

TABLE 22. CHANGES IN SPENDING AND REVENUES UNDERLYING THE SECOND POLICY OPTION (By calendar year, in billions of dollars, on an NIA basis)

	1981	1982	1983	1984	1985	1986
<b>Expenditure Changes</b>						
Nondefense	0	-35	-51	-63	-72	-74
Defense	<u>0</u>	<u>4</u>	<u>9</u>	<u>17</u>	<u>33</u>	<u>52</u>
Total	0	-31	-42	-46	-39	-22
<b>Revenue Changes</b>						
Modified Roth-Kemp	-10	-37	-69	-113	-152	-180
Smaller Depreciation Plan	<u>-5</u>	<u>-14</u>	<u>-15</u>	<u>-16</u>	<u>-17</u>	<u>-18</u>
Total	-15	-51	-84	-129	-169	-198

roughly similar pattern (see Table 23). The major difference is that the second option is less inflationary, and the growth in real GNP is less than in the first policy option.

#### ADMINISTRATION AND CBO PROJECTIONS COMPARED

The CBO alternative--that is, the CBO projection incorporating the Administration's budget policies--is compared with the Administration's own projection in Table 24. There are only minor differences in 1981. Both foresee lackluster real growth and continued high inflation. Between 1982 and 1986, the differences become more substantial. The CBO alternative has weaker growth in the near term but approaches the Administration's growth rates in the out-years when the effects of the tax cuts outweigh the effects of the spending cuts. Inflation and interest rates come down more slowly in the CBO estimates. In the CBO alternative, real GNP growth averages 1 percentage point a year below the Administration's estimates, inflation (as measured by the GNP deflator) 1-1/2 percent a year higher, and the Treasury bill rate more than 3 percentage points higher.

TABLE 23. ESTIMATES OF THE EFFECTS OF THE SECOND FISCAL POLICY OPTION  
 COMPARED WITH THE CBO FIVE-YEAR PROJECTION (By calendar year)

	1981	1982	1983	1984	1985	1986
<b>GNP (percent change, year over year)</b>						
Second Option	11.7	11.1	10.7	11.6	11.3	11.0
CBO Five-Year Projection	11.9	12.3	11.8	11.7	11.2	10.8
<b>Real GNP (percent change, year over year)</b>						
Second Option	1.2	1.8	2.0	3.4	3.8	4.2
CBO Five-Year Projection	1.4	2.9	2.9	3.3	3.4	3.5
<b>GNP Deflator (percent change, year over year)</b>						
Second Option	10.3	9.1	8.5	7.9	7.3	6.5
CBO Five-Year Projection	10.3	9.2	8.6	8.1	7.6	7.1
<b>CPI (percent change, year over year)</b>						
Second Option	11.3	9.5	8.8	8.0	7.4	6.5
CBO Five-Year Projection	11.3	9.5	9.0	8.3	7.7	7.2
<b>Unemployment Rate (percent, annual average)</b>						
Second Option	7.8	7.9	8.1	8.0	7.8	7.4
CBO Five-Year Projection	7.7	7.6	7.5	7.4	7.2	7.0
<b>Three-Month Treasury Bills (percent, annual average)</b>						
Second Option	12.6	13.5	11.0	9.8	9.2	8.7
CBO Five-Year Projection	12.7	13.8	11.6	10.3	9.8	9.6

NOTE: The CBO current policy forecast in Chapter IV reflects the recently revised GNP data for 1980. These revisions have not been incorporated here.

There are four possible, not mutually exclusive, explanations of why the CBO estimates derived from historical experience differ from the Administration's projection of the economy under its program:

TABLE 24. COMPARISON OF ADMINISTRATION PROJECTION AND CBO ALTERNATIVE INCORPORATING THE ADMINISTRATION'S BUDGET PROPOSALS (By calendar year)

