1005

CAPITAL FORMATION AND INFLATION

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

SECOND SESSION

JUNE 18, 1980

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CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:35 a.m., in room 2128, Rayburn House Office Building, Hon. Chalmers P. Wylie (member of the committee) presiding.

Present: Representative Wylie.

Also present: John M. Albertine, executive director; Charles H. Bradford, minority counsel; Paul B. Manchester, Susan K. McGinnis, and Mayanne Karmin, professional staff members; Betty Maddox, administrative assistant; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE WYLIE, PRESIDING

Representative WYLIE. The hearing will come to order. Senator Bentsen has been unavoidably detained this morning, Mr. Williams, and copies of his opening statement will be made available, from which I will borrow generously and also will borrow some of the charts which he has made available to us.

The House went in session at 10 a.m. I notice that right now there is a vote on. So what I would like to do is run to the House floor, make my vote, and I promise to be back in 10 minutes, maybe 5.

[A short recess was taken.]

Representative WYLIE. For the last 1½ years, the Joint Economic Committee has been stressing the importance of increasing our rate of productivity growth, which has recently been the lowest among the major industrialized nations. The drop in our productivity growth rate has been a significant cause of our worsening inflation and falling real wages. Economists agree the greatest single cause of this slowdown has been the inadequate rate of capital formation.

To encourage capital formation, as well as to provide the means of financing it, we must have adequate, nonillusory aftertax rates of return on investment. There is a great deal of confusion on this issue. On the one hand, we read in the newspaper about record profits, and critics charge that industry's returns are excessive or even obscene.

But the reported data is misleading because it fails to take inflation into account. Inflation depresses the growth of business activity, job formation, and wages by interfering dramatically with depreciation. The tax code only permits a tax deduction of the historical cost of plant, equipment and inventory. When inflation increases the cost of new plant, equipment and inventory, and the firm finds the money it

has set aside for replacement is inadequate, it must use taxable income to supplement its depreciation allowances just to maintain its productivity capacity—just to stand still.

Thus actual economic depreciation is understated and profits are overstated. Inflation disallows the deduction of a real cost of doing business, increases the firm's tax liability, and reduces its ability to grow.

The results are clear. The United States is becoming a third-rate industrial power. The country is not even investing enough just to replace wornout equipment and to provide new workers with the tools to do their jobs. Capital per worker is falling. Productivity and real average weekly earnings are falling. Real spendable earnings for the average worker have fallen below the levels of 1964.

The United States simply cannot afford the social and military consequences of falling living standards and a declining industrial base.

In Michigan today they are selling bumper stickers that read: "Unemployment, Made in Japan." I think that today's hearing will prove that the truth is: "Unemployment, Made in Washington."

These issues are summarized in these four charts [indicating], and I would like to direct your attention now to chart No. 1 over here, which Senator Bentsen had made up for the Joint Economic Committee, which shows apparent total profit and profit corrected for the gains arising solely from inventory and understated depreciation allowances. This illusory profit amounted to more than $57 billion last year. Corrected profit was only 70 percent of that apparent profit.

It should be noted that all of this data is in current dollars. If it were expressed in 1972 dollars, growth rates for all of these series would be much lower and possibly negative.

Of course taxes must be paid on apparent profit, because depreciation charges are based on historical cost, and inventory profits for firms who have not switched to last-in-first-out—LIFO—accounting are fully taxed.

Now, chart 2 shows the apparent tax rate: 40 percent last year; but if taxes are divided by adjusted profits, a higher corrected tax rate is obtained, 57 percent last year, the highest in this decade except for 1974.

Profits after taxes with and without these adjustments for inflation are shown on chart 3. Last year, corrected aftertax profits were just about one-half of apparent aftertax profits. This was the lowest ratio of the 1970's except for 1974.

Now, the most dramatic results are shown on chart 4, where apparent and corrected retained earnings are compared. Since retained earnings become a crucial source of funds for reinvestment in capital formation, these data are particularly troublesome.

Corrected retained earnings last year were only one-seventh of apparent retained earnings. In 1974, corrected retained earnings were actually negative. Dividends were maintained only by, in effect, liquidating some of the assets owned by the nonfinancial corporate sector.

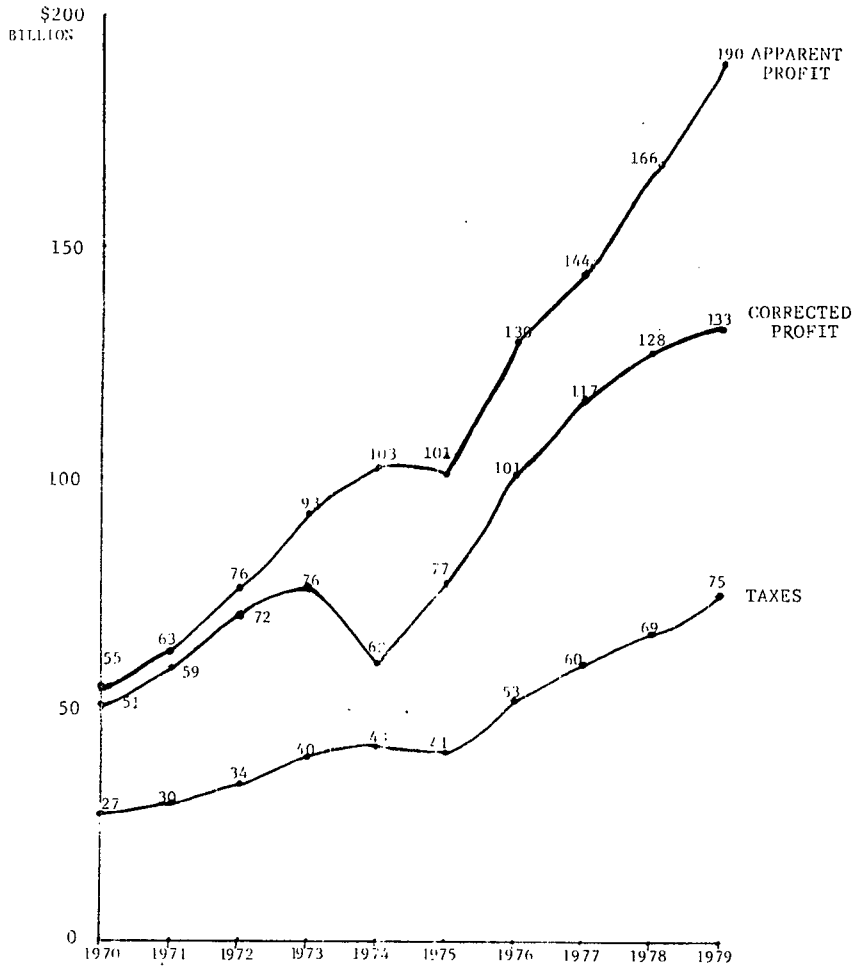
So taken as a whole these charts indicate the need to stimulate capital formation by providing tax relief somewhere to offset the adverse impacts of inflation.

This year for the first time, we also have detailed inflation-adjusted data for individual companies as a result of a new standard issued by the Financial Accounting Standards Board, and we will hear more about that in today's hearing. We have delayed you too long, Mr. Williams, for which I apologize. But I do want to get these charts into the record.

[The charts referred to follow:]

CHART 1

APPARENT PROFIT, PROFIT CORRECTED
FOR INFLATION, TAXES
1970-79

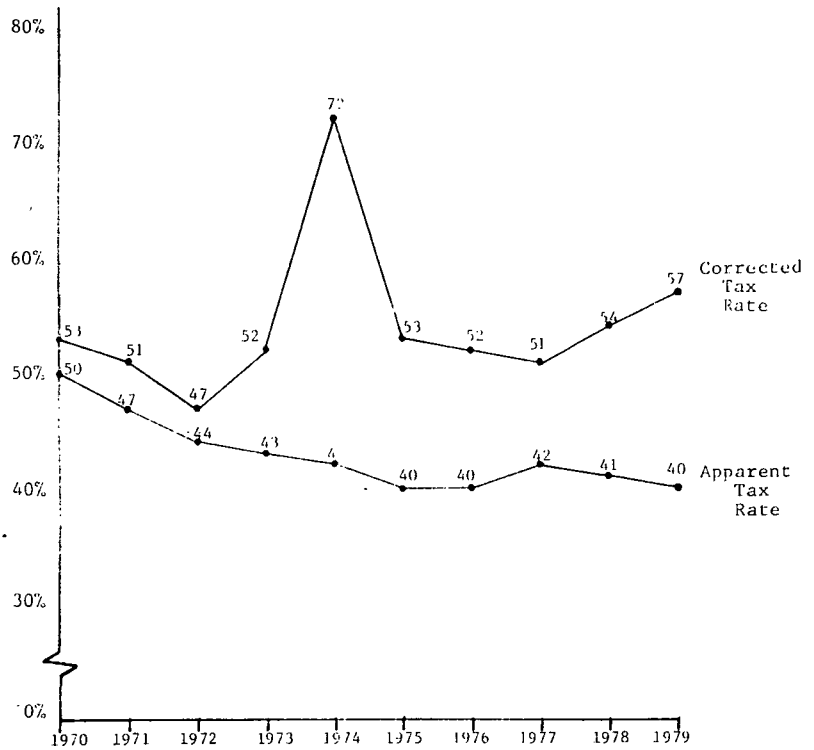


Source: Department of Commerce

CHART 2

APPARENT AND CORRECTED
TAX RATES

1970-79

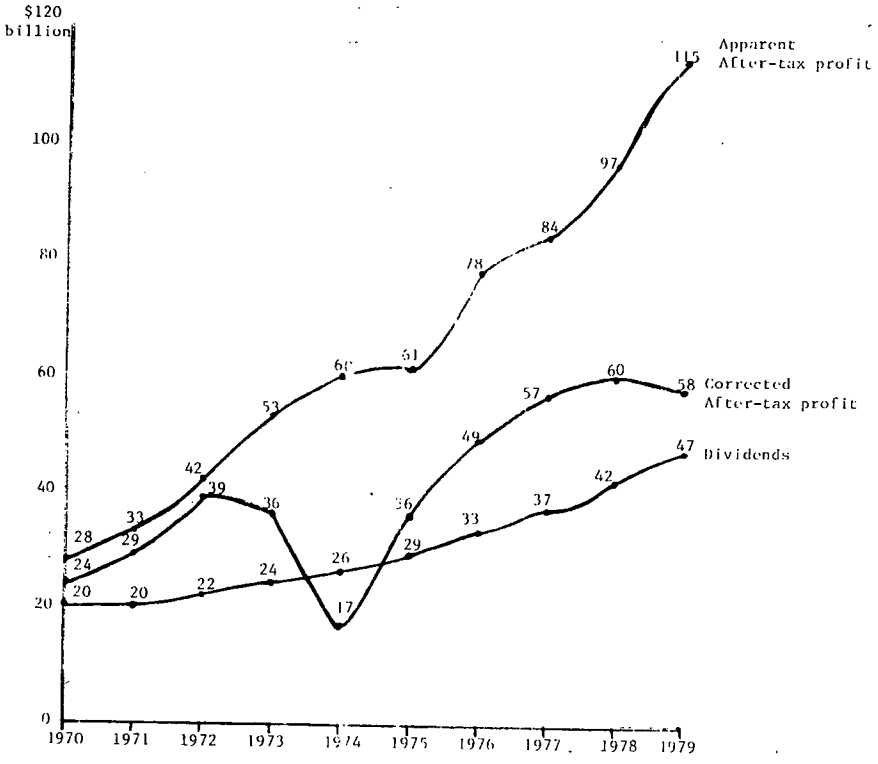


Source: Department of Commerce

CHART 3

APPARENT AND CORRECTED AFTER-TAX
PROFITS, DIVIDENDS

1970-79

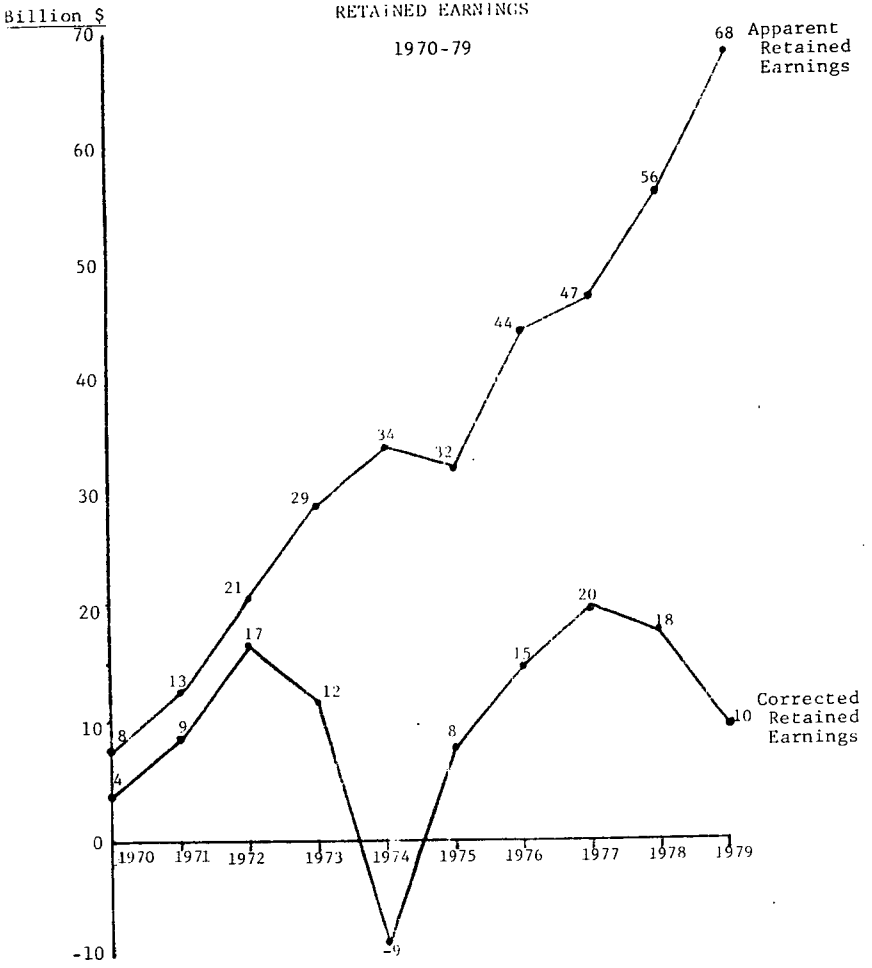


Source: Department of Commerce

CHART 4

APPARENT AND CORRECTED
RETAINED EARNINGS

1970-79



Source: Department of Commerce

Representative WYLIE. We will hear from the Honorable Harold M. Williams, who is Chairman of the Securities and Exchange Commission.

STATEMENT OF HON. HAROLD M. WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C.

Mr. WILLIAMS. Thank you, Congressman. I can't imagine a more important issue to be talked about today. I appreciate this opportunity to testify concerning inflation accounting, which is intended to reflect the impact of inflation and changing prices on the operations and financial condition of individual companies.

As the committee may be aware, the Commission has been a strong advocate of inflation accounting as a means to provide investors with financial information material to their investment decisions. It has been our belief that financial information prepared according to inflation accounting principles enables investors to obtain more relevant information about the current economics of a business enterprise which has experienced significant inflation than do financial statements prepared on the basis of historic cost.

Thus, the Commission was pleased when, last September, the Financial Accounting Standards Board issued its Statement of Financial Accounting Standards No. 33, requiring the reports of certain large, publicly held companies to disclose financial information prepared according to two accounting methods designed to communicate the effects of inflation.

The first—constant dollar accounting—generally translates traditional historic-cost financial reports according to general price increases. The second method—called current cost accounting—is based on the replacement cost of the specific company's assets and expenses.

Statement No. 33 represents an extraordinary milestone for the accounting profession—and not merely because it departs from the profession's exclusive reliance on historic-cost-based accounting. Rather, its greatest importance may be in its message of the profession's willingness to address difficult issues in an innovative, conceptional mode.

Statement No. 33 is not held out as a definitive standard on inflation accounting. Instead, it recognizes that the state of the art does not permit a definitive standard, that a degree of experimentation is called for, and that such important issues cannot await formulation of a perfect solution. However, while there may prove to be a need to further perfect the methodologies of inflation accounting, the present standards are well enough developed—and are much more informative and accurate for these purposes—to justify confidence in their use for establishing orders of magnitude. This is particularly true because, in addition to providing minimum standards for disclosure, statement No. 33 urges all companies to provide whatever additional information would make the financial information more meaningful in relation to their specific situations.

It is my understanding that, in his testimony today, Donald Kirk of the Financial Accounting Standards Board will discuss the technical aspects of statement No. 33. I will, therefore, devote the balance of my statement to the important—and disquieting—picture of the eco-

nomic health of American industry that has been revealed by applying inflation accounting methods to financial reporting, as well as some ramifications of that condition.

The press, financial analysts and others have been analyzing the data reported by American business for the year 1979. Price Waterhouse & Co., Inc., an international accounting firm, whose chairman, Joseph Connor, will also testify before this committee today, recently released its analysis of these inflation-adjusted financial reports for a significant number of the Nation's largest companies. The study, which is the broadest based yet released, provides a composite perspective of American industry significantly different than that provided by historic-cost accounting procedures. It shows that inflation-adjusted corporate income among the industrial companies included in the analysis is only 60 percent of the figure that had been reported, under traditional accounting methods, to represent corporate income. And, the 40-percent disparity would have been even greater except that it excludes companies for which the adjustment results in a loss.

Since corporate income is substantially lower than previously perceived, distribution is a much higher percentage of income than traditional measures and not rules of thumb have reflected. For example, it was widely noted that corporations for 1979 are taxed at an effective corporate tax rate of 39 percent, as contrasted to a 48-percent theoretical tax rate.

In fact, inflation acounting methods reveal that the composite of industrial corporations pay a significantly higher—53 percent—real tax rate. Similarly, the general assumption, using historic-cost accounting, had been that cash dividend payments on common stock are about one-third of corporate aftertax income, when in reality they are double—two-thirds of inflation-adjusted income after taxes.

Most disturbing, however, is that the aggregate of those composite figures for taxes and dividends paid on an inflation-adjusted basis approaches—and in some industries exceeds—corporate income. That means that much of the corporate community is distributing as taxes and dividends, more than its real income. These figures indicate that portions of the industrial sector must be paying their taxes and dividends out of capital resources. That, for all practical purposes, means that a substantial part of American industry—the historic keystone of our prosperity—is in liquidation.

For years we have been warned of such hidden costs of inflation. Statement No. 33 has revealed these costs, and, in my opinion, they may be more than our economy can reasonably be expected to bear. Indeed, these figures show that so-called record—some say "obscene"—levels of profit, in real terms, fall far short of meeting the ongoing capital requirements of this Nation and, indeed, represent the liquidation of our corporate sector.

This disparity between perceived and real profit levels exists because, under historic-cost accounting, figures thought to represent profits are swollen by including inventory appreciation—even when the inventory necessarily must be replaced—and by depreciating fixed assets based on original prices—even when the replacement costs are much greater. In short, under inflationary conditions, the conventional measures of profits and profitability have proven grossly misleading.

However, the capital markets—to which corporations essentially deprived of real retained earnings must turn for capital—cannot rationally allocate resources on the basis of misleading financial information, such as characterizing payouts of capital as dividends from profits. And, any misallocation is particularly critical because, in inflationary times, investment capital becomes unusually scarce as the erosion of wealth and decreasing real income squeeze savings and frustrate equity investing.

I do not think it is necessary to elaborate at length on the economic and social price which we would pay over time for inadequate or irrational capital allocation. The ability of U.S. products to compete in world markets depends on our ability to develop new technology—and to minimize the growth in unit labor costs—all of which depend on capital investment.

Another major issue which these trends raise is whether the U.S. economy will grow in the coming decade at a rate sufficient to absorb new entrants into the labor force. Unemployment and underemployment are directly related to capital investment.

Representative WYLIE. Mr. Williams, I must respectfully ask if you will suspend for a few moments again. There is a call for a quorum. You have a very important statement with some very important thoughts for this committee, which we will receive. I want to give you all the time within the framework of your time limitations that you need.

But again, if I may be excused for 15 mintues.

Mr. WILLIAMS. I will be here.

[A short recess was taken.]

Representative WYLIE. I'm sorry for the interruption, but I did not call the quorum call. So would you please proceed with your statement.

Mr. WILLIAMS. Thank you, Congressman.

I was discussing some of the implications, both economically and socially, of inadequate capital allocation. I had touched on the need to develop new technology and minimize growth in unit labor costs and the need to absorb new entrants into the labor force.

Similarly, the productivity of U.S. industry depends on the growth of capital per worker. Increases in employee compensation—whether in wages or benefits—are inflationary if not matched by increased productivity; thus, further squeezing profits and increasing inflationary pressures.

Moreover, the capital shortage problem is particularly serious for growth companies. The strength and vitality of growing companies—large and small—are key to the future of our country. They are the source of much of our technological innovation, the nucleus of new industries, and the major creator of new jobs on which both our economic and social future depend.

Finally, the capital squeeze not only impairs investments in plants and equipment, but it also generates a conservatism on the part of management which adversely affects investment spending in research and development for new products, processes, and services.

While the urgency of this crisis was not fully documented previously and not understood by many, I believe that sophisticated market

professionals and investors have instinctively understood the reality and acted to mitigate the misleading of the capital markets. As an illustration, the reason, in my opinion, that some capital-intensive industries are selling at extraordinarily low price-earnings ratios is not because of erroneous undervaluations. After all, stock investments are, in reality, a risk purchase of a share in a corporation's future income stream. These low price-earnings ratios appear to reflect a skepticism of the adequacy of the future dividend potential of much of American industry to provide an appropriate and competitive aftertax return for that risk. They recognize the industry's current inability to recapitualize adequately to assure it ability to be competitive in the future. Indeed, this appreciation that inflation has particularly severe consequences on certain industries argues the greater relevance of current cost accounting—which discloses the effects of inflation on each corporation—compared to constant dollar accounting—which merely reflects across-the-board price increases that may not fully communicate the condition of the specific corporation or industry.

While providing such inflation-adjusted financial information to investors is the Commissioner's primary interest in encouraging the development of these accounting methods, inflation accounting also provides a more informed basis for other economic decisionmaking. For example, it is particularly urgent that business adopt inflation-adjusted internal accounting practices—and I understand that a number of companies are already doing so. In many cases, inflation-adjusted information will have a significant impact on intelligently assessing and controlling corporate costs—such as the relation of increasing labor costs, which are often influenced in their negotiation by overstated profit figures, to real productivity. And, accurate inflation-adjusted information is necessary for realistic pricing, as well as for a rational level of dividend payouts based on real corporate profits. Of course, in other instances, these figures will reveal that some lines of business are no longer viable in inflationary times and should not consume valuable capital resources.

The availability of inflation-adjusted financial information also should precipitate a reassessment of governmental policies toward business—particularly, regulatory and tax policies, both of which are now tied to erroneous perceptions and obsolete accounting methods which distort what our economic system can afford.

Although Government policies, particularly tax policies, are generally thought to involve the transfer of income to finance social responsibilities and goals, we are now aware that much of business is in the dangerous process of liquidating its capital, in large part, to comply and pay its tax bills. It is, therefore, urgent that we consciously consider whether this situation represents the best possible balance between, on the one hand, the public's need to finance programs directed to critical social problems and, on the other, our interest in facilitating the healthy and profitable private sector that generates the real wealth which could resolve many of these problems.

Finally, I should emphasize that, even with the widespread application of inflation accounting principles to accurately communicate the condition of economic entities and to provide for more rational deci-

sionmaking, we must not avoid confronting the underlying economic problem, which is the sustained existence of inflation. Indeed, one of the most important aspects of inflation accounting is that it documents to national policymakers the already heavy punishment which our industrial capabilities have sustained from a period of continuing inflationary pressures. But current financial reports, as disquieting as they are, can only suggest the terrible consequences that await this Nation if this trend continues and accelerates. We have been provided with a warning which we cannot ignore: Controlling inflation must be the first priority of our Nation's economic policy.

Thank you, Congressman.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF HON. HAROLD M. WILLIAMS

Congressman Wylie and Members of the committee: I appreciate this opportunity to testify concerning inflation accounting, which is intended to reflect the impact of inflation and changing prices on the financial condition of individual companies. As the committee may be aware, the Commission has been a strong advocate of inflation accounting as a means to provide investors with financial information material to their investment decisions. It has been our belief that financial information prepared according to inflation accounting principles enables investors to obtain more relevant information about the current economics of a business enterprise which has experienced significant inflation than do financial statements prepared on the basis of historical cost.

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[1] Price Waterhouse & Co., Disclosure of the Effects of Inflation : An Analysis (May 1980).

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For years we have been warned of such hidden costs of inflation. Statement No. 33 has revealed these costs and, in my opinion, they may be more than our economy can reasonably be expected to bear. Indeed, these figures show that so-called record—some say "obscene"—levels of profit, in real terms, fall far short of meeting the ongoing capital requirements of this Nation and, indeed, represent the partial liquidation of our corporate sector.

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Moreover, the capital shortage problem is particularly serious for growth companies. The strength and vitality of growing companies—large and small—are key to the future of our Country; they are the source of much of our technological innovation, the nucleus of new industries, and the major creator of new jobs on which both our economic and social future depend.

Finally, the capital squeeze not only impairs investments in plants and equipment, but it also generates a conservatism on the part of management which adversely effects investment spending in research and development for new products, processes and services.

While the urgency of this crisis was not fully documented previously and not understood by many, I believe that sophisticated market professionals and investors have instinctively understood the reality and acted to mitigate the misleading of the capital markets. As an illustration, the reason, in my opinion, that some capital intensive industries are selling at extraordinarily low price-earnings ratios is not because of erroneous undervaluations. After all, stock investments are, in reality, a risk purchase of a share in a corporation's future income stream. These low price-earning ratios appear to reflect a skepticism of the adequacy of the future dividend potential of much of American industry to provide an appropriate and competitive aftertax return for that risk. They recognize its current inability to recapitalize adequately to assure its ability to be competitive in the future. Indeed, this appreciation that inflation has particularly severe consequences on certain industries argues the greater relevance of current cost accounting—which discloses the effects of inflation on each corporation—compared to constant dollar accounting—which merely reflects across-the-board price increases that may not fully communicate the condition of the specific corporation or industry.

While providing such inflation-adjusted financial information to investors is the Commission's primary interest in encouraging the development of these accounting methods, inflation accounting also provides a more informed basis for other economic decisionmaking. For example, it is particularly urgent that business adopt inflation-adjusted internal accounting practices—and I understand that a number of companies are already doing so. In many cases, inflation-adjusted information will have a significant impact on intelligently assessing and controlling corporate costs—such as the relation of increasing labor costs, which are often influenced in their negotiation by overstated profit figures, to real productivity. And, accurate inflation-adjusted information is necessary for realistic pricing, as well as for a rational level of dividend payouts based on real corporate profits. Of course, in other instances, these figures will reveal that some lines of business are no longer viable in inflationary times and should not consume valuable capital resources.

The availability of inflation-adjusted financial information also should precipitate a reassessment of governmental policies towards business—particularly, regulatory and tax policies, both of which are now tied to erroneous perceptions and obsolete accounting methods which distort what our economic system can afford. Although government policies, particularly tax policies, are generally thought to involve the transfer of income to finance social responsibilities and goals, we are now aware that much of business is in the dangerous process of liquidating its capital, in large part, to comply and pay its tax bills. It is, therefore, urgent that we consciously consider whether this situation represents the best possible balance between, on the one hand, the public's need to finance programs directed to critical social problems and, on the other, our interest in facilitating the healthy and profitable private sector that generates the real wealth which could resolve many of these problems.

Finally, I should emphasize that, even with the widespread application of inflation accounting principles to accurately communicate the condition of economic entities and to provide for more rational decisionmaking, we must not avoid confronting the underlying economic problem, which is the sustained existence of inflation. Indeed, one of the most important aspects of inflation accounting is that its documents to national policymakers the already heavy punishment which our industrial capabilities have sustained from a period of continuing inflationary pressures. But current financial reports, as disquieting as they are, can only suggest the terrible consequences that await this Nation if this trend continues and accelerates. We have been provided with a warning which we must not ignore: Controlling inflation must be the first priority of our Nation's economic policy.

Representative WYLIE. Thank you, Mr. Williams, for your excellent statement. And I want to commend you for working with the Financial Accounting Standards Board to require inflation-adjusted financial statements from the hardest hit companies.

The information you obtain from this procedure I think is absolutely vital if we are to awaken the Congress to the precarious position of U.S. industry and to the urgent need for action. So I compliment

you for getting that information together and for your thought-provoking statement.

What we want to do is to try to be fair with American business. I think everybody agrees that we need more capital to increase worker productivity, and I think, by and large, American business has kept faith with our democracy by hiring more than 20 million new people over the past 10 to 12 years. These people came into the labor force because they became of age or, in the case of many women, their families had been raised, and they wanted a second career.

So American businessmen have given them a chance, it seems to me. And I think it's appropriate for the political establishment to return the favor. These businessmen have hired these 20 million people, and the 20 million people now need equipment and capital to increase their own productivity. I think we in Congress have to come up with a program to help business obtain this needed capital for their employees to work with, so business can increase worker productivity.

Do you generally agree with that statement?

Mr. WILLIAMS. I would in principle, Congressman. I think our ability to absorb the large increment in the work force in the past decade has indeed been a very significant one. It should temper our judgment as to what constitutes an acceptable level of unemployment as well.

I would suggest these decisions to hire on the part of industry must, of course, by and large be sound economic decisions, and the ability to retain them must similarly be. And I think they would show, although I don't have the evidence myself, that we are experiencing a decline in productivity that probably relates in part to the quality level of education in this country.

But I think our ability to remain competitive in this country and world markets is going to depend upon our ability to maximize the productivity of our work force, both through educational programs and primarily though increased capital.

Repesentative WYLIE. You say you think the decline of productivity is related somewhat to the decline in education?

Mr. WILLIAMS. I believe so, yes, sir.

Representative WYLIE. Not on the number of people going into the schools, but on their ability to do the kind of work available?

Mr. WILLIAMS. I think the educational quality that's coming out of our public schools today is not what it has been. And it may be that the skill level required of much of our work force is growing, and it will continue to do so. The country is in a sense becoming aware at this point of technological advances like robots, and we will be needing more people who can operate the robots.

Representative WYLIE. Let me get into another direction. I'll pursue that perhaps a little bit later on. But in order to increase productivity, I've been thinking—during my service here on the Joint Economic Committee and on the Banking Committee, that perhaps what we really need is some sort of an increase in investment tax credits, some way to directly stimulate new investment.

I'm not saying that we should do that and mutually exclude or exclude any other possibility, but what would you think of increasing investment tax credits relative, say, to liberalized depreciation allowances or other forms of tax relief?

Mr. WILLIAMS. This is an area I have thought about in the past, but I am not sure I have all the relevant factors in mind. Historically, one of the concerns of investment tax credit has been commitment. But, we may be overcoming that. I think we need to have some certainty as to what the credit will be for planning purposes, because of the long gap between the time the investment commitment is made and the time the facilities are actually in place and the tax credit becomes operative.

Beyond that, I guess the largest question of investment tax credit that I've heard recently, or that I'm aware of, relates to the narrow limits on what prices of investments are covered by investment tax credit.

Representative WYLIE. I get into that because in your prepared statement you say that part of the problem is that much of the corporate community is distributing more than its real income in taxes and dividends. And I think, if you take that into account, many firms have had losses in real terms—I think that's reflected on these charts up here—with respect to profits. And I think that maybe these companies in some cases are actually shrinking in size.

Mr. WILLIAMS. I think that's right, Congressman. I think the investment tax credit can address the type of issue you're talking about. There would need to be some structural changes made in it, however. First, one would have to assure its being there when the investments are made. Historically, we have run hot and cold on investment tax credit. Second: I think there have been some areas excluded from the investment tax credit which would have to be reassessed. Third: If I recall correctly, the investment tax credit is only applied against income, so you need a level of profitability to realize the benefit of the investment tax credit. The companies that are not adequately profitable are small companies, where perhaps the need might be the greatest. They may not quite have the benefit from the investment tax credit that would be desired as an incentive.

