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ECONOMIC PRIORITIES FOR BUSINESS

An Address By
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I studied with considerable interest the findings of a recent survey entitled "How Americans Judge Basic Institutions" reported in the February 13 issue of U.S. News and World Report. The poll examines how a sampling of individuals rate some of our national institutions, including business and professional groups and their leaders. My own interest in the survey sprang, not merely from the results, but from the perverse way in which those results track the direction of my own career, a career which has progressed -- and I use that word advisedly -- from lawyer to business executive to educator to regulator. Those questioned were asked to rank the various institutions on a scale of 1 to 7, and, based on the numerical average of the responses, the editors classified the institutions as "relatively good," "medium," or "relatively poor" in terms of the public's perception of their ability to get things done.

The respondents rated large business as "relatively good" with an average rating of 4.47 and business executives -- the field in which I spent the largest share of my working career -- as "relatively good" with a rating of 4.43. The legal profession, another earlier phase of my career, came in at "medium" with a 3.99 average rating. Educators, the group to which I belonged when I was Dean of the Graduate School of Management at UCLA, also earned a "medium" rating, but with a lower average of 3.84. The Democratic Party was rated as "relatively poor" at 3.29, and my present affiliation, "regulatory agencies," was similarly perceived as "relatively poor" with an even lower average rating of 3.20. Finally, the Republican Party at 3.10 and politicians at a dismal 2.69 closed out the field. Since I have no interest in becoming a politician, it seems that the only course open to me in order to continue the inexorably downward trend in my career is to move over to the Republican Party.

I interpret this data, and other similar studies, to reflect a sense that, in terms of effectiveness in discharging what is perceived as its primary mission, business is generally more effective at delivering goods and services than regulators generally are at regulating. I would have to agree. And while regulators work at doing better -- and perhaps even at doing less and doing it better -- I am concerned that business not impair its ability to do its job at least as well as it has.

For that reason, I am especially pleased to speak this evening on economic priorities for business -- and particularly on inflation. The subject is an important one; in fact, inflation is the most serious economic problem facing our country. I would like to trace briefly the consequences which flow from the gap inflation opens between conventional measures of corporate financial performance and economic reality, and to sketch the outlines of some of the responses to that gap which I believe to be worthy of your consideration.

The Problem: Inflation and Economic Realty

Corporate earnings are regarded as the most basic numerical measure of corporate performance and business success, and, in the aggregate, of the success of the business sector as a whole. Investment decisions, executive promotions, public attitudes toward business, tax policy, the implementation of social programs, and a host of other judgments rest largely on the number which appears on "the bottom line."

Because, I suppose, of the precision which numbers imply, it is easy to lose sight of the fact that corporate profits, like any measurements, are no more reliable than the assumptions on which they rest. Financial reporting depends on a wide variety of

assumptions and conventions -- the use of historical costs, the various methods of depreciation, the criteria for distinguishing between capital expenditures and expenses, and many others. While I am not disputing the logic of those principles, in my view, the resulting corporate earnings figures should never have been treated as precise; business earnings would more meaningfully be reported or interpreted as a range rather than a single figure -- exact down to the penny when reported in the form of earnings per share.

In any event, whatever the significance of corporate profit figures in an inflation-free economy, the impact of inflation has compelled a re-examination of the meaning of the portrait of corporate earnings which traditional financial reporting paints. Increasingly, we are becoming aware that the consequences of reliance exclusively on a measure which distorts the economic contours of business performance are felt throughout the economy -- from the overall capital formation process to the day-to-day managerial decisionmaking in each firm. More broadly, if our ability to judge and report the economic performance of business is skewed, then both the public and its elected representatives are unable accurately to analyze the contribution which business is making to our society.

During the past 10 or 15 years, the public has come to demand more and more that business discharge obligations which might, in some sense, be thought of as social rather than purely economic -- the protection of the air, water, and the other facets of the natural environment; the promotion of occupational safety; the implementation of the national policy of equality of employment opportunity; and similar objectives might fall in this category. In the long run, of course, it may be difficult or impossible to separate the economic components of each from the social components. In any event, these new

factors are now as real a part of the equation of business responsibility as are the more traditional goals of providing employment and a source of livelihood for our workforce and of producing the goods and services necessary to satisfy a rising level of expectations with respect to the standard of living.