	1981	1982	1983	1984	1985	1986
GNP (percent change, year over year)						
CBO Alternative <u>a/</u>	11.8	11.9	11.5	11.4	11.7	10.9
Administration	11.1	12.8	12.4	10.8	9.8	9.3
Real GNP (percent change, year over year)						
CBO Alternative <u>a/</u>	1.3	2.5	2.7	3.0	3.8	3.7
Administration	1.1	4.2	5.0	4.5	4.2	4.2
GNP Deflator (percent, change, year over year)						
CBO Alternative <u>a/</u>	10.3	9.2	8.6	8.1	7.5	7.0
Administration	9.9	8.3	7.0	6.0	5.4	4.9
CPI (percent change, year over year) <u>b/</u>						
CBO Alternative <u>a/</u>	11.3	9.5	8.9	8.2	7.7	7.1
Administration	11.1	8.3	6.2	5.5	4.7	4.2
Unemployment Rate (percent, annual average)						
CBO Alternative <u>a/</u>	7.8	7.9	7.8	7.7	7.5	7.2
Administration	7.8	7.2	6.6	6.4	6.0	5.6
Three-Month Treasury Bills (percent, annual average)						
CBO Alternative <u>a/</u>	12.6	13.7	11.5	10.2	9.7	9.3
Administration	11.1	8.9	7.8	7.0	6.0	5.6

NOTE: The CBO current policy forecast in Chapter IV reflects the recently revised GNP data for 1980. These revisions have not been incorporated here.

a/ The CBO alternative projection was derived by removing from the current-policy baseline all tax changes not already legislated, and then incorporating the effects of the fiscal policy changes proposed by the Administration.

b/ The Administration projects the CPI for urban wage earners and clerical workers (CPI-W), whereas CBO projects the CPI for all urban consumers (CPI-U).

- o The economic baselines may differ. The Administration has not provided the Congress with its assessment of how the economy would behave absent its proposed fiscal policy changes, but its baseline projection may be more optimistic in its assumptions about world oil prices, weather, international economic relations, and so on, than is the CBO five-year baseline projection.
- o The proposed fiscal policy changes, especially the tax reductions, may have a greater impact on total productive capacity than postwar experience suggests.
- o The monetary policy assumed in the CBO estimates differs from that of the Administration's scenario. In addition, the latter assumes a quicker impact of tight money on inflation than indicated by previous episodes of restrictive monetary policy.
- o The Administration is assuming unspecified, but apparently substantial, changes in government regulations, which could affect prices, resource allocation, and economic growth. The CBO estimates assumed no regulatory change.

The first explanation cannot be assessed until more information about the Administration's baseline is available. All that can be said now is that the differences are potentially quite large. More can be said about the last three possible reasons.

#### Fiscal Policy Changes and Total Productive Capacity

The Administration's policy could have a more favorable effect on the growth of real output and on inflation than indicated in the CBO alternative. This could happen if the tax cuts have a larger effect on total productive capacity than is suggested by historical experience. <sup>5/</sup> If such an effect occurs, it would come largely

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<sup>5/</sup> Econometric models, which reflect economic history, by no means ignore the behavior of productive capacity--the "supply side." Supply is reflected in a number of ways: the supply of financial capital, the supply of physical capital, the supply of materials, and the supply of labor--both in numbers of workers and in their hours worked. Postwar experience indicates that tax changes have the strongest direct impact on

from a sharper increase in labor supply and/or a larger increase in saving and investment than has occurred in the past.

Labor Supply. A personal income tax cut could generate a large increase in labor supply if a substantial portion of the population responded to the increased take-home pay by working more hours. A cut in marginal tax rates, such as proposed in Roth-Kemp, might have this effect. But it is also possible that a number of workers could respond to their higher take-home pay by working less, since fewer hours would be needed to achieve a given level of real income. For many persons, of course, the ability to vary hours on the job is sharply circumscribed by institutional arrangements governing the workweek.

The net effect of these various influences is an empirical question. A CBO review of the literature in this area concluded that a 1 percent rise in disposable real wages might induce a net increase in labor supply of 0.1 to 0.3 percent. <sup>6/</sup> The evidence also indicates that most of the sensitivity of work-leisure choices is concentrated among second earners in households, especially married women.

A stylized exercise using those findings can illustrate the possible impact of the proposed tax cut on labor supply. If it is generously assumed that the average marginal tax rate is 30 percent, three 10 percent cuts would eventually reduce that rate

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5/ (Continued)

supply by changing the cost of investing in plant and equipment. Tax effects on other determinants of total supply--such as labor-force participation and allocative efficiency--have been included in large econometric models, but their estimated size is typically small.