Representative WYLIE. It used to be argued that stocks were a good helge against inflation, but that certainly hasn't been the case in the last decade and a half, has it?

Mr. WILLIAMS. No, sir, it hasn't.

Representative WYLIE. You mentioned that the stock market seems to have understood the underlying problem of falling real profits—after inflation is taken into account, the market is down. Capital-intensive stocks like steel, utilities, and railroads are down especially sharply.

Could you go into what the market is trying to tell us for just a moment?

Mr. WILLIAMS. Yes, sir. You know, the real benefit of FAS–33 is that it provides a structure and a discipline for the first time for individual companies to translate their own situations into an inflation-adjustment context. But there have been aggregated studies over time—the Department of Commerce figures, and others as well—leading to an awareness that began, I'd say, particularly around 1973–74, that inflation was a debilitating problem and one that would be with us for some time.

Around that time many market analysts began developing their own data as well, industry by industry. And we have a growing

acceptance of something that is called the efficient-market theory, which, in effect, says that that type of information in the hands of sophisticated analysts and investors does translate itself into the market price for individual equities. The parameters are that the companies have to be broadly traded with a sophisticated investment following; that would certainly include most, if not all, of the companies of size where there are large, publicly owned equity positions.

What this tells us is that the information in at least reasonably sensitive form has been available to the investment community, and I would say, by and large, has translated itself into the market price for most equities, most notably the equities of capital-intensive companies, which today are selling at four and five times earnings under adjustment.

And I think basically that's the reason for it. There's a large skepticism about the ability of those companies to recapitalize themselves and to continue to pay dividends at the level they're paying now.

Representative WYLIE. I guess the point is maybe that the market knows, but maybe we in Washington don't know or haven't paid attention.

Mr. WILLIAMS. I suspect the market knows it best. I suspect management knows it reasonably well, but they haven't in all instances been willing to face it. But certainly the public doesn't know it, Congressman. And I'd say we, in Washington, have not acknowledged it to the extent that we need to.

Representative WYLIE. To what extent has inflation contributed to the problem, the problems in the steel industry and automobile industry?

Mr. WILLIAMS. It's certainly a contributing factor I'd say, in all candor, I can't lay it primarily on inflation. And yet, if I recall correctly, if we go back to about a decade or so or more—probably a decade and a half ago—the steel industry—which had been reporting their earnings on the basis of accelerated depreciation—switched to historic depreciation for reporting purposes, not for tax purposes. I think that was before the impact of our recent higher levels of inflation, which suggests even at that time they were concerned about their market price and about their ability to raise that capital to make the kind of changes they needed to make. Then higher levels of inflation exacerbated the problem which already existed.

Representative WYLIE. Are you planning any further efforts to redefine—say, extend inflation-adjusted financial statements vis-a-vis capital formation?

Mr. WILLIAMS. I would say we have two things at this point. One is an ongoing program to assure as best we can that the individual companies are doing the best they can to provide this data and to interpret it in the context of their companies; second, that the media understand the importance of this information and translate in understandable terms to the public at large and to Washington. Over time, it will probably be 2 or 3 years before we have enough experience—before the FASB has enough experience—to determine whether to narrow the methodology to a single method or what changes to make in the existing methodologies.

But, as I say, I don't think that will be forthcoming, certainly not this year. And I question whether it will be next year.

Representative WYLIE. Mr. Williams, I want to thank you very much for an excellent statement. This is a very interesting one. However, we do have another panel in the wings. Thank you very much for your patience. I am sorry you were interrupted by the quorum calls.

Mr. WILLIAMS. Thank you. I appreciate your interest and time.

Representative WYLIE. Thank you, Mr. Williams.

Now we have Mr. L. Stanton Williams, who is chairman of the board of PPG Industries, representing the Business Roundtable of Pittsburgh, Pa.

Mr. WILLIAMS. Thank you.

Representative WYLIE. Mr. Donald J. Kirk, chairman of the Financial Accounting Standards Board of Stamford, Conn.; and Mr. Herman I. Liebling, former Chief Economist of the Treasury Department, professor of economics at Lafayette College, Easton, Pa.

Mr. Liebling, we want to welcome you to the hearing before the Joint Economic Committee this morning. I'm sorry there aren't more members here, but we have so many hearings going on this morning.

We also have Mr. Joseph E. Connor, chairman of Price Waterhouse & Co. Mr. Connor, would you take your place at the table this morning?

I was told, Mr. Williams, that you have to be back in Pittsburgh at 2 p.m., but I would like to go ahead with one of the other witnesses first because Representative Moorhead said he would like to be here to hear your testimony and to say hello to you, so we're going to tell him that, and in the meantime I think we will proceed to hear from Mr. Donald Kirk.

Mr. Kirk, would you proceed for about 5 minutes. I can tell your statement is probably a little longer than 5 minutes. You might want to summarize, and we'll include your entire statement in the record.

STATEMENT OF DONALD J. KIRK, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD, STAMFORD, CONN.

Mr. KIRK. Thank you, Congressman. I will do as you suggest.

As you introduced me, I am chairman of the Financial Accounting Standards Board, and I will briefly summarize my prepared statement that was delivered to you yesterday.

The FASB's function is important because decisions regarding the allocation of capital—that is, investment and credit decisions—are based on financial information most of which is the product of the financial reporting process.

As you have heard this morning, the traditional accounting model which is often described as the historical cost basis has its deficiencies, particularly in a time of rising prices. It has those deficiencies because it generally measures the depreciation of buildings, machinery, and equipment on the basis of the cost of acquiring those assets, often many years in the past.

In brief, financial reporting by corporations until now has focused on historical cost and nominal dollars and has ignored current costs and the declining value of the dollar. Conventional accounting has served us well when prices were relatively stable, but given the current

level of inflation, it's fair to say that for the most companies some portion of conventional earnings represents an erosion of operating capability. In other words, if all of net earnings after taxes are paid as dividends, companies would not retain enough out of revenues to replace resources used up.

In September of last year, the FASB issued its statement No. 33, Financial Reporting and Changing Prices. The essential requirement of that statement, which applies to the annual financial reports of approximately 1,500 of the largest industrial and financial companies, is the presentation of two supplementary measures of operating income, together with certain other inflation-adjusted information.

The two supplementary measures of income are, first, operating income with cost of goods sold and depreciation adjusted for changes in the general purchasing power of the dollar since that inventory and depreciable assets were acquired. We refer to that as "constant dollar income."

The second one is operating income with cost of goods sold and depreciation measured at current cost at the date of sale or use, and we refer to that as "current cost income."

Statement 33 was effective for annual reports of calendar years 1979 and subsequent years. We have allowed a transition period because of the difficulty of accumulating certain of the information that we are ultimately asking for.

Referring to the requirements of statement 33, the information in constant dollars has two benefits to investors.

First: It enhances comparisons it avoids erroneous judgments that can be made based on financial information expressed solely in nominal dollars.

Second: Investors seek to enhance their wealth not necessarily in terms of nominal dollars but in terms of the command of those dollars over goods and services.

Turning to current cost, current cost matches today's costs with today's revenues rather than yesterday's costs with today's revenues. Accounting for current cost separates the effect of holding assets during a period of changing prices from the results of using or selling those assets. We think that information provides an improved basis for understanding the factors that affect the amount of cash available for distribution, replacement, and expansion out of funds generated internally.

Although the specific prices of goods and services may tend to move in the same direction as general prices, that's not always the case, and there are many examples where specific prices deviate significantly from the general price level change.

We have combined the two methods, general inflation adjustments and specific price adjustments, in the requirements of statement 33.

In addition to our own efforts, the Board has encouraged others to study the impact of statement 33. At present, only a few preliminary analyses have been completed. You will hear a report on one of those from Mr. Connor, and I will not recite any of the findings of that particular study. The findings of that study are consistent in their reporting of lower operating profits and higher dividend payout ratios with a number of other studies that have been made available to the Board and certainly consistent with numerous reports in the press.

What do these alternative income computations and other supplementary disclosures have to do with capital formation?

Capital formation involves a choice between saving and investment on the one hand and consumption on the other. Capital allocation involves selection from among alternative investment opportunities. Capital is formed and allocated largely on the basis of individual investor decisions, and those decisions are based on part on financial information.

We believe that the information called for by statement 33 aids investors in assessing risks and returns, thereby reducing the uncertainties surrounding their investment decisions. The information also may be of benefit to those in Government and elsewhere who are concerned with income tax policy, national income economic policy, and policymaking in general.

As you know and as shown by the charts here this morning, macroeconomists have for years made overall inventory and capital consumption adjustments in preparing national income statistics. Statement 33 should provide them with more detailed and more accurate information.

The Board believes that statement 33 meets an urgent need for information about the effects of changing prices.

The requirements of the statement are expected to promote a better understanding by the general public of the problems caused by inflation. Statements by business managers about those problems are unlikely to have sufficient credibility unless financial reports provide quantitative information about the effects of inflation on business income.

The Financial Accounting Standards Board is not and should not be in a position of advocating any particular tax policies or national economic programs. We believe, however, that we have added some tools for those whose responsibility it is to shape national economic policies.

I appreciate having been invited to appear before the committee. I will be pleased to anwser any question you may have. Thank you.

Representative WYLIE. Thank you very much, Mr. Kirk. We appreciate your statement.

[The prepared statement of Mr. Kirk, together with attachments, follows:]

PREPARED STATEMENT OF DONALD J. KIRK

Good morning. I am Donald J. Kirk, Chairman of the Financial Accounting Standards Board. The FASB is the independent body designated in the private sector—and recognized by the Securities and Exchange Commission—to establish standards of financial accounting and reporting. Those standards are, in effect, rules governing the preparation of financial reports by businesses and other enterprises.

The FASB's function is important because decisions regarding allocation of capital—that is, investment and credit decisions—are based in part on financial information, much of which is the product of the financial accounting and reporting process.

The traditional accounting model—the one by which financial statements of business enterprises have been prepared in the United States since public financial reporting began—is often described as the "historical cost" basis of accounting. When inventories, land, buildings, machinery, equipment, and other assets have been reported in a company's balance sheet, they generally have been measured on the basis of the amount originally paid to acquire those assets, regardless of changes in prices subsequent to acquisition date.

And in measuring its net income under conventional accounting, a company deducts from its current sales revenue the historical cost of the goods that were sold—not their current costs—and deducts as depreciation a portion of the historical cost of buildings, machinery, equipment, and other long-lived assets used in operations, rather than an amount representing the current cost of those long-lived assets at the time they are used.

Not only has accounting traditionally focused on historical costs rather than current costs, but the historical costs represent an aggregation of dollars of varying value in terms of purchasing power. Although individual wage earners have readily recognized that comparing this year's and last year's wage rates in nominal dollars can be illusory, and at the macro level we all seem to understand that meaningful information about growth in the U.S. economy must be measured in terms of "real" or "constant" dollars, financial reporting by corporations until now has focused on nominal dollars and has ignored the declining value of the measuring unit.

While retaining the historical cost/nominal dollar measurement basis, for some time accounting has attempted indirectly to allow for the effects of changing prices by two techniques: One is the last-in, first-out (LIFO) inventory accounting method, by which the cost of the most recently acquired inventories is charged against sales revenues in measuring earnings. The other is the use of accelerated depreciation, which skews the periodic depreciation charges toward the early years of an asset's life.

Those two techniques, at best, are crude attempts to compensate for the higher current costs experienced by businesses. They focus exclusively on income determination and, as a result, play havoc with the balance sheet. Moreover, both are mehods of accounting for historical costs, and do not give accounting recognition to changes in prices after an asset is acquired. Nor do they come to grips with the changing general purchasing power of the dollar.

Conventional accounting has served us well when prices were relatively stable. But, given the current level of inflation, it is fair to say that, for most companies, some portion of the conventional earnings measure represents an erosion of operating capability—that is, a portion of those conventional earnings may need to be retained in order to acquire new assets needed to sustain the capacity of the enterprise to provide a constant supply of goods and services. In other words, if all of net earnings, after taxes, are paid as a dividend, companies would not retain enough out of revenues to replace resources used up. Inflation increases the possibility that all, or even more, of real earnings may be paid out in dividends, and conventional accounting does not tell us the magnitude of the shortfall.

Although the adjustment of historical cost accounting data for changes in the general purchasing power of the dollar or for changes in the current prices of specific goods and services had been proposed in the United States at various times during the past fifty years, it took the shock of double digit inflation and the subsequent persistence of high rates of inflation to create the climate in which FASB action became possible.

The principal result of that action to date has been the issuance, in September 1979, of FASB Statement No. 33, "Financial Reporting and Changing Prices." The essential requirement of that Statement, which applies to the annual financial reports of the approximately 1,500 largest industrial and financial companies in the United States, is the presentation of two supplementary measures of operating income, together with certain other data.[1]

The affected companies are required to present, as supplement to their basic annual financial statements:

Operating income with cost of goods sold and depreciation measured on the same historical cost basis as in the primary financial statements but adjusted for changes in the general purchasing power of the dollar since the inventory and depreciable assets were acquired (called "constant dollar" accounting); and

Operating income with cost of goods sold and depreciation expense measured at current cost at the date of sale or use.

In addition, the companies are required to present:

The current cost amounts of inventory and of property, plant, and equipment at the end of the current fiscal year; and

[1] The FASB has previously furnished copies of Statement No. 33 to the staff of the Joint Economic Committee. A summary of Statement No. 33 is attached as an exhibit to this statement.

The increase or decrease in the current cost amounts of inventory and property, plant, and equipment during the year, net of the effect of general inflation.

The net gain or loss of purchasing power that resulted from holding monetary assets such as cash and cash receivables and from owing monetary obligations during the year.

The affected companies are also required to present a five-year summary of selected financial data measured in constant dollars to facilitate the assessment of trends.

Statement 33 was effective for annual reports for calendar year 1979 and subsequent years. However, initial presentation of current cost information was permitted to be postponed until 1980 reports in recognition of the possible difficulty in accumulating the necessary data in time for 1979 reports.

Examples of Statement 33 disclosures taken from the 1979 annual reports of three U.S. corporations are attached as exhibits to this statement.[2]

Accounting information stated in terms of constant dollars has two principal benefits to investors, credit grantors, and other financial statement users. First, it enhances comparisons. Erroneous judgments can be made based on financial information when that information is stated in nominal dollars that represent significantly different purchasing power from item to item, enterprise to enterprise, and period to period. Second, investors and creditors seek to enhance their wealth not in terms of numbers of dollars but in terms of the command of their dollars over goods and services in the market place. Measures presented only in nominal dollars tend to veil "real" return on investment and "real" wealth.

The informational advantage of current cost accounting is that it matches today's costs with today's revenues, rather than yesterday's costs with today's revenues. Accounting for current costs, separates the effects of holding assets during a period of increasing (or declining) prices from the results of using or selling those assets. For example, it separates the so-called "inventory profits" or "holding gains" from operating margins. That separation seems likely to provide to users an improved basis for understanding the results of past periods and for assessing the prospects for future periods. It also provides an improved basis for understanding the factors that determine the amount of cash available for distribution, replacement, and expansion out of funds generated internally by a business.

The two approaches to reflecting the effects of changing prices—constant dollar accounting and current cost accounting—address different problems. Constant dollar accounting is concerned with general inflation; current cost accounting is concerned with changes in specific prices. To illustrate, consider an asset purchased for $100 on January 1 of year X. During that year, the market buying price of that asset increases to $110, and the general level of prices increases 8 percent.

The historical cost of the asset is $100. Its current cost at year-end is $110. That does not mean, however, that the owner of the asset is 10 percent wealthier at the end of the year than at the beginning, if wealth is thought of in terms of command over goods and services. With 8 percent general inflation, $110 will buy only around 2 percent more than $100 would have bought a year earlier. From a purchasing power perspective, the assetholder had only a 2 percent increase in wealth.

If that asset is an item of inventory and is sold on December 31 of year X for $125, conventional accounting would report a $25 profit on the sale—the difference between the $125 sales price and the $100 original cost. Were the company that sold the inventory to distribute the $25 profit to its shareholders as a dividend, though, it would find itself with only $100 in cash remaining—not enough to replace the inventory item, whose market price has risen to $110. On a current cost accounting basis, profit on the sale would be reported at $15—the $125 sales price less the $110 current cost. The $15 could be distributed, and the company would still have sufficient cash to replace its inventory and maintain the same level of operating resources at the end of the year that it had at the beginning.

Although the prices of specific goods and services may tend to move in the same direction as the general level of prices, specific price changes are often widely disparate. In recent years, for instance, increases in the prices of gold and petroleum have far outpaced the general inflation rate, while the prices of calculators today generally are much less than they were five or ten year ago.

[2] The three are General Electric Company, Household Finance Corporation, and Storage Technology Corporation.

Current cost accounting and constant dollar accounting are, therefore, complementary approaches that can be combined—and indeed have been combined in Statement 33—for meaningful financial reporting.

By its very nature, Statement 33 is experimental, and in several important senses it is not yet finished. For one thing, the Board is presently giving consideration to the applicability of current cost measures to certain special types of assets of companies in the forest products, mining, oil and gas, and real estate industries. Those assets are unprocessed natural resources (such as estimated oil and gas reserves) and income producing real estate properties. As FASB proposal on this matter has recently been published, and we will conduct public hearings on that proposal in July.

Statement 33 is also unfinished in the sense that it raises certain issues to which the Board intends to give further study, for example, whether the purchasing power gains or losses from holding monetary items and the increases in current cost amounts of inventories and fixed assets constitute elements of "earnings." Moreover, because it is plowing new ground, the Board plans to conduct one or more major research projects on all aspects of the usefulness of the Statement 33 data—how the data is, or is not, being used by professional investors, bankers, and others. We have recently appointed a task force of experts to assist us in this effort.

There are under way at the Board several projects that are closely related to Statement 33. Principal among them is our project on funds flows and liquidity—aimed at determining the kinds of information about an enterprise's flow of funds and its liquidity position that is useful for investor and creditor decision-making.

In addition to its own efforts, the Board has encouraged others to study the impact of Statement 33. Only a few preliminary analyses have been completed to date. Perhaps the two most comprehensive are studies recently published by Price Waterhouse & Co., an international accounting firm, and by Duff and Phelps, Inc., financial analysts and consultants. Price Waterhouse studies 157 of the Fortune 500 industrial companies and 58 of the largest financial, retailing, transportation, and utility companies. Duff and Phelps studied 337 industrials and 111 utilities.

Overall, for most industry groups, both studies found that inflation-adjusted operating income on either a constant dollar or current cost basis was anywhere from 40 percent to 70 percent lower than operating income on the traditional measurement basis. The diminution was greatest in capital-intensive industries that tend to have relatively old physical plant—auto manufacturers and public utilities. Companies in some industries reported declines considerably less than average—aerospace, publishing, and financial institutions; and the current cost earnings of the computer and office machinery industry were actually more than historical cost earnings—undoubtedly because technological advances have brought about significant operating efficiencies.

Rates of returns on assets, in real or current costs terms, were only around one-third to one-half of those computed on a historical cost basis, and effective tax rates were typically 10 to 30 percentage points higher than those reported on the conventional historical cost basis.

For Price Waterhouse's 157 industrial companies overall, the historical cost dividend payout ratio of 33 percent doubled to around 67 percent on both a current cost and constant dollar basis. In some industries, dividend payments exceeded inflation-adjusted income from operations, which means that in those industries companies effectively were paying dividends out of capital. These industries are automobiles, food and beverage, retailing, and public utilities.

The findings of those two studies are consistent with a number of other analyses that have been made available to the Board. Numerous periodicals, including Business Week, The New York Times, The Washington Post, and Fortune, report similar results.

Price Waterhouse also has published a special study of inflation adjustments in the public utility industry. That study of 81 electric, gas, and water companies reports that the average utility's operating income was 73 percent less on a constant dollar basis and 109 percent less on a current cost basis than reported in the primary financial statements. Even within this single industry, results varied widely. For 13 of the 81 companies, a historical cost earnings per share turned into a restated current cost net loss per share. The Duff and Phelps study of 111 utilities found similar substantial declines.

What do these atlernative income computations and other supplementary disclosures have to do with capital formation?

Capital formation involves a choice between saving and investment on the one hand and consumption on the other. Capital allocation involves selection from among alternative investment opportunities. In a free enterprise economy such as ours, capital is formed and allocated largely on the basis of individual investors' decisions. Those decisions are based, in great part, on financial information—information for assessing expected rates of return, risks and uncertainties, estimates of future rates of general inflation, expectations of future price changes for specific commodities, and so on. The tax laws and the economic policies and programs of government, of course, bear heavily on investors' decisions.

As a general proposition, higher expected rates of return encourage capital formation; similarly, reduced risks and uncertainties encourage capital formation. Moreover, in making investment decisions, those with capital to supply seek a return commensurate with the risks involved.

We believe that the information called for by Statement 33 aids investors in assessing risks and returns, thereby reducing the uncertainties surrounding their investment decisions. Statement 33 data adds a dimension to those assessments beyond that provided by conventional accounting. The data helps investors to distinguish between returns on capital and returns of capital, and between earnings that result from management decisions to use resources in operations and earnings that accrue from market price fluctuations. The data also assists in assessing the extent to which a company has been successful in maintaining operating capability in the face of rising prices. Constant dollar data facilitates intra-company, inter-company, and inter-period comparisons.

A number of studies have shown that, in the past, even in the absence of the detailed inflation-adjusted information called for by Statement 33, securities prices have tended to follow crude approximations of constant dollar and current cost data more closely than nonadjusted historical cost numbers. It is not unreasonable to expect that the new inflation adjustments will enhance investors' assessments, to the considerable benefit of decision-making within the U.S. capital markets, though it is too early to perform meaningful analyses at this point.

We believe that the information called for by Statement 33 may be of benefit to those in government and elsewhere who are concerned with income tax policies and national economic policymaking in general. As you know, macroeconomists have, for years, made overall inventory and capital consumption adjustments in preparing national income statistics. Statement 33 should provide them with more detailed and more accurate information, and our staff has been meeting with representatives of a number of Federal agencies to explain the Statement and discuss the resulting data with them.

The Financial Accounting Standards Board is not—and should not be—in a position of advocating any particular tax policies or national economic programs. We believe, however, that we have added some tools for those whose responsibility it is to shape national economic policies.

I appreciate having been invited to appear before this committee, and I will be pleased to answer any questions the committee may have.

Attachments.

Financial issues: the impact of inflation

Inflation is commonly defined as a loss in value of money due to an increase in the volume of money and credit relative to available goods and services, resulting in a rise in the level of prices. Inflation in the U.S. is generally recognized to be caused by a combination of factors, including government deficits, sharp increases in energy costs, and low productivity gains including the effect of proliferating government regulations.

Although loss of purchasing power of the dollar impacts all areas of the economy, it is particularly onerous in its effect on savings — of both individuals in forms such as savings accounts, securities and pensions, and of corporations in the form of retained earnings.

For the individual, with inflation of 6% a year, the dollar saved by a person at age 50 will have lost three-fifths of its value by the time the person is age 65. With a 10% inflation rate, almost four-fifths of the dollar's value is lost in 15 years. This problem affects almost everyone, including those presently working and especially those who are on fixed incomes.

The situation is rendered even more difficult by the progressive income tax system. A Congressional staff study reports that a family of four with an income of $8,132 in 1964 would need a 1979 income of $18,918 to have kept pace with the increase in the Consumer Price Index over the years. However, the 1979 income of $18,918 puts the family into a higher tax bracket which, when coupled with increased Social Security taxes, reduces real after-tax income $1,068 below the equivalent 1964 level.

Your Company and all U.S. businesses face a similar problem. Business savings are in the form of retained earnings — the earnings a company keeps after paying employees, suppliers and vendors, and after payment of taxes to government and dividends to share owners. If a company is to continue in business, much less grow, it must be able to save or retain sufficient earnings, after providing a return to its share owners, to fund the cost of replacing — at today's inflated prices — the productive assets used up. Retention of capital in these inflationary times under existing tax laws is a challenge facing all businesses.

U.S. tax regulations permit recognition of the impact of inflation on a company's inventory costs by use of the LIFO (last-in, first-out) inventory method. In general, under the LIFO method, a company charges off to operations the current cost of inventories consumed during the year. With inflation averaging over 11% last year, the negative impact on operations of using current costs with respect to a supply of goods is substantial. Financial results are portrayed more accurately when the LIFO method is used in periods of high inflation, and GE has used LIFO for most of its U.S. manufacturing inventories for a quarter-century. The Statement of Earnings on page 32 is on that basis. As supplementary information to that Statement of Earnings: use of the LIFO method increased 1979 and 1978 operating costs by $430.8 million and $224.1 million (to $20,330.7 million and $17,695.9 million), respectively, with a corresponding reduction of reported pre-tax profits.

Unfortunately, U.S. tax regulations fail to provide an equivalent to LIFO for the impact of inflation on a company's costs of property, plant and equipment. Instead, deductions for wear and tear on these assets are based on original purchase costs rather than today's replacement costs. In general, the resulting shortfall must be funded from after-tax earnings.

The supplementary information shown in Table 1 restates operating results to eliminate the major effects of inflation discussed above. Table 1 compares GE operating results as reported on page 32 with results adjusted in two ways. First, results are restated to show the effects of general inflation — the loss of the dollar's purchasing power — on inventories and fixed assets. The second restatement shows results restated for changes in specific prices — the current costs of replacing those assets. Your management feels that the last column in Table 1 is the more meaningful and has therefore shown, in Table 2 on page 30, five years of results on that basis, also adjusted to equivalent 1979 dollars to make the years comparable. While the techniques used are not precise, they do produce reasonable approximations.

In these earnings statements, specific adjustments are made to (1) *cost of goods sold* for the current cost of replacing inventories and (2) *depreciation* for the current costs of plant and equipment. The restatements for inventories are relatively small because GE's extensive use of LIFO accounting already largely reflects current costs in the traditional statements. However, a substantial restatement is made for the impact of inflation on fixed assets, which have relatively long lives. The $624 million of depreciation as traditionally reported, when restated for general inflation, increases to a total of $880 million. But the restatement necessary to reflect replacement of these assets at current costs grows to $980 million. The net effect of these restatements lowers reported income of $6.20 a share to $4.68 on a general inflation-adjusted basis and $4.34 on a specific current cost basis.

It is significant to note that for the five years 1975-1979, even after adjustment for inflation, your Company has shown real growth in earnings and a steady increase in share owners' equity over the entire period. After adjusting earnings for current costs and restating all years to equivalent 1979 dollars, your Company's average annual growth rate in real earnings was 21% since 1975 and 8% since 1976. This means that the growth in GE's earnings has been real, not just the product of inflation.

An important insight from these data is depicted in the pie charts at right. These show that, over the five years 1975-1979, because of inflation 10% more of GE's earnings were taxed away than appeared to have been the case using traditional financial statements. While the traditional earnings statements indicated an effective tax rate of 41% over this period, the "real" tax rate averaged 51% of profits before taxes. Consequently, earnings

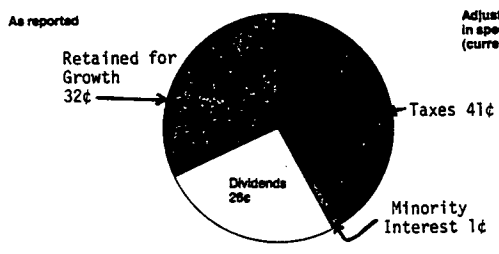
Table 1: supplementary information – effect of changing prices (a)

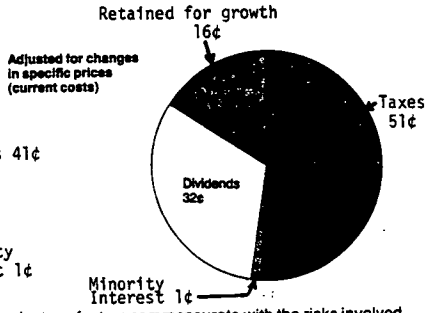
(In millions, except per-share amounts)

The notes on page 30 are an integral part of this statement.

For the year ended December 31, 1979	As reported in the traditional statements	Adjusted for general inflation	Adjusted for changes in specific prices (current costs) (b)
Sales of products and services to customers	$22,461	$22,461	$22,461
Cost of goods sold	15,991	16,093	16,074
Selling, general and administrative expense	3,716	3,716	3,716
Depreciation, depletion and amortization	624	880	980
Interest and other financial charges	258	258	258
Other income	(519)	(519)	(519)
Earnings before income taxes and minority interest	2,391	2,033	1,952
Provision for income taxes	953	953	953
Minority interest in earnings of consolidated affiliates	29	16	13
Net earnings applicable to common stock	$ 1,409	$ 1,064	$ 986
Earnings per common share	$ 6.20	$ 4.68	$ 4.34
Share owners' equity at year end (net assets) (c)	$ 7,362	$10,436	$11,153

Use of each dollar of earnings
Based on total earnings before taxes 1975-1979





retained for growth were cut in half to 16% of income before tax, not 32% as reflected in the traditional financial statements. Over the period, share owners received a measure of protection against inflation's impact as about two-thirds of after-tax earnings were distributed — equivalent to an average annual growth rate of about 8% in *real* dividends.

An area receiving special attention by management is experimentation with the use of inflation-adjusted measurements at the individual business and project level for capital budgeting. Since 1973, your Company has been experimenting with various techniques to measure the impact of inflation, to incorporate the perspectives provided by such measurements into decision-making, and to stimulate awareness by all levels of management of the need to develop constructive business strategies to deal with inflation. The objective is to ensure that investments needed for new business growth, productivity improvements and capacity expansions earn appropriate *real rates of return* commensurate with the risks involved. Such supplemental measurements can assist in the entire resource allocation process, starting with initial project approval, implementation and subsequent review.

Improving productivity to offset inflationary forces is a primary goal established by top management that is being stressed throughout General Electric. As discussed on the back cover of this Annual Report, the Company has committed significant levels of resources to research and development activities to accelerate innovation and increase productivity. In addition, General Electric's production base continues to be expanded and modernized through increasing investments in plant and equipment. For example, $1,262 million and $1,055 million were spent on strengthening General Electric's production base in 1979 and 1978, respectively. Imaginative and diligent coupling of production techniques and equipment is critical to the maintenance and improvement of your Company's profitability.

Table 2: supplementary information – effect of changing prices (a)

GENERAL ELECTRIC COMPANY p.3

(In millions, except per-share amounts)

Current cost information in dollars of 1979 purchasing power (b) (All amounts expressed in average 1979 dollars)	1979	1978	1977	1976	1975
Sales of products and services to customers	$22,461	$21,867	$20,984	$20,015	$19,022
Cost of goods sold	16,074	15,548	14,793	14,145	13,914
Selling, general and administrative expense	3,716	3,566	3,606	3,360	3,018
Depreciation, depletion and amortization	980	1,000	986	979	1,006
Interest and other financial charges	258	249	238	222	251
Other income	(519)	(466)	(467)	(350)	(235)
Earnings before income taxes and minority interest	1,952	1,970	1,828	1,659	1,068
Provision for income taxes	953	995	926	853	620
Minority interest in earnings of consolidated affiliates	13	13	20	26	26
Net earnings applicable to common stock	$ 986	$ 962	$ 882	$ 780	$ 422
Earnings per common share	$ 4.34	$ 4.22	$ 3.88	$ 3.45	$ 1.88
Share owners' equity at year end (net assets) (c)	$11,153	$11,020	$10,656	$10,526	$10,056
Other inflation information					
Average Consumer Price Index (1967 = 100)	217.4	195.4	181.5	170.5	161.2
(Loss)/gain in general purchasing power of net monetary items	$(209)	$(128)	$ (61)	$ (20)	$ 19
Dividends declared per common share	2.75	2.78	2.52	2.17	2.16
Market price per common share at year end	47⅞	50½	58¼	69⅜	60¼

Notes to supplementary information — Tables 1 and 2

(a) This information has been prepared in accordance with requirements of the Financial Accounting Standards Board (FASB). Proper use of this information requires an understanding of certain basic concepts and definitions.

