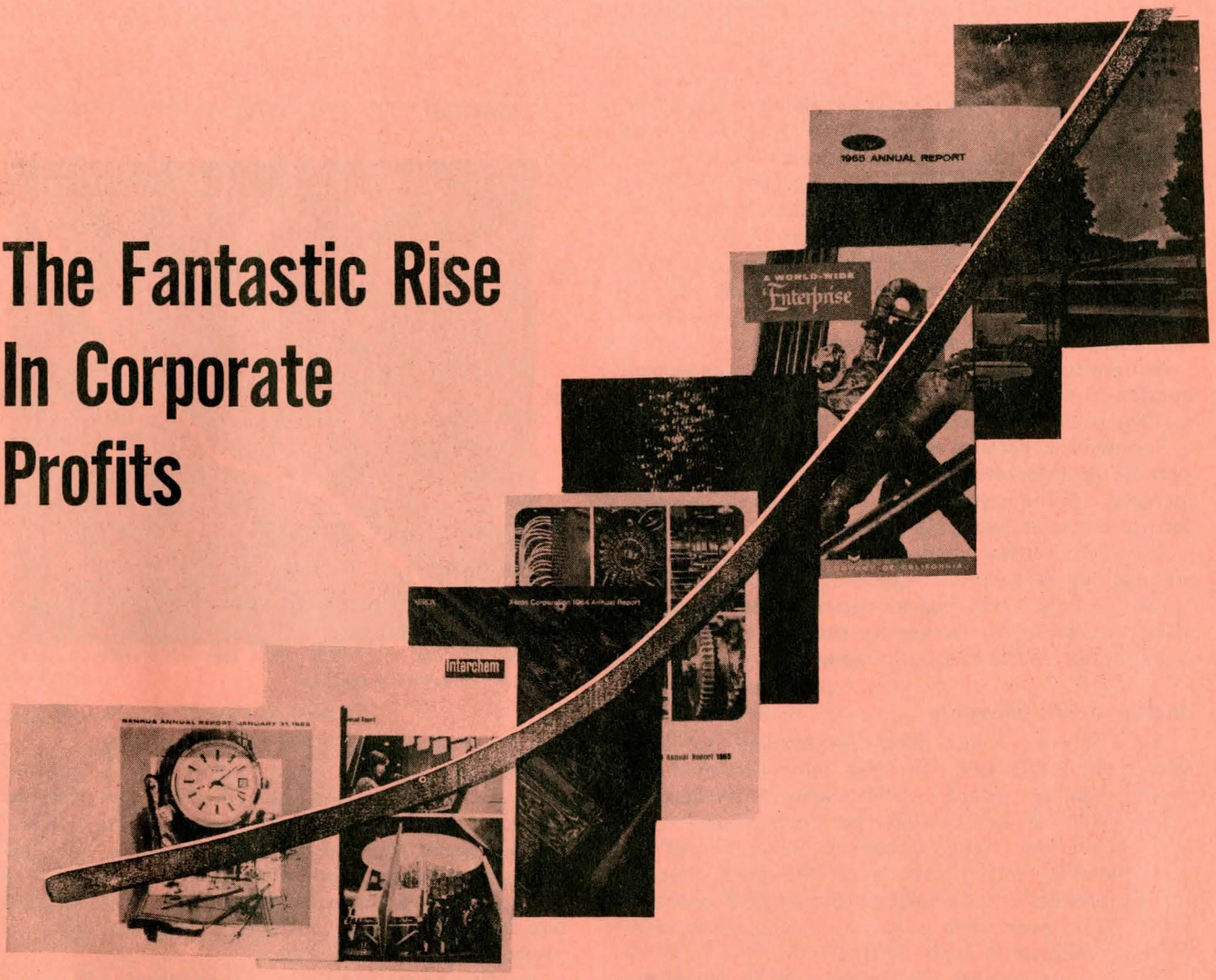
The Fantastic Rise In Corporate Profits



If General Motors had been satisfied in 1965 with a 13 percent rate of return on investment—the after-tax profit rate enjoyed by the average U.S. manufacturing corporation—it could have raised the wages and salaries of every one of its employes everywhere in the world by nearly $3,000. Or it could have cut the wholesale price of every car and truck it sold by about $300, permitting a substantially greater cut in the retail price.