6/ Congressional Budget Office, An Analysis of the Roth-Kemp Tax Cut Proposal (October 1978). In a more recent review of the literature, Don Fullerton concluded that a 0.15 percent net increase in labor supply from a 1 percent rise in the disposable wage was a generous estimate of the overall response. See Don Fullerton, "On the Possibility of an Inverse Relationship Between Tax Rates and Government Revenues," NBER Working Paper No. 467 (April 1980).

by about 8 percentage points. That change in after-tax earnings, combined with the more optimistic estimate of labor-supply elasticity (0.3), implies that the labor supply could grow by an additional two-thirds percentage point per year between 1981 and 1986 as a result of the tax reductions.

Saving and Investment. Another possible supply-side response to decreased marginal personal income tax rates would be an increase in saving and investment. Some empirical studies have found a positive relationship between saving and the after-tax rate of return. One study found a large effect on savings--a 1 percent increase in the return on capital leads to a 0.4 percent increase in saving. 7/ But even with such an optimistic estimate of saving response, and an immediate corresponding increase in fixed (rather than inventory) investment spending, a doubling in the after-tax rate of return would increase the capital stock by less than 1-1/2 percent in the first year. 8/

Three 10 percent tax cuts would not, by themselves, double the after-tax rate of return. Assuming a very generous average marginal rate of 40 percent on income from savings, the tax reductions would reduce that rate by about 11 percentage points. Assuming--again very generously--that current saving equals one-tenth of the capital stock and that all additional saving is channeled into productive investment, the capital stock could increase by roughly an additional one-half of a percentage point a year through 1986.

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7/ Michael Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, vol. 86 (April 1978). Professor Boskin includes spending on housing and consumer durables in his measure of saving. Other studies have found the impact on saving to be much less than Boskin. See, for example, Philip Howrey and Saul Hymans, "The Measurement and Determination of Loanable Funds Saving," Brookings Papers on Economic Activity (1978:3).

8/ In 1979, given personal saving (flow-of-funds basis) of \$121 billion, a 100 percent increase in after-tax return would have increased savings by about \$48.4 billion, which was less than 1.5 percent of the capital stock including housing and consumer durables. Congressional Budget Office, The Productivity Problem: Alternatives for Action (January 1981).

Conceivably, that rate of accumulation could be pushed up even higher as a result of the distribution of the personal income tax cuts. More than four-fifths of the tax relief would go to households earning more than the median income. To the extent that high income groups save proportionately more of any added income, the saving response would be greater than the estimates indicate. Moreover, financial capital would be used more efficiently if the tax reductions induced a shift of savings from tax shelters to more productive outlets.

However large the eventual response, capital stock is not likely to increase quickly in response to tax changes. Major fixed capital projects typically require several years to plan, design, finance, and implement. The full impact of tax changes designed to promote capital formation would probably not be felt during the first few years after enactment.

The first few years, of course, are only the beginning. The effects of greater saving and investment are cumulative and become increasingly important in the longer run. If, for example, the stock of business fixed capital were to grow at a rate one percentage point higher than the average of the 1970s (which was about 3.5 percent per year), the increment to the capital stock would be about 45 percent of the existing capital stock--enough to increase labor productivity as much as 10 percent by the year 2000. Such a change would make an important contribution to the improvement of average living standards.

Overall Effect. The effect of lower tax rates on productive capacity and real output could be substantial. Using quite generous assumptions about the ways people respond to tax cuts, the reductions could raise the productive capacity of the economy by about 3 percent in 1986, which means that the average annual growth of real output could increase by about an additional one-half of a percentage point per year through 1986. 9/