Thus, as a society, we are placing increased demands on our private enterprise system. The problem of marshalling sufficient capital in order that business may discharge its role in accomplishing these goals is a serious one. Unfortunately, however, the effects of inflation upon the present methods of reporting business performance obscure the increasingly pressing need to bring forth additional capital and, indeed, may lull us -- as government policymakers, as decision-makers in private business, and as individual citizens -- into a belief that corporations are generating more than adequate funds to satisfy our long-term demands for capital.

The public perception seems increasingly to be that American business profits -- particularly those of the largest firms, those most able and most responsible for aiding in accomplishing our national objectives -- are huge and growing larger. This misimpression leads inevitably to demands that the government take steps -- often through tax policy -- to moderate those profits and to divert them to the commonweal, either directly through the funding of federally-mandated programs of social value, such as OSHA, or indirectly through what we have come to call transfer payments whereby corporate taxes are reallocated to social purposes.

In my judgment, American corporations, as a whole, rather than generating shockingly high profits, are earning at dangerously low levels relative to their long-term reinvestment needs if they are to discharge the responsibilities we expect them to

shoulder. Profit trends -- especially as they affect cash flow available to replenish, modernize, and expand assets and to pay dividends -- are probably the most important factors in evaluating common stocks in the marketplace. Despite their importance, however, I believe that the function and level of corporate earnings and corporate ability to generate the cash needed to replace and expand productive capacity over time are seriously misunderstood today -- in large measure because of the hidden impact of inflation.

It is commonplace to read in the press that particular well-known corporations have reported "record" or "all-time high" earnings. In terms of the absolute number of dollars involved, these statements are, of course, true. It is, however, useful and important to put those figures in perspective. And when the perspective is comparative earnings over time, their "real" value, and the ability of business to generate required new capital, then what are reported as "record" earnings may prove to be disappointingly low.

How can corporate profits be low in any sense when reported after-tax earnings of non-financial enterprises hit a record of $77 billion in 1976 and, according to estimates, went even higher in 1977? One striking element is the consistent, substantial understatement of depreciation in an inflationary environment. This is, however, by no means the only way in which accounting based on historical costs distorts corporate profits. Valuation methods which do not exclude inflation-generated inventory profits also overstate income. Both of these problems erode the value of reported earnings while adding to taxable income and thus generating tax liabilities which may, in fact, have to be paid partly out of capital. As long as reported earnings continue to fail to take into account an accurate assessment of the economic costs of using and replacing the assets,

both current and fixed, which produce those earnings, investors, managers, government policymakers, and the general public will all necessarily remain uncertain, confused, and misled as to the level, expected growth, and rate of change of profit.

Studies have shown that, if depreciation were recomputed based on the current-cost, double-declining balance method in order to charge against revenues a sum which more accurately reflected both the manner in which capital equipment was consumed and the cost, in inflated, current dollars of replacing it, and if inventory consumption charges, as reflected in the cost of goods sold, were reconverted from historical to current costs, 1976 after-tax profits of non-financial corporations would shrink to some $43 billion -- only a little more than half the $77 billion figure reported. In effect, corporations reported as profit $34 billion required to offset or restore capital consumption. By comparison, in 1966, the year in which the market peaked, reported after-tax earnings were $40 billion -- about half of the 1976 reported figure of $77 billion -- while inflation-adjusted profits in 1976 were $39 billion -- only 10 percent below after-tax earnings a decade later.

If we direct our attention to the share of its profits which business retains after dividends as a source of capital for reinvestment, studies indicate that annual retained earnings, adjusted as described above and converted to constant 1972 dollars, fell from $28 billion in 1966 to $7.9 billion in 1976 -- a drop of around 70 percent -- and produced a $13.3 billion deficit, after dividends for 1974 alone. While there were net additions to adjusted retained earnings in 1975 and 1976, those additions were insufficient to offset the 1974 deficit. Thus, over the most recent three-year period for which final figures are

available -- 1974 to 1976 -- business has, in effect, apparently paid dividends out of capital.