For GM, 1965 was a banner year. It marked the first time that any corporation earned over $4 billion in profits, before taxes, and over $2 billion in profits after taxes.

But GM was not the only corporation which enjoyed a feast in 1965. It was true of company after company.

In 1960, after-tax profits for all corporations stood at the high level of $26.7 billion. By 1965, these profits skyrocketed to $44.5 billion—an increase of 67 percent. Over one-half of this increase occurred during the last two years, as after-tax profits shot up by more than 14 percent in 1964 and by nearly 20 percent in 1965. In the first quarter of 1966, according to early reports, profits soared an additional 12 percent.

Meanwhile, during this 1960-65 period, dividend payments grew by 41 percent—from $13.4 billion to $18.9 billion—but wage and salary payments lagged badly and rose by only 32 percent.

As a result of this upward surge in profits, rates of return on investment have increased sharply. In 1960, the ratio of profits after taxes to stockholders' equity was 9.2 percent in manufacturing. In 1965, it was 13 percent—a rise of more than 40 percent over the 1960 level.

At this rate of return, the average manufacturing company would, in less than 8 years, earn enough after taxes to double its stockholders' equity. And stockholders' equity—the value of the stockholders' investment—includes, in addition to the original investment in stocks, all accumulated surplus (derived mainly from undistributed profits).

Using the rate of return on stockholders' equity as the profitability yardstick, Forbes magazine earlier this year indicated the extent to which many corporations were bursting at the seams with profits in 1965. The number one ranking went to Eastern Air Lines, which had a rate of return of over 50 percent. In other words, it was earning money at a rate which

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would, in effect, double its stockholders' investment in two years! For General Motors, which ranked 12th, the pace was somewhat slower. At the rate which GM was generating income in 1965—26 percent return on equity—its stockholders would have to wait four years for their investment to double.

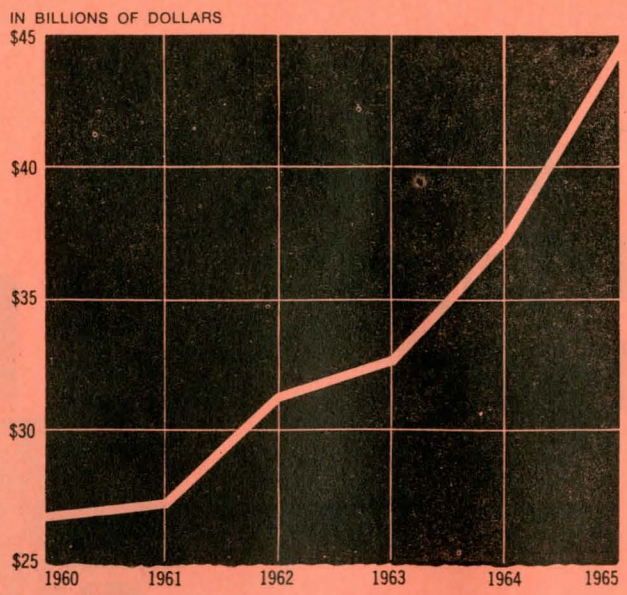
That was the kind of year it was. Profitwise, 1965 was spectacular and stunning as the steady upward spiral of profits continued. And it has carried over into 1966 as profits continue to skyrocket.

Moreover, businessmen's expectations for the second quarter of 1966 are bullish and optimistic, according to Dun and Bradstreet, Inc.

Seventy-five percent of the 1,465 businessmen reporting on expectations are looking for net profits to increase. Of the remaining 25 percent, only 2 percent foresee a decline, while 23 percent predict no change.

It was only a few years ago that businessmen were complaining of a "profit squeeze." This legend of a "profit squeeze" was put to rest as financial report after financial report showed the earnings of American corporations zooming steadily upward.

CORPORATE PROFITS AFTER TAXES



Source: U. S. Department of Commerce.