The heading "As reported in the traditional statements" refers to information drawn directly from the financial statements presented on pages 32 to 44. This information is prepared using the set of generally accepted accounting principles which renders an accounting based on the number of actual dollars involved in transactions, with no recognition given to the fact that the value of the dollar changes over time.

The heading "Adjusted for general inflation" refers to information prepared using a different approach to transactions involving inventory and property, plant and equipment assets. Under this procedure, the number of dollars involved in transactions at different dates are all restated to equivalent amounts in terms of the general purchasing power of the dollar as it is measured by the Consumer Price Index for all Urban Consumers (CPI-U). For example, $1,000 invested in a building asset in 1967 would be restated to its 1979 dollar purchasing power equivalent of $2,174 to value the asset and calculate depreciation charges. Similarly, 1978 purchases of non-LIFO inventory sold in 1979 would be accounted for at their equivalent in terms of 1979 dollars, rather than in terms of the actual number of dollars spent.

The heading "Adjusted for changes in specific prices (current costs)" refers to information prepared using yet another approach to transactions involving inventory and property, plant and equipment assets. In this case, rather than restating to dollars of the same general purchasing power, estimates of current costs of the assets are used.

In presenting results of either of the supplementary accounting methods for more than one year, "real" trends are more evident when results for all years are expressed in terms of the general purchasing power of the dollar for a designated period. Results of such restatements are generally called "constant dollar" presentations. In the five-year presentations shown above, dollar results for earlier periods have been restated to their equivalent number of constant dollars of 1979 general purchasing power (CPI-U basis).

Since none of these restatements is allowable for tax purposes under existing regulations, income tax amounts are the same as in the traditional statements (but expressed in constant dollars in the five-year summary).

There are a number of other terms and concepts which may be of interest in assessing the significance of the supplementary information shown in Tables 1 and 2. However, it is management's opinion that the basic concepts discussed above are the most significant for the reader to have in mind while reviewing this information.

(b) Principal types of information used to adjust for changes in specific prices (current costs) are (1) for inventory costs, GE-generated indices of price changes for specific goods and services, and (2) for property, plant and equipment, externally generated indices of price changes for major classes of assets.

(c) At December 31, 1979, the current cost of inventory was $5,251 million, and of property, plant and equipment was $7,004 million. Estimated current costs applicable to the sum of such amounts held during all or part of 1979 increased by approximately $1,111 million, which was $329 million less than the $1,440-million increase which could be expected because of general inflation.

Supplementary Information on the Impact of Inflation on Accounting Data (Unaudited)

HOUSEHOLD FINANCE CORPORATION p.1

Introduction

Inflation has an ever changing and increasingly pervasive impact on the economy of the United States, Canada and other countries where Household's businesses are conducted. In the United States, the value of a 196" dollar, as determined by the National Consumer Price Index for All Urban Consumers ("CPI-U"), deteriorated to less than 46¢ by 1979. In accordance with generally accepted accounting principles, financial statements have traditionally reported amounts based on actual (historical) dollars without adjustment for the constantly changing purchasing power of currency. The accounting profession has advanced many complex theories as to how the resulting inflation-caused distortion of traditional accounting measurements should be reported but none have received wide acceptance. In recognition of the increasing significance of inflation, the Financial Accounting Standards Board issued in 1979 Statement No. 33, Financial Reporting and Changing Prices, requiring that large businesses begin to experiment with measuring and reporting on the impact of inflation and include selected supplemental disclosures with annual financial statements.

The recommended disclosures include presentation of three basic types of accounting data—historical cost/nominal dollar, historical cost/constant dollar and current cost. **Historical cost/nominal dollar** is the presentation which shareholders traditionally receive. It is these amounts that are presented in the Corporation's basic financial statements and elsewhere throughout the Annual Report.

Historical cost/constant dollar is a concept used to adjust historical currency transactions into units of the same (constant) general purchasing power. The Statement requires that Household adjust historical dollars for this disclosure using the CPI-U. This index measures general inflation on a national basis for various commodities including such items as food, housing and fuel. Because it is a general inflationary measure and national in scope, it may not accurately portray the impact of inflation on Household's businesses.

Current cost identifies certain assets and expenses associated with use or sale of products and services in terms of what their current cost would have been when they were used or sold rather than what their nominal cost actually was. Obviously Household's inventories, stores and manufacturing plants would generally cost more to replace than when they were originally acquired. To maintain productive capacity, earnings must yield sufficient capital to replace inventories and facilities as they are sold or consumed. The current cost concept is specifically applied to each businesses' products, methods of operation, and types and locations of assets but it unrealistically assumes that like kinds of property, plant and equipment would be purchased and ignores changes such as improved technology.

The Statement also requires that disclosures distinguish between monetary and nonmonetary assets and liabilities. **Monetary** items are assets and liabilities which do not change in price and will be converted into a fixed amount of dollars. Examples of monetary items include cash, receivables and short and long-term debt. A net monetary asset position in an inflationary period results in a loss of purchasing power. On the other hand, a net monetary liability position results in a gain in purchasing power because the amount required to satisfy the net liability, expressed in units of comparable purchasing power, decreases with inflation. Nonmonetary items are assets and liabilities which do have occasion to change in price and which may or may not change at the same rate as general inflation. Examples of nonmonetary items include inventory, rental vehicles, property, plant and equipment.

The Statement requires that increases in current costs based on specific prices of inventories, revenue-earning assets, property, plant and equipment be compared with amounts based on general price level changes calculated using the CPI-U. The resulting amount, commonly known as **holding gains and losses**, is a measure of the additional increase or decrease in asset values that resulted from the Corporation holding specific assets instead of the general "market basket" of goods and services that is used to derive the CPI-U.

Household has elected to present inflation data in accordance with the partial restatement provisions of the Statement. Accordingly, only inventories, cost of goods sold, revenue-earning assets, property, plant, equipment and depreciation have been restated.

The reader is cautioned to exercise due care in use of the supplemental information on the impact of inflation on accounting data. In accordance with the Statement, none of the data (for instance, additional costs of goods sold and depreciation expenses) has been adjusted for theoretical income tax benefits. Further, not only are the presentations experimental in nature but they are based on simplified concepts, shortcut calculations, subjectivity and abbreviated disclosure.

Current Year Data
(All data in millions of average 1979 dollars)

	Nominal Basis	Constant Basis	Current Basis
Finance	$ 90.4	$ 87.7	$ 89.7
Merchandising	57.1	(7.0)	33.4
Manufacturing	19.7	13.2	12.7
Transportation	17.6	(7.3)	4.8
Corporate	(23.6)	(23.6)	(23.6)
Total Income	$161.2	$ 63.0*	$117.0*
Per Common Share:			
Primary	$ 3.33	$ 1.20	$ 2.37
Fully Diluted	$ 3.15	$ 1.20*	$ 2.28*

*If the purchasing power gain or loss on net monetary items held were included in constant basis and current basis income, which management believes is more representative of the inflation impact on the Corporation's operations, income would be $114.2 and $168.2 million or $2.23 and $3.28 per fully diluted share, respectively.

HOUSEHOLD FINANCE CORPORATION p.2

Data by Business (All data in millions of average 1979 dollars)	Nominal Basis	Constant Basis	Current Basis	Nominal Basis	Constant Basis	Current Basis
	Finance			Transportation		
Revenues	$ 836.1	$ 836.1	$ 836.1	$ 310.8	$ 310.8	$ 310.8
Operating expenses, etc.	444.3	444.3	444.3	181.9	181.9	181.9
Depreciation	6.7	9.4	7.4	69.4	94.3	82.2
Interest	258.0	258.0	258.0	28.4	28.4	28.4
Unrealized foreign exchange (gain)	(7.4)	(7.4)	(7.4)			
Provision for taxes on income	44.1	44.1	44.1	13.5	13.5	13.5
Total expenses	745.7	748.4	746.4	293.2	318.1	306.0
Income	$ 90.4	$ 87.7	$ 89.7	$ 17.6	$ (7.3)	$ 4.8
Purchasing power gain (loss) on net monetary items held during the year		$ (36.0)	$ (36.0)		$ 26.8	$ 26.8
At December 31, 1979:						
Property, plant and equipment			$ 70.8			$ 50.8
Revenue-earning assets						$ 307.5
Increase in current cost of revenue-earning assets and property and equipment			$ 5.0			$ 21.9
Effect of increase in general price level			8.3			40.9
Increase in current cost over (under) increase in general price level			$ (3.3)			$ (19.0)
Net assets at year end	$1,239.0*	$1,424.6*	$1,430.2*	$ 86.6	$ 121.2	$ 106.0

*Represents net assets of all businesses.

	Merchandising			Manufacturing		
Net sales and revenues	$3,918.8	$3,918.8	$3,918.8	$ 245.6	$ 245.6	$ 245.6
Cost of goods sold, buying and occupancy	3,107.2	3,157.6	3,117.1	171.3	176.0	176.0
Depreciation and amortization	33.6	47.3	47.4	6.6	8.4	8.9
Selling and administrative	643.1	643.1	643.1	31.4	31.4	31.4
Interest	32.8	32.8	32.8	1.4	1.4	1.4
Unrealized foreign exchange (gain)				(0.1)	(0.1)	(0.1)
Provision for taxes on income	45.0	45.0	45.0	15.3	15.3	15.3
Total expenses	3,861.7	3,925.8	3,885.4	225.9	232.4	232.9
Income	$ 57.1	$ (7.0)	$ 33.4	$ 19.7	$ 13.2	$ 12.7
Purchasing power gain (loss) on net monetary items held during the year		$ 62.6	$ 62.6		$ (2.2)	$ (2.2)
At December 31, 1979:						
Inventories			$ 728.4			$ 81.0
Property, plant and equipment			512.0			51.0
Increase in current cost of inventories and property, plant and equipment			$ 85.9			$ 17.6
Effect of increase in general price level			135.8			15.3
Increase in current cost over (under) increase in general price level			$ (49.9)			$ 2.3
Net assets at year end	$ 472.9	$ 609.6	$ 626.7	$ 133.3	$ 149.7	$ 157.4

HOUSEHOLD FINANCE CORPORATION p.3

Five Year Data

	1979	1978	1977	1976	1975
Net Sales and Revenues—					
Constant 1979 Millions of Dollars:					
Finance	$ 836.1	$ 821.2	$ 810.7	$ 736.0	$ 710.4
Merchandising	3,918.8	3,685.6	3,410.0	3,215.0	3,000.6
Manufacturing	245.6	258.3	250.7	262.8	229.9
Transportation	310.8	291.3	240.9	221.6	208.9
Cash Dividends Declared per Common Share:					
Nominal Dollars	$ 1.50	$1.375	$ 1.25	$ 1.15	$ 1.05
Constant 1979 Dollars*	1.50	1.53	1.50	1.47	1.42
Shareholders' Book Value per Common Share at Year End:					
Nominal Dollars	$24.19	$22.96	$20.95	$19.51	$18.07
Constant 1979 Dollars*	22.91	24.17	24.47	24.33	23.62
Market Price per Common Share at Year End:					
Nominal Dollars	$18.13	$17.50	$18.25	$21.50	$16.00
Constant 1979 Dollars*	17.17	18.75	21.32	26.82	20.92
Average Consumer Price Index for All Urban Consumers Using Average 1967 Dollars as Base of 100.0	217.4	195.4	181.5	170.5	161.2

*Constant 1979 dollar amounts represent mid-year averages.

Finance

Household's cash dividends and book value per common share have kept pace with inflation. The CPI-U annual compounded inflation rate over the past five years has averaged 8% while dividends increased at a 9% rate and book value at a 7.1% rate. Market price per common share, however, has had an erratic pattern in terms of constant dollars. Generally, it has tended to fluctuate somewhat in relation to interest rate levels.

Substantially all of Household's assets and liabilities are of a monetary nature with the exception of its investments in nonconsolidated subsidiaries and its relatively small amount of physical assets. Since these monetary assets exceed monetary liabilities, the net asset position resulted in a $36 million loss of purchasing power in 1979. Appropriately, the data also show small holding losses and depreciation adjustments which are indicative of the relatively small amount of physical assets. The increase in current cost is less than the general price level change that Household is experiencing primarily because of declining replacement costs for data processing equipment.

Merchandising

The Merchandising business adopted the last-in, first-out (LIFO) method of valuing inventories in 1979 to more closely match current acquisition costs of merchandise with sales. For this reason, the nominal cost-of-goods-sold usually approximates that computed on a current cost basis. The difference in current cost over nominal cost for cost-of-goods-sold results principally from the restoration at the beginning of the year of markdown and other valuation reserves. We believe that current cost is a more realistic presentation of the effects of inflation on the Merchandising business.

We believe that the use of the mandatory broad-based CPI-U for measuring inflation under the constant dollar basis is inaccurate and misleading. Actual inventory costs during the year increased in the range of 5 to 8%, which is well below the 13% rate used in the CPI-U. Therefore, constant dollar costs of goods sold are inflated artificially by approximately $40 million due to this difference in inflation rates.

More than 85% of Merchandising's assets are nonmonetary, consisting of inventory and property and equipment. These assets are largely financed in the normal course of business by trade payables and other forms of debt, all monetary in nature. As a result, the net monetary position yields a $62.6 million gain in purchasing power using the CPI-U. The Company experienced a holding loss of $49.9 million, however, by having this large investment in nonmonetary assets. This results from the specific value of these assets increasing at a slower rate than the general inflation rate as measured by the CPI-U.

Manufacturing

The Manufacturing business also adopted the LIFO method of accounting for domestic inventories in 1979. Cost of goods sold on a constant dollar and current cost basis exceed nominal costs as the inflation data also include presentation of foreign cost-of-goods-sold on a LIFO basis. Further, the impact of restoring general FIFO valuation reserves to income when LIFO was adopted has been eliminated in this presentation.

Inflation based on specific prices increased at a faster rate than based on general inflation. This is due to the substantial impact that rapidly increasing prices of petrochemicals, silver and primary metals have had on inventory costs.

Transportation

Transportation's assets are primarily rental and lease vehicles which are nonmonetary in nature. Most of the liabilities in this business, however, are monetary. The general inflation rate as measured by the CPI-U has exceeded the actual inflation rate experienced which we believe causes constant dollar data to be misleading. The current dollar presentation includes inflation adjusted increases in depreciation but ignores inflation adjustments for the ultimate gain or loss on disposal which management considers to be an inseparable element of depreciation.

Notes to Consolidated Financial Statements
Storage Technology Corporation and Subsidiaries

The following interim financial information presents 1979 and 1978 results of operations on a quarterly basis. Per share amounts have been adjusted from those previously reported for the 1979 and 1978 stock splits (Note 7).

Quarter ended	March 30, 1979	June 29, 1979	Sept. 28, 1979	Dec. 28, 1979
	(in thousands, except per share amounts)			
Revenues	$95,787	$119,856	$129,644	$134,166
Cost of revenues	61,486	75,754	82,619	85,989
Gross profit	34,301	44,102	47,025	48,177
Operating expenses	17,608	23,539	22,828	23,740
Interest expense, net	3,454	4,223	4,316	4,751
Provision for income taxes	5,693	7,026	8,549	8,132
Net income	$ 7,546	$ 9,314	$ 11,332	$ 11,554
Earnings per common and common equivalent share	$ .30	$ .37	$ .45	$ .46
Earnings per common share—assuming full dilution	$ .30	$ .37	$ .45	$ .46

Quarter ended	March 31, 1978	June 30, 1978	Sept. 29, 1978	Dec. 29, 1978
	(in thousands, except per share amounts)			
Revenues	$54,244	$66,959	$79,467	$99,755
Cost of revenues	36,392	43,125	48,644	54,834
Gross profit	17,852	23,834	30,823	44,921
Operating expenses	9,726	12,078	14,189	21,857
Interest expense, net	1,554	2,075	2,270	3,069
Provision for income taxes	3,023	4,291	6,464	10,022
Net income	$ 3,549	$ 5,390	$ 7,900	$ 9,973
Earnings per common and common equivalent share	$ .16	$ .24	$ .34	$ .41
Earnings per common share—assuming full dilution	$ .16	$ .24	$ .32	$ .41

Note 14 - Information on Effects of Changing Prices (Unaudited)

General background

Financial statements of business enterprises presented in accordance with generally accepted accounting principles have traditionally reported amounts reflecting historical costs and dollars of varying purchasing power and accordingly do not adequately measure the effects of inflation on a business. Changing prices, particularly during periods of high inflation, can have significant effects. In recognition of the need to provide readers of financial statements with information to assist them in assessing these effects, the Financial Accounting Standards Board (FASB) issued Statement No. 33, Financial Reporting and Changing Prices, which requires that certain information about the effects of inflation on business enterprises be disclosed.

The information which follows is consistent with the requirements of Statement No. 33, and is intended to provide certain measurements of the effects of inflation on STC's operations and financial position.

Methods of measuring effects of changing prices

The two methods prescribed by the FASB for measuring the effects of changing prices were used in calculating the information which follows.

The first method provides data adjusted for "general inflation" using the Consumer Price Index for all Urban Consumers as a broad-based measure of general inflation. The objective of this approach is to provide financial information in dollars of equivalent

purchasing power (constant dollars) so that revenues for each year are matched with expenses expressed in corresponding units. In addition, financial data presented for a series of years is made more comparable by reporting the amounts for each year in terms of a common measure of purchasing power.

The second method adjusts for "changes in specific prices." The objective of this method is to reflect the effects of changes in the specific prices (current costs) of the resources actually used in STC's operations, so that measures of these resources and their consumption reflect the current cost of replacing these resources, rather than the historical cost amounts actually expended to acquire them. Adjustments for changes in specific prices of property, plant and equipment were based on external price indexes closely related to the assets being measured. The current costs of inventories, computer peripheral rental equipment, spare parts for field service and related cost of sales and depreciation were based on recent manufacturing costs.

It should be noted that both of the above described methods inherently involve the use of assumptions, approximations and estimates. The results should be viewed in that context and should not be viewed as precise indicators of the effects of inflation.

Review of information presented

Supplementary financial data adjusted for the effects of changing prices

In calculating net income adjusted for general inflation and changes in specific prices, the amounts reported in the primary financial statements have been adjusted for depreciation expense (of property, plant and equipment and computer peripheral rental equipment) and those manufacturing costs related to cost of sales, service and installation. Revenues and all other operating expenses are considered to reflect the average price levels for the year and accordingly have not been adjusted. The adjustment to operating expenses related to depreciation of property, plant and equipment is not significant and has been included with the adjustment to cost of sales, service and installation.

Although the adjustments described above affect pretax income for constant dollar and current cost reporting, no adjustment has been made to the historical cost provision for income taxes because of the relationship of the various income tax codes to historical cost accounting.

The adjustments to expenses included in the primary financial statements are summarized as follows (in millions):

	Constant dollar accounting	Current cost accounting
Increase (decrease) in:		
Depreciation of property, plant and equipment	$ .7	$ .7
Depreciation of rental equipment	3.2	.1
Cost of sales, service and installation, exclusive of depreciation	14.5	(13.3)
Total increase (decrease) in expenses	$18.4	$(12.5)

The adjustment for depreciation of property, plant and equipment increased expense for both constant dollar and current cost accounting. These adjustments are less than 10% of historical cost depreciation largely because most of STC's property, plant and equipment was acquired in the last three years and therefore historical cost closely reflects current dollars.

The adjustments to depreciation of rental equipment and to cost of sales, service and installation (both of which reflect STC's manufacturing costs) reflect a $17.7 million increase in expense under constant dollar accounting and a $13.2 million reduction in expense under current cost accounting. These varying results demonstrate the differences between the constant dollar and current cost methods. Constant dollar accounting restates historical costs using the general inflation rate. Inherent in this method is the assumption that all costs increase at the same rate as the Consumer Price Index. The constant dollar method does not reflect STC's and the industry's experience wherein technological advances have offset much of

Storage Technology Corporation
and Subsidiaries

the inflationary cost pressures felt in other industries. The current cost method reflects STC's ability to reduce manufacturing costs through technological advances which enable production efficiencies and component cost reductions. However, this result is not necessarily indicative of a lower future cost trend, since the factors contributing to a lowering of costs in the past may not be present in the future. Given STC's experience, it is your management's belief that the current cost method is a more appropriate method of accounting for inflation.

Included in the disclosures are two additional measures of the effects of inflation. The first measure, "gain from decline in purchasing power of net monetary liabilities," demonstrates the effect of having net monetary liabilities during a period of declining purchasing power. In 1979 this effect for both methods was a gain of $12.5 million. Net monetary liabilities include all of STC's consolidated assets and liabilities, other than inventories, computer peripheral rental equipment, spare parts for field service, property, plant and equipment, other assets, the residual portion of net investment in sales-type leases and contractual rents for future periods.

The second additional measure, "increase in current cost, net of inflation," reflects the benefit of acquiring or holding certain nonmonetary assets (inventories, computer peripheral rental equipment, spare parts for field service and property, plant and equipment) at values less than the current year-end replacement value. The $.1 million includes a $2.8 million increase in current costs of such assets net of a $2.7 million increase related to the general rate of inflation.

Net assets, after giving effect to the above two adjustments, would be $149.6 million for constant dollar accounting and $180.6 million for current cost accounting.

Five-year comparison of selected supplementary financial data adjusted for effects of changing prices

The five-year comparison shows the effect of adjusting historical revenues to amounts expressed in terms of average 1979 dollars, as measured by the Consumer Price Index. Revenues for 1975 through 1978 would be higher than reported in the primary financial statements and the adjusted percentage increase in revenues in each of those years to 1979 would be correspondingly less. The market price per share amounts show a similar trend of slower growth in each of the earlier years to 1979 when restated to average 1979 dollars.

Supplementary financial data adjusted for the effects of changing prices for the year ended December 28, 1979 (in millions, except per share amounts)

	Primary statements	Adjusted for general inflation (constant dollar)	Adjusted for changes in specific prices (current costs)
Total revenues	$479.5	$479.5	$479.5
Cost of sales, service and installation	286.9	302.1	274.3
Depreciation of rental equipment	19.0	22.2	19.1
Other operating expenses	104.5	104.5	104.5
Total costs and expenses	410.4	428.8	397.9
Income before taxes	69.1	50.7	81.6
Provision for income taxes	29.4	29.4	29.4
Net income	$ 39.7	$ 21.3*	$ 52.2
Earnings per primary and fully diluted share	$ 1.58	$ .85*	$ 2.07
Gain from decline in purchasing power of net monetary liabilities		$ 12.5	$ 12.5
Increase in current cost, net of inflation			$ .1

*As described previously, it is management's belief that the results of the constant dollar method of measuring the effects of inflation are not appropriate based upon STC's past experience of reduced costs through technological advances.

Storage Technology Corporation
and Subsidiaries

The current cost of inventories, computer peripheral rental equipment, spare parts for field service and property, plant and equipment, net of accumulated depreciation, at December 28, 1979 and corresponding historical cost amounts are as follows (in millions):

	Inventories	Computer peripheral rental equipment	Spare parts for field service	Property, plant and equipment	Total
Current cost	$110.9	$62.4	$22.3	$78.1	$273.7
Historical cost	$110.9	$65.6	$23.9	$70.9	$271.3

Five-year comparison of selected supplementary financial data adjusted for effects of changing prices (in average 1979 dollars):

	Unadjusted for effects of changing prices	Adjustment	Adjusted total
Total revenues (in millions)			
1979	$479.5	$ —	$479.5
1978	$300.4	$33.8	$334.2
1977	$162.3	$32.1	$194.4
1976	$121.8	$33.5	$155.3
1975	$ 98.8	$34.4	$133.2
Market price per common share at end of fiscal years (after adjustments for stock dividends and stock splits):			
1979	$17.13	$ (.94)	$16.19
1978	$15.38	$1.09	$16.47
1977	$ 5.44	$ .91	$ 6.35
1976	$ 2.73	$ .68	$ 3.41
1975	$ 2.26	$ .70	$ 2.96

The average consumer price indexes used in calculating the above adjustments for the effect of changing prices were as follows: 1979-217.4; 1978-195.4; 1977-181.5; 1976-170.5; 1975-161.2. Adjusted data on dividends per common share is not presented because no cash dividends have ever been paid by STC.

Financial Accounting Standards Board

Summary Statement of Financial Accounting Standards No. 33 Financial Reporting and Changing Prices

September 1979

This Summary is provided for persons interested in an overview of the Statement. It does not include all the provisions of the Statement. Those concerned with implementation should refer to the complete text.

Summary
Statement of Financial Accounting Standards No. 33
Financial Reporting and Changing Prices

September 1979

Financial Accounting Standards Board
of the Financial Accounting Foundation
HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 33

Financial Reporting and Changing Prices

SUMMARY

This Statement applies to public enterprises that have either (1) inventories and property, plant, and equipment (before deducting accumulated depreciation) amounting to more than $125 million or (2) total assets amounting to more than $1 billion (after deducting accumulated depreciation).

No changes are to be made in the primary financial statements; the information required by the Statement is to be presented as supplementary information in published annual reports.

For fiscal years ended on or after December 25, 1979, enterprises are required to report:

a. Income from continuing operations adjusted for the effects of general inflation
b. The purchasing power gain or loss on net monetary items.

For fiscal years ended on or after December 25, 1979, enterprises are also required to report:

a. Income from continuing operations on a current cost basis
b. The current cost amounts of inventory and property, plant, and equipment at the end of the fiscal year
c. Increases or decreases in current cost amounts of inventory and property, plant, and equipment, net of inflation.

However, information on a current cost basis for fiscal years ended before December 25, 1980 may be presented in the first annual report for a fiscal year ended on or after December 25, 1980.

Enterprises are required to present a five-year summary of selected financial data, including information on income, sales and other operating revenues, net assets, dividends per common share, and market price per share. In the computation of net assets, only

inventory and property, plant, and equipment need be adjusted for the effects of changing prices.

Illustrative formats for disclosure of the required information are included in this Summary as Schedules A, B, and C (pages 32-34 of the Statement).

To present the supplementary information required by this Statement, an enterprise needs to measure the effects of changing prices on inventory, property, plant, and equipment, cost of goods sold, and depreciation, depletion, and amortization expense. No adjustments are required to other revenues, expenses, gains, and losses.

In computations of current cost income, expenses are to be measured at current cost or lower recoverable amount. Current cost measures relate to the assets owned and used by the enterprise and not to other assets that might be acquired to replace the assets owned. This Statement allows considerable flexibility in choice of sources of information about current costs: An enterprise may use specific price indexes or other evidence of a more direct nature. This Statement also encourages simplifications in computations and other aspects of implementation: In particular "recoverable amounts" need be measured only if they are judged to be significantly and permanently lower than current cost; that situation is unlikely to occur very often.

The Board believes that this Statement meets an urgent need for information about the effects of changing prices. If that information is not provided: Resources may be allocated inefficiently; investors' and creditors' understanding of the past performance of an enterprise and their ability to assess future cash flows may be severely limited; and people in government who participate in decisions on economic policy may lack important information about the implications of their decisions. The requirements of the Statement are expected to promote a better understanding by the general public of the problems caused by inflation: Statements by business managers about those problems are unlikely to have sufficient credibility until financial reports provide quantitative information about the effects of inflation.

Special problems arise in the application of the current cost requirements of this Statement to certain types of assets, notably natural resources and income-producing real estate property. The Board will consider those problems further and address them in an Exposure Draft with a view to publishing a Statement in 1980. This Statement gives guidance on the treatment of those assets and related expenses for enterprises that present current cost information for fiscal years ending before December 25, 1980.

This Statement calls for two supplementary income computations, one dealing with the effects of general inflation, the other dealing with the effects of changes in the prices of resources used by the enterprise. The Board believes that both types of information are likely to be useful. Comment letters on the Exposure Draft revealed differences of opinion on the relative usefulness of the two approaches. Many preparers and public accounting firms emphasized the need to deal with the effects of general inflation; users generally preferred information dealing with the effects of specific price changes. The Board believes that further experimentation is required on the usefulness of the two types of information and that experimentation is possible only if both are provided by large public enterprises. The Board intends to assess the usefulness of the information called for by this Statement. That assessment will provide a basis for ongoing decisions on whether or not provision of both types of information should be continued and on whether other requirements in this Statement should be reviewed. The Board will undertake a comprehensive review of this Statement no later than five years after its publication.

The measurement and use of information on changing prices will require a substantial learning process on the part of all concerned. In view of the importance of clear explanations to users of financial reports of the significance of the information, the Board is organizing an advisory group to develop and publish illustrative disclosures that might be appropriate as a guide to preparers in particular industries.

SCHEDULE A

STATEMENT OF INCOME FROM CONTINUING OPERATIONS ADJUSTED FOR CHANGING PRICES

For the Year Ended December 31, 1980

(In (000s) of Average 1980 Dollars)

Income from continuing operations, as reported in the income statement		$ 9,000
Adjustments to restate costs for the effect of general inflation		
Cost of goods sold	(7,384)	
Depreciation and amortization expense	(4,130)	(11,514)
Loss from continuing operations adjusted for general inflation		(2,514)
Adjustments to reflect the difference between general inflation and changes in specific prices (current costs)		
Cost of goods sold	(1,024)	
Depreciation and amortization expense	(5,370)	(6,394)
Loss from continuing operations adjusted for changes in specific prices		$(8,908)
Gain from decline in purchasing power of net amounts owed		$ 7,729
Increase in specific prices (current cost) of inventories and property, plant, and equipment held during the year*		$ 24,608
Effect of increase in general price level		18,959
Excess of increase in specific prices over increase in the general price level		$ 5,649

* At December 31, 1980 current cost of inventory was $65,700 and current cost of property, plant, and equipment, net of accumulated depreciation was $85,100.

SCHEDULE B

STATEMENT OF INCOME FROM CONTINUING OPERATIONS ADJUSTED FOR CHANGING PRICES

For the Year Ended December 31, 1980

(In (000s) of Dollars)

	As Reported in the Primary Statements	Adjusted for General Inflation	Adjusted for Changes in Specific Prices (Current Costs)
Net sales and other operating revenues	$253,000	$253,000	$253,000
Cost of goods sold	197,000	204,384	205,408
Depreciation and amortization expense	10,000	14,130	19,500
Other operating expense	20,835	20,835	20,835
Interest expense	7,165	7,165	7,165
Provision for income taxes	9,000	9,000	9,000
	244,000	255,514	261,908
Income (loss) from continuing operations	$ 9,000	$(2,514)	$(8,908)
Gain from decline in purchasing power of net amounts owed		$ 7,729	$ 7,729
Increase in specific prices (current cost) of inventories and property, plant, and equipment held during the year*			$ 24,608
Effect of increase in general price level			18,959
Excess of increase in specific prices over increase in the general price level			$ 5,649

* At December 31, 1980 current cost of inventory was $65,700 and current cost of property, plant, and equipment, net of accumulated depreciation was $85,100.

SCHEDULE C

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES

(In (000s) of Average 1980 Dollars)

	Years Ended December 31,				
	1976	1977	1978	1979	1980
Net sales and other operating revenues	265,000	235,000	240,000	237,063	253,000
Historical cost information adjusted for general inflation					
Income (loss) from continuing operations				(2,761)	(2,514)
Income (loss) from continuing operations per common share				$ (1.91)	$ (1.68)
Net assets at year-end				55,518	57,733
Current cost information					
Income (loss) from continuing operations				(4,125)	(8,908)
Income (loss) from continuing operations per common share				$ (2.75)	$ (5.94)
Excess of increase in specific prices over increase in the general price level				2,292	5,649
Net assets at year-end				79,996	81,466
Gain from decline in purchasing power of net amounts owed				7,027	7,729
Cash dividends declared per common share	$ 2.59	$ 2.43	$ 2.26	$ 2.16	$ 2.00
Market price per common share at year-end	$ 32	$ 31	$ 43	$ 39	$ 35
Average consumer price index	170.5	181.5	195.4	205.0	220.9

Representative WYLIE. Mr. Williams, I have sent word to Congressman Moorhead that you are at the table now. He says he is tied up in the Government Operations Committee. He asked me to pay his respects. He will still try to get here, but I do know you have a time limitation, so we'll ask you to proceed with your testimony at this time.