The effect of this effort to adjust corporate earnings for inflation is even more startling from the perspective of federal tax policy. During the past 11 years, the effective tax rate on reported corporate tax basis earnings has generally hovered around 42 percent. However, if actual tax liability is compared to pre-tax profits adjusted for inflation-based underdepreciation and inventory gains, a much different picture emerges: In 1966, the effective rate on adjusted earnings was quite close to the 42 percent rate on reported income. In 1976, the effective tax was 56 percent, while in 1974 it was an amazing 80 percent. Not only are we reporting the consumption of capital as income, but we are paying taxes on it. Inflation, and the failure of the tax system to recognize its distortions, have increased the real rate of corporate taxation substantially without congressional action and without the debate that would occur if such a tax increase were formally proposed.

If we are to meet our need for adequate new investment, the disclosure and taxation systems must be converted into tools which will aid the effort rather than obstacles which frustrate it.

The Impact on Capital Formation

In 1976, the Department of Commerce prepared one of the most detailed and comprehensive discussions of investment requirements ever undertaken. Its findings are generally consistent with other studies. In its "Study of Fixed Capital Requirements of the U.S. Business Economy, 1971 to 1980," the Department's Bureau of Economic

Analysis looked at capital needs on an industry-by-industry basis. The purpose of this study was to estimate the amount of investment necessary, through 1980, in order to have an economy capable of meeting three objectives -- reasonably full employment, a national program of environmental protection, and decreased dependence on potentially unstable foreign energy resources. The Bureau found that real capital investment -- that is, nonresidential, fixed investment -- must average about 11.4 percent of gross national product. Capital spending has, however, not led the economic recovery, averaging less than 10 percent for the recovery period. In fact, the Department predicted recently that the rate of real capital spending during 1977 would be only 8 percent and would be lower still in 1978, running at half the figure which the Administration had targeted as necessary to reduce unemployment.

The Department's 1976 study also contains interesting findings with respect to the uses to which new investment would be put. It found that the majority of the projected national investment needs during the period analyzed would be employed simply to keep us from slipping below present productive capacity. This finding is a reflection of our chronically low rate of capital formation in the last decade.

And to the extent that investment is insufficient, society will pay the price in terms of fewer jobs, a generally lower standard of living, and -- perhaps most importantly -- a perception that our economic system is not capable of satisfying our needs. Reginald H. Jones, the Chairman and Chief Executive Officer of General Electric, has translated this concept into an analogy which, I think, aptly illustrates the problem. He notes that one of the watershed developments in human history was the concept of plant husbandry -- that, by saving some of the seeds produced by this year's crop for next year's planting,

the continuation and indeed the increasing prosperity of society could be achieved. He then observes:

> "The same thing applies to industrial societies and business firms. Every year, some part of the total output -- some seed corn -- has to be saved and reinvested in the replacement, modernization and expansion of the industrial machine. This is the process of capital formation. And nations that neglect their capital formation find themselves susceptible to scarcity, inflation, unemployment, and declining standards of living.
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> In recent years, the United States has been eating into its industrial seed corn."

The Impact on Corporate Decisionmaking

Financial reporting which ignores the impact of inflation also has important implications in business decisionmaking. The most obvious area in which this occurs is in the process of estimating capital needs, the internally-generated capital available, and the projected returns from proposed investments.

Further, disregard for the impact of inflation on the adequacy of earnings distorts pricing decisions. If corporate profits are insufficient to generate the capital necessary to maintain existing capacity, a part of the reason may be that the goods and services which the firm sells are priced unrealistically relative to their true costs of production. It may be difficult for one business to correct underpricing if its competitors choose to ignore the problem, and, in some industries, foreign competition would make correction impossible. Eventually, of course, both those who recognize that they are eroding their capital and those who do not will have to come to grips with the truth. Thus, financial reporting which obscures or ignores the impact of inflation impedes efforts to identify and deal with emerging problems until they become crises.

Finally, there undoubtedly are managers who are being compensated and promoted in return for showing increases in the reported earnings of their operations when, in reality, they are dissipating its capital.

The Impact on Public Confidence in Business

If the validity of the general type of analysis I have outlined is accepted -- or, at minimum, if it is accepted that the net effect of financial reporting premised on a stable level of prices is to buoy profits unrealistically upward when the environment becomes inflationary -- it seems clear that we are caught in a dilemma. Much of the public perception -- encouraged by traditional methods of financial reporting -- is that business profits are already too large -- even obscene -- and still growing. At the same time, the economic reality is that American business overall is not generating and retaining funds adequate even to replace existing capacity and continue operations at present levels. Indeed, some businesses may actually be distributing their capital and be in the process of liquidation.