Rising Profit Margins

As a matter of fact, most corporations are in a very comfortable situation. Not only are sales and profits spinning upward to new heights; profit margins on each item of sales also have been increasing.

Profit margins change as changes occur in cost per unit, including labor costs, or in the price charged for the product or as changes occur in both cost and price. Thus, even when prices are steady, profit margins can increase if costs decline.

Profit margins also can increase even when the cost per unit increases. This would come about with a rise in prices that more than compensates for any increase in unit costs.

With this in mind, it is easy to see why profit margins have shown such a surge during the sixties. Prices have been inching up. At the same time, increases in productivity, or efficiency, in a key sector—manufacturing—have been outstripping wage gains. As a result, unit labor costs in manufacturing have declined—by eight-tenths of one percent last year, according to the Economic Report of the President. And, as a matter of fact, they have been declining almost steadily since 1960.

The net effect of these two occurrences during the 1960s can be readily seen in the President's Economic Report. In 1960, for manufacturing corporations, the after-tax profit per dollar of sales amounted to 4.4 cents. In 1962, the figure was 4.5 cents. By 1964, it had jumped to 5.2 cents. And last year it was 5.6 cents. Thus, between 1960 and 1965, the after-tax profit margin on each dollar of sales increased by more than 25 percent.

Windfalls from Government

All this time, of course, the volume of sales was rising rapidly. As a result, the two factors were increasing simultaneously—more items were being sold and the profit on each item sold was growing.

But there also are other reasons for the upward surge in profits, not the least of which has been the attitude of the federal government in its tax policies.

The biggest single bonanza has been the 1964 tax law. It reduced corporation income taxes from a 52 percent rate down to 48 percent. That tax cut has had the effect of increasing corporate after-tax profits by about $3 billion.

Another recent windfall to the corporate kitties was the 7 percent investment tax credit enacted in 1962. This credit—which reduces tax liability by 7 cents for every dollar invested in new equipment—has added about $2 billion to after-tax profits of corporations.

Finally, the point must be made that corporate profits—high as they are—are actually understated. The federal government made this possible by liberalizing depreciation allowances, first in 1954 and again in 1962.

Prior to 1954, government regulations regarding depreciation—the amounts which businessmen legitimately deduct from gross income to compensate for the wear and tear on plants and machines—were generally determined by dividing the cost of an item by the number of years of its useful life. Under this system a $10,000 machine with an expected life of ten years would be depreciated at the rate of $1,000 a year for ten years.

But action was taken in 1954 and 1962 to liberalize these regulations and to allow the cost of plant and equipment to be deducted at a much more rapid rate. As a result of these changes, the depreciation costs in the recent past have been far greater than they ordinarily would have been had the regulation changes not been made. Like any other cost, larger depreciation write-offs mean correspondingly lower

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profits. These changes have meant additional billions were added to depreciation costs and subtracted from what normally would have been profits.

As a result of the 1962 action to speed up depreciation costs, current corporate tax liabilities have been reduced by approximately $1.7 billion. When this tax saving is added to the $3 billion resulting from the tax cut in 1964, and to the $2 billion resulting from the 1962 investment tax credit, the magnitude can be readily seen. The entire package represents a bonanza of $6.7 billion in 1966.

Depreciation charges are, of course, a legitimate cost of doing business. But when a firm is given an extra $1 million deduction for depreciation, it ends up with $480,000 in the corporation till which ordinarily would not have been available. Without the opportunity to step up its depreciation charges, the $1 million would have been treated as income and the $480,000 would have been the tax (at the 48 percent rate) on that income. Thus, when depreciation allowances are speeded up, more and more dollars are made available, at that moment in time, to corporations.