Mr. WILLIAMS. Thank you, Congressman. I do have until noon, so I'm not under tremendous pressure.

Representative WYLIE. Maybe he will arrive soon.

STATEMENT OF L. STANTON WILLIAMS, CHAIRMAN OF THE BOARD, PPG INDUSTRIES, ON BEHALF OF THE BUSINESS ROUNDTABLE, PITTSBURGH, PA.

Mr. WILLIAMS. I do appreciate the opportunity to testify today before the Joint Economic Committee. I also request that my prepared statement which has been submitted to the committee be made a part of the published record of this hearing.

Representative WYLIE. Your prepared statement will be made a part of the record.

Mr. WILLIAMS. I would add, I am accompanied by associates from both the Business Roundtable and PPG.

The overriding challenge to our domestic economy today is to stimulate business investment, improve productivity and at the same time reduce the righ rate of inflation. The capital needs of industry are directly affected by inflation, which not only increases the cost of capital, but also substantially raises the price of replacing existing plant and equipment and providing increased and more efficient capacity.

Our existing tax structure was not designed to deal with a highly inflationary economy and, as a result, taxable income computations significantly overstate the real earnings of taxpaying entities, with effective income tax rates at levels well beyond statutory rates.

Moreover, high inflation makes the environment for investment more speculative, with returns appearing more uncertain. As a result, businessmen are reluctant to commit resources to making additional investment, plants become outmoded, and the rate of productivity growth declines.

During the past several years business has reported record annual earnings in their published financial statements. These favorable reports were all the product of existing generally accepted accounting principles. Our normal conception of profit is that it represents the excess of revenues over costs, and that such profit is then available for two purposes—to pay dividends to the owners of the enterprise for the use of their invested capital, and to reinvest in expanded assets, the use of which can generate additional profits.

But inflation undermines the calculation of costs used in the profit determination process. Inventory valuation and depreciation of machinery and equipment are the two principal problems in an inflationary economy in the determination of costs. An inventory item may have cost $1 to produce, but if it costs $1.10 to replace it in inventory because of inflation, then that 10-cent differential should

logically be charged against earnings prior to determining profit. Conventional historic cost accounting would define that 10 cents as a part of profit. I trust it is apparent that a series of transactions of that nature in a continuing inflationary economy will result in a gross overstatement of earnings.

The same theory applies to depreciation which, in conventional historic accounting methods, is a recovery of the original cost of a piece of equipment over its estimated useful lifetime. Consequently, a $1,000 piece of equipment depreciated ratably over 10 years yields a $100 annual depreciation charge by conventional accounting methods. But if as a result of inflation, the replacement cost of that piece of equipment is now $2,000, the appropriate way to determine profit is to recognize the $2,000 replacement value in the depreciation calculation. To do otherwise means that, as with inventories, inadequate depreciation has brought about a substantial overstatement of profits.

The complexities of large business enterprises do not make it easy to calculate and report the true economic profits as epitomized by these two simple examples. But businessmen and objective economic students do agree that the earnings reported by industrial business enterprises in accordance with conventional accounting standards do overstate real earnings.

Accountants and businessmen have for years been trying to find an equitable and acceptable method of reflecting the effects of inflation on financial statements of diverse business enterprises. It is not an easy task.

The Financial Accounting Standards Board finally issued their directive No. 33 last year, which prescribes some experimental approaches for adoption in 1979 and 1980 annual reports as supplemental data. Most businessmen, and even the FASB, realize that standard 33 is only a start, and further modification of techniques will be required to obtain numbers with which we can all be comfortable as appropriately reflecting inflation's effects. But I and much of the business community applaud the effort and the intent. The direction is right.

My own company has record earnings in 1979 as measured by conventional accounting methods. Those earnings represented 7 cents for each dollar of sales—not bad in comparison with other industrial companies. But after applying FASB 33 for inflation effects, those earnings were between 4 to 5 cents per dollar of sales. Neither level of earnings can be described as "obscenely high," and yet that was a particularly good year for us. Since earnings and prospective earnings represent the principal sources of new capital for growth and new jobs, I have great interest in ways of improving capital formation.

Price Waterhouse, one of the largest public accounting firms, has recently published an analysis of the FASB 33 data reported by some of the Fortune 500 firms in their 1979 annual reports. PPG data was not inconsistent with the results of their survey. I understand Mr. Connor, senior partner of Price Waterhouse, will elaborate further on the results of the survey.

In the remaining moments of my testimony, I would like to draw a few conclusions about the effects of inflation on business enterprises,

and then suggest the direction which government might take to reduce inflation, increase productivity, and increase jobs.

FASB 33 may not be, and probably is not, the definitive method of measuring the effect of inflation on corporate financial statements. But on an overall basis, the calculations are broadly accurate, and I suggest these conclusions:

First: Reported profits greatly overstate the true economic facts and real corporate profits are not excessive or obscene, but rather are inadequate to support industrial growth.

Second: Of the profits that are generated, the real percentage taken for taxes is amazingly high.

Third: Strong corporate profits are a major prerequisite of any program to improve capital formation.

The single most important offset to rising wages in the economy is productivity. If wages increase at a rate of 8.5 percent and productivity in the same year rises 0.5 percent, under these circumstances the embedded rate of inflation is 8 percent.

As we enter the decade of the 1980's, the nation should launch a major program of productivity improvement involving a commitment from all sectors of the economy—including labor, business, and governments—to improve the efficiency of our economic systems.

The Business Roundtable supports this committee's recommendation for a tax cut designed to stimulate capital formation and savings and investment. We would, however, suggest that the effective date for such a tax cut be no later than January 1, 1981, preferably sooner. The cornerstone of any tax reduction program should be passage by Congress of H.R. 4646 and S. 1435, that is, the 10–5–3 Capital Cost Recovery System which you, Congressman, cosponsored.

It seems to me that passage by Congress of the 10–5–3 formula for taxes will be an important solution to the inadequate depreciation problem. 10–5–3 is not, of course, the equivalent of replacement cost depreciation. But replacement cost depreciation would have difficult administrative problems. 10–5–3 has the virtue of being easy to administer and from the cash flow standpoint, it could prove to be roughly equivalent.

Capital formation is essential for increased productivity and economic progress, and 10–5–3 is the most effective piece of proposed legislation for stimulating capital investment. I urge the Congress to get on with hearings on a tax cut and hopefully affirmative action on 10–5–3 Capital Allowance System.

Representative WYLIE. Thank you very much, Mr. Williams, for an excellent statement.

[The prepared statement of Mr. Williams on behalf of the Business Roundtable, together with exhibits I, II, and III and a position paper entitled "Capital Formation: A National Requirement," follows:]

PREPARED STATEMENT OF L. STANTON WILLIAMS

My name is L. Stanton Williams. I am the Chairman of PPG Industries, Inc. I sincerely appreciate the opportunity to testify before the Joint Economic Committee today on behalf of The Business Roundtable and to focus my remarks on the interaction between inflation, profitability and capital formation.

The overriding challenge to our domestic economy today is to stimulate business investment, improve productivity and at the same time reduce the high embedded rate of inflation. Long-term capital spending will improve the U.S.

standard of living and will enable American industry to more effectively compete in world markets, thereby providing important relief to our balance of payments problems. The capital needs of industry are directly affected by inflation, which not only increases the cost of capital, but also substantially raises the price of replacing existing plant and equipment and providing increased and more efficient capacity. Our existing tax structure was not designed to deal with a highly inflationary economy and as a result taxable income computations significantly overstate the "real" earnings of taxpaying entities with effective income tax rates at levels well beyond statutory rates.

Moreover, high inflation makes the environment for investment more speculative. The returns from a prospective investment appear more uncertain. As a result, businessmen are reluctant to commit resources to making additional investment, plants become outmoded and the rate of productivity growth declines.

During the past several years business has reported "record" annual earnings in their published financial statements. These favorable earnings reports were all the product of existing "generally accepted accounting principles." The calculation of profits of a business enterprise by conventional accounting methods is accurate in a non-inflationary economy, but brings about a substantial overstatement of profits in an inflationary period when the dollar is constantly changing in value.

Conventionally reported, or "book" profits, exceed true economic profits because they are based on accounting practices that undervalue the cost of inventories, depreciation, and working capital when there is inflation. When inventories are accounted for by the first-in, first-out accounting method, price increases between the time the inventories are accumulated and the time they are liquidated are treated (and taxed) as income even though such income is needed to restock inventories at higher replacement costs and is not, therefore, a true economic gain. Similarly, book profits are overstated because depreciation deductions are based on the historical cost of the asset involved, even though the true economic cost of the wear and tear occurring is the higher replacement cost of the asset. As an indicator of expected profits, book profits are especially deficient since they are based on an understatement of what depreciation would be on new investment.

I have attached hereto an Exhibit I, a table which compares the 1965–79 reported book profits on non-financial corporations to their real operating profits, adjusted for inflation. The data clearly indicated the impact of inflation. While book profits after tax (column 3) rose by more than 18 percent from 1978 to 1979, after-tax operating profits actually declined by 13 percent when adjusted for inflation (column 7). Indeed, 1979 operating profits (after taxes and corrected for inflation), while well above the low point reached in the recession year 1974, were about 38 percent below the high point reached in 1966, a year of rapid economic expansion.

Accountants and businessmen have for years been trying to find an equitable and acceptable method of reflecting the effects of inflation on financial statements of diverse business enterprises. It is not an easy task. The Financial Accounting Standards Board (FASB) finally issued their directive No. 33 last year which prescribes some experimental approaches for adoption in 1979 and 1980 annual reports as supplemental data to the conventional historical data. Most businessmen, and even the FASB, realize that FASB 33 is only a start, and further modification of techniques will be required to obtain numbers with which we can all be comfortable as appropriately reflecting inflation's effects. But I and much of the business community applaud the effort and the intent. The direction is right.

My own company had record earnings in 1979 as measured by conventional acconuting methods. Those earnings represented seven cents for each dollar of sales—not bad in comparison with other large industrial companies. But after applying FASB 33 for inflation effects, those earnings were apparently 4 to 5 cents per dollar of sales. Neither set of earnings can be described as "obscene", and yet that was a particularly good year. Since earnings and prospective earnings represent the principal sources of new capital for growth and new jobs. I have great interest in ways of improving capital formation.

Price Waterhouse, a large public accounting firm, has recently published an analysis of the data reported by some of the Fortune 500 firms in their 1979 annual reports. PPG data was not inconsistent with the results of their survey, Using the FASB 33 approach, adjusting for inflation, earnings for industrial corporations were 40 percent below what was reported on the normal historical basis. Return on net assets employed was 8 percent, as contrasted with the 17 per-

cent reported. And quite significantly, the effective tax rate on an inflation adjusted basis, was 53 percent rather than the average 39 percent repoted on an historical basis.

In the remaining moments of my testimony, I would like to draw a few conclusions about the effects of inflation on business enterprises, and then suggest the direction which government might take to reduce inflation, increase productivity and increase jobs.

FASB 33 may not be, and probably is not, the definitive method of measuring the effect of inflation on corporate financial statements. But on an overall basis, the calculations are broadly accurate, and I suggest these conclusions:

First, reported profits greatly overstate the true economic facts and real corporate profits are not excessive or "obscene", but rather are inadequate to support industrial growth;

Second, of the profits that are generated, the real percentage taken for taxes is amazingly high; and

Third, strong corporate profits are a major segment of any program to improve capital formation.

The single most important offset to rising wages in the economy is productivity. If wages increase at a rate of 8.5 percent, and productivity in that year rose 0.5 percent, under these circumstances the embedded rate of inflation is 8.0 percent. Over the past decade, while there has been a significant increase in the labor force, there has been a significant decrease in the rate of growth of plant and equipment. This has reduced the growth of labor productivity, reduced the growth rate of real wages and contributed to the nation's expanding list of economic problems. Exhibit II, attached hereto, verifies that productivity has grown much more slowly over the past 10 years than previously and is currently showing virtually no growth. When the growth of productivity falls, but the rate of increase in wages remains constant (or increases), unit labor costs increase, as illustrated in Exhibit III. With unit labor costs rising, as they have in recent years, selling prices are forced upward in order to preserve profit margins.

The need for faster labor productivity growth is particularly great, given continuing high rates of U.S. price inflation. Reducing the rate of inflation without more unemployment is, to a large extent, a matter of increasing productive capacity through improvements in labor productivity, or of increasing market supply without decreasing effective demand. There are a number of economists who believe that the supply side of the battle with inflation has been neglected in recent years, and that more needs to be done to boost output through removal of government impediments to growth in business investment and production. In particular, there is concern that, unless adequate attention is devoted to capacity expansion, the U.S. economy will periodically encounter inflationary bottlenecks and shortages in key industries.

For a fuller discussion of the capital formation needs of our country today, I have attached hereto a position paper prepared by The Business Roundtable Taxation Coordinating Committee.

As we enter the decade of the 1980's in an environment of higher inflation, economic policy should be redirected from reliance on short-run policy action toward reducing the long-run determinants of the inflation rate. Fiscal restraint by the government is a necessary ingredient in any policy aimed at stemming inflation and providing the basis for long-term economic growth. The nation should launch a major program of productivity improvement involving a commitment from all sectors of the economy—including labor, business and government—to improve the efficiency of our economic system.

The Business Roundtable supports the Committee's recommendation for a tax cut designed to stimulate capital formation and savings and investment.[1] We would however suggest that the effective date for such a tax cut be no later than January 1, 1981, preferably sooner. The cornerstone of my tax reduction program should be passage by Congress of H.R. 4646/S. 1435 (The "10–5–3" Capital Cost Recovery System), which you, Mr. Chairman, sponsored. At least half of the total tax cut should be directed to incentives for increased capital investment.

It seems to me that passage by Congress of the "10–5–3" formula for taxes will be an important solution to the inadequate depreciation problem. "10–5–3" is not, of course, the equivalent of replacement cost depreciation. But replacement cost depreciation would have difficult administrative problems. "10–5–3"

[1] Joint Economic Committee 1980 Annual Report.

has the virtue of being easy to administer, yet from the cash flow standpoint, of at least a growing business enterprise, it could prove to be roughly equivalent. Capital formation is essential for increased productivity and economic progress, and "10–5–3" is the most effective piece of current proposed legislation for stimulating capital investment.

I urge the Congress to get on with hearings on a tax cut and hopefully affirmative action on "10–5–3."

EXHIBIT 1

ADJUSTMENT OF REPORTED PROFITS OF NONFINANCIAL CORPORATIONS, 1966–79

[In billions of dollars]

Year	(1) Book profit before tax	(2) Income tax liability	(3) Book profits after tax (3)=(1)−(2)	(4) Increase in costs due to inflation			(5) Operating profits before tax as adjusted (5)=(1)−(4)	(6) Operating profits after tax as adjusted [3] (6)=(5)−(2)	(7) Operating profits as adjusted in 1967 dollars
				CCA [1]	IVA [2]	Total increase			
1966	69.5	29.5	40.0	−3.8	2.1	−1.7	71.2	41.7	42.9
1967	65.4	27.7	37.7	−3.6	1.7	−1.9	67.3	39.5	39.5
1968	71.9	33.6	38.3	−3.6	3.4	.2	72.1	38.5	36.9
1969	68.4	33.3	35.1	−3.5	5.5	2.0	66.4	33.0	30.1
1970	55.2	27.3	27.8	−1.5	5.0	3.5	51.7	24.4	21.0
1971	63.2	29.9	33.4	−.5	5.0	4.5	58.7	28.8	23.7
1972	75.9	33.5	42.4	−2.7	6.6	3.9	72.0	38.5	30.7
1973	92.7	39.6	53.1	−1.8	18.6	16.8	75.9	36.3	27.3
1974	102.9	42.7	60.2	3.0	40.4	43.4	59.5	16.8	11.4
1975	101.3	40.6	60.7	11.9	12.4	24.3	77.0	36.4	22.6
1976	130.0	52.6	77.4	14.4	14.7	29.1	100.9	48.3	28.3
1977	143.5	59.6	83.9	11.9	15.1	27.0	116.5	56.9	31.3
1978	166.1	68.8	97.3	12.6	25.2	37.8	128.3	59.5	30.5
1979	190.2	75.1	115.1	15.6	41.8	57.4	132.9	57.8	26.6
Percentage change 1966–79	+174	+155	+188				+87	39	−38

[1] Capital consumption allowance.
[2] Inventory valuation adjustment.
[3] Since this is a retrospective recomputation of profits, it takes as given the corporate income taxes actually paid. If tax liabilities had been figured on the adjusted pretax profits, the after-tax effect of the adjustment would, of course, have been reduced by the tax-saving resulting therefrom. But since they were actually figured on the reported profits throughout, there were no such tax savings. Adjusted after-tax profits are simply adjusted pre-tax profits minus actual taxes on reported profits.

Source: Department of Commerce.

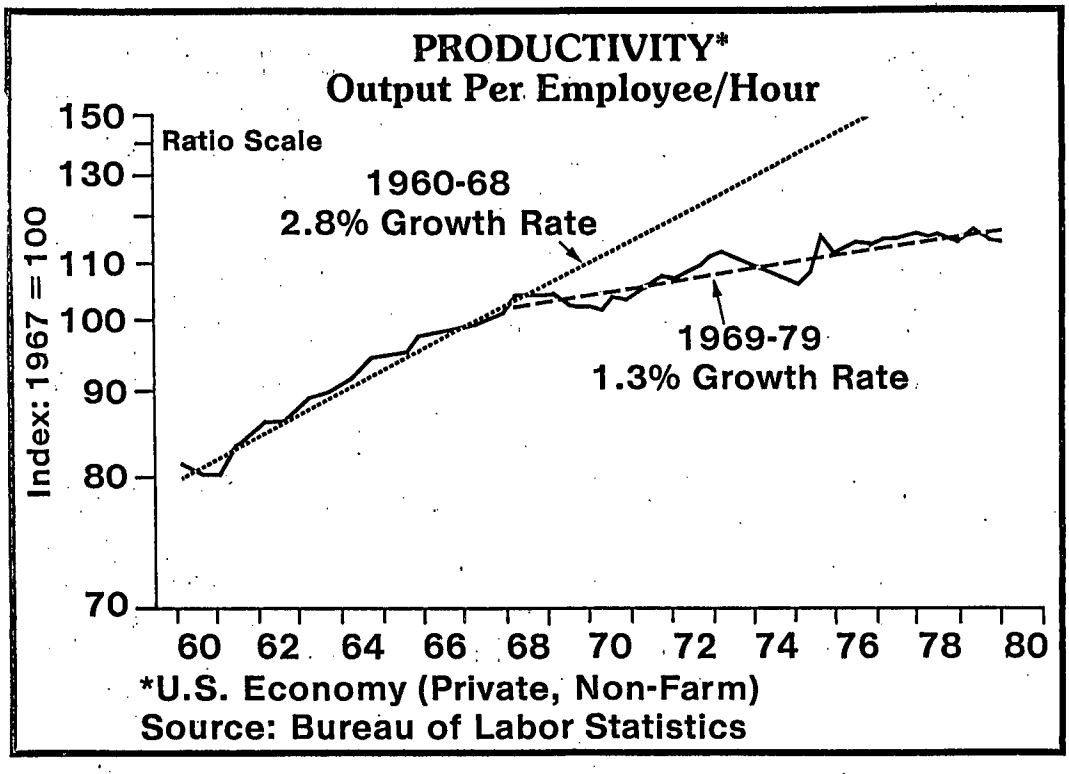

PRODUCTIVITY*
Output Per Employee/Hour
Ratio Scale
Index: 1967 = 100
150
130
110
100
90
80
70
1960-68
2.8% Growth Rate
1969-79
1.3% Growth Rate
60 62 64 66 68 70 72 74 76 78 80
*U.S. Economy (Private, Non-Farm)
Source: Bureau of Labor Statistics

Exhibit III

% CHANGE IN PRODUCTIVITY AND WAGE LEVELS

Capital Formation: A National Requirement[1]

SUMMARY

The U.S. economy faces a serious problem of inadequate capital formation. The rate at which American business is investing in new capital assets is below the level required to meet the needs of sustained economic growth, a full employment economy, improved labor productivity, decreased dependence on foreign sources of petroleum, and continued environmental improvement.

The U.S. economy trails all other major industrialized countries in both productivity growth and the share of gross national product devoted to capital formation. What's more, in the past decade the growth in U.S. plant and equipment has not kept pace with the growth of the U.S. labor force. This has sharply curtailed normal expansion in the amount of plant and equipment available for each U.S. worker and slowed productivity growth. As the rate of increase in the U.S. capital-labor ratio fell from 2.8 percent per year from 1963–73 to less than 1.0 percent per year from 1973 to 1978, there was a parallel drop in U.S. labor productivity growth from 2.3 percent to less than 1.0 percent per year—and actually declined slightly during 1979. Lagging capital formation explains a significant share of the poor U.S. productivity performance.

By most accounts, real nonresidential fixed investment will have to total about 12 percent of real GNP in coming years to meet our pressing—and increasingly capital-intensive—national goals and to assure a rising standard of living for all Americans. Presently, the ratio of real fixed investment to real GNP is about 10 percent, almost 2 percentage points below the prescribed rate. Thus, more capital is needed to reverse lagging productivity growth, curb inflation, and get the economy moving again.

More capital requires a higher rate of savings and investment—which, in turn, requires the expectation of a higher rate of return. And therein lies the problem. As a result of a tax system that taxes nominal income instead of real income, after-tax profits in U.S. businesses do not provide an adequate incentive to save and invest, particularly under a regime of mounting government regulations that increase the risk of investment.

Inflation has driven an enoromous wedge between the book profitability of U.S. corporations, with which the public is most familiar, and the true, inflation-adjusted, rate of return. Conventionally reported book profits overstate real economic profits because they are based on accounting practices that undervalue the cost of inventories, depreciation, and working capital when replacement costs are rising. What's more, book profitability is not corrected for the purchasing power loss due to inflation.

While the average book profitability of U.S. non-financial corporations reached an historic high in 1978, profitability adjusted for the impact of inflation was actually negative and lower than in any postwar year, other than the recession year 1974. The real rate of return on corporate equity investment has fallen from a 1955-65 average of 4.1 percent to a negative 1.5 percent average over the past five years, since double-digit inflation first struck.

The negative returns of recent years are even more alarming in light of the increasing risks of U.S. capital investment. In an inflationary period, the real cost of debt declines, and corporations are inclined to increase the importance of debt in their capital structure. Yet, higher debt-equity ratios increase the volatility of shareholders' returns and the riskiness of all corporate investment.

Moreover, unpredictable rates of inflation leave investors less willing to commit funds to long-term projects. Escalating and mercurial government regulations further increase risk premiums. When business cannot accurately predict the costs of changing environmental, health, safety, and other economic regulations, long-term commitments become increasingly uncertain and unattractive. Investments in new technologies, which have the most uncertain and longest-term payoffs of all, are particularly hurt. Unfortunately, these are also the investments which provide the greatest hope for dramatic increases in productivity and living standards.

The time has come to rethink and restructure our tax laws, our business regulations, and all other government policies that influence the willingness of business to invest in the long-term health of the U.S. economy The U.S. will reap the benefits of more capital only if we are willing to redesign the government

[1] Taxation Coordinating Committee position paper of the Business Roundtable.

policies that are the primary cause of our current low rate of savings and investment.

A. The need for capital accumulation

Economists have long recognized the importance of capital formation to sustained economic growth. A society increases its standard of living primarily by increasing the productivity of its labor force; and sustained increases in productivity and living standards primarily come from investment in more and better capital—from the construction of more efficient plant and equipment, the discovery and development of new energy resources and energy-saving technologies, research and development of new products and production techniques, and improvements in the skill and health of workers. In a far from trivial sense, economic progress consists of capital formation.

In recent years, there has been widespread concern that the rate of U.S. capital formation is inadequate. It is, of course, not easy to measure "adequacy." "Adequacy" depends on a society's goals and other value judgments about the importance of future versus current consumption. What matters is not the absolute level of investment flows, but whether these flows are sufficient to assure a rate of growth in the total supply of goods and services to an economy that enables a healthy rate of over-all economic growth with reasonable price stability and minimum unemployment. In addition, new capital investment is needed to allow a country to meet a range of specific socially mandated goals, such as those for energy production and conservation, environmental improvement, and the skill, health, and safety of workers.

The principal symptoms of capital inadequacy include a number of characteristics of the U.S. economy in recent years. Most important among these are lagging productivity growth, persistent inflation, and a number of unmet, capital-intensive national needs, particularly those relating to the energy problem.

1. *U.S. trails in capital investment and productivity growth.*—Government statistics indicate that, among the principal industrialized countries of the world the United States has the lowest share of gross national product devoted to capital formation, and also the lowest rate of labor productivity growth.

TABLE 1.—SHARE OF GNP DEVOTED TO PRIVATE, NONRESIDENTIAL GROSS CAPITAL FORMATION AND GROWTH RATES OF LABOR PRODUCTIVITY

	Investment ratio[1]		Average annual percent change in productivity[2]			
	Percent	Rank	1963–73	Rank	1973–77	Rank
Japan	19.7	1	8.7	1	2.8	2
France	14.1	2	4.6	2	2.7	3
West Germany	12.8	4	4.6	2	3.2	1
Canada	13.4	3	2.4	5	.5	4
United Kingdom	11.7	5	3.0	4	.5	4
United States	10.2	6	1.9	6	0	6

[1] Measured as the annual average of gross private, nonresidential fixed investment at current prices as a percent of current gross national product, 1970–77.
[2] Measured by growth in real domestic product per employed person, using own country's price weights.

Source: OECD, National Accounts, 1979; and Economic Outlook, July 1979.

Output per American worker grew at an annual average rate of 1.9 percent between 1963 and 1973, but grew by only 1.0 percent per year from 1973 to 1978 and declined slightly in 1979. While productivity has also dropped significantly in other major industrialized countries since the early 1970's, it did not change the United States' last place international ranking. Indeed, in many instances, it widened the gap between productivity growth in the U.S. and growth elsewhere. This has unfortunate implications for the ability of the United States to maintain its international lead in living standards. By some accounts, output per worker in Germany has already surpassed that in the United States. And if the most recent trends in productivity growth continue into the 1980's, output per worker in France, Japan and Canada would also exceed levels attained in the United States by 1985 or shortly thereafter.

2. Lagging capital formation largely explains the poor U.S. productivity performance.—In analyzing the poor relative productivity performance of the U.S. economy, the Joint Economic Committee recently concluded that, while some of

the faster growth in foreign countries may be due to their "catching up" by adopting (or adapting) U.S. technology . . . other more basic factors, such as the higher rates of capital formation in the other countries play an important role." [1a] Countries that devote the largest shares of their GNP to capital formation tend to have the fastest rates of productivity growth.

For the United States there has, likewise, been a close correspondence between periods of above-average growth in labor productivity and periods of relatively rapid capital formation. Between 1963 and 1973, for example, high rates of U.S. private investment led to a growth of about 2.8 percent per year in the amount of capital available per hour worked by all persons in the private non-farm sector, but, since 1973, that growth has dropped to less than 1.0 percent per year. Likewise, the rate of growth in U.S. output per hour worked in the private, non-farm sector has fallen to 1.0 percent per year since 1973 from the 1963–73 average rate of 2.3 percent per year.[2]

To be sure, there are a number of factors other than capital formation that may help explain why U.S. productivity performance has lagged in recent years, relative both to foreign economies and to earlier U.S. postwar experience. Faster employment growth, a more service-intensive economy, increasing government regulation, less intensive efforts on research and development, and rising energy prices, for example, are among the more frequently cited additional reasons for the productivity slowdown.

However, even after allowing for these other factors, the weakness of business fixed investment over the past several years still explains a major share of the productivity slowdown. Recent studies by economists at the Bureau of Labor Statistics and Data Resources both conclude that slower growth in the capital stock can explain the principal share of the post-1973 drop-off in U.S. productivity growth from earlier trends.[3] The public policy implication is inescapable. As the 1979 Report of the Joint Economic Committee put it, "The cumulative loss of capital stock during the recession, combined with projections for continued rapid labor force increase, strongly suggests that special measures to promote capital spending are needed. . . ."

3. Increased capital formation would help to ease inflation.—The need for faster productivity growth is particularly great, given continuing high rates of U.S. price inflation. Reducing the rate of inflation without more unemployment is, to a large extent, a matter of increasing productive capacity through improvements in labor productivity, or of increasing market supply without decreasing effective demand. There are a number of economists who believe that the supply side of the battle with inflation has been neglected in recent years, and that more needs to be done to boost output through removal of government impediments to growth in business investment and production. In particular, there is concern that, unless adequate attention is devoted to capacity expansion, the U.S. economy will periodically encounter inflationary bottlenecks and shortages in key industries.

Statistical measures of capacity utilization offer only an imperfect guide to the adequacy of the current stock of plant and equipment or, alternatively, to the presence or absence of excess demand and, hence, inflationary pressures in product markets. Much, if not most, of capacity that is currently designated as "not utilized" is comprised of high-cost, over-aged, and inefficient—sometimes energy or environmentally inefficient—equipment and facilities which are maintained for standby use only in emergencies or to meet other special situations. As a result, de facto "full" capacity utilization occurs appreciably below 100 percent of official capacity. This is suggested by the data presented in the chart below:

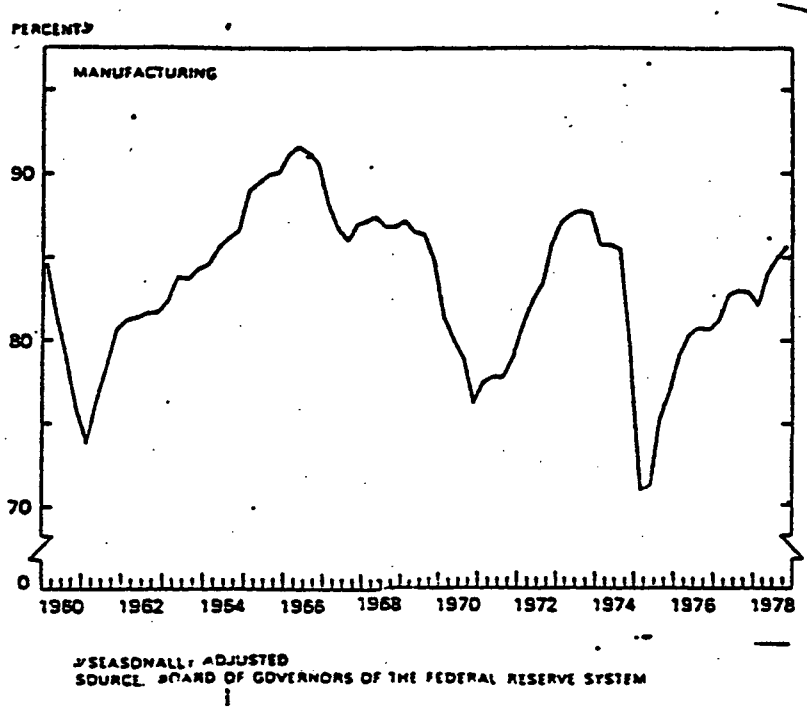
[1a] The 1979 Joint Economic Report, 1979, pp. 58–59.

[2] Since there has been a decline over the postwar period in the average hours worked per week, both in the United States and abroad, measures of productivity based on the number of employed persons have increased less rapidly than measures based on the number of hours worked which is a superior index of labor input. Yet, data for hours worked in the total economy are not available on a consistent international basis. Thus, productivity is defined as output per person employed for the comparisons in Table 1.