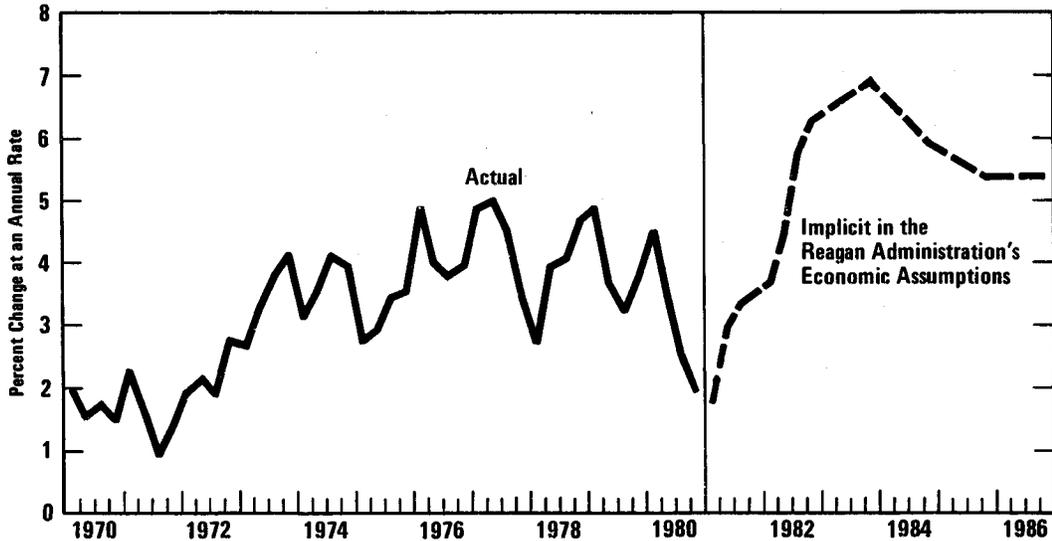
### Monetary Policy

The Administration's projection is based on the assumption of a steady reduction in money-supply growth during the forecast

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9/ Additional assumptions used to derive this estimate include constant returns to scale, market-clearing factor prices, and a homogeneous labor supply.

Figure 17.  
 Percent Change in the Velocity of M1B from Two Years Earlier



SOURCES: Federal Reserve System, Board of Governors; U.S. Department of Commerce, Bureau of Economic Analysis; Executive Office of the President, Office of Management and Budget.

period: "To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half of those levels by 1986." <sup>10/</sup>

The monetary policy assumptions raise two major questions. The first concerns consistency. Is the assumption of halving the growth of money consistent with the rest of the Administration's projection, especially the near double-digit growth of nominal GNP through 1986? Second is the question of the impact on inflation and growth. Can the assumed monetary policy slow the momentum of inflation without causing lost production and jobs?

Consistency. Halving the growth of the money supply while increasing the rate of economic growth would require an increase in the rate at which money turns over--that is, its velocity. The two-year annual rate of growth of M1B velocity is shown in Figure 17. The chart is divided into two parts, showing actual performance from 1970 to 1980 and the Administration's assumptions

<sup>10/</sup> A Program for Economic Recovery (February 18, 1981), p. II-23.

from 1981 to 1986. As can be seen, the assumed growth rates in the velocity of money substantially exceed previous experience.

More troublesome, the rapid rise in money velocity is assumed to occur simultaneously with a substantial drop in interest rates. Since velocity growth is a rough measure of the demand for money relative to supply, the assumption is that the price of money--interest rates--will fall while the relative demand for money is strong.

Inflation. An important characteristic of monetary policy assumed in the Administration's projection is that it can induce a substantial slowdown in inflation without causing a reduction in output and employment. Such a favorable outcome would be a sharp break with the past. Inflation, once started, appears to develop substantial momentum. Because of that momentum, previous attempts to reduce inflation with tight money have initially resulted in higher unemployment and decreased output; only later does lower inflation result.

In a review of periods of restrictive monetary policies through the 1969-1970 recession, Milton Friedman concluded that "prices reacted decidedly later than production, and reacted with a lag varying from eleven to thirty-one months." 11/ Professor Friedman was examining the initial reaction of prices; others have estimated that the full impact of tight money on prices occurs with a lag of perhaps 5 to 10 years. The experience of the most recent recessions in 1973-1975 and in 1980 does not suggest that the costs in output and jobs were any smaller than in earlier downturns.

The stubborn momentum of inflation, even when product and labor markets are slack, is an historical fact that has been built into the large econometric models. The momentum of inflation may, however, be the result of widespread expectations that future government policies, most notably monetary policy, will continue to feed inflation. If so, a credible change in monetary policy could change expectations of future inflation, which in turn could reduce the upward bias of wage and price decisions, sharply slowing inflation without sacrificing output and employment.

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11/ Milton Friedman, "Have Monetary Policies Failed?" American Economic Review (May 1972), p. 14.