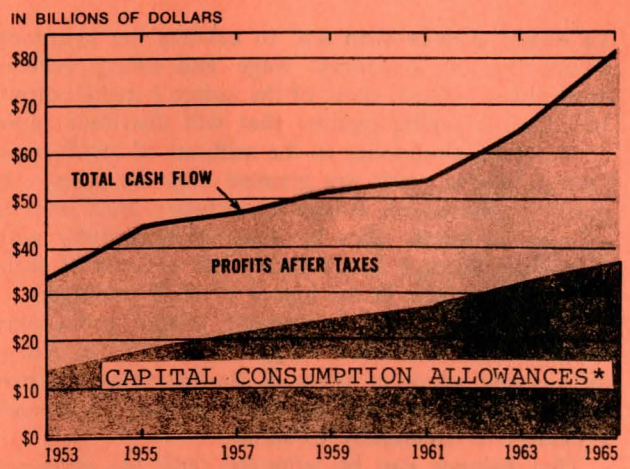
"Cash Flow"—A Growing Hoard

The role of depreciation allowances and the methods by which they are computed cannot be minimized, for these procedures are an integral part of the corporate financial picture. The sheer magnitude of these allowances make them a vital factor in any corporate financial analysis. In 1960, these allowances totaled $24.9 billion; by 1965 they had risen to $36.1 billion.

Increasingly, there has been growing recognition of the significance of corporate depreciation allowances. It has become an accustomed practice when analyzing a corporation's financial picture to look not only at the corporation's profits and the ratio of profits to stockholders' equity, but also to look at the "cash flow"—profits after taxes plus depreciation reserves.

It is, after all, cash flow which best describes the real financial strength of the company—the amount of money the company generates, after payment of all costs and taxes. For it is cash flow—especially when looked at in relation to the stockholders' equity—that will tell a potential investor how well a company is doing and what its resources are—resources from which to pay wages and dividends and/or to expand investment in plant and equipment.

THE CORPORATE CASH FLOW†



† The corporate "take" out of production, after payment of all costs and taxes.
** Primary depreciation allowances.*
Source: U. S. Department of Commerce.

It is in connection with the growth of this cash flow to corporations that one gets a real sense of the massive movement of money into corporate treasuries. Between 1960 and 1965, total cash flow to all corporations grew from $51.6 billion to $80.5 billion or 56 percent. And "retained" cash flow—that is, after payment of record-level dividends—grew from $38.2 billion to $61.6 billion—a staggering 61 percent.

Moreover, 1965's total cash flow came to 19.8 percent of the corporate gross product—that is, the value of all goods and services produced by corporations. The corporate take-out of production has not been this large since the extremely abnormal year of 1950.

This tremendous and growing hoard of cash has serious implications for the economy. The corporations are taking in more money in undistributed profits and depreciation reserves—"retained" cash flow—than they have been able to invest in new plant and equipment—even with the investment boom that has been in progress for the last three years. In 1965 alone, for all non-financial corporations, the excess came to $7.8 billion. And, since 1959, it totals $40.9 billion.

Some of these excess funds have found their way overseas as more and more corporations invest abroad—and thereby contribute to the nation's balance of payments problem. Moreover, a new trend has developed—the "self-cannibalization" that is occurring among many corporations. This fact was brought home by Leo A. Guthart just one year ago in the Harvard Business Review.

Guthart found 651 different corporations which were listed on the New York Stock Exchange that were in the business of re-acquiring their own common stock shares during the decade 1954 to 1963. Since the cash available to corporations increased in 1964 and 1965, there is every reason to believe this trend has continued.

The President's Economic Report for January 1966 shows that all non-financial corporations (all corporations, except banks and insurance companies) actually reduced their outstanding stock in 1963 by $300 million. In 1964, their net increase of stock was only $1.4 billion and in 1965 merely $200 million, despite the sharply rising investments in plants and machines from $35.7 billion in 1963 to $49.1 billion in 1965.

Boom and Bust

By far the most important immediate consequence of all this loose cash in the corporate treasuries—when combined with the incentives provided by the

tax laws—is the investment boom that it has generated. This boom is now in its third year. Most analysts agree that, like such booms in the past, this one, too, cannot be sustained. It is creating imbalances because it is adding to productive capacity too rapidly. The purchasing power of the population—especially the low- and middle-income groups—is not growing at the pace that would be needed to buy the goods that will flow from all this new investment.

The nation's most recent experience with such a trend occurred just about 10 years ago. Then, following the incentives for investment that came with the 1954 tax changes, there was a boom in expenditures for new plant and equipment. These expenditures soared in 1955 and 1956. But, in 1957, as idle productive capacity increased, businessmen began to cut back on these outlays. Eventually, the impact of this action was felt throughout the economy and, by 1958, unemployment had climbed to more than 7 percent of the labor force.