[3] Norsworthy, J. R. and Harper, M. J., "The Role of Capital Formation in the Recent Productivity Slowdown." Working Paper 87, Office of Productivity and Technology, U.S. Department of Labor, January 1979; Siegel, Robin "Why Has Productivity Slowed Down?" Data Resources U.S. Review, March 1979.

Chart 1

Capacity Utilization Rate in U.S. Manufacturing, 1960–78



In both the mid-1960's and early 1970's, the nation's stock of plant and equipment was such that as overall capacity utilization rate reached 90 percent, capacity strain occurred in a number of key industries, and inflation worsened. By late 1978, the utilization of industrial capacity was below, but not far below, the peak levels reached in 1966–1968 and 1972–1973. According to the Council of Economic Advisers, to avoid recurrent capacity strains, especially in raw materials industries, future "investment would have to grow at rates approximating those of the 1962–66 period." As explained presently, this would require a significant increase in U.S. investment activity.

4. More capital is needed to achieve unmet capital-intensive national goal.—Another major reason for concern about the adequacy of U.S. capital accumulation is the existence of several national goals whose fulfillment would require high levels of investment spending. In particular, vast capital outlays are going to be needed to solve the nation's energy problem without sacrificing economic growth and continued improvement of the environment and the safety and health of workers. Even energy programs that are predominantly aimed at greater conservation rather than more energy production require substantial capital inputs, whether for making automobiles and appliances more energy efficient, switching from oil to coal as an industrial boiler fuel, or improving the insulation of homes and office buildings. More capital will clearly be needed for opening up new sources of energy: for solar collectors and synthetic fuel plants, for oil and gas drilling at greater depths and farther afield, or for bringing in natural gas by pipeline from the north of Alaska. These energy investments are likely to cost hundreds of billions of dollars over the next decade, in addition to the conventional capital requirements our economy will face.

The future protection of the environment will similarly require more investment, as will the protection of the health and safety of workers and consumers. All of these protection measures cost money and improve the quality of our lives,

but they do not usually produce more goods. They only occasionally increase and more likely decrease physical output per worker. This means that some of the recent growth in U.S. capital accumulation may not be productive investment.

Business expenditures for pollution abatement have risen to a significant fraction of total business fixed investment in recent years—about 5 percent in the 1976–78 period. What's more, in some of the industries that are likely to be of particular importance in solving the U.S. energy problem—petroleum chemicals, primary metals, and public utilities—the percentage of total investment devoted to pollution abatement has often been over 10 percent, or more than twice the national average. Since investments for pollution abatement and other social objectives are additive to investment that would expand capacity, higher total investment will be needed if we are to meet both our output goals and our social objectives.

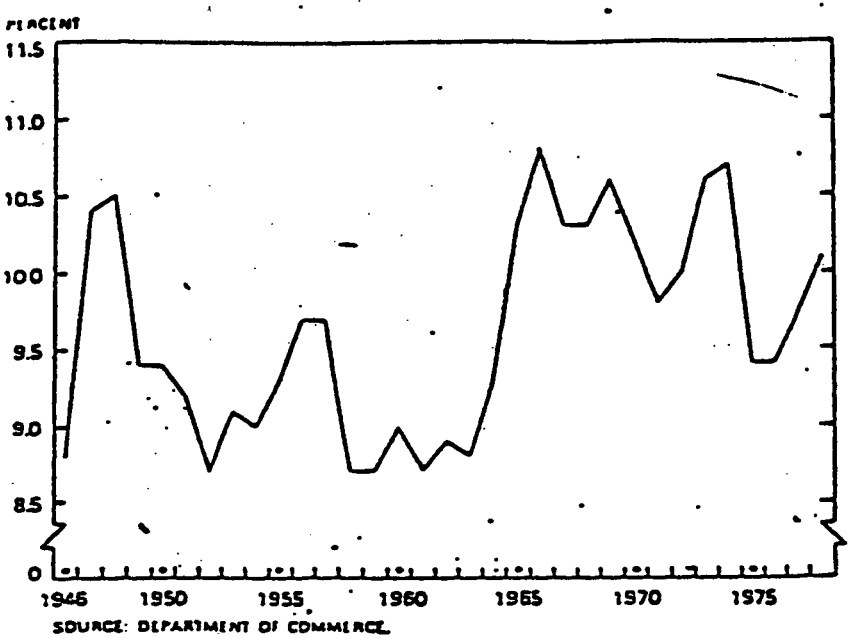
B. Investment goals for the future

In order to assure a U.S. capital stock in the 1980's that is sufficient to meet the needs of a full employment economy, improved labor productivity, decreased dependence on foreign sources of petroleum, and continued environmental improvement, the United States will need to set aside in the future a somewhat larger percentage of capital formation of GNP. By most accounts, real nonresidential fixed investment will have to total about 12.0 percent of real GNP in the years to come. This was the recommendation of the Joint Economic Committee this year and the Council of Economic Advisers in the last three presidential administrations.

Over the last 15 years, the ratio of real business fixed investment to real GNP has averaged only 10 percent (both in 1972 dollars).[8a] As Chart 2 shows, while real capital spending peaked near the end of 1973 at almost 11 percent of real GNP, it fell sharply during the recession of 1974–75, and has not fully recovered since:

Chart 2

Real Nonresidential Fixed Investment as Percent of Real GNP



[8a] The investment ratio in current prices has averaged 10.2 percent over the last 15 years because U.S. capital goods prices have risen at a slightly faster rate than general prices (GNP deflator).

By 1977, the third year of the recovery, real business investment was still only 9.6 percent of real GNP. It was not until 1978 that U.S. capital spending again reached the 10 percent level. The latest data produce a ratio of 10.5 percent.

While growth in capital spending from the current 10.5 percent of GNP to the goal of 12.0 percent may not appear great, it must be remembered that the latter figure has never been reached in this country in the entire postwar period (although most other industrialized countries have recorded much higher ratios). One percent of GNP is about $14 billion in 1972 dollars, and business investment spending on the same deflated basis has been running at an annual rate of about $150 billion.

Thus, the prescribed 1.5 percent point increase in the ratio would require a 15 percent increase in total business fixed investment. While this is not an insurmountable goal, it will require significant reorientation of economic policies to bring forth the desired investment—especially if the country is entering a period of restrained growth attributable to recession, inflation, higher energy prices, and restricted energy supplies.

C. Economic forces determining the level of investment

An economy's rate of capital accumulation is determined, on the supply side, by the willingness to save or to refrain from consuming all of one's income and, on the demand side, by the incentive to invest, or to purchase new business assets. When an economy is operating at a high level of employment and capacity utilization, an increase in the willingness to invest without a corresponding increase in the willingness to save will lead to inflation and higher rates. Accordingly, efforts to stimulate more capital accumulation during nonrecessionary periods must be directed at higher levels of both savings and investment. This is also true for efforts to increase the long-term, secular rate of capital formation.

1. Determinants of savings.—There are two principal continuing sources of savings in the United States: personal savings and retained corporate earnings. While, historically, governments (at all levels) have sometimes been net suppliers of savings through budget surpluses and debt payments, in 15 out of the last 20 years, governments have been net borrowers. During the last four years alone, the federal government borrowed over $200 billion, more than 40 percent of total private savings. While state and local government surpluses of $84 billion in the 1975–78 period offset this to a considerable degree, the net deficit still amounted to almost $120 billion. Reduction of this deficit would permit more investment to be carried out with less risk of inflationary pressures.

In addition to the after-tax rate of return, personal saving appears to depend upon such things as income, how fast and in what direction income is changing, wealth, the availability of consumer credit, inflation, and the extent to which people are covered by social insurance programs. Demographics also seem to have an effect: people tend to save more when they pass the age of 40 and become increasingly concerned about retirement income. This suggests that, if past savings patterns are maintained, the overall personal savings rate could decline as there will be relatively more people in the high-spending, low-savings age brackets (20–34) over the coming decade, and fewer in the high-saving age brackets (40–54). Personal savings may also be held down, if there continue to be further liberalizations of social security and other government welfare programs.

Since social security is almost entirely a pay-as-you-go system, there are no compensating government savings to offset the reduction in private savings. The result is less total savings in the economy than would be the case, if a larger share of savings for retirement were put into private pension funds or individual savings accounts that would increase the supply of funds for private investment.

Tax rules further depress individual savings during periods of inflation. Savers must pay tax, not only on their true income from savings, but also on their inflationary gains. As anyone with a savings account knows, an 8 percent interest rate, even before taxes, was not enough last year to compensate savers for the loss in the purchasing power of money that resulted from 9 percent inflation. Present tax rules ignore this negative real rate of return and tax individuals on the full nominal amount of interest receipts. Consequently, it is remarkable that personal saving held up as well as it did over the last decade or so. It has only in the 1976–78 period that personal saving declined to 5.4 percent of disposable personal income from a 1970–75 average of 7.4 percent. In 1979 the savings rate fell under 4 percent.

2. Determinants of investment.—When a business invests in new capital assets, it expects revenues from the sale of the output of the new assets to be sufficiently greater than the sum of the costs of labor and materials, wear and tear on the

assets, and taxes to yield adequate returns to the suppliers of investment capital. These expected earnings from investment will be paid out to stockholders in the form of dividends, to bondholders in the form of interest, or retained for reinvestment ("saved") in the firm. The willingness to invest is obviously greater the larger is the expected return on investment, given the risk involved. Government can encourage more business investment through tax reforms that reduce taxes on income from capital, through monetary policies that decrease the cost of funds raised to finance investment, and through measures to diminish the risk of investment such as curbing inflation and reducing the costs and uncertainties of government regulation.

D. The return on corporate assets

Exact data are not available on the key determinant of business investment: the expected risk-adjusted, profitability on new investment. All that is available are measures of the current profitability of existing capital, and these may be a poor guide to expected profits, especially during a period of inflation.

Nonetheless, they are all we have to work with in evaluating what might be done to encourage increased investment in the U.S. Accordingly, in the following pages, attention is paid to a number of different measures of U.S. profits and profitability, and effort is made to adjust these measures so that they better indicate investors' prospective returns on new investment.

1. Corporate profits.—Largely as a result of inflation, the true operating profits of U.S. corporations have fallen in value since the 1960's. Conventional measures of business profitability do not, however, reveal this important fact. Nor do they provide a reliable guide to prospective returns on new investment.

Conventionally reported or "book" profits exceed true economic profits because they are based on accounting practices that undervalue the cost of inventories, depreciation, and working capital when there is inflation. When inventories are accounted for by the first-in, first-out accounting method, price increases between the time the inventories are accumulated and the time they are liquidated are treated (and taxed) as income even though such income is needed to restock inventories at higher replacement costs and is not, therefore, a true economic gain. Similarly, book profits are overstated because depreciation deductions are based on the historical cost of the asset involved, even though the true economic cost of the wear and tear occurring is the higher replacement cost of the asset. As an indicated of expected profits, book profits are especially deficient since they are based on an understatement of what depreciation would be on new investment.

To correct for these shortcomings, the Commerce Department applies two adjustments to aggregate profit figures for the corporate sector of the U.S. economy. First, an "inventory adjustment" (IVA) is used to remove inventory profits. Second, a "capital consumption adjustment" (CCA) corrects for the difference between depreciation allowances used in computing book profits and the current cost of the capital used in production (updated book value). Applying these two adjustments to book profits yields a figure referred to as profits from current production or "operating profits." Deduction of corporate tax liability (federal, state, and local yields the amount available for dividends and for additions to inventories, plant, and equipment after existing capital used during the accounting period has been replaced. The purchasing power of the resulting sum can then be assessed by correcting for the general rate of inflation (Consumer Price Index).

Note that this measure of investors' real, inflation-adjusted earnings does not include capital gains on corporate plant or equipment since these gains primarily reflect increases in the general level of prices. Even if these assets could be readily liquidated, no increase in command over economic resources or purchasing power would result (unless the after-tax capital gain exceeded the inflation rate, which is unlikely). As pointed out in an analysis by Patrick Corcoran, an economist at the Federal Reserve Bank of New York: [4]

"Exclusion of such capital gains is consistent with the following definition of income: total capital is the maximum amount of money which could be spent by holders of corporate debt and equity during the current period and which would still enable them to spend the same amount in real terms in each ensuing period. In other words, if equity and bondholders elect to spend nominal capital gains from plant and equipment and inventories, they would have to liquidate some

[4] Patrick J. Corcoran, "Inflation, Taxes, and Corporate Investment Incentives," Federal Reserve Bank of New York Quarterly Review, Autumn 1977.

physical assets and therefore reduce the real value of the earnings stream in succeeding periods."

Table 2 compares the 1965–79 reported book profits of non-financial corporations to their real operating profits, adjusted for inflation. The data clearly indicate the impact of inflation. While book profits after tax (column 3) rose by more than 18 percent from 1978 to 1979, after-tax operating profits actually declined by 13 percent when adjusted for inflation (column 7). Indeed, 1978 operating profits (after taxes and corrected for inflation), while well above the low point reached in the recession year 1974, were about 38 percent below the high point reached in 1966, a year of rapid economic expansion.

Even this computation probably understates the true erosion of corporate profits due to inflation. For one thing, the estimate of current cost depreciation is based on straight-line cost recovery. If double declining balance cost recovery were assumed to reflect more accurately the actual time pattern of capital consumption, the excess of current cost depreciation over income tax depreciation in 1978, for example, would rise from 13 billion to nearly 23 billion.

The estimate also excludes the cost that inflation imposes on the holding of non-interest bearing cash balances that are needed for the day-to-day management of a business. Just as more dollars are required to maintain inventories during a period of inflation, so more dollars are required to provide working capital, e.g., to cover accounts payable, the amount of which rises with inflation. Yet currency, bank demand deposits, and net trade credits (accounts receivable less accounts payable) all lost purchasing power as a result of inflation. For example, such losses amounted to over 9 billion dollars in 1978, none of which diminished taxable business income.

2. The effective corporate tax rate.—Under presently required tax accounting rules, a rise in the inflation rate both lowers real, after-tax profits and raises the effective corporate tax rate. For example, the income tax liability of non-financial corporations amounted to 39 percent of their book profits in 1979 [column (2) divided by column (1) in Table 2], but almost 53 percent of their operating profits before tax as adjusted for the understatement of costs due to inflation [column (2) divided by column (5)]. As the data in Table 2 demonstrate, the discrepancy in the recession year 1974 was even greater—from a 42 percent reported tax rate to a 72 percent effective rate.

TABLE 2.—ADJUSTMENT OF REPORTED PROFITS OF NONFINANCIAL CORPORATIONS, 1966–79

[In billions of dollars]

Year	(1) Book profit before tax	(2) Income tax liability	(3) Book profits after tax (3)=(1)−(2)	(4) Increase in costs due to inflation			(5) Operating profits before tax as adjusted (5)=(1)−(4)	(6) Operating profits after tax as adjusted[1] (6)=(5)−(2)	(7) Operating profits as adjusted in 1967 dollars
				CCA	IVA	Total increase			
1966	69.5	29.5	40.0	−3.8	2.1	−1.7	71.2	41.7	42.5
1967	65.4	27.7	37.7	−3.6	1.7	−1.9	67.3	39.5	39.9
1968	71.9	33.6	38.3	−3.6	3.4	.2	72.1	38.5	36.9
1969	68.4	33.3	35.1	−3.5	5.5	2.0	66.4	33.0	30.1
1970	55.2	27.3	27.8	−1.5	5.0	3.5	51.7	24.4	21.0
1971	63.2	29.9	33.4	−.5	5.0	4.5	58.7	28.8	23.7
1972	75.9	33.5	42.4	−2.7	6.6	3.9	72.0	38.5	30.7
1973	92.7	39.6	53.1	−1.8	18.6	16.8	75.9	36.3	27.3
1974	102.9	42.7	60.2	3.0	40.4	43.4	59.5	16.8	11.4
1975	101.3	40.6	60.7	11.9	12.4	24.3	77.0	36.4	22.6
1976	130.0	52.6	77.4	14.4	14.7	29.1	100.9	48.3	28.3
1977	143.5	59.6	83.9	11.9	15.1	27.0	116.5	56.9	31.3
1978	166.1	68.8	97.3	12.6	25.2	37.8	128.3	59.5	30.5
1979	190.2	75.1	115.1	15.6	41.8	57.4	132.9	57.8	26.6
Percentage change 1966–79	+174	+155	+188				+87	39	−38

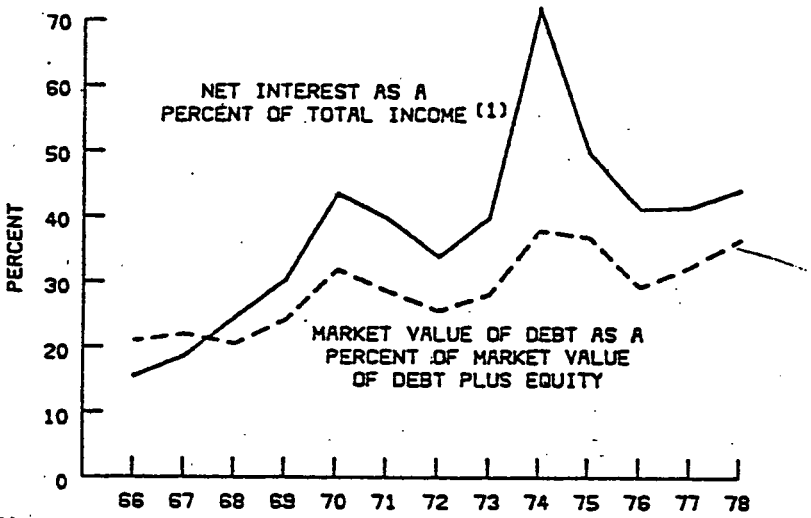
[1] Since this is a retrospective recomputation of profits, it takes as given the corporate income taxes actually paid. If tax liabilities had been figured on the adjusted pretax profits, the after-tax effect of the adjustment would, of course, have been reduced by the tax-saving resulting therefrom. But since they were actually figured on the reported profits throughout, there were no such tax savings. Adjusted after-tax profits are simply adjusted pre-tax profits minus actual taxes on reported profits.

Source: Department of Commerce.

3. *Increased reliance on debt financing.*—Corporations have obtained some relief from these higher effective tax rates through increased reliance on debt financing. In an inflationary period, the real, after-tax cost of debt declines, and corporations are induced to increase the importance of debt in their capital structures. And this has clearly happened since inflation accelerated in the mid-1960's. The importance of the market value of debt relative to the market value of debt plus equity rose from 21 percent in 1966 to nearly 37 percent in 1978 for U.S. non-financial corporations.

Chart 3
Measures of Increased Reliance Upon Debt Financing

-U.S. Nonfinancial Corporations, 1966-1978-



(1) NET INTEREST (INTEREST PAID LESS INTEREST RECEIVED) AS A PERCENT OF NET INTEREST PLUS ADJUSTED, AFTER-TAX OPERATING PROFITS (AFTER-TAX BOOK PROFITS LESS IVA, CCA, AND INFLATION-INDUCED LOSS ON CASH BALANCES).

SOURCE: FLOW OF FUNDS ACCOUNTS, FEDERAL RESERVE BOARD.

As a result of higher debt-equity ratios, interest has comprised a greater share of the total return of capital invested in non-financial corporations during the 1970's than in the earlier postwar years. As shown in Chart 3, net interest paid by non-financial corporations (after adjustments for interest received) reached a postwar peak of 72 percent of the total earnings of all security owners during the recession year 1974 and has declined since then to a 1976–78 average of 42 percent. By contrast, net interest paid was less than 20 percent of total income from capital in all postwar years prior to 1967.

4. *Rate of return on equity investment.*—One consequence of today's greater "leveraging" of operating profits has been recent recovery in the nominal return on stockholder's equity in non-financial corporations. Issuers of debt gain during periods of inflation because they are able to repay the debt with dollars that have less purchasing power than the dollars originally invested.

Conventionally reported measures of shareholders' returns do not take account of the inflation-induced reduction in the real value of shareholders' liability to bondholders. Thus, to get a better picture of the true economic gains to equity investors, it is necessary to add the devaluation of corporate debt back to profits.

After adjustment is also made for the impact of inflation on inventories and depreciation, the resulting measure of returns to shareholders can be divided by the current replacement value of the corporate capital owned by equity owners to arrive at an improved measure of real corporate profitability. The ratio of current adjusted earnings to the replacement cost of corporate assets also provides a superior measure of the expected profitability of new equity investment.

The data in Table 3 reveal a substantial discrepancy between this measure of the rate of return on stockholders' equity (column 2) and the book profitability with which shareholders are most familiar (column 1). With nominal book returns at almost 15 percent in 1978, the 1955–78 series on book profitability suggests no long-run deterioration in corporate profits, but the numbers are unadjusted for the ravages of inflation. Neither the numerator nor the denominator of book rates of return is corrected for the impact of rising prices on corporate costs. What's more, there is no final correction for the purchasing power loss due to inflation. A near 15 percent return in 1978 with 9 percent annual inflation is clearly worth less than, say, a 9 percent return in 1961 with 1 percent inflation (15—9=6, while 9—1=8).

Contrary to popular impression, there has been no recent recovery in U.S. corporate profitability. When fully corrected for price increases, the reported 14.8 percent book return of 1978 becomes a negative 1.4 percent return. Shareholders' real rates of return have dropped from an average of 4.1 percent during 1955–65 (before serious inflation struck) to a negative 1.5 percent average over the past five years, since double-digit inflation first appeared.

The negative returns of recent years are even more alarming in light of the increased risk of U.S. capital investment. Higher debt-equity ratios, for one thing, increase the volatility of shareholders' returns and the riskiness of all corporate investment. Unpredictable rates of inflation, for another, leave investors less willing to commit funds in long-term projects, especially if there is also the possibility that government price controls will prevent recovery of rising costs. Risk premiums demanded by investors have further increased because of escalating and mercurial business regulations. As Princeton economist Burton Malkiel has explained, changing government regulations have added to the cost, increased the delays, and raised the risk of corporate investment projects.[5] As a result, recent corporate profitability has been inadequate to bring forth needed new investment. Investments in new technologies, which have the most uncertain and longest-term payoffs of all, are particularly hurt. Yet, these are also the investments which provide the greatest hope for dramatic increases in productivity and living standards.

5. *Rate of return on total corporate investment.*—The last two columns in Table 3 present total corporate income (adjusted profits plus net interest) expressed as a percent of the current replacement cost of corporate assets. This measure combines shareholders' returns with those of bondholders. Accordingly, total corporate income excludes the gain to shareholders as a result of the reduction of the real value of corporate liabilities to debt holders, which occurs as the general price level rises. The counterpart of the shareholder's gain is the debt holder's loss. Consequently, when inflation causes a redistribution of wealth from creditors to debtors, there is no net effect on total income from corporate capital.

While the calculated rate of return on total corporate income is deficient insofar as it incorporates the earnings performance of both old and new assets, rather than just new assets alone, some idea of investors' expected returns on new purchases of capital can, nonetheless, be obtained. And over the last decade, there has clearly been a worsening of the profit outlook. From a postwar high of 6.7 percent in 1964–65, the real rate of return on total corporate income fell to a postwar low of minus 8.9 percent in 1974 and "recovered" to a zero rate of return in 1976. Real profitability in 1977 and 1978 was, however, once again negative despite increased business activity.

This failure of corporate income to achieve even a positive real rate of return, let alone to regain former levels of profitability surely explains why current levels of U.S. capital formation are inadequate to meet economic goals. It also suggests what needs to be done if the U.S. is to devote a greater share of national income to savings and investment, as so many private and government economists are advising. With much of corporate income taken away in taxes levied on nominal instead of inflation-adjusted income, corporate investments cannot provide an adequate incentive to save and invest.

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[5] "Productivity—The Problem Behind the Headlines." Harvard Business Review, May–June 1979.

TABLE 3.—RATES OF RETURN ON INVESTMENT IN U.S. NONFINANCIAL CORPORATIONS, 1955–78

Year	Rates of return on stockholders' equity				Rate of return on total capital	
	Book profitability [1]		Cost adjusted profitability [2]		Cost adjusted [3]	
	Nominal	Real [4]	Nominal	Real [4]	Nominal	Real
1955	12.6	12.2	6.0	5.6	6.7	6.3
1956	12.0	9.1	5.2	2.3	5.4	2.5
1957	11.2	8.2	4.9	1.9	4.8	1.8
1958	9.1	7.3	3.8	2.0	4.3	2.5
1959	10.5	9.0	4.8	3.3	5.7	4.2
1960	9.7	8.2	5.0	3.5	5.4	3.9
1961	9.2	8.5	4.4	3.7	5.3	4.6
1962	10.0	8.8	5.8	4.6	6.5	5.3
1963	10.6	9.0	6.3	4.7	6.9	5.3
1964	11.5	10.3	7.5	6.3	7.9	6.7
1965	12.6	10.7	9.0	7.1	8.6	6.7
1966	13.0	9.6	8.8	5.4	8.5	5.1
1967	11.8	8.8	7.7	4.7	7.7	4.7
1968	12.3	7.5	7.6	2.9	7.0	2.3
1969	11.6	5.5	6.9	.8	6.0	−.1
1970	9.8	4.3	4.4	−1.1	4.8	−.7
1971	10.3	6.9	5.2	1.8	5.2	1.8
1972	11.4	8.0	6.4	3.0	5.9	1.8
1973	13.4	4.6	8.7	−.1	5.3	−3.5
1974	13.8	1.6	8.4	−3.8	3.3	−8.9
1975	11.9	4.9	5.2	−1.8	4.3	−2.7
1976	13.9	9.1	4.8	0	4.8	0
1977	14.0	7.2	6.2	−.6	4.9	1.9
1978	14.8	6.7	6.7	−1.4	4.6	−3.5

[1] Average return on net worth for worldwide operations of U.S. corporations. Data from Citibank.
[2] After-tax U.S. profits corrected for inflation (CCA plus IVA plus the devaluation of net financial liabilities) divided by U.S. net worth (physical capital component value at current cost). These data were calculated by the Council of Economic Advisers (Economic Report of the President, 1979, table 30, p. 128).
[3] After-tax U.S. profits corrected for the inflation-induced increase in operating costs (IVA, straight-line CCA, and loss on cash balances), plus net interest, divided by the current cost of net U.S. assets. Data from Corcoran, Federal Reserve Bank of New York Quarterly Review, autumn 1977.
[4] Deflated by the annual change in the CPI.

E. Role of government policy in encouraging more capital investment

The challenge is clear. More capital would increase productivity and raise our standard of living. But more capital requires a higher savings and investment rate, and a higher rate requires the expectation of a higher return. The time has come to rethink and restructure our tax laws, our environmental restrictions, our business regulations, and all other government policies that influence the willingness of business to invest in the future of the U.S. economy. The United States will reap the benefits of more capital and improved living standards only if we are willing to redesign the governmental policies that are the primary cause of our current low rate of savings and investment.

Representative WYLIE. We would now like to hear from Mr. Joseph E. Connor, chairman of Price Waterhouse & Co.

STATEMENT OF JOSEPH E. CONNOR, CHAIRMAN AND SENIOR PARTNER, PRICE WATERHOUSE & CO., NEW YORK, N.Y.

Mr. CONNOR. Thank you, Congressman.

I am the chairman and senior partner of the U.S. public accounting firm of Price Waterhouse. I have looked forward to this opportunity to speak to your group this morning.

My statement is based upon an analysis that my firm did of disclosure in corporate annual reports of compliance with what has been termed earlier today FAS 33, the financial reporting and changing prices standard. Make no mistake about it, FAS 33 is a major milestone on the path of U.S. financial reporting. It is a positive, authoritative response to the challenge of inflation; it's not just another reporting requirement. It tells a vital story, and that story is simply put: Hidden

confiscatory taxation, the story of earnings that are anything but obscene, and the story of illusory growth patterns in sales, earnings, and dividends.

As recently completed, my firm's study of the first go-around inflation reporting under FAS 33 entailed review of 215 published annual reports issued by some of the most prestigious companies in America, operating in 18 different industries. We believe that this study represents a very good cross section of experience to date and provides trustworthy and enlightening answers to a key question. And that question is: What is emerging by way of new useful information that dramatizes the ravages of inflation on American business?

I have with me a copy of our final report, and I respectfully request that it be made part of the hearing record.

Representative WYLIE. Without objection, that will be done, sir.

Mr. CONNOR. Thank you.

At this time, I would like to summarize my findings and offer my perceptions of what they mean, as a practicing CPA and a practicing businessman in my own right.

In our study of experience with FAS 33, we concentrated on five key statistics of business performance and viability and on two key statistics of particular relevance to public investors. For an overview of these results, I will focus on the composite averages in the seven areas of measurement for some 157 industrial companies whose reports we analyzed. They represent 14 industry groups, and they are by far the largest part of our sample.

Let me turn first to the five measures of business performance. Sales growth from 1975 to 1979 averaged 76 percent as historically reported, compound annual growth of about 15 percent for the 4-year period. On the face, those figures show healthy, reassuring growth in volume of business, but how much was merely the result of inflation? When those sales numbers were restated in constant dollars for all of the years, the average growth from 1975 to 1979 shrank to 33 percent, less than 8 percent compounded annually. That's considerably less healthy, far from reassuring. In other words, a very significant portion of apparent growth was in fact attributable solely to inflation.

Income from continuing operations—the second statisic—computed in constant dollars declined in every instance from the corresponding amount computed in historic units of money, in a number of cases, from respectable profits to substantial losses. Excluding the latter case, the average decline was 40 percent. For the companies that chose to give 1979 current cost information, the average decline in income from continuing operations as restated was about the same, with some intriguing exceptions. Certain high-technology companies reported improved results on a current-cost basis, reflecting increasing efficiency of productive plant and effective cost-containment in the manufacture of products.

Under FAS 33 purchasing power gains and losses are excluded from restated income from operations. Companies with substantial debt disclose substantial purchasing power gains in some cases, more than offsetting declines resulting from other aspects of restatement. Informed opinion differs sharply on whether such gains are sometimes or never a component of earnings, but, in any event, those companies appear

to have shifted a portion of the inflationary burden from owners to creditors.

The third statistics, return on net assets, or RNA, computed to reflect changing prices exhibits a similar picture of decline when compared with the traditional measurement. Based on historical units of money, RNA for all the surveyed companies averaged about 17 percent. Restated, it declined to 8 percent on both a constant-dollar and a current-cost basis.

Dividend payout ratios, which averaged about 33 percent on the traditional basis, increased overall and averaged to about 65 percent on both bases of restatement.

Effective tax rate, a most important statistic from the standpoint of viability today and capital formation tomorrow, as traditionally measured, it averaged 39 percent. As restated, it averaged 53 percent for both constant dollar and current costs, well in excess of statutory rates that ostensibly mark limitations imposed by law.

Let me turn now to the inflation-oriented data of particular relevance to investors; that is, the measurement of growth in cash dividends and yearend stock prices. FAS 33 requires presentation of cash dividends paid per share and of yearend stock prices for the 5 most recent years expressed in constant dollars for all years. Clearly, these figures are of direct interest and high importance to investors. They go to the heart of the matter: How am I really doing with my investment in X company as contrasted to how I appear to be doing?

Based on historical stock prices, the average increase over the last 4 or 5 years was 74 percent. This declined to 24 percent when restated in constant dollars of 1979 purchasing power. In the case of cash dividends, the average increase for the 4-year period dropped from 90 to 41 percent when restated.

Included in the composite averages are many individual cases in which restatement transformed apparent growth in share prices in dividends or both into declines. Indeed, if restated amounts exhibit any growth, it means the investors in that company have, in fact, more than held their own during those 5 inflation-ridden years. Many investors haven't, and none did as well as they thought they were doing.

These data convey valid and cogent messages about the position of American business in an inflationary era, and it is of considerable interest that the messages are about the same regardless of how the inflation adjustment was applied, constant dollars or current cost.

