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INFLATION AND THE RECAPITALIZATION OF AMERICA

AN ADDRESS BY

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I would like to talk to you about a subject that is on everyone's mind, but perhaps from a somewhat different perspective. The subject is inflation and the role of inflation in what I call the recapitalization of America. Secretary Miller, in a New Orleans speech yesterday, said that inflation remains the Country's number one priority. The President has told us the same. Although I hope that recognition lasts in an election year, there will be enormous pressures to moderate the economic impacts of recession -- out of what one might call anything from political expediency to pragmatism.

A New York Times editorial this morning discussed the need to moderate inflation. While I cannot quote it verbatim, the author of the editorial, in effect, expressed the concern that we not attack inflation by increasing the number of unemployed, and as time goes on, we will hear more such concerns.

My sense, at this point, is that the efforts to combat inflation that are now being conducted in Washington are perhaps unusually strong and committed. I think that is, primarily if not entirely, because of the efforts of Chairman Volcker of the Federal Reserve System.

But, as the economy continues to turn downward, the pressure will continue to mount that we need to moderate the impact of our efforts to get inflation under control. I happen to share the view that this will be a deep and serious recession, thereby raising the prospect that it will be every bit as serious as the one in the mid-70s, and we will begin to see pressures against anti-inflationary efforts. These pressures will mount as the percentage of the unemployed grows and as the average member of the public in this Country realizes that perhaps, not only are members of his or her family unemployed, but that his or her own income is not keeping up with the impact of inflation. Many of these same people will turn to the financial pages of the daily newspapers and find that corporate profits are reportedly hitting new record highs, and we can expect to hear a resurgence of the common theme about the obscenity that we call corporate profits.

This will come about, in part, because of the oil company profitability which tends, overall, to enhance very dramatically the total increase in profitability on the part of American business. Indeed, at this point, if we subtract oil company and related profits from the profits of American industry as a whole, profitability thus far this year would be down from what it was last year.

What we are faced with is a total lack of recognition on the part of the American public -- and largely on the part of the American political scene -- of the true status of American business profits, as well as the purpose of those profits and of an effective method to measure the adequacy of those profits in relation to their purpose. This is not a new problem. Its newness is only by degree. The problem is much more serious now than it might have been 20 years ago when inflation was running anywhere from one to three percent. In fact, it was some 30 years ago when a very prestigious group called a Study Group on Business Income met and proposed that, in addition to reporting income on an historic cost basis, American business should reflect income more realistically in terms of current income and the impact of inflation, and the impact of other types of one-time occurrences as they relate to corporate income.

Incidentally, it was also almost exactly 30 years ago that a group called the Paley Commission issued a report on the energy future of this Country. It predicted, in gross terms, the forthcoming shortage of energy which we also chose to ignore.

This year, in addressing the impact of inflation, the Financial Accounting Standards Board, with some encouragement from the SEC, issued a standard that calls for two developments in adjusting corporate earnings to reflect the impact of inflation. Beginning with 1979, American corporations above a certain minimum size will report, as supplemental information, the impact of inflation as adjusted for the

Consumer Price Index -- in other words, to keep earnings on a constant dollar basis from year to year. Beginning with 1980, they will also be required, through supplemental information, to reflect the impact of adjusting assets and income based on current cost -- in effect reflecting the measure of what it will take today to replace inventories, equipment and plant, as well as other fixed assets that were being utilized or that were used up in the process of generating the income for the year being reported. The FASB also encouraged companies to report on both bases, commencing in 1979 (if they could and would), but without requiring both until 1980. The Commission also encouraged such reportings by offering to withdraw its existing replacement cost reporting requirements as to those companies that reported both ways in 1979.

We have the information being reported. At a first cut, as contrasted to income from continuing operations required on a traditional historic cost basis, income reported on either a constant dollar or current cost basis ran at 60 percent of historic cost income -- precisely, 60 percent on a constant dollar basis; 61-1/2 percent on a current cost basis. The return on net asset on an historic cost basis -- the traditional accounting basis -- is 16.3 percent. On a constant dollar or current cost basis, identically, it is 7.9 percent -- less than one-half of the return on net asset that is reported under an historic cost basis. The dividend pay-out ratio is 33 percent of earnings based on the historic cost approach, and is 69 percent based on an adjusted income figure. The corporate tradition is to think in terms of a third of their income being distributed as dividends, when in reality, they are approaching 70 percent.