The lesson from history is clear. The increases in spending for plant and equipment cannot continue for long to rise faster than increases in total demand.

Not only can this trend not be sustained. It is creating distortions in the economy. At the present time, for example, it is generating pressures on prices through its excessive demand for materials.

The rise in prices has led to much talk about the need to "slam on the brakes" in order to slow down the economy. What is needed, however, is a slowing down of just one sector—business investment in plant and equipment—because it is such an important factor in the pressure on prices.

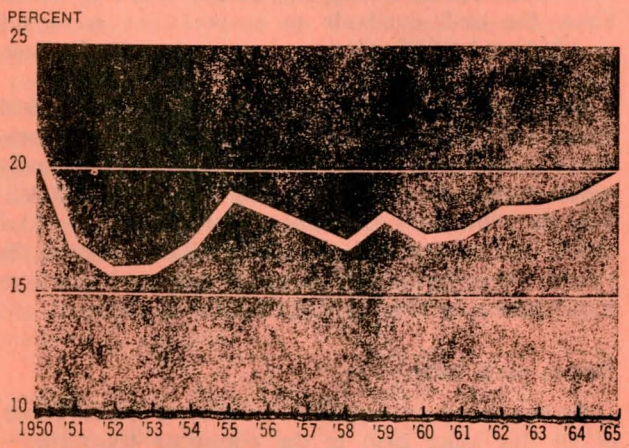
Tighter money—the classical approach to an economy that is heating up—has not had any visible effect on the problem. The high interest rates have not deterred the corporations. This is because corporate cash hoards are so great they have been able to finance the investment boom out of internal sources of funds.

On the other hand, the higher interest rates have hurt residential construction and they have very likely curtailed state and local government expenditures for much-needed public services.

There is a need to be selective. The source of the present problem lies mainly in the large sums of cash that have been accruing to the corporate coffers and the incentives to business for excessive outlays for plant and equipment. And it is here—in the 7 percent investment tax credit, in the reduced corporation income taxes and in the liberalized depreciation allowances—that an answer must be sought.

Moreover, the economy is not yet operating at full employment and it has unused productive capacity. There are about 3 million workers still unemployed and over 1½ million workers forced to work part-time because full-time jobs are not available. Under these circumstances, the country cannot afford to have the entire economy slow down simply because of the problems generated by one sector.

HOW MUCH CORPORATIONS TAKE OUT OF CORPORATE OUTPUT*



The corporate cash flow (after-tax profits plus depreciation allowances) as a percent of corporate gross product. This is the corporate "take," after payment of all costs and taxes, out of the value of corporate production.

Source: U. S. Department of Commerce.

The Need for Balance

When dividends, profits and corporate cash flow rise too fast in relation to other forms of income, the chance to maintain adequate production and job growth is undermined. This is true because the soaring business returns are too often gained at the expense of family income and consumers lack enough money to buy the rising volume of goods and services that are produced. As the rise of sales lags behind industry's capacity to produce, the amount of idle plants and machines increases and ultimately a production downturn occurs.

Thus the present economic expansion cannot continue too much longer if profits persist in rising so much faster than family buying power. And unless public and private economic policies are redirected in order to raise the ability of millions of families to consume, it is evident that the current profits boom will lead to trouble.

To avoid a recession and to achieve the necessary balance in the economy, wage and salary earners must obtain a fairer share of the nation's rising output. In addition, public policies that will distribute more of the rising abundance to the millions of low-income families whose needs are greatest must be vigorously pursued. Moreover, American industry must help to sustain maximum sales by sharing more fully with the public through lower prices the benefits of technological progress in the highly efficient industries.

In the short run, the present profits boom may enrich a few. But these staggering profits, gained at the expense of other parts of the economy, destroy the chance for balanced economic growth. And such a balance is absolutely essential.

That balance can be achieved, and the economy can continue to grow—without recurring ups and downs—only if all groups in society share fairly in economic progress.