I submit, in summary, that these inflation-adjusted date portray a pattern of business growth that gives little cause for comfort, demolish the tired shibboleth "obscene business profits," suggests that dividend expectations may not comport with the realities of capital formation to modernize and expand the Nation's plant, and demonstrate that business must have realistic tax relief from inflation if it is to provide full employment and achieve competitive productivity.

From both the standpoint of the investor and the standpoint of business itself. the inflation messages conveyed by these statistics are compelling. If business is to effectively deal with the erosive effects of inflation and, more importantly, increase productivity, employment, and competitiveness in the years to come, there must be monetary and fiscal initiatives that will enable American business to do the job.

I urge you to continue your efforts to convince other Members of Congress that such initiatives are essential to help revitalize our economy. Thank you.

Representative WYLIE. Thank you, too, Mr. Connor, for an excellent statement, in which I think I may have detected a note of pessimism, which I will get into a little later on.

[The prepared statement of Mr. Connor, together with a report entitled "Disclosure of the Effects of Inflation: An Analysis," follows:]

PREPARED STATEMENT OF JOSEPH E. CONNOR

I am Joseph E. Connor, Chairman and Senior Partner of the United States public accounting firm of Price Waterhouse & Co. I am privileged to have the opportunity to testify before the Joint Economic Committee on our findings concerning the effects of inflation on American businesses. My statement is based upon our analysis of disclosure in corporate annual reports in compliance with Financial Accounting Standard No. 33, "Financial Reporting and Changing Prices," better known as FAS 33.

FAS 33 is a major milestone on the path of U.S. financial reporting—a positive, authoritative response to the challenge of inflation. It is not just another reporting requirement. Rather, it tells a vital story: the story of hidden, confiscatory taxation; the story of earnings that are anything but "obscene"; the story of illusory growth patterns in sales, earnings and dividends.

WHAT FAS 33 DOES

Before presenting the results of our analysis, let me provide some background to explain what FAS 33 does, and why the results it is producing are so important to the future of the U.S. economy—an economy badly in need of revitalization.

Economists differ on the causes of inflation, on how to control it—even on its nature. But they agree that its result is, simply, the erosion of money's command over things. Americans in all walks of life voice that result in simpler terms: "The dollar doesn't go as far as it used to." For American business, the impact might be stated slightly differently: "There aren't as many dollars as it seems there are"—not in terms of profits, not for capital investment and expansion, not for stockholders. For years, traditional financial reporting served to mask that simple, crucial fact.

Traditional financial reporting is based on cost, measured in historical units of money. A fundamental assumption is that the unit is stable—once a dollar, always a dollar, whether invested in the business a century ago or booked as sales a week ago.

Inflation demolishes the stable-unit assumption. With the erosion of U.S. purchasing power, financial statements that mix dollars of 1965, 1972, 1976, and 1979—and a lot of statements do—are in effect, and invisibly, commingling four different currencies.

Because of the disparate purchasing power of the four currencies, a dollar of cost incurred in 1965, or 1972, or 1976 is not recovered by a dollar of 1979 revenue. Failure to recover costs produces a corresponding overstatement of earnings—as reported and as taxed. The results are the famous "obscene" profits, and the infamous unseen taxation of shareholders' capital.

Inflation has other consequences for financial reporting, too. Every rise in the general price level depresses the economic value of money. The owner of monetary assets—cash and receivables—loses purchasing power; the borrower of money gains it. These losses and gains can be a significant factor in evaluating business results and financial position in inflationary times. Under traditional accounting, these losses and gains go undetected.

Now, after many years of discussion and development, we have FAS 33, requiring, for the first time, the disclosure of supplementary data to the financial statements which will help demonstrate the erosion effect of inflation on business capital.

Under FAS 33, certain large, publicly-held companies must include information in their annual reports about the effects of both general price changes (constant dollar information) and specific price changes (current cost information), beginning with 1979 reports.

PRICE WATERHOUSE ANALYSIS OF FAS 33

For our own information, we began informal monitoring of disclosures under FAS 33 as soon as calendar 1979 reports were available. Because the results of even limited sampling appeared to be of such obvious interest to our clients (and, potentially, to a host of others in the business and investing communities), we formalized the project and its parameters.

As recently completed, our study of first-go-round inflation reporting under FAS 33 entailed review of 215 published annual reports, issued by some of the most prestigious companies in America, operating in eighteen different industries. We believe that our study represents a good cross-section of experience to date and provides trustworthy and enlightening answers to a key question: What is emerging by way of new, useful information that dramatizes the ravages of inflation on American business?

I have with me a copy of our final report, and I respectfully request that it be made part of the hearing record. At this time, I would like to summarize our findings, and offer my perceptions of what they mean, as a practicing CPA and as a member of the business community deeply concerned with inflation's threat to the U.S. economy.

In our study of experience with FAS 33, we concentrated on five key statistics of business performance and viability, and on two key statistics of particular relevance to public investors. The statistics for business performance are: Sales growth; Income from continuing operations; return on net assets; divided payout ratios; and effective tax rate.

The statistics of interest to investors are: Growth in dividends, and growth in year-end stock price.

All of these were drastically affected by measurement in inflation-adjusted figures. The results are most informative and signficant.

For an overview of these results, I will focus on the composite averages in the seven areas of measurement for the 157 industrial companies whose reports we analyzed. They represent fourteen broad industry groups. They are by far the largest part of our sample, and the statistics are a dramatic indiction of just what inflation is doing to business and investors.

EFFECTS OF INFLATION ON BUSINESS PERFORMANCE

Let me turn first to the five measures of business performance.

Sale growth from 1975 to 1979 averaged 76 percent as historically reported—compound annual growth of about 15 percent for the four-year period. On their face, those figures show health, reassuring growth in volume of business; but how much of it was merely the result of inflation?

When sales were restated in constant dollars for all the years, the average growth from 1975 to 1979 shrank to 33 percent—less than 8 percent compounded annually. That's considerably less health, far from reassuring. In other words, a very significant portion of apparent growth was, in fact, attributable to inflation.

Income from continuing operations computed in constant dollars declined in every instance from the corresponding amount computed in historical units of money, in a number of cases from respectable profits to substantial losses. Excluding the latter cases, the average decline was 40 percent.

For the companies that chose to give 1979 current cost information, the average decline in income from continuing operations as restated was about the same, with some intriguing exceptions. Certain high-technology companies reported improved results on a current cost basis, reflecting increasing efficiency of productive plant and effective cost containment in the manufacture of products.

Under FAS 33, purchasing power gains and losses are excluded from restated income from operations. Companies with substantial debt disclosed substantial purchasing power gains, in some cases more than offsetting declines resulting from other aspects of restatement. Informed opinion differs sharply on whether such gains are sometimes, always, or never a component of inflation-adjusted earnings, but in any event those companies appear to have shifted a portion of the inflationary burden from owners to creditors.

Return on net assets, or RNA, computed to reflect changing prices exhibits a similar picture of decline when compared with traditional measurement. Based on historical units of money, RNA for all the surveyed companies averaged about 17 percent. Restated, average RNA declined to 8 percent, on both a constant dollar and a current cost basis.

Dividend payout ratios, which averaged about 33 percent on the traditional basis, increased overall, and in some cases dramatically, upon restatement. They averaged about 65 percent on both bases of restatement.

Effective tax rate is a more important statistic from the standpoint of viability today and capital formation tomorrow. As traditionally measured (including deferred tax provisions), it averaged 39 percent. As restated, it averaged 53 percent for both constant dollars and current costs, well in excess of statutory rates that ostensibly mark limitations imposed by law.

EFFECTS OF INFLATION ON THE INVESTOR

Let me turn now to inflation-oriented data of particular relevance to the investor, that is, the measurements of growth in cash dividends and year-end stock prices.

FAS 33 requires presentation of cash dividends paid per share and of year-end stock prices, for the five most recent years, expressed in constant dollars for all years.

Clearly, these are figures of direct interest and high importance to investors. They go to the heart of the matter: How am I really doing with my investment in *X* company in inflationary times, as contrasted with how I appear to be doing?

Based on historical stock prices as quoted, the average increase from 1975 to 1979 was 74 percent. This declined to 24 percent when restated in constant dollars of 1979 purchasing power. In the case of cash dividends, the average increase for the four-year period dropped from 90 percent to 41 percent when restated in constant dollars.

Included in the composite averages are many individual cases in which restatement transformed apparent growth—share prices, dividends, or both—into decline. Indeed, if restated amounts exhibit any growth, it means that the investors in that company have in fact more than held their own during those five inflation-ridden years. Many investors haven't, and none did as well as they thought they were doing.

WHAT NEEDS TO BE DONE

These data convey valid and cogent messages about the position of American business in an inflationary era—and it is of considerable interest that the messages are about the same overall, regardless of whether the basis of restatement is constant dollars or current costs.

I submit that these inflation-adjusted data:

Portray a pattern of business growth that gives little cause for comfort;

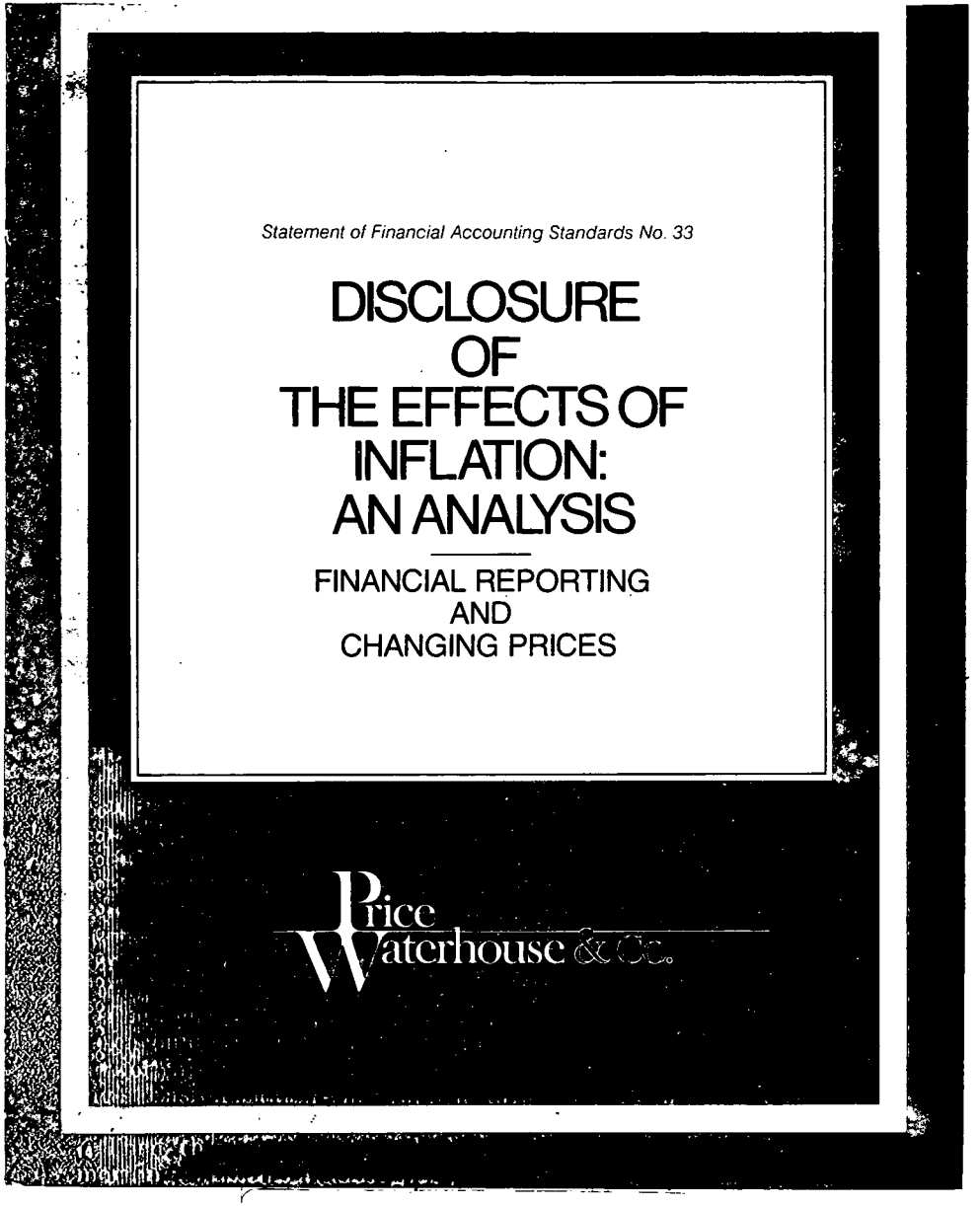
Demolish the tired shibboleth of "obscene" business profits;

Suggest that dividend expectations may not comport with realities of capital formation to modernize and expand the nation's plant; and

Demonstrate that business must have realistic tax relief from inflation if it is to provide full employment and achieve competitive productivity.

From both the standpoint of the investor and the standpoint of business itself, the inflation messages conveyed by these statistics are compelling. If business is to effectively deal with the erosive effects of inflation and, more importantly, increase productivity, employment, and competitiveness in the years to come, there must be monetary and fiscal initiatives that will enable American business to do the job. I urge you to continue your efforts to convince other members of Congress that such initiatives are essential to help revitalize our economy.

Thank you.


Statement of Financial Accounting Standards No. 33
DISCLOSURE OF THE EFFECTS OF INFLATION: AN ANALYSIS
FINANCIAL REPORTING AND CHANGING PRICES
Price Waterhouse & Co.

DISCLOSURE OF THE EFFECTS OF INFLATION: AN ANALYSIS

FINANCIAL REPORTING AND CHANGING PRICES

Table of contents

Introduction

In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 33, *Financial Reporting and Changing Prices*. This statement requires certain large, publicly held companies to include information about the effects of both general price changes (constant dollar information) and specific price changes (current cost information) beginning with 1979 annual reports.

Constant dollar accounting is simply the expression of historical cost financial statement amounts in units of the same purchasing power. Current cost accounting is a method of measuring and reporting assets and expenses associated with the use or sale of assets at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.

FAS 33 requires disclosure of specific quantitative data for the current fiscal year and for the five-year period ending with the current fiscal year. Data to be disclosed for the current fiscal year include:

1. Information on income from continuing operations on both a current cost and a constant dollar basis.
2. The purchasing power gain or loss on net monetary items.
3. The current cost amount of inventory and property, plant and equipment.
4. The increase or decrease in the current cost amount of inventory and property, plant and equipment, net of inflation.
5. Total depreciation expense on both a current cost and a constant dollar basis.

The following information is required for each year in the five-year period in addition to items 1, 2 and 4 above:

1. Net sales.
2. Income per common share from continuing operations on both a current cost and a constant dollar basis.
3. Net assets at year-end on both a current cost and a constant dollar basis.
4. Cash dividends per share.
5. Year-end market price per share.
6. Consumer price index.

Only sales, dividend and market price information must be presented for years ending before December 25, 1979, and presentation of current cost information for 1979 may be postponed until the 1980 annual report is issued.

In FAS 33, the FASB stated, "The measurement and use of information on changing prices will require a substantial learning process on the part of all concerned." It also encouraged experimentation within the guidelines of FAS 33. This study summarizes selected data produced as a result of FAS 33. Additional techniques which will be useful in analyzing the data will undoubtedly be developed as users of financial statements become more familiar with the changing prices information and the methods used to compute it.

May 1980

Findings

Seven statistics have been chosen which are believed to be both interesting and useful in evaluating the changing prices data. Although some might contend that comparing measurements computed using different measuring units is inappropriate, we believe the FASB intended that such comparisons be made as part of the experiment in reporting information on changing prices and have thus provided the data.

Income from continuing operations as a percentage of historical income — This statistic is the ratio of income from continuing operations as reported on a constant dollar and current cost basis to that reported in the historical financial statements. Both the gain or loss in purchasing power from net monetary items and the increase or decrease in current cost amounts are excluded from this computation. The FASB required that these items be reported separately because of the controversy over whether they should be considered income. If the purchasing power gain or loss had been included in constant dollar income, that amount would have been higher for all industries except the financial companies and, in several instances, would have exceeded 100% of historical income.

Summary of findings

Income

	Historical	Constant dollar	Current cost
Industrial	100%	60%	63%
Financial	100	95	NR
Retailing	100	42	NR
Transportation	100	56	30
Utilities	100	31	17

NR — Not reported because of insufficient data.

Effective tax rate — This statistic is an overall comparison of the effective tax rate on historical, constant dollar and current cost bases. Deferred taxes are included. While it might be useful to measure the tax rate on several other bases, such as domestic vs. foreign and current vs. deferred, we have not done so because the information is not available as to foreign taxes and we consider it simplistic to omit all deferred taxes since all timing differences eventually reverse. Furthermore, should some form of indexing be adopted in the tax system to recognize inflation, it is possible that there would be a trade-off for some existing tax incentives. Thus, we believe that measurement of the gross tax rate is the most useful at present.

Summary of findings

Tax rate

	Historical	Constant dollar	Current cost
Industrial	39%	53%	53%
Financial	28	28	NR
Retailing	42	68	NR
Transportation	30	44	50
Utilities	34	62	78

NR — Not reported because of insufficient data.

Return on net assets — This statistic is the percentage return on net assets on historical, constant dollar and current cost bases. In this statistic the purchasing power gain or loss and the increase or decrease in current cost amounts are excluded from income but are generally included in the computation of net assets as required by the FASB.

Summary of findings

Return

	Historical	Constant dollar	Current cost
Industrial	17%	8%	8%
Financial	14	13	NR
Retailing	16	5	NR
Transportation	16	5	2
Utilities	10	4	2

NR — Not reported because of insufficient data.

Dividend payout ratio — This statistic measures the percentage of income paid as cash dividends on common stock on historical, constant dollar and current cost bases. The ratios were computed based on income measurements prescribed by the FASB which exclude the purchasing power gain or loss and the increase or decrease in current cost amounts.

Summary of findings

Payout

	Historical	Constant dollar	Current cost
Industrial	33%	65%	66%
Financial	32	35	NR
Retailing	31	299	NR
Transportation	29	42	72
Utilities	76	543	521

NR — Not reported because of insufficient data.

Growth — The information presented in 1979 annual reports permits the measurement of growth in terms of constant dollars over five years in three areas:

1. Sales.
2. Dividends.
3. Year-end stock price.

The sales growth statistic permits an investor to determine what proportion of the reported increase is primarily the result of inflation. The dividend and stock price information permit an individual investor to determine how his investment has fared in the face of inflation. If the stock price shows any growth, the investor has more than held his own against inflation. Likewise, if the dividend shows any growth, the yield on the stock has more than held its own against inflation.

Summary of findings

Growth

	Sales		Dividends		Stock price	
	H	C	H	C	H	C
Industrial	76%	33%	90%	41%	74%	24%
Financial	86	38	46	12	69	22
Retailing	112	57	104	51	12	(21)
Transportation .	99	49	81	33	99	42
Utilities	64	22	18	(9)	(4)	(32)

H — Historical. C — Constant dollars. ( ) — Decrease.

The detailed results of our study of the changing prices information are presented in the accompanying series of graphs which include:

1. An industrial company composite graph.
2. Separate graphs for the 14 industries included in the industrial company composite.
3. Separate graphs for the financial, retailing, transportation and utility companies.

Segmentation of the study

Our analysis of the results of the FAS 33 disclosures encompassed the annual reports of 215 companies:

- 157 industrial
- 25 financial
- 12 retailing
- 10 transportation
- 11 utilities

The 157 industrial companies were further broken down into 14 broad industry groups as follows:

Aerospace	Metal manufacturing
Automotive	Office machinery
Chemicals	Paper and forest products
Electronics and appliances	Petroleum
Food and beverage	Pharmaceuticals
Glass products and containers	Publishing
Machinery and equipment	Tobacco

Of the 215 companies, 83, or about 39%, chose to present current cost data. All were required to present constant dollar data.

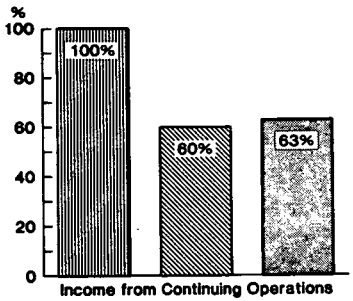
Companies were selected on a judgmental basis from the 1979 *Fortune Directory* of the 500 largest industrial, 150 largest banking, life insurance and financial, 50 largest retailing, 50 largest transportation and 50 largest utility companies. We attempted to obtain a representative group for analysis. Companies which had losses on any basis of measurement were excluded. The composite and industry statistics were derived as simple arithmetic averages of the percentages computed for the individual companies. Thus, no individual company's results dominate the statistics.

The sample of 157 industrial companies for the composite constant dollar disclosures comprises over 30% of the *Fortune 500;* the sample of 68 for the composite current cost disclosures comprises about 14%. We believe these sample sizes are sufficient to ensure that the overall industrial composite statistics are reasonably reflective of the group as a whole. The individual industry statistics, computed from much smaller sample sizes (particularly for current cost) and based on a judgmental assignment of companies to industries, is obviously less statistically reliable. These latter statistics, we believe, should be used only as general indicators of orders of magnitude.

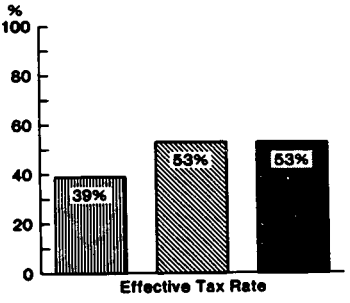
The historical and constant dollar data represent all 215 companies included in the study. The current cost data represent only the 83 companies which reported current cost data. We recognized that this difference in sample size could result in noncomparability of the current cost data with the other data and investigated the degree of noncomparability. The difference in the number of companies included in the two samples has no significant effect on the comparability of the industrial company composite statistics. There is, however, some lack of comparability of the current cost data with the other data in the individual industry statistics because some of the individual percentages for historical and constant dollar data are different when only the companies which presented current cost data are included. This causes slight differences in expected rela-

tionships among the data as presented. Major trends, though, are generally the same as that of the larger group of companies, e.g., constant dollar income is less than historical income and current cost income is less than constant dollar income. The only industries in which the apparent trends would be reversed are the food and beverage and glass products and containers industries. We did not present separate historical and constant dollar statistics by industry for the companies which reported current cost data because of the relatively small number of companies for each industry in the current cost sample which make the data less reliable and because we wanted to avoid presenting an excessive amount of data.

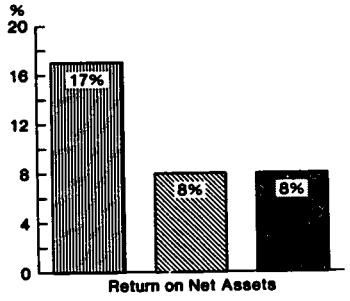
Industrial companies composite



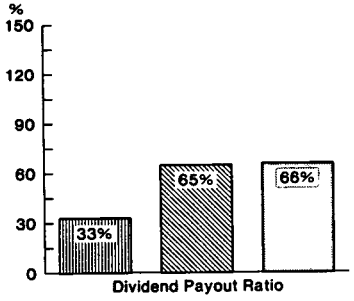
Income from Continuing Operations



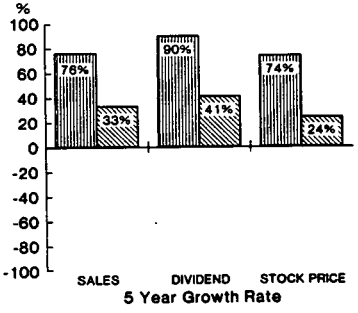
Effective Tax Rate



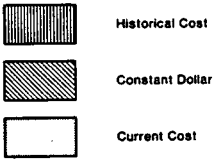
Return on Net Assets



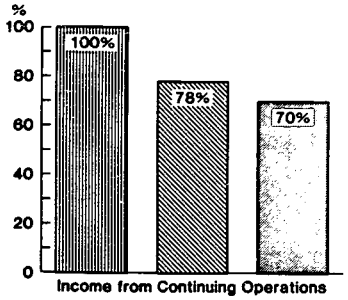
Dividend Payout Ratio



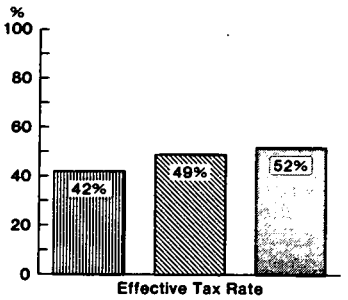
5 Year Growth Rate



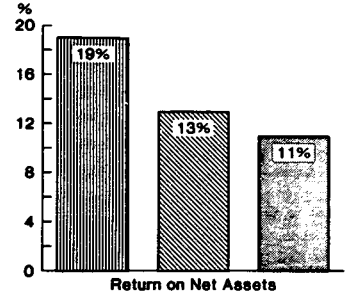
Aerospace



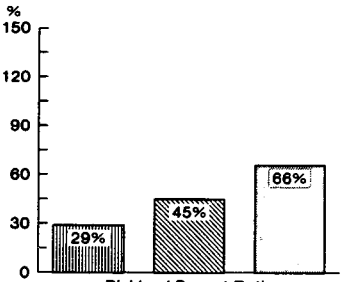
Income from Continuing Operations



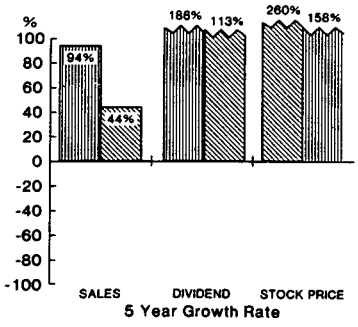
Effective Tax Rate



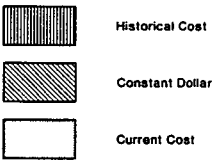
Return on Net Assets



Dividend Payout Ratio



5 Year Growth Rate



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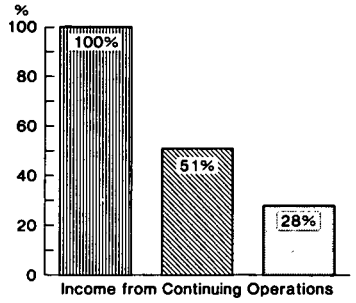
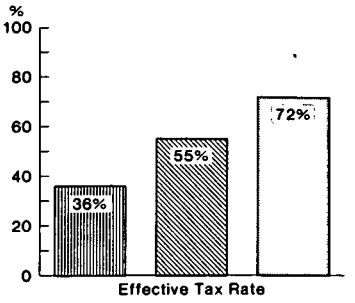
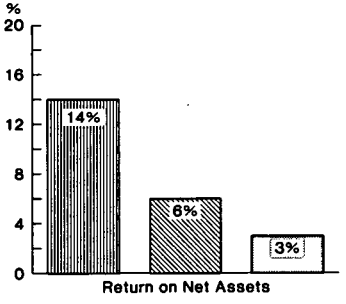
Automotive



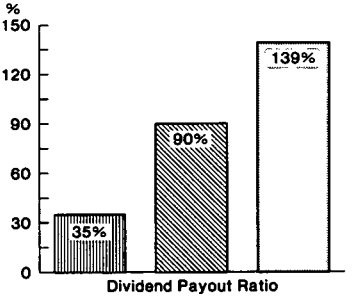
Income from Continuing Operations



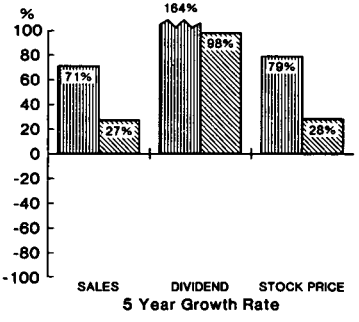
Effective Tax Rate



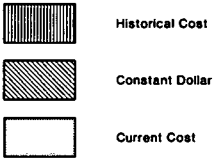
Return on Net Assets



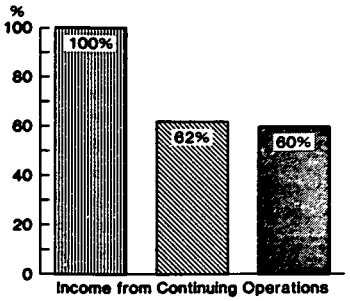
Dividend Payout Ratio



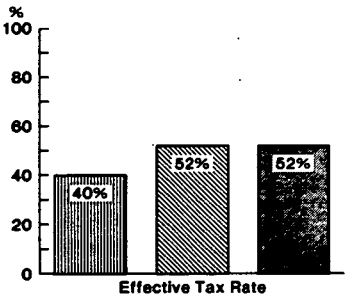
5 Year Growth Rate



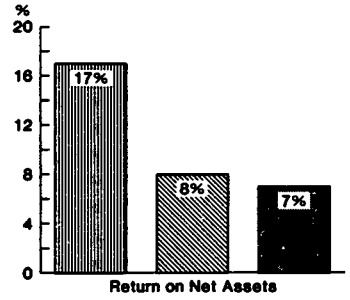
Chemicals



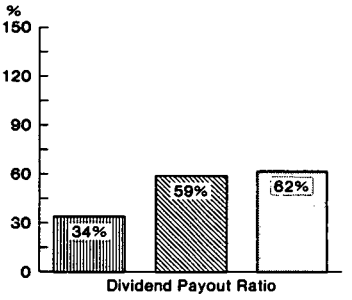
Income from Continuing Operations



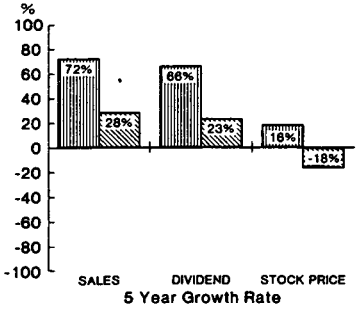
Effective Tax Rate



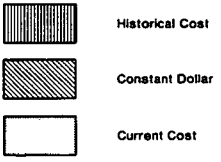
Return on Net Assets



Dividend Payout Ratio



5 Year Growth Rate



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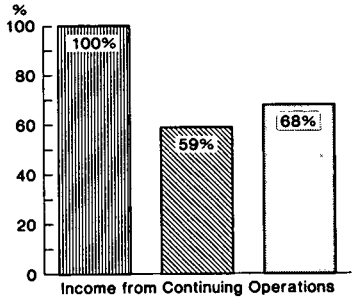
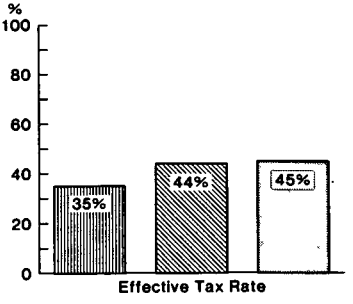
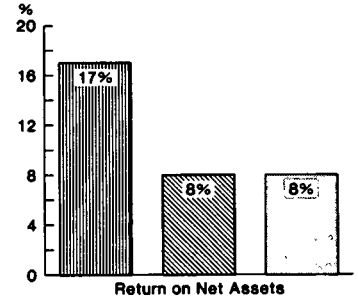
Electronics and appliances