Unfortunately, it is by no means certain that a tight monetary policy--however steadfast and credible--will translate wholly and quickly into reduced inflation. Previous Federal Reserve announcements of restrictive policies--as in the autumn of 1979--have not brought significant immediate reductions in inflation. More important, there may be other reasons for the stubborn momentum of inflation even during periods of slack product and labor markets. Particularly relevant in the 1970s was the ability of some individuals and groups to maintain their customary growth in real income in the face of adverse changes in relative prices--as when the doubling of world oil prices in 1979 was accompanied by an upward adjustment of many other prices and wages.

It must be recognized, however, that the policies proposed by the Administration are a sharp departure from the recent past. No one can be certain whether or not a restrictive monetary policy can reduce inflation more quickly, and with less cost, in this environment than in the past. The Administration's projected inflation rates are certainly possible. If they turn out to be correct, then the prospects for the entire policy package are favorable. But as yet there is little empirical basis for assuming such an outcome. 12/

### Regulatory Change

The Administration's economic package includes the promise of substantial changes in the government regulation of prices, resource allocation, environment, health, and safety. Large econometric models typically assume that the regulatory environment remains unchanged. Consequently, the impact of such changes would have to be estimated independently of the models and factored into their projections.

Clearly, the economic impact of regulatory change can be large. CBO estimated, for example, that trucking deregulation could lower the Consumer Price Index by 0.3 to 0.5 percentage

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12/ For a recent review of the evidence, see Robert J. Gordon, "Why Stopping Inflation May Be Costly: Evidence from Fourteen Historical Episodes," National Bureau of Economic Research Conference on Inflation (Washington, D.C., February 27, 1981).

point by 1985. <sup>13/</sup> The recent deregulation of airlines and current steps to deregulate railroads are expected to lower prices by significant amounts. Furthermore, although decontrol of domestic crude oil prices is expected to increase the CPI, this change, like the others just mentioned, will improve resource allocation, increasing the overall productive capacity of the economy.

It is not possible at this time to estimate the impact of the Administration's regulatory changes, since they have not yet been specified. As they are spelled out, their effects should be estimated and the projections adjusted accordingly.

#### Other Factors Influencing the Estimates

This chapter has enumerated a number of reasons why the outcome of the Administration's economic policies could be more favorable than indicated by postwar experience. On the other hand, there are at least three factors that could make the next five years, even with enactment of the Administration's policies, significantly worse than history suggests.

First, world commodity prices--especially for oil and food--may rise more rapidly than assumed. Poor weather, political unrest in the Middle East, or other adverse events could combine with the sticky adjustment of domestic prices and some accommodation by the Federal Reserve to push inflation significantly higher than projected. The CBO estimates simply assume that there will be no such adverse price "shocks" through 1986--an assumption that caused projections made in the 1970s persistently to underestimate future inflation.

Second, the CBO estimates have made no allowance for a variety of secondary effects resulting from the proposed spending cuts. To the extent that state and local governments would raise taxes to offset lost federal funds, or that persons losing benefits would make claims on welfare entitlement programs, or that exports would be lost as a result of cuts in Export-Import Bank funding, and so on, the budget cuts would have a more negative effect on the

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<sup>13/</sup> Congressional Budget Office, Inflation Impact Analysis for S.2245, March 27, 1980.

economic outlook. Moreover, to the extent that the budget cuts would reduce government capital spending, overall capital formation--and consequently the future growth of productivity--could be less than projected by CBO.

Third, the CBO estimates have made no allowance for the possibility that phasing in the 10-5-3 depreciation proposal may initially have an inhibiting effect on investment. Phasing in of accelerated depreciation could result in some postponement of investment as businesses wait for the arrival of larger tax benefits. If this were to happen on a large scale, the short-run benefits would be reduced. Once the program was fully phased in, however, there could be a surge of investment, reflecting purchases that had been previously postponed. 14/

#### CONCLUSION

Underlying the current problems of the U.S. economy is the fact that productivity growth slowed to a crawl in the 1970s. The first fiscal policy option examined--the one incorporating the Administration's program--attacks the problem of slow productivity growth by attempting to move resources from consumption to investment. It attempts to increase private saving by means of substantial tax reductions for households and speeded-up depreciation write-offs for business. It would limit the rise of public dissaving (deficits) associated with the tax cuts by reducing the growth in federal spending, especially in programs encouraging consumption. To the extent that current marginal tax rates curtail work effort, saving, and investment or distort the efficient allocation of resources, productive capacity would be further enhanced.

