consistent straight-line, historical-cost basis. The second component is the adjustment made for price changes in fixed nonresidential investment. This is done by converting straight-line depreciation from historical cost to replacement cost. The capital consumption adjustment recognizes that tax-based depreciation may differ from economic depreciation because of the actual depreciation schedules used and the rate of inflation.

Chart 1 shows the relationship among after-tax reported profits, the inventory valuation adjustment (IVA), and economic profits. The charts tell different stories about the health of tax-based depreciation during the 1975 expansion and the average growth of profits over recent cycles. Although reported profits have been weak, economic profits remain strong. The charts tell different stories about the health of tax-based depreciation during the 1975 expansion and the average growth of profits over recent cycles. Although reported profits have been weak, economic profits remain strong.

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As reported for tax purposes.

Recent corporate profits from current production could be viewed as weak or strong, depending on how they are measured. On the one hand, after-tax reported profits of nonfinancial corporations have indeed been sluggish, increasing at a 14 percent annual pace over the current expansion. This is substantially below the 20 percent annual rate of growth, on average, for reported profits in post-Korean War recoveries. On the other hand, numbers can be deceiving, and reported profits are not the most accurate indicator of earnings from current production. Reported profits are simply the difference between total receipts and total expenses which include “depreciation” as reported for tax purposes. Economic profits, which adjust reported profits for price changes and depreciation allowances, are generally thought to be a better gauge of corporate performance. In contrast to reported profits, after-tax economic profits of nonfinancial corporations have been strong in the current expansion, growing at a 45 percent annual pace, which far exceeds their average annual rate of 19 percent in previous expansions.

An examination of after-tax reported and economic profits of nonfinancial corporations over the last three decades shows that reported profits were not much different from economic profits until the inflationary 1970s, when inflationary profits have declined with the rate of inflation. Profits measured in constant and adjusted for inflationary gains. However, LIFO cannot completely eliminate inventory profits from reported profits, since it does not reflect inventory changes in reported profits. This problem has been dealt with by allowing for changes in inventory prices. This adjustment has been made by the federal tax law.


2. The other commonly used inventory accounting method is the first-in-first-out (FIFO) method of figuring inventory costs for income taxes.