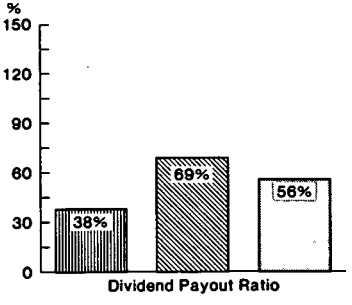
Income from Continuing Operations



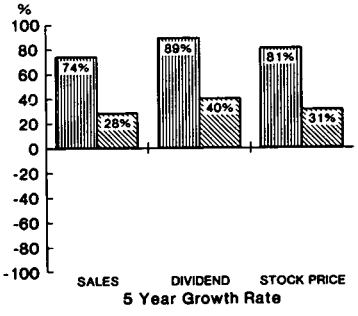
Effective Tax Rate



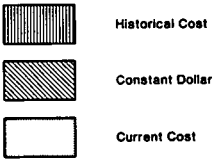
Return on Net Assets



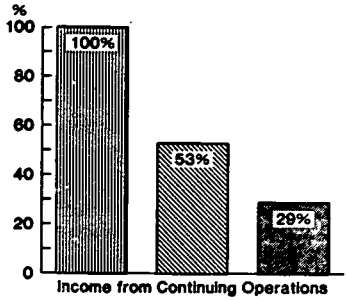
Dividend Payout Ratio



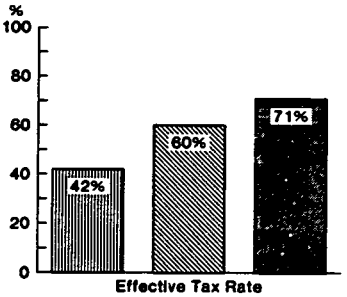
5 Year Growth Rate



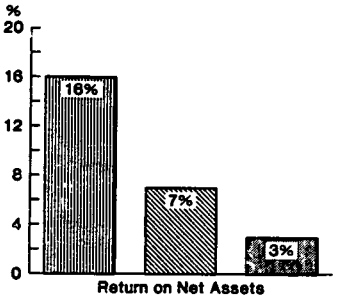
Food and beverage



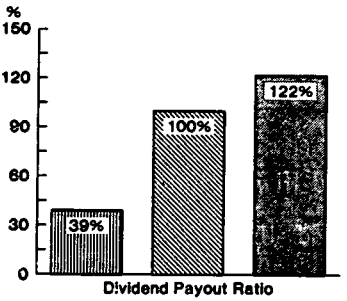
Income from Continuing Operations



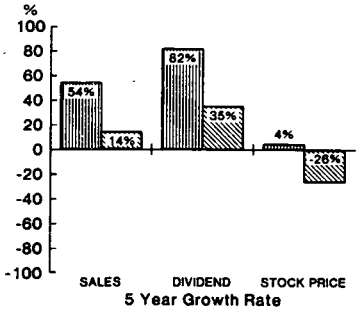
Effective Tax Rate



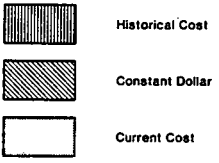
Return on Net Assets



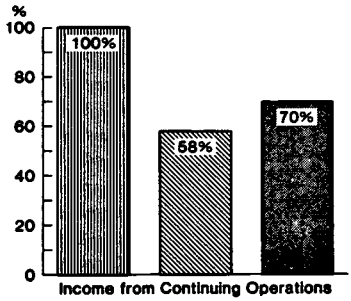
Dividend Payout Ratio



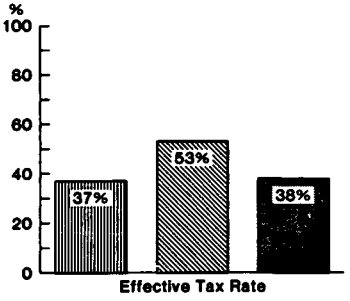
5 Year Growth Rate



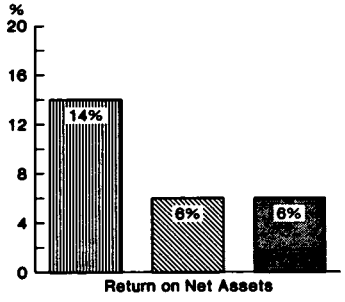
Glass products and containers



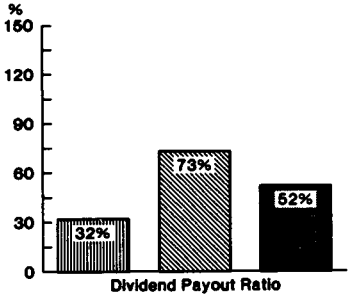
Income from Continuing Operations



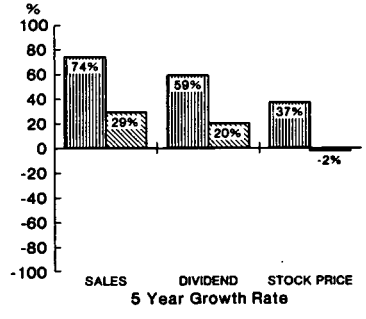
Effective Tax Rate



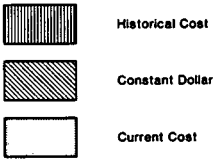
Return on Net Assets



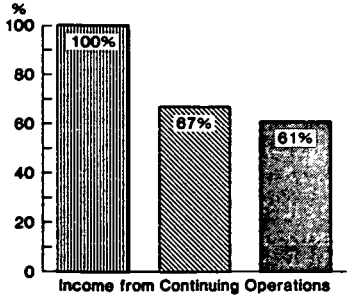
Dividend Payout Ratio



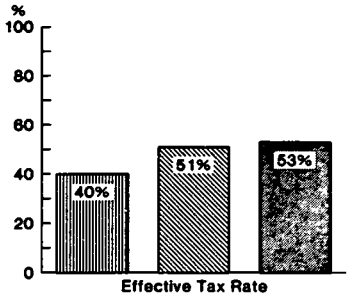
5 Year Growth Rate



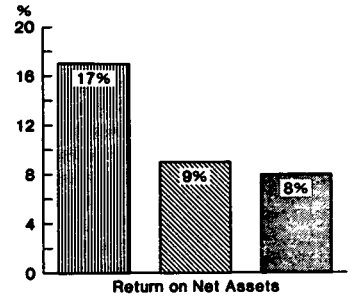
Machinery and equipment



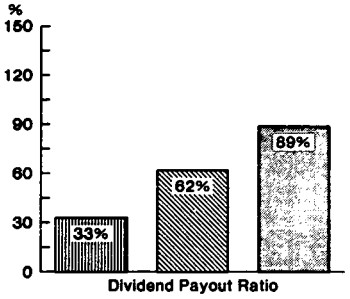
Income from Continuing Operations



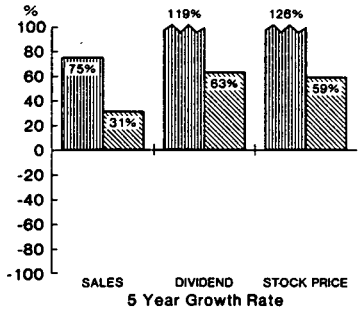
Effective Tax Rate



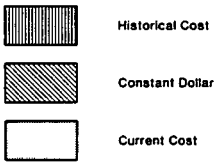
Return on Net Assets



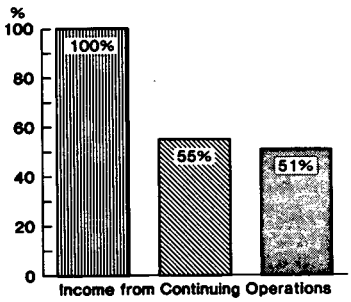
Dividend Payout Ratio



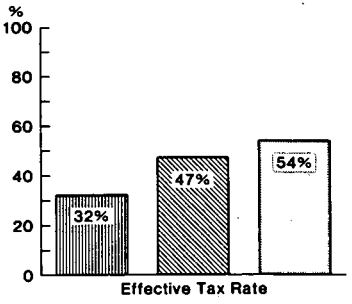
5 Year Growth Rate



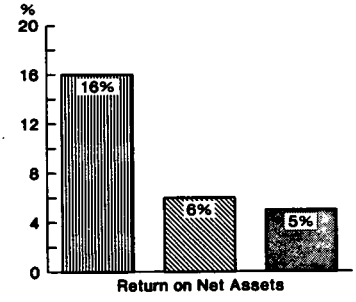
Metal manufacturing



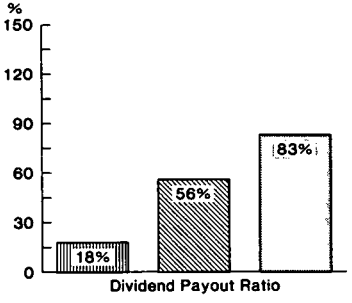
Income from Continuing Operations



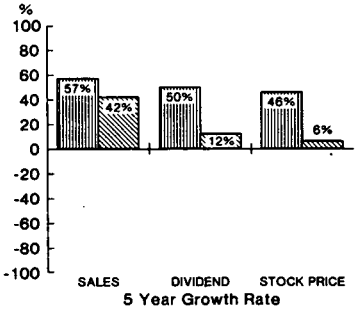
Effective Tax Rate



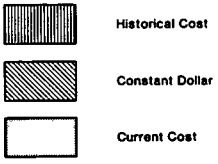
Return on Net Assets



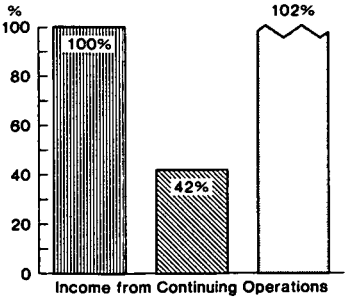
Dividend Payout Ratio



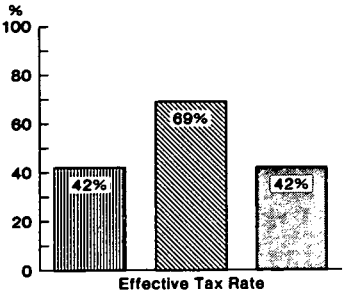
5 Year Growth Rate



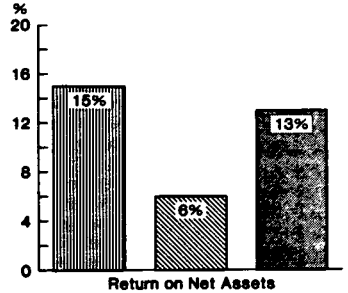
Office machinery



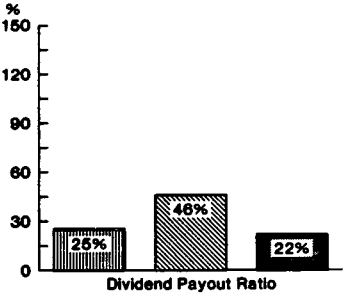
Income from Continuing Operations



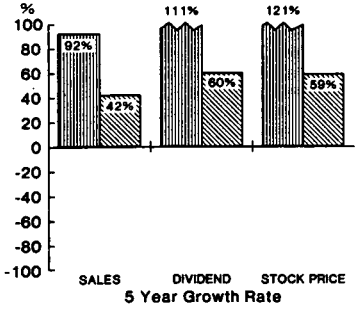
Effective Tax Rate



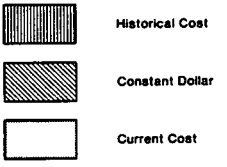
Return on Net Assets



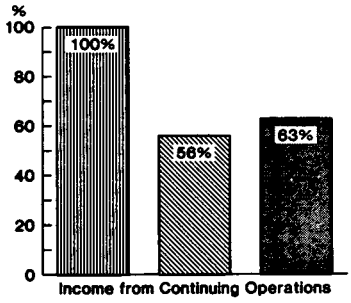
Dividend Payout Ratio



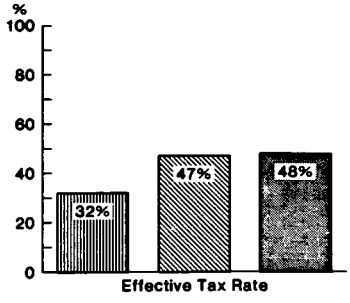
5 Year Growth Rate



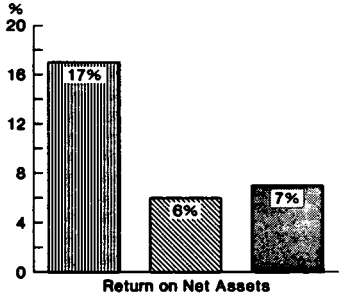
Paper and forest products



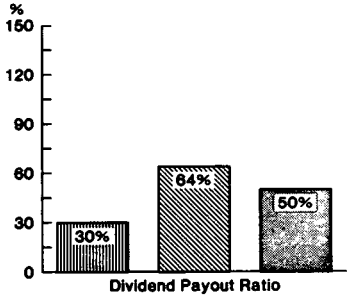
Income from Continuing Operations



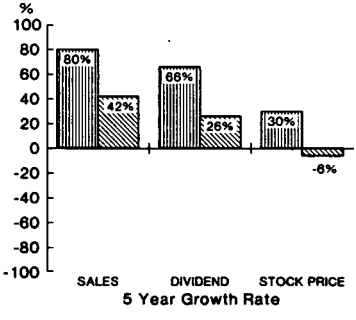
Effective Tax Rate



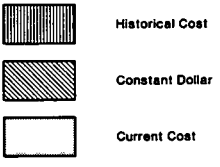
Return on Net Assets



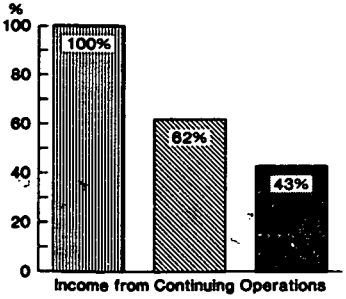
Dividend Payout Ratio



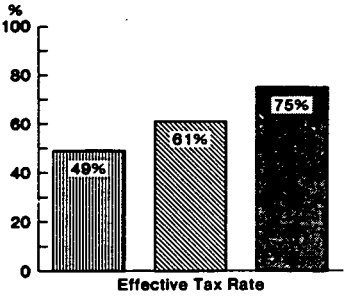
5 Year Growth Rate



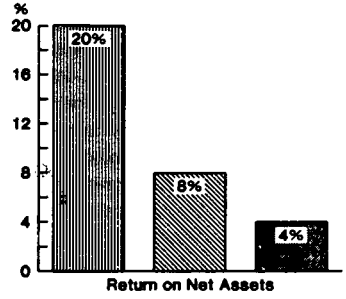
Petroleum



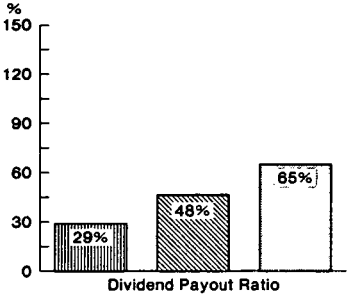
Income from Continuing Operations



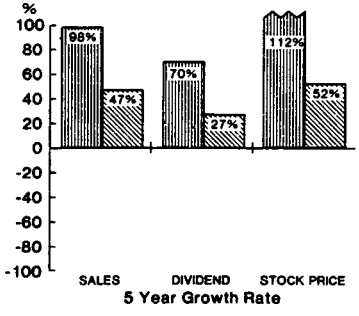
Effective Tax Rate



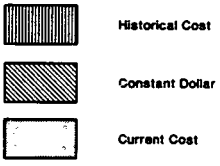
Return on Net Assets



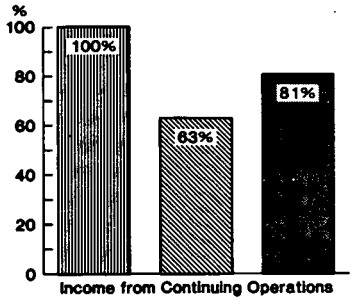
Dividend Payout Ratio



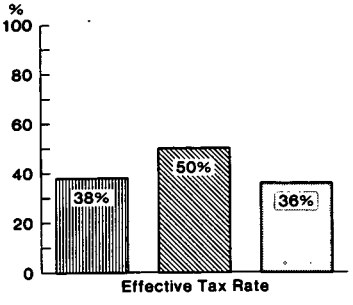
5 Year Growth Rate



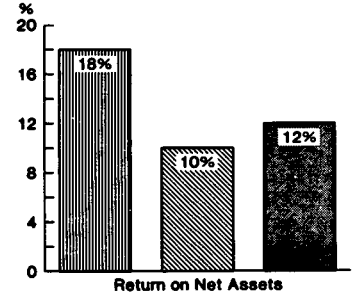
Pharmaceuticals



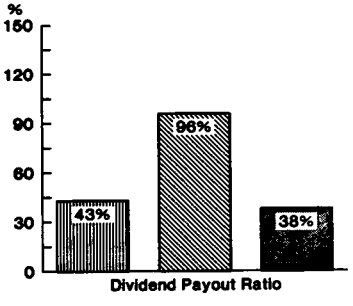
Income from Continuing Operations



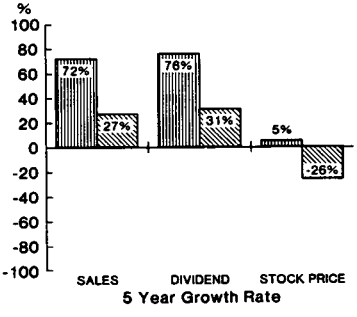
Effective Tax Rate



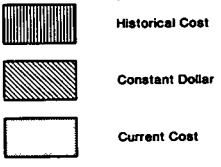
Return on Net Assets



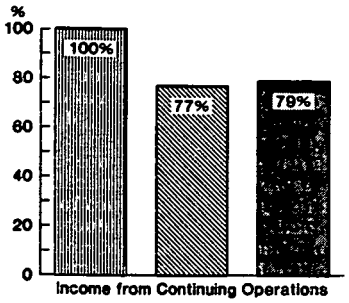
Dividend Payout Ratio



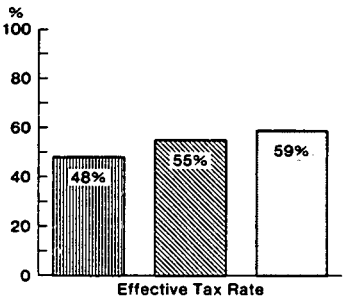
5 Year Growth Rate



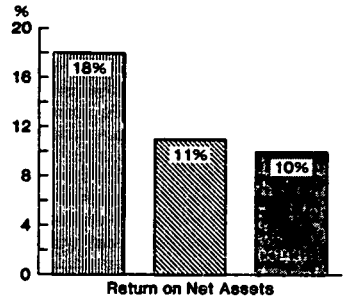
Publishing



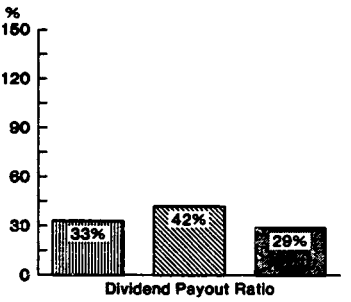
Income from Continuing Operations



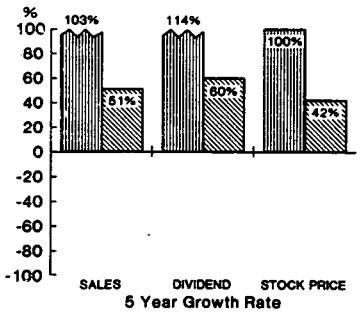
Effective Tax Rate



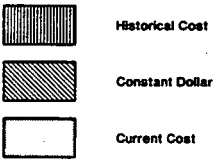
Return on Net Assets



Dividend Payout Ratio



5 Year Growth Rate



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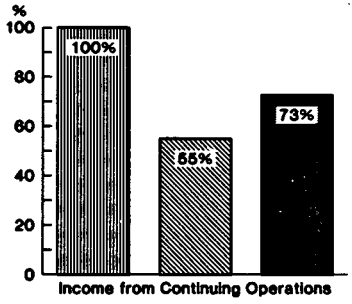
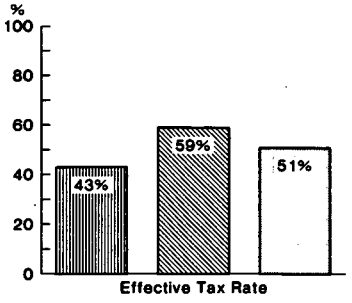
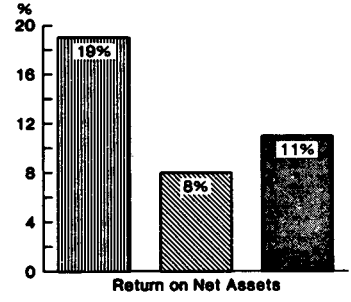
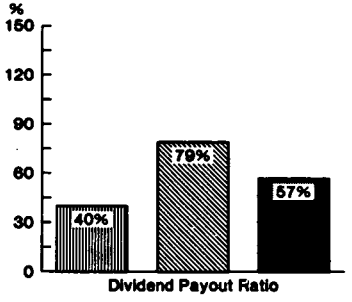
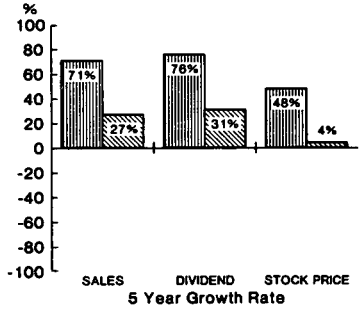
Tobacco

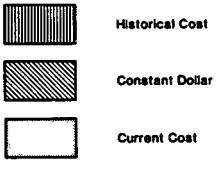

%
100
80
60
40
20
0
100%
55%
73%
Income from Continuing Operations


%
100
80
60
40
20
0
43%
59%
51%
Effective Tax Rate

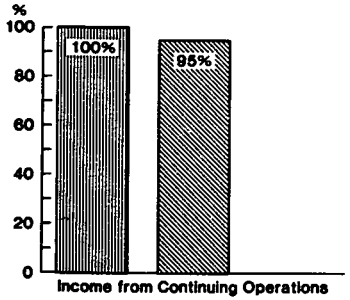

%
20
16
12
8
4
0
19%
8%
11%
Return on Net Assets

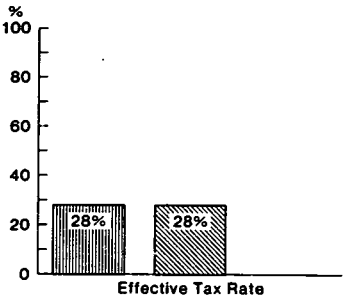

%
150
120
90
60
30
0
40%
79%
57%
Dividend Payout Ratio

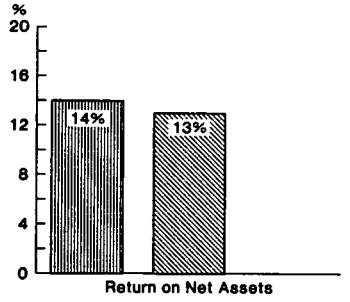

%
100
80
60
40
20
0
-20
-40
-60
-80
-100
71%
27%
76%
31%
48%
4%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate

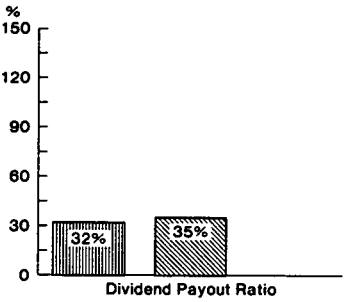

Historical Cost
Constant Dollar
Current Cost

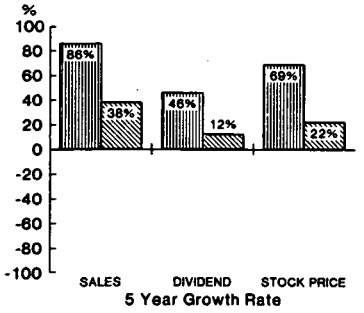
Financial

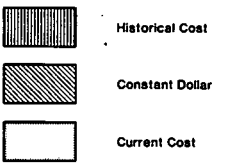

%
100
80
60
40
20
0
100%
95%
Income from Continuing Operations


%
100
80
60
40
20
0
28%
28%
Effective Tax Rate

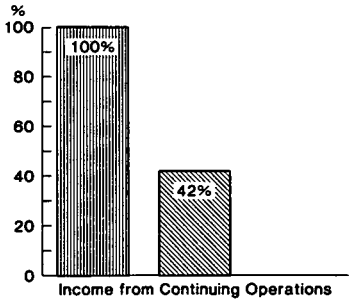

%
20
16
12
8
4
0
14%
13%
Return on Net Assets

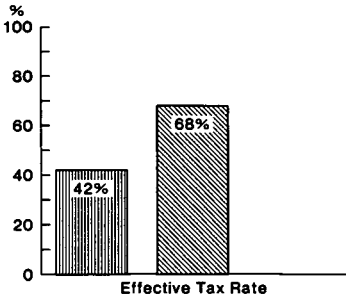

%
150
120
90
60
30
0
32%
35%
Dividend Payout Ratio

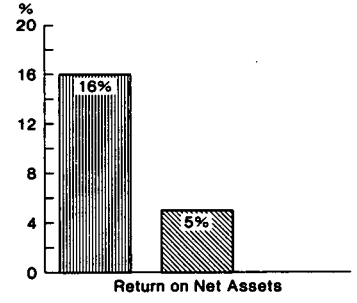

%
100
80
60
40
20
0
-20
-40
-60
-80
-100
86%
38%
46%
12%
69%
22%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate

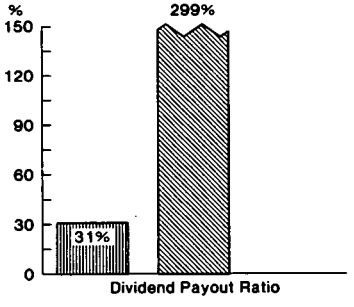

Historical Cost
Constant Dollar
Current Cost

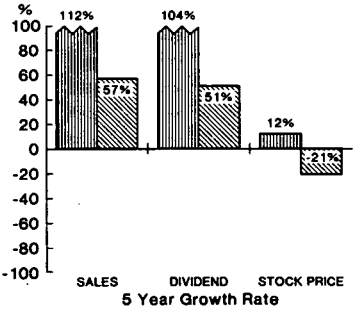
Retailing

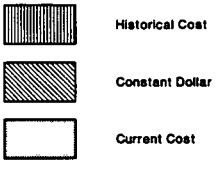

%
100
80
60
40
20
0
100%
42%
Income from Continuing Operations


%
100
80
60
40
20
0
42%
68%
Effective Tax Rate

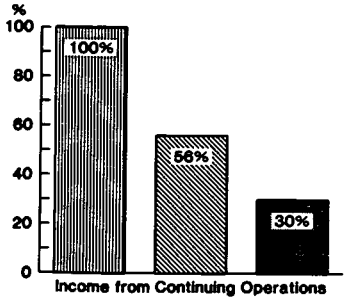

%
20
16
12
8
4
0
16%
5%
Return on Net Assets

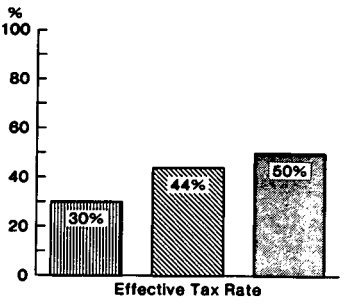

%
150
120
90
60
30
0
299%
31%
Dividend Payout Ratio

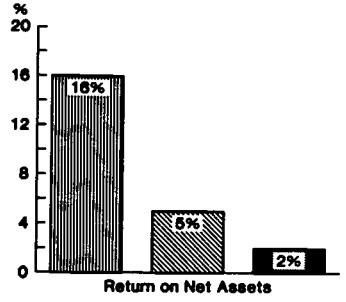

%
100
80
60
40
20
0
-20
-40
-60
-80
-100
112%
57%
104%
51%
12%
21%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate

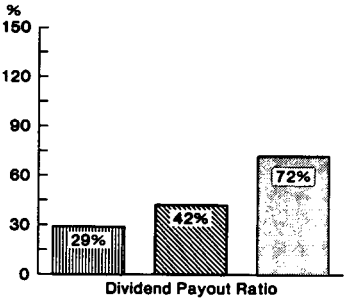

Historical Cost
Constant Dollar
Current Cost

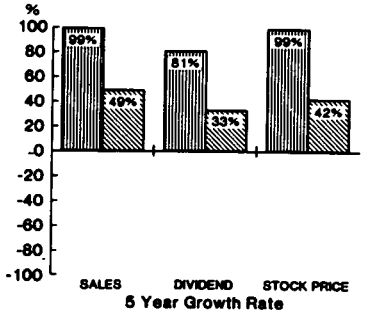
Transportation

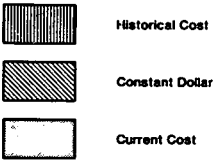












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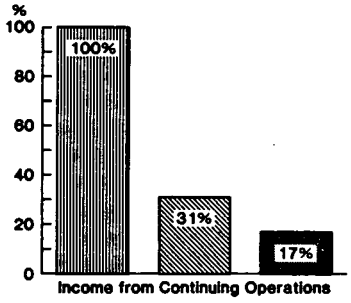
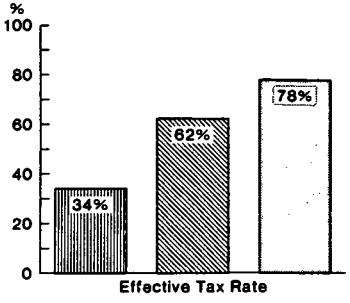
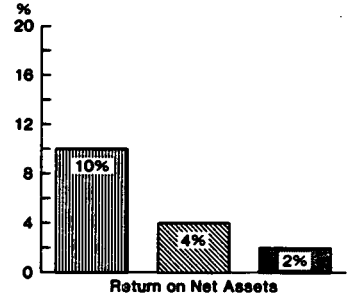
Utilities



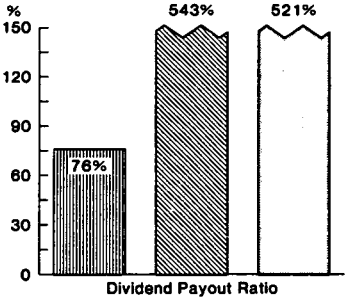
Income from Continuing Operations



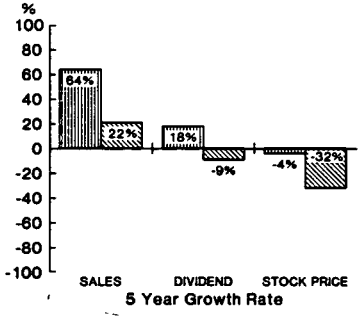
Effective Tax Rate



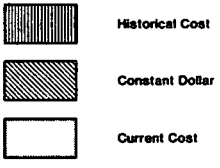
Return on Net Assets



Dividend Payout Ratio



5 Year Growth Rate



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Representative WYLIE. My apologies for mispronouncing your name the first time I mentioned it, Mr. Liebling. Could we hear from you now, please.

STATEMENT OF HERMAN I. LIEBLING, SMITH PROFESSOR OF ECONOMICS AND BUSINESS, LAFAYETTE COLLEGE, EASTON, PA., AND FORMER CHIEF ECONOMIST, DEPARTMENT OF THE TREASURY

Mr. LIEBLING. Thank you very much, Congressman. I was delighted to be invited to attend this session, to join this panel. In 1974 when I was with the Treasury, I became interested in this problem, and used the term of "phantom profits" to describe the impact of inflation.

And I was glad to note in succeeding years that it was adopted. I haven't had that kind of a success always, because I also once talked about "soft-landings," in late 1973 and that didn't develop until 1974–75; and it was not "soft."

Phantom profits, however, is persistent as a phrase to describe what is happening to the trend of profits when it is historically calculated.

Representative WYLIE. May I ask you to pull the microphone closer?

Mr. LIEBLING. Surely.

And I think that it does describe more realistically what the well-being of American corporations has been. Now, that well-being has been vastly overstated. A fundamental structural shift has developed since the 1960's, and these are clearly evident in the figures when proper allowance has been made for the ravages of inflation on historically reported costs.

Special shortrun factors do not explain the decline of corporate rates of return in the 1970's to 30-year lows. At so-called full employment, however that is defined, rates of return are simply too low by historical standards, either on a pretax basis or on a posttax basis.

Now, some studies like those made by Messrs. Feldstein and Summers, the Council of Economic Advisers and others, make certain kinds of cyclical adjustments, which enable them to indicate that should we get back to full employment, there would be adequate rates of return. However, my studies, which are documented in a book referred to in this statement, show that even after you make cyclical adjustments, the rates of return would be low. In other words, full employment profits are just too low, given the present institutional structure.

Now, due to the inflation, conventional balance sheets and income statements no longer deliver messages that are economically significant; a deterioration in the financial position of U.S. business has developed, which has been concealed by the historically costed values used in these conventional statements.