Moving resources from current consumption to productive investment will raise productivity growth. But three things should be kept in mind. First, a substantial increase in investment, accumulated over a number of years, is necessary to change the capital stock--or labor productivity--substantially.

Second, the program is not costless. Increased investment means reduced consumption. Some people will be hurt by the

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14/ See Congressional Budget Office, Entering the 1980s: Fiscal Policy Choices (January 1980), pp. 74-80.

cuts in government spending. Others will not gain much from the proposed tax cuts--but would benefit more from alternative types of tax cuts.

Third, the Administration's proposed personal tax cut is a virtually irreversible commitment to large reductions over the next three years. There is a danger that, if it achieves the tax cuts but not the proposed spending cuts, the result could be increased inflation.



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## CHAPTER VI. PROFITS AND BUSINESS INVESTMENT

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The profitability of American business has been declining. Profits, or the economic return to capital and to business risk-taking, are a major factor determining business investment and willingness to innovate--which in turn are significant determinants of economic growth. In the decade of the 1970s, the (after-tax) economic return on capital was considerably lower and more uncertain than during the earlier postwar period. The decline in profitability was particularly sharp in industries such as autos and steel and in regulated industries, but it was evident in most durable goods manufacturing. By contrast, profitability rose in the energy sector and in American-owned business abroad. 1/

This chapter analyzes long-term trends in the after-tax returns on capital. It discusses the role of capital spending and innovation in productivity growth. Finally, the chapter briefly explores possible ways of stimulating economic growth, including measures that would deal with the structural adjustments occurring in the economy, of which the diverse profit trends and unemployment rates are symptomatic.

### LONG-TERM TRENDS IN PROFITABILITY

An investor trying to decide on the best use of his funds is most likely to be guided by the return he can expect after taxes and by the amount of uncertainty involved. He will weigh many considerations, including the demand for the product, the availability and cost of funds, and government regulatory and tax policies. For the researcher, some good indicators of the incentives to invest in different industries are rates of capacity

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1/ Inflation has made it especially difficult to determine just what has happened to the return on capital, particularly the after-tax return. There is little agreement among economists as to which measure of return on capital is most appropriate. Not all indicators point to a decline in profitability.

utilization, the returns on existing capital, and the share of profits in national income. 2/

### Income Shares and the Return on Capital

Income Shares. For the economy as a whole, economic profits (profits adjusted to reflect the replacement cost of depreciated capital and inventories but excluding capital gains) as a share of national income have tended to decline since World War II, although wide fluctuations are evident (see Figure 18 and Table 25). The profit share is highly cyclical, falling sharply in recessions and advancing rapidly during periods of prosperity. Thus, the profit share increased substantially from the early to mid-1960s (a period of prosperity), but fell sharply afterward until the early 1970s. No further decline in the profit share has been evident during the 1970s. 3/

A better understanding of long-run trends in profitability can be gained by focusing on the domestic nonfinancial corporate sector. The picture is similar (Figure 18 and Table 26). The mid-1960s stand out as a period in which the profit share was especially high, and the 1970s as one in which the profit share was especially low. As shown in Table 26, the interest component of the return to capital increased during the 1970s, in part because inflation pushed interest rates higher. In addition, firms relied

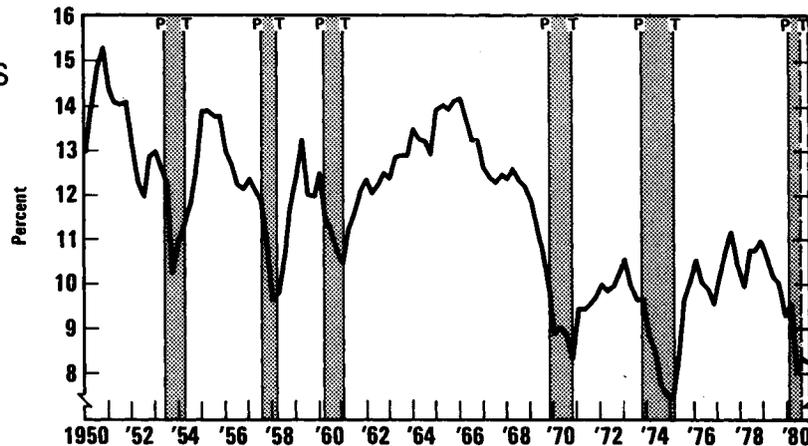
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2/ Studies of profits and the return on capital have tended to focus on the share of profits and interest in total factor incomes. One reason is that certain problems associated with the measurement of capital can be avoided by analyzing factor shares of income.