It is difficult to overstate the importance of a better public grasp of the size, in real terms, of corporate income. Constant reports of "record" corporate earnings, while at the same time business is pleading the case for tax and other incentives to stimulate capital spending, aggrevate the credibility gap which already exists. The net result is both a decline in the credibility of business, based on those inordinate business profits as reported, and government action -- or inaction -- which is not consistent with enhancing the effectiveness of our economic system. Aggravation of the public's confusion concerning profits -- and the manifestations of that confusion in governmental responses -

- is perhaps the most serious consequence of financial reporting which fails to acknowledge that the unit of measurement -- the dollar -- is not constant.

Steps To Solution

I would like now to outline some steps which, in my judgment, would contribute to solving the problems I have described. Although I recognize the costs and difficulties in changing corporate reporting procedures and in persuading Congress to alter the tax laws, I believe that more realistic accounting and tax practices could be an important step toward educating the public, their elected officials, and other policymakers to the impact of inflation, to the dimensions of the problem of capital formation, and to the direction in which policy must move in order to deal successfully with the problem.

First, I believe that inflation accounting -- as a supplement to, not a substitute for, historical cost accounting -- must become a permanent feature of financial reporting. In my judgment, the need for disclosure of the impact of inflation on corporate performance is simply no longer open to serious debate. The question is not whether it should be disclosed, but how.

As I imagine many in this room are well-aware, in 1976 the Commission adopted Accounting Series Release No. 190 requiring major companies to disclose the impact of inflation on inventories, productive capacity, and cost of sales. I recognize that many corporate managers have greeted the opportunity which ASR 190 affords them to provide a perspective on reported earnings with something less than enthusiasm. As I have tried, however, to point out this evening, financial reporting must aid investors, business managers, politicians, and the general public in realistically evaluating the performance

and capabilities of private enterprise. This is not a theoretical or abstract problem. It impacts directly on the capital formation process and on society's attitudes toward the effectiveness of the private enterprise system.

My purpose tonight is not to defend the methodology of the Commission's current replacement cost rules. In fact, the Commission recently issued a release requesting comments on any problems which companies have encountered in providing replacement cost data pursuant to ASR 190. However, although I am mindful of the expense which developing replacement cost data has entailed, this area is, I believe, one in which the cost of compliance with government regulation will prove to be far outweighed by the benefits. Accordingly, I hope that ASR 190 will not be written off as another example of bureaucracy in action, but rather that the industry will work with the Commission by submitting its best thinking and insights on how the users of financial information can be given a meaningful picture of the impact of inflation on reported corporate earnings. The resulting benefits in more rational tax policy, improved investor confidence in business, and better public and governmental understanding will, in my view, repay the costs of developing such a disclosure system many times over.

In addition, some modifications in our tax structure are clearly necessary to stimulate capital formation. Without attempting to be comprehensive or prescriptive, I would offer five suggestions for a plan of positive action to promote capital formation:

1. Further acceleration of depreciation schedules for tax purposes.

2. Expansion of the investment tax credit. This may entail an increase in the tax credit percentage rate, a removal of the 50 percent cap on the credit, and provision for the elilgibility of plant expenditures. The extension of the investment tax credit to plant might be especially appropriate given the latent need for wholesale replacement of aging production capacity.

3. Reduction of the corporate tax rate. Any reduction would provide some relief from double taxation and would, at least to a degree, help to undo the effects of the inflation-generated increases in the corporate tax rate that I mentioned earlier. President Carter has proposed a cut in corporate taxation which, if enacted, would hopefully accomplish this goal.

4. Integration of the corporate and personal tax systems. In general, the effects of double taxation are a serious impediment to capital formation, and I would support steps to ameliorate the problem. I expect that, to the extent that corporations judge investments and competitive pricing policies on an after-tax basis, a substantial part of this savings might, over time, be passed to customers.

5. Retention of the capital gain treatment. Indeed, I would advocate returning the scope of those provisions to where they were earlier this decade. Much of the capital gains we tax now reflect the impact of inflation and not a true capital gain at all.