Many more potential Chryslers become visible when balance sheets and income statements are adjusted for inflation to account for the replacement cost of inventory and depreciation. In a variety of large companies, profits reported on the basis of historical cost are converted to losses when calculated on a replacement cost of capital basis. Moreover, taxes are paid on phantom historically costed profits, and these on the average are 10 points higher than the 46-percent Federal maximum rate.

Indeed, in many instances, dividends paid have been in excess of real, after tax profits, thereby reducing the capital available for use in deployment and command of resources needed in the production process, as has been explained by Mr. Kirk. In other words, operating capability has been eroded. It should be no surprise that growth of efficiency is in a declining phase in the economy. Moreover, the erosion of capital may be the major factor in explaining the dull performance of the stock market in recent years.

While approaching the danger point in many companies, this erosion in capital has affected, to some degree, the totality of corporate business in the 1970's, as I will explain in detail later. In real terms, replacement costed retained earnings of nonfinancial corporations represents the sole internal source of funds that might be applied for net growth in investment—these funds could support the finances of only 1.2 percent of the value of current production in the 1970's. That does not account for internal funds that might used for investment.

That 1.2 percent in the 1970's comparies with 4.1 percent in the 1960's. Inevitably, this restricted the availability of funds for such other uses like investment in the 1970's.

Now, it is the retardation in the growth of capital formation, and in the capital-labor ratio, which has contributed to the decrease in productivity trend in the U.S. economy, the acceleration in unit labor costs and in the inflation rate, and many other disturbances such as the deterioration in the international position of the dollar and so on.

With the economy slipping into recession, the prospects for capital formation are dimmed further by current cyclical depressants. Thus, the longer term deterrents will have, on top of them, the usual cyclical negative influences.

As capacity utilization rates ease over this year and next, in reaction to the recession, the need for spending on plant and equipment will appear less pressing; and, as a result, stretchouts, deferrals and even cancellations of planned capital spending will occur. These circumstances will be reinforced by reductions in funds available for internal sources as profits decline. This will surely overpower the positive effect on investment from the expected reduction in long-term interest rates, which may be small in magnitude in any event.

Accordingly, the outlook for capital formation to change to a favorable or optimal growth rate in the early 1980's appears unlikely due to both long-term and cyclical factors. This would extend the period of slower growth in the capital stock, which in the 1973–79 period had declined substantially from earlier years. And indeed, the record of decline would be worse if account were to be taken of those capital stock expenditures which have been made for pollution abatement, which surely does not contribute to increased efficiency or productivity. Perhaps of greater significance was the retardation of growth in the capital-labor ratio in the late 1970's, since this measures in approximate fashion the contribution of labor to productivity and the degree to which labor can be utilized efficiently.

Productivity, of course, had declined absolutely in 1979, following several years of declining growth. The issue arises: How to reverse this trend. It would appear that the capital formation is the leading remedy.

Other suggestions have been made to increase productivity: The aging of the labor force in future years, it has been said, would increase productivity; increased expenditures for R. & D. is said to increase productivity; other measures have been recommended. However, there is one certain way of increasing productivity about which there is no argument at all; and that is by raising the fixed labor-capital radio—that is virtually unnchallenged.

Now, citing some figures with respect to the inadequacy of funds available to business for investment, nonfinancial corporations on a pretax basis from domestic operations, were $190.2 billion in 1979, which represented a $24 billion rise, 14.5 percent above the previous years. However, if the replacement costs of inventory and capital consumption is used, the so-called inventory valuation and capital consumption adjustments in the national accounts, profits before taxes are shown to have increased only $4.6 billion, or only 3.5 percent more than the 1978 level.

Indeed, in most recent years, book values have overstated economic profits on a before-tax basis in the range of one-fourth to one-third.

On a post-tax basis, the profit gains in nominal or current dollars have been even more limited.

Now, much of that is shown on the charts you have presented. However, I do have a set of statistics in my statement which supplement those charts. I especially refer to my figures on those profits which have been deflated and converted into 1972 dollars.

Representative WYLIE. We will include those statistics in the record. Please summarize the balance of your statement, if you can.

Mr. LIEBLING. Fine.

Well, those statistics in my prepared statement do show substantial declines in real profits both on a pretax and post-tax basis during the 1970's.

Now, I would conclude by indicating that those valuable studies that were presented earlier here—those done by Price-Waterhouse and those done by the FASB—need to be revised.

I would suggest some areas of research along the following lines: Those studies don't seem to differentiate between profits earned domestically and those earned abroad. It would seem to me that future studies ought to make that differentiation. The policy recommendations would then proceed with an improved statistical base.

Another recommendation which I would make is that we might consider the conceptual basis and scope of the gains on the real debt, which in many studies are added to profits. Apparently the FASB does make that kind of calculation. But, that is an incomplete kind of adjustment.

Of course, you can add back the real gains on the debt to profits, but then you should also take into account such things as the losses which may be incurred under inflationary conditions on the basis of the unfunded liability to pension funds, as noted in my prepared statement.

Now, there is an incomplete accounting there. It is a sort of minor correction —perhaps I shouldn't say minor—it is of a technical nature. But, if one is going to take the leap in terms of such a procedure as adding back the real gains on the debt to profits, one should do it on a complete basis, taking account of all liabilities, whether recorded or not. And I would recommend studies along that line.

There are some beginnings of them. I intend to get into them myself.

Now, with respect to policy, enough has been said here, I think, that I will not get into it any further.

Representative WYLIE. Thank you very much, Mr. Liebling for your significant contribution. I think if you want to expand your thoughts with regard to your modifications of the Price Waterhouse report for the record, that will be welcome.

[The prepared statement of Mr. Liebling follows:]

PREPARED STATEMENT OF HERMAN I. LIEBLING

Inflation, Capital Formation and Corporate Rates of Return

The well-being of American corporations has been vastly overstated. A fundamental structural shift since the mid-1960's has generated reduced profitability rates, clearly evident in the figures when proper allowance has been made by the ravages of inflation on historically-reported costs. Special short-run factors do not explain the decline of corporate rates of return in the 1970's to 30-year lows. At so-called full-employment, rates of return are simply too low by historical standards, either on a pre-tax or post-tax basis. If problems of retarded economic growth, lessened productivity, rising costs and inflation have arisen in the United States, as they surely have, they are directly connected with a deterioration in the ability of business to finance capital formation.

Due to the inflation, conventional balance sheets and income statements no longer deliver messages that are economically significant: a deterioration in the financial position of U.S. business that developed in the 1970's has been concealed by the historically-costed values used in these statements.

Record sales and profits in recent years scored by corporations in conventional accounting statements have been misleading. Far from being "obscene", the inflation of the 1970's has worked to the detriment of profits, notably when expressed as a relative share of all incomes generated in production and as a rate of return on the current value of assets. As profitability declined, it exerted a drain on resources available for reinvestment, forced recourse to debt financing, and increased the vulnerability of enterprises to swings in the business cycle. Many more potential "Chryslers" become visible when balance sheets and income statements are adjusted for inflation to account for the replacement cost of inventory and depreciation, along the lines recommended by the Financial Accounting Standards Board (Statement 33) as a supplementary statement to conventional reports. In a variety of large companies, profits reported on the basis of historical cost are converted to losses when re-calculated on a replacement cost-of-capital basis. Moreover, taxes are paid on "phantom profits" . . . on the average, 10 points higher than the 46-percent maximum rate.

Indeed, in many instances, dividends paid have been in excess of real after-tax profits, thereby reducing the capital available for use in deployment and command of resources needed in the production process. During a period of rising prices, larger amounts of money are needed because inventory, plant and equipment and other assets cost more in order to maintain previous rates of operation. In other words, operating capability has been eroded. It should be no surprise that growth of efficiency is in a declining phase in the economy. The erosion of capital may be the major factor in explaining the dull performance of the stock market in recent years.

While approaching the danger point in many companies, this erosion in capital has affected, to some degree, the totality of corporate business in the 1970's, as explained in detail below. In real terms, replacement-costed retained earnings of nonfinancial corporations (which represents the sole internal source of funds that might be applied for net growth in investment) could support the finances of only 1.2 percent of current production in the 1970's. This compared with 4.1 percent in the 1960's. Inevitably, this restricted the availability of funds for such other uses like investment in the 1970's; and, indeed, a slow-up in the growth of capital formation did develop because its finance was made increasingly difficult. These and other analyses and results are shown in detail in my book, "U.S. Corporate Profitability and Capital Formation: Are Rates of Return Sufficient?" (Pergamon Press).

It is the retardation in this growth (and in the capital-labor ratio) which has contributed to the decrease in productivity trend in the U.S. economy, the

acceleration in unit labor costs and in the inflation rate, and other disturbances such as the deterioration in the international position of the dollar.

With the economy slipping into recession, the prospects for capital formation are dimmed further by cyclical depressants. These will develop on top of longer-term deterrents and they will persist for a while if the usual cyclical pattern emerges. As capacity-utilization rates ease over the next year or two in reaction to the recession, the need for spending on plant and equipment will appear less pressing and, as a result, stretch-outs, deferrals and even cancellations of planned capital spending will occur. These circumstances will be reinforced by a reduction in funds available from internal sources, as profits decline. This will surely overpower the positive effect on investment from the expected reduction in long-term interest rates, which may be small in magnitude in any event.

Accordingly, the outlook for capital formation to a favorable or optional growth rate in the early 1980's appears unlikely due to both long-term and cyclical factors. It would extend a period of slower growth in the capital stock, which in the 1973–79 period had declined to a growth rate of 2.5 percent per annum in the nonfarm business sector, down nearly half from the 4.5 percent rate in 1965–73 and the 3.3 percent rate in 1948–65. (And indeed, the record would be worse if account were to be taken of those capital stock expenditures which have been made for pollution abatement.) Perhaps of greater significance was the retardation in recent years in the growth of the capital-labor ratio since this measures in approximate fashion the contribution of labor to productivity and the degree to which labor can be utilized efficiently. On this basis, the record for recent years shows considerable deterioration, with the 1973–79 period registering annual growth of 0.6 percent, as compared with 2.6 percent in 1965–73 and 2.2 percent in 1948–55.

Coincident with this decline in the capital-labor ratio in recent years has been an associated and like movement in productivity. During 1973–79, productivity has slipped to an annual rate of 0.6 percent—and, indeed, an actual decline was scored in 1979. This compares with a 2.0 percent rate in 1965–73.

No single remedy may be prescribed as sufficient or certain to reverse the downtrend in productivity growth. Looking ahead, one source of improvement may result from the increase in the average age of the labor force in the 1980's. Gains from other causes like increased outlays on research and development, education and training, etc., are possible but surely less certain. By contrast the effect of raising fixed capital-labor ratios (plus the usually greater technical proficiency of new capital) is virtually unchallenged. Accordingly, a strengthening in the incentive to invest by improving corporate ability to finance capital formation and by raising rates of return is of the highest priority.

THE MYTHS OF REPORTED PROFITS

Adam Smith observed that "profit is so very fluctuating that the person who carries on a particular trade cannot always tell you himself what is the average of his annual profit." Since then, the measurement of profit has remained controversial, invoking as it does concepts of social justice held by diverse groups in society. Perhaps it is the most politicized of economic magnitudes, leading to charges of obscenity or its profit-push impact on inflation when a particular quarter's results show a large increase; relative silence is observed when profits fall (unless a bankruptcy of a particular company looms near).

The conventional accounting statement for income, as reported to stockholders, is of limited use during a period of inflation. While record profits were registered on a so-called book basis, year-after-year since 1965, these represented substantial overstatements because part of such earnings must be allocated to replacing inventories and the capital used up in production. During inflation, these current costs are higher than the usual historically-costed allowances made for replacement of inventory and capital. To illustrate, for nonfinancial corporations, pretax profits from domestic operations before taxes on the so-called book basis were $190.2 billion in 1979, which represented a $24 billion rise or 14.5 percent above the previous year. However, if the replacement cost of inventory and capital consumption is used—the so-called inventory valuation and capital consumption adjustments in the national accounts—profits before taxes are shown to have increased only $4.6 billion, or only 3.5 percent more than the 1978 level. Indeed, in most recent years, books values have overstated profits before taxes, in the range of one-fourth to one-third.

On a post-tax basis, profit gains in nominal or current dollars have been even more limited. In 1979, post-tax book profits increased $18.1 billion to $115.5 billion. But, after allowances for replacement cost of inventory and depreciation,

post-tax profits declined in 1979, as the table shows. (The striking gains of the oil companies in 1979, which have been attributed to foreign operations, are not included in the domestic product of the nonfinancial corporate sector).

TRENDS IN "BOOK" VERSUS ECONOMIC PROFITS (NONFINANCIAL CORPORATIONS)

[Percent change]

	1978–79	1973–79	1966–79
Book profits:			
Before tax	14.5	105.2	173.7
After tax	18.3	116.9	188.0
Economic profits:			
Before tax	3.6	74.9	86.7
After tax	−2.9	58.7	38.6
Capital income:			
Nominal	7.2	81.7	129.1
Real	.9	20.3	8.8
After tax,[1] in 1972 dollars	−10.2	−8.8	−34.4

[1] Economic profits before taxes plus interest paid.

Perhaps the most striking aspects of the table is the trend in real profits. On an after-tax basis, real post-tax profits at $35 billion in 1972 dollars were down from earlier periods; indeed, they experienced a sharp loss in 1979 from 1978. During this latter year, real earnings had increased to $39 billion in 1972 dollars, though remaining lower than the average of $40 billion in the 1960's.

This pattern of deterioration, in modified fashion, is also registered when interest paid is added to profits in order to secure the return to all suppliers of capital, whether of equity or debt origin. So defined, "capital income" in 1979 had more than doubled since 1966. But, this was less than one-tenth higher when measured in constant 1972 dollars.

The return on capital

Since profits alone or capital income (which includes interest paid) is the reward for investment, it is useful to view the trend in this reward in relation to invested capital. This issue is discussed in detail in my book on corporate profitability (referred to on page 2 of this analysis). It's conclusion is that after the inflation impacts are taken into account on profits (or on capital income), as well as the upward reevaluation of assets that this entails, rates of return appear to have declined sharply in the 1970's. Briefly, this calculation involves pre-tax or post-tax economic profits in current dollars in the numerator (an alternative is to add interest paid to secure capital income); and current dollar replacement cost of either depreciable assets or total assets in the denominator.

On this basis, it is clear that rates of return have declined in the post-war period and dramatically so. Much light is cast thereby on the retarded growth of capital formation in the United States when it is observed that even before taxes are paid, the corporate rate of return on depreciable assets during the 1970's had slipped to 9.4 percent, down substantially, by four percentage points, from the record of any prior post-war decade. This decline is evident whether profits as such, or the capital income concept, is used in the numerators. Conceptually, the return on total assets is superior. The results are shown in the table below.

RATES OF RETURN OF TOTAL ASSETS[1] OF NONFINANCIAL CORPORATION

[In percent]

Period averages	Pretax		Posttax	
	With interest	Without interest	With interest	Without interest
1950–55	7.4	7.1	3.4	3.1
1960–69	7.6	6.8	4.5	3.7
1970–78	5.7	4.3	3.4	2.0

[1] Total assets at replacement cost in current dollars. (See U.S. Corporate Profitability and Capital Formations: Are Rates of Return Sufficient? p. 9).

The appearance of adequate profitability in post-war United States is attained in other studies (e.g., Modigliani & Cohn, Cagan & Lipsey, etc.) by adding on to profits the real gains on corporate debt, whether realized or not, which result from inflation. These gains are illusory, in part or in whole; they represent an incomplete accounting of debts incurred by corporations. For example, unfunded liabilities to employee pension plans are omitted, though these obligations would increase with inflation and work to reduce earnings.

Other implications of inflation adjustment

It has been more broadly recognized that inflation-adjusted are lower than reported profits; and consequently, that tax rates and the tax burden as higher than they appear to be. For nonfinancial corporations, the "effective" Federal tax rate was 53 percent in 1979, though the U.S. statutory maximum was 46 percent. (Higher "effective" rates have been reported incorrectly at 57 percent, which would include state and local government taxes).

Nevertheless, the significance of payment of taxes on earnings that do not adequately measure the impact of inflation is its growing burden. For nonfinancial corporations, the effective tax rate on inflation-adjusted earnings at 57 percent in 1979 compares with 46 percent as an average in the 1960's and 44 percent as an average for the 1950's. While the intent of legislation enacted by the Congress over the past several years has been to reduce corporate tax rates, the effect of inflation has worked to defeat this objective.

The dividend-payout ratio is dangerously higher when the inflation impact on profits is taken into account. Prior to inflation adjustment, the payout ratio for nonfinancial corporations seemed to be a modest 41 percent for 1979; in fact, it was nearly twice that—81 percent of post-tax inflation-adjusted profits. In the light of this result, it would appear that for many corporations the dividends paid exceeded income. This would mean that an erosion of capital is taking place in many companies.

Investment that typically was financed by retained earnings no longer may rely on this source. With dividend payments so high in relation to inflation-adjusted profits, retained earnings of corporations in recent years have trended down. Averaging $16.0 billion during 1976–79, they compare with $22.0 billion in 1965–67 and $15.1 billion averaged for all of the 1960's.

The record is considerably worse when adjustment is made for price-level changes. Real undistributed profits were only $10.3 billion for 1976–79, measured in 1972 dollars, much lower than $26 billion level in 1965–67 and $19.7 billion averaged in all of the 1960's.

ANALYSIS OF STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 33

Considerable attention and research has been conducted by the Financial Accounting Standards Board in recent years on the effects of inflation on business. In Statement No. 33 of September 1979, FASB recommends that large, publicly-held enterprises provide supplementary statements to conventional financial reports which are addressed to the needs of investors, creditors and other users in assessing performance during an age of inflation. Users of the statement were to be provided information which:

Assess future cash flows. Since conventional financial statements include measurements of expenses and assets at historical costs, they may distort the availability of cash flows when current prices are used in their calculations.

Assess enterprise performance. "The worth of an enterprise can be affected by prudent timing in purchase of assets during inflation."

Make allowances for erosion of operating capability. Minimum quantities of inventory, property and plant and equipment and other assets are needed to maintain existing levels of output. To the extent that inflation erodes historically-costed inventory, fixed assets and other assets, information on that erosion should be provided.

Assess erosion of general purchasing power. As prices rise, larger amounts of money are required by enterprise to maintain the same amount of purchasing power of its capital.

These objectives are salutary in dealing with the problems on assessing the well-being of corporations during periods of inflation. The adjustments recommended by FASB follow two methods: conversion of historical data to account for the general effects of inflation by restatements of values, using the

consumer price index; and conversion of historical data by use of specific price indexes that were applicable to the company's specific assets.

Perhaps the newness of the attempt to assess the impact of inflation has permitted some flaws in the FASB recommendations that might easily be eliminated. Some of them are of a technical nature.

Earnings from domestic operations should be differentiated from those emanating from abroad. This is a distinction which clearly needs to be made, especially in view of the different price deflators that would need to be applied to physical assets.

The net gain to earnings from debt owing to inflation has been narrowly conceived. Just as the inflation reduces the debt burden, so may the burden increase if account is made of unfunded liabilities to employee pension funds.

Of a more fundamental nature is the choice that might be made between constant-cost and current-cost methods of inflation accounting. By itself, it would appear that the constant dollar approach, which uses the consumer price index as its modus operandi, probably lacks relevance to a company's operations. The uniqueness of each company argues against use of so general a measure of price change as the consumer price index.

In contrast, the current-cost approach bears directly on a measure that shows how to maintain operating capability. It bears directly on the issue of the productivity of capital and thereby is directly relevant and significant to the current and prospective value of an enterprise.

Perhaps greater distinction should be made by FASB between holding gains from inflation, which involve a restatement of owner's investment, and income from continuing operations.

PROFITABILITY AND CAPITAL FORMATION IN THE UNITED STATES

The slippage in inflation-adjusted profitability inevitably has dulled optimal growth in capital formation in the United States. The issue goes beyond the toll taken by taxes, dividends or the high cost of borrowing—although it would appear that each of these has been, and again can be, important in the encouragement of capital formation.

The basic problem relates to recognition that even pre-tax corporate profits show a downtrend since the mid-1960's that cannot be explained by special factors described by Feldstein and Summers in their negative reply to their published study *"Is the Rate of Profit Falling?"*

A fundamental structural shift lies underneath the reduced profitability rates. Basic cost-price relationships have experienced considerable change, being expressed in a smaller share of profits and a larger share of compensation of employees in the national product. One statistic makes this clear: Real labor compensation averaged 49 percent higher in the 1970's than in the 1960's, compared with 11 percent for real capital income. On top of this has been the rise in costs of energy, environmental protection and increased government regulation generally. Companies have been unable to raise prices sufficiently in the usual market adjustments to these pressures.

A dilemma is thereby posed: Whether the adjustment should be reflected in price increases which encourage the inflation, if that were possible in view of international competition; or whether such efforts should proceed to restrain the inflation through demand management? A third and worse option might be "incomes policy" of some variety.

A fourth approach might contain some of these elements but would place a major reliance on securing increased investment and the productivity that dampens the rise in unit labor costs which contributed to lower profitability in the first place. Tax policies directed toward increasing after-tax profitability would represent a step in this direction. But this measure alone would not suffice unless three uncertainties are resolved:

Assurances concerning the containment of inflation. In the current institutional setting, inflation has been reflected more in rewards to labor compensation rather than capital income share; it thereby has increased the risk premium to investment.

Assurances of economic policies upon which growth of the economy proceeds more steadily, providing a sobriety to investment plans now lacking.

Moderating growth of Government expenditures and increasing rewards for corporate and individual savings to provide the resources for investment. The existing debate concerning this needs no elaboration here.

Representative WYLIE. Mr. Williams, I know you have time limitations. If we go on longer than you may be here, feel free to excuse yourself.

You have suggested that what we really need to do to stimulate the economy and increase capital formation is to have tax reductions beginning on January 1, 1981; correct?

Mr. WILLIAMS. Or earlier.

Representative WYLIE. Or earlier. And you have suggested that you would emphasize or favor the approach of the 10–5–3 depreciation schedule bill, which I have cosponsored, as has been suggested. Now, would you comment with respect to the liberalized depreciation schedule versus tax cuts across the board versus increased permanent investment tax credit as a stimulant? Do we need all three, or should one come before the other, and what would be the effect?

I'm inclined, as I said in my opening statement, to favor the increased permanent investment tax credit, because I think it's quicker, the accounting procedure isn't as difficult, et cetera.

Mr. WILLIAMS. I guess, rather than addressing the theoretical differences, there are merits of various approaches. I am somewhat of a pragmatist, I guess, in the sense that, as between a permanent investment—increase in permanent investment tax credit and the capital cost allowances, there has been a substantial amount of agreement among a number of the business community, a number of cosponsors in Congress. I think there is a predisposition to accept the 10–5–3 approach, and they conceivably might end up with substantially the same result.

But my recommendation would be, if we got that kind of agreement, let's move ahead and get it done, because it will be very helpful in this arena.

Now, as to other—the cost of capital allowance, capital cost allowance or investment tax credit will get at the question of really improving the cash available in corporations or business enterprises for increased capital investment. I think there's another part of the equation in capital formation which we must address, and that is to encourage saving among our people. So I think that side of it must also be addressed.

There are a number of ways in which there have been proposals——

Representative WYLIE. Encourage savings through exemption of some interest from income taxation.

Mr. WILLIAMS. Yes, and rollover in capital investment; the double taxation of dividends and even the recognition of inflation in the capital gains tax, which even the personal capital gains tax is confiscatory. So my recommendation would be to move in the directions, one, of the capital cost allowance, and second, in the areas of encouraging savings among individuals.

Representative WYLIE. I'm going to take advantage of the position in which I now find myself and ask, for my own personal guidance, to have the rest of the panel comment on the question.

Mr. CONNOR. Accountants usually don't speak up first—but why not. Congressman, the words "capital formation" have been used a number of times this morning. I really think we're dealing with two things: not just capital formation alone, but capital maintenance first and then capital formation.

I support the concept of 10–5–3, much along the lines as commented on by the previous speaker, Mr. Williams. I view that as a measurement process of what is an appropriate measure of net income for taxation purposes; that business has a right to get back the equivalent purchasing power of the fixed assets that they once ploughed into a business and which creates current jobs and maintains them. That in by view is just maintaining the capital base of the country through the tax system.

The investment tax credit is a capital stimulant in many respects, and perhaps can be looked at somewhat differently from the maintenance program, but nonetheless a stimulus. I think first things first, and the 10–5–3 looks to me like the first approach.

Representative WYLIE. Thank you very much.

Mr. Kirk.

Mr. KIRK. Congressman, I will start by saying that the FASB's concern is the measurement of economic activity, to really make those who use that information understand better the results of that economic activity. And I think the figures that are resulting from our efforts are pointing out everything that you have heard this morning: that there is a problem. We hope that they convince people of that problem, the general public, people here in Washington, so steps can be taken.

Exactly how those steps should be taken I defer to others to comment on. But it's clear that some stimulus is needed to help business, encourage investment, and bring about greater capital formation in the business community.

Representative WYLIE. Thank you.

Mr. Liebling.

Mr. LIEBLING. Well, I would like to endorse measures which would increase the capability of American business to finance investment. But, I would suggest very, very strongly that a major element in the retardation of capital formation in this country has been the stop-and-go economic policies which has been followed in Washington, both of a fiscal or monetary nature.

It would seem to me that we have to look at this as part of a broad package. True, we need these specific measures, but we just simply have to reduce the uncertainty of measures which confronts American business and make it difficult for them to take these investment decisions. Such elementary questions arise as: What kind of plant should we have—constructed in what fashion? Decisions like this are discussed and there is no resolution of them due to energy, environmental, or safety regulations, because of the uncertainty.

There's not only uncertainty along that line, but also there's uncertainty with respect to what the rate of economic growth might be in future years. Now, I must say that the urgency with which we are addressing ourselves in terms of various tax measures may lead to poor results. We have to take measures which are going to be effective on a long-term basis. We should not think in terms of "quick fixes." And I feel an atmosphere of quick fixes is presently developing.

Representative WYLIE. I feel that atmosphere also. I was questioned by a television reporter in my district last weekend about the unemployment rate, which is now 9.4 percent in Ohio, being second of all

the States. And I was asked what Congress is going to do about unemployment. And I was reminded when the same question was asked in 1977. We started throwing money into public service, public works type programs, which were quite expensive and didn't do much for the long haul, as evidenced by what's happened since then.

So I think there is a tendency to fall into that pattern again. I think that if we do that and don't address ourselves to the No. 1 problem, which is still inflation, to my way of thinking, and try to work our way through this period on a long-term basis to create productive private sector jobs, Congress might start throwing money at the problem of unemployment, to create quick-fix jobs which don't really produce anything, and thereby increase inflation beyond what we have already known.

Mr. LIEBLING. I couldn't agree more, Congressman.

Representative WYLIE. That was just a comment I made at the time.

Mr. Williams, PPG and the Business Roundtable obviously support inflation-adjusted reporting in order to reveal the urgency of tax relief for depreciation of capital, and you have used PPG's own profit figures to illustrate this problem.

What does the decline in the rate of return on investment and the reduced real earnings brought about by inflation do to business' desire and ability to invest? In other words, can we trace our productivity or decline thereof and competitive problems primarily to our own tax and regulation mistakes, as opposed to foreign shocks or things beyond the control of Congress? In other words, if we in Congress address this problem and get away from these stop-and-go policies to which Mr. Liebling referred, will American business seize the opportunity to turn this country around?

In other words, do you feel that the future is really in our hands?

Mr. WILLIAMS. I want to hasten to say that I do not think that tax reform is the sole answer to our problem. I think government is also involved, and government is not the sole source of our problems. But government is also involved in the size of government itself and the drag that that has on the economy, the tremendous increase in regulation which has occurred, particularly in recent years, the failure to address the very important problem of energy in this country.

And so I don't want to say that business has no black sheep of its own or no problems of our own. But this question as far as the national economy is broader than just tax policy as it relates to government, but also includes some of these other factors which will go a great distance if we can somehow remove some of the uncertainties.

Representative WYLIE. Thank you.

Mr. Liebling and Mr. Connor, both: Mr. Liebling, you said in your prepared statement many more potential Chryslers become visible when balance sheets and income statements are adjusted for inflation. And Mr. Connor, your study showed that by traditional measures taxes on corporations average 39 percent of income, but in reality taxes average 53 percent of real economic profits. These are averages.

What about the worst cases? How many firms that look profitable are really losing money? What industries are they concentrated in?

What new Chryslers do we see coming down the road? And what can we do about it?

Mr. Liebling, do you want to comment on that?

Mr. LIEBLING. I realized I was risking that question when I made the statement. All one has to do is take, let's say, a dozen of the largest or large corporations and look at their annual statements and make the necessary adjustments. And you do find that the gains are converted into losses. And if you look over the figures on a 5-year period, it does appear that a number of companies are in trouble.

Now, I would not like to specify which those companies are. But it is clear that many potential Chryslers are on the scene. And perhaps Price Waterhouse in this study uncovered that as well. If they wish to reveal where that occurred, I would leave it to them.

Mr. CONNOR. We do not want to reveal the individual companies, merely because I don't happen to have the individual companies with me, but I do have the industry composites. Automotive was a very severe one by way of fall-off, in net operating income. Retailing, about the same degree. The utility companies' income dropped to 31 percent of its historical amount when adjusted for inflation. That itself was extremely severe and the most severe.

There are individual companies, a handful within the group of 215, which showed absolute losses. Several of them were in the more capital-intensive areas, as you would expect.

Representative WYLIE. Thank you. I have some other questions here, some of which I may submit for the record. But I think maybe, probably, it is time for us to close up the hearing. I do appreciate very much the contributions that each of you have made and your participation here this morning, and I think in closing, in one sentence, if I may get it from you, from your expertise, a recommendation as to what Congress should do. I think that would be very beneficial to the record.

Mr. Connor.

Mr. CONNOR. As I said in commenting on Mr. Williams' statement, I believe sincerely that the "obscene" profit issue has been dispelled by what we have said today and what research preceded that. A serious matter of tax relief and incentive is presented to you. I think ultimately the final solution to this may be a much better determination of what is taxable income in the sense of the type of inflation adjustment that we have been discussing today. The 10–5–3 proposal is on the table. It does much of the job. It recognizes the recovery of costs in appropriate current dollars, and I think that's the immediate issue that you should address, and I'm delighted to hear that you are the sponsor of that legislation.

Representative WYLIE. Thank you.

Mr. Kirk.

Mr. KIRK. I would say there's one message that I would bring to you—that you and other Members of Congress recognize that profits are not what they have been reported to be. And we hope that the information that is now being reported will bring that message to you and others in the public so they appreciate there is a problem that has not been portrayed adequately in the past.

Representative WYLIE. I think that message came through. Thank you.

Mr. Liebling.

Mr. LIEBLING. Well, there are three steps, one of which I haven't touched on because of time limitations. The first of these is that this Nation needs a steady-as-you-go economic policy.

No. 2, we need a reduction in the uncertainty about the outlook, not only generally, but with respect to the specific requirements, with respect to government regulation in the environmental area and safety area, as well as the government regulation area generally.

No. 3—and I didn't get into this in my statement—there has been what appears to be a technical—I'm sorry, a structural shift in the shares of income going to capital and labor. In the 1970's, that share was abnormal judged by historic standards. We need some restoration of the more normal share, and that might be done in terms of somehow increasing cash flow investable funds to the property share.

Representative WYLIE. Thank you very much, gentlemen. I think this has been an outstanding morning. Your testimony, it seems to me, was very thought provoking. We will read the record.

I'm sorry more members weren't here to appreciate what you had to say, but there were a lot of hearings going on this morning. I will suggest to the chairman of the Joint Economic Committee, the full committee, that we circulate your testimony on this by summary to all the members so that they may have the benefit of it, but I do thank you very much. This has, I think, been an excellent set of presentations. Thank you.

The committee stands adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

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