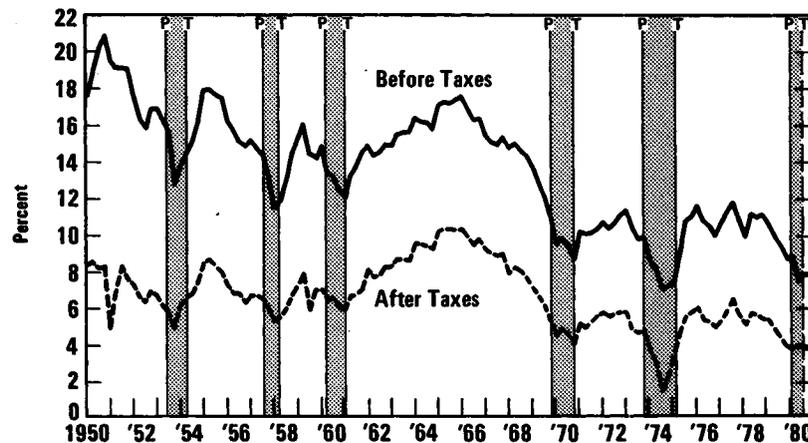
3/ One of the long-run factors that has tended to decrease the profit share (and increase the labor share) has been the increase in the size of the government sector. In the National Income Accounts, all of the income originating in the government sector is considered labor income, and no economic return on government capital is included. The relative decline in agriculture also helped to increase both the labor share of national income and the profit share, because the proprietor form of business organization is prevalent in farming. Such income includes a return both on capital invested and on the labor of the proprietor and his family.

Figure 18.  
Economic Profits

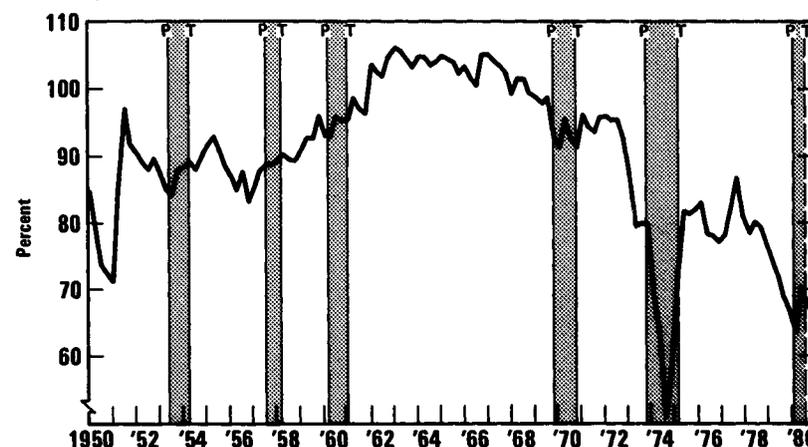
Total Economic Profits as a Share of National Income



Economic Profits of Nonfinancial Corporations Relative to Their Gross Domestic Product



Economic Profits of Nonfinancial Corporations Relative to Their Book Profits



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE 25. THE DISTRIBUTION OF NATIONAL INCOME, 1950-1979

	Percent of National Income (Annual Average)		
	1950-1959	1960-1969	1970-1979
Corporate Profits before Income Taxes <u>a/</u>	12.6	12.4	9.7
After corporate income taxes <u>b/</u>	6.1	7.1	5.2
Compensation of Employees	68.6	70.8	74.8
Net Interest	1.8	3.6	6.1
Proprietors' Income	13.8	10.0	7.5
Indirect Business Taxes	3.3	3.1	1.9
Total	100.0	100.0	100.0

a/ Economic profits are reported profits adjusted for inventory valuation and capital consumption. Economic profits, as measured in the National Income Accounts, exclude capital gains or losses.

b/ Economic profits less federal, state, and local income taxes.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

more on debt as a means of financing investment. Taken together, the share of interest and before-tax profits in national income fell to 13.1 percent in the 1970s, from 16.6 percent for the 1960s and 16.9 percent for the 1950s. 4/

4/ CBO's analysis suggests that some, but not all, of the decline in profit shares during the 1970s was associated with the business cycle, specifically lower capacity utilization.