The New Economic Environment

Having talked about what government should do for business -- and may not -- let's look at what business should do for itself. I am very concerned that business, troubled by the many uncertainties it faces, is shifting into neutral waiting for the storm to pass.

Inflation is the most severe retardant to business vitality on the economic landscape. Perhaps, however, the persistence of inflation is only symptomatic of a larger change in the business climate. Nineteen seventy-seven was, after all, a good year in terms of business activity, profits, and dividends. Most sets of economic statistics were at all time highs. Not many years ago, record highs in employment, income, production, spending, savings, and financial transactions would have been reason for genuine bullishness. Today they go unnoticed.

For a long list of reasons we can all recite, we are both feeding and reflecting a lack of confidence -- indeed a crisis in confidence -- a lack of confidence in our economy, in our government, in ourselves, and in our ability to control and solve our problems. The uncertainty is particularly acute, for it was only a decade ago in the 60's that many were convinced that, at the national level, we had indeed mastered the economic cycle. Now we find that, not only have we not mastered it, but we are not certain we even understand it. Traditional cyclical theory neither explains what is happening nor forecasts what lies ahead.

And at the corporate or investor level, most things we did in the 60's turned out right, and we became impressed with our judgment and wisdom. Now those same actions turn out all wrong. And we are beginning to sense that these conditions, both macro and micro, will probably continue at least through the remainder of the business careers of the present crop of CEOs.

We have a decision to make. Do we let lack of confidence dominate our thinking? Do we "wait and see"? Do we build corporate histories of inaction and indecision? And do we indulge in self-fulfilling prophecy, collectively feed the mood of lack of confidence, and drive the economy and the society deeper into the hole while we wit for "the other guy" to show the way or for your friendly Washington public servant to give you an incentive? Or do we venture forth and find new ways to make progress in this new reality we have to live with?

We can expect much less certainty and more crises in the years ahead. Yet there will also be opportunities for progress for those who have the foresight and wisdom to look for and pursue them.

None of our problems are susceptible of easy solutions. They are part of a new, unsteady "steady state." And those who are awaiting the return of the boom economy of the prior decade before committing themselves to positive action are making a serious mistake. In simple terms, I believe that what we should do is to recognize that we are going through a difficult and important period of economic, social, and political transition in this country -- and that the period will be prolonged and lacking in the predictability that we experienced in the post-war era. What is needed is for business to apply its very best thinking to how to prosper and have an impact in such an environment -- to have the confidence and the courage to move forward and take risks and not wait for the game to become more inviting.

In terms that a Chicago audience will understand, many corporations and chief executives may be acting like Sewell Avery. Waiting for the picture to clarify is futile and just another way of playing it safe. Walter Hoadley of the Bank of America stated the alternatives this way:

> "Each organization and individual now has a fundamental choice to make, consciously:
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> 1. To adjust to this new era of major structural change by adopting or reaffirming a positive, aggressive posture rooted in the conviction that new opportunities can be found in changing periods and that we must learn to live with these new conditions, while not foregoing our right to try to modify and improve them; or
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> 2. To retrench by pursuing a prolonged wait-and-see, defensive, cautious posture and very likely to partially liquidate (as at least a few companies are already doing). The consequences of this choice, if made widespread, obviously will be depressing for the general economy."

Waiting for certainty or comfort ensures the deferral of corporate growth. Piling up cash is not an end in itself and is no tribute to corporate management. Nor is a tender for your company's stock. Nor is an invitation to a take-over. If you do not put your resources to work -- in increased efficiency -- in plant and equipment -- in new products -- in marketing -- in research and development -- in acquisition -- or in expansion -- you are part of the problem. If you do not put your resources to work to express your views timely on social issues, government priorities, and regulation, and in being sure your own house is in order, the consequences are predictable.

We need to consider whether the waiting game is being overdone. We understand the lack of certainty. We understand the kind of risks that are involved. But this is the new reality, and we need to adapt to it; we need to recognize that there are opportunities within it. Our the responsibility to the company and to the company's contribution to the society call for courage and investment and not for waiting for Congress or the President to make life easier or more certain. The problem is of national and international consequence. But it originates in the individual mind, and the solution lies with you and me. Let's get on with it.