TABLE 26. THE DISTRIBUTION OF GROSS DOMESTIC PRODUCT OF NONFINANCIAL CORPORATIONS, 1950-1979

	Percent of Gross Domestic Product (Annual Average)		
	1950-1959	1960-1969	1970-1979
Corporate Profits before Income Taxes <u>a/</u>	16.1	14.9	10.0
After corporate income taxes <u>b/</u>	7.0	8.3	5.0
Compensation of Employees	64.8	64.2	66.3
Net Interest	0.8	1.7	3.1
Depreciation	9.1	8.8	9.9
Indirect Business Taxes	9.2	10.4	10.7
Total	100.0	100.0	100.0

a/ Economic profits are reported book profits adjusted for inventory valuation and capital consumption; they exclude capital gains or losses.

b/ Economic profits less federal, state, and local income taxes.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Return on Capital. The return on business capital--economic profits plus net interest as a percent of the estimated value of the capital stock--has fallen, especially since the 1960s (Table 27). The average return in the 1970s (9.6 percent) was considerably

TABLE 27. RATE OF RETURN ON DEPRECIABLE ASSETS AND RATE OF RETURN ON STOCKHOLDERS' EQUITY OF NONFINANCIAL CORPORATIONS, 1955-1979

	Average Annual Percent		
	1955-1959	1960-1969	1970-1979
Rate of Return on Depreciable Assets <u>a/</u>	11.9	13.5	9.6
Rate of Return on Stockholders' Equity <u>b/</u>	5.1	7.1	6.6

a/ Profits before taxes plus capital consumption and inventory valuation adjustments plus net interest paid, as a percent of depreciable assets valued at current replacement cost. Data for the inventory component of depreciable assets do not reflect national income and product accounts benchmark revisions.

b/ After-tax profits corrected for inflation effects, including capital gains on reduced value of net debt due to inflation, divided by net worth (physical capital component valued at current replacement cost). Data do not reflect national income and product accounts benchmark revisions.

SOURCE: Economic Report of the President (January 1981), Table B-86.

below the average for the 1960s (13.5 percent) and somewhat below the average for 1955-59 (11.9 percent). 5/

5/ Some analysts question whether or not the decline in the return on capital in the 1970s was part of a long-run phenomenon or merely cyclical. The evidence suggests that profit rates were lower during the 1970s even after adjusting for the business cycle. But tests to determine whether there was a longer-run trend of falling profit rates have not been statistically conclusive. See Martin Feldstein and Lawrence Summers, "Is the Rate of Profit Falling?" Brookings Papers on Economic Activity, 1977:1, pp. 211-228.

Another and more narrow measure of profitability is the rate of return on stockholders' equity, adjusted for the effects of inflation. That measure, shown in the bottom row of Table 27, declined only slightly in the 1970s compared with the 1960s. The principal reason is that the numerator for that series includes the capital gains from the reduction in the real value of net corporate liabilities. But the gain to stockholders from those reductions was roughly offset by losses to creditors.

### Inflation, Return on Capital, and Taxes

Inflation has greatly complicated the measurement of the returns on capital and of the tax rate on the income from capital. This section describes briefly the way in which inflation affects capital income, and why it leads to some differences of opinion among investigators as to trends in the after-tax return on capital.

Why does inflation greatly complicate the analysis of trends in the return to capital? For one thing, it causes the reported or "book" profits to exceed "economic profits," which are profits based on the replacement cost of fixed capital and inventories but excluding capital gains (Figure 18). In addition, inflation shrinks the real value of corporate liabilities. Finally, as inflation gets incorporated in expectations, interest rates tend to rise to compensate lenders.

The tax system does not distinguish between nominal income and income adjusted for inflation. Nominal interest (including the inflation component) is tax deductible for borrowers, but taxable for lenders. In addition, accrued changes in the value of assets are not considered in the tax system unless realized. Among the implications are:

- o Depreciation of business capital is understated for tax purposes, and inventory profits tend to be overstated (many businesses do not use the LIFO method of accounting although they are permitted to do so);
- o The effect of inflation on the return to capital depends on the tax situation of the business and of the lender;