Additionally, the effective income tax rate is 41 percent as compared to earnings on an historic cost basis, but 59 percent on a constant dollar basis; and 55 percent on a current cost basis. We effectively have a substantially higher tax rate -- and without the benefit of public or Congressional debate or deliberation.

Now, what is so significant about all of this? I think the real significance of it is that, by and large, the business and commercial community in this Country is, in my judgment, not generating adequate income on which to replace plant and equipment as it becomes outmoded; to invest in capital expansion; to invest in productivity; or, indeed, to invest in new products or the other types of activity that an adequate rate of return encourages. Further it is not merely a matter that the plant or equipment is being used up, but rather corporations today are not generating adequate funds to replace the plant or equipment. This undercapitalization tends to cause conservatism beyond plant and equipment and flows over into other kinds of "discretionary" spending, which then tends not to be funded. It is that discretionary spending, whether it is research and development, new product introduction, or whatever, that truly fuels the economic growth and future of this Country. That story is basically unknown and it is not being told. It is in that context that I come to what I call the recapitalization of America.

There are, indeed, companies in this Country who are paying dividends, at not 70 percent of income, but, in effect, out of capital. There are industries in this Country that do not have the capability today, nor can they expect in the future to have the capability, solely out of income in real terms, to replace their plant and equipment. There are capital-intensive industries, and I think you can identify them as well as I can, where there is literally no prospect that these companies can turn themselves around without something much more fundamental occurring -- perhaps a change in tax policy. But, when an economy runs into trouble, or when things get tight, or when the government and the public begin to look at such things as where can we get more tax revenue, or who should bear the burden of whatever programs or policies the government might endeavor to establish -- unless the true story of corporate profitability is told and is understood, and the role of corporate profitability in establishing the future of this Country is well understood -- then we can expect a continuation of the view that corporate profits are already too high, are already excessive, that the corporate community, in effect, does not understand or share the concern for the public good and the public welfare, and that, therefore, transfers of corporate profits through taxation, direct or indirect, will continue to be a much more prominent vehicle than this Country can afford.

The Financial Accounting Standards Board rule can be implemented in many different ways. General Electric is one of several companies which has built its entire annual report around this theme, including the cover, and talks about the impact of inflation on their earnings, talks about a need for change in tax policy, and indeed, General Electric has gone to the point of almost literally operating internally with two accounting systems, so that their management decisions are based on the same understanding of the impact of inflation.

But there are other companies who, at the other extreme, bury this information in the footnotes wrapped around disparaging language to the effect that the information is meaningless and an investor ought to ignore it. That, in my judgment, is irresponsible. It is irresponsible in relation to the individual company and it is irresponsible as an act of corporate citizenship.

The responsibility for telling the real story of corporate profits must be placed on the corporate community, the accounting community, and those who serve as interpreters of those communities to the larger public -- whether such people are involved in the investment community or the media.

Most importantly, the primary responsibility for providing the information rests on the corporate community. Now, I understand the reluctance to do that. Reluctance comes, in part, from the fact that it makes earnings look worse, and one does not like to go around saying that earnings are not as good as they appear to be -- particularly, when in many cases they do not resemble them at all! There are a number of situations where earnings become a loss. I think when you are talking about an average differential of 40 percent between the historic cost and constant dollar, and you recognize that included in those numbers are companies like the oil companies with substantial growth, you realize that you are probably talking median numbers and there are many that are well below those numbers -- whose disparity is more like 50 and 60 percent.

There are also incentive compensation arrangements that are based on increased earnings that might well, under certain circumstances, be in jeopardy or at least ought to be reconstructed based on real earnings. But the board of directors and the company ought to decide what they want to pay for. Do they want to pay for paper earnings or do they want to pay for providing incentive for real earnings -- and to what extent?

Many managements are concerned that reporting of real earnings will hurt the market for their equities. But the market understands the impact of inflation quite well. The reason that some capital-intensive companies are selling at 3 and 4 times earnings is not because they are undervalued, but because, in reality, they are selling at 10 and 15 times earnings. The market well understands that they are capital intensive -- that they are eating their seed corn, as Reg Jones of General Electric would characterize it -- and that their prospects for turnaround are really not very good. It is this perspective that provides a much better barometer of cash flow and the future ability to pay dividends than do historic cost numbers -- and indeed in many instances dividends are inordinately high in real terms, and the dividend policy of many companies cannot continue as they are.

All this, I think, brings an increasing sense to the need for corporate disclosure. While the approach to disclosure is new and there are some flaws in it, they are not structural flaws. The system merely needs to be improved over time. It is still somewhat experimental, but the story has to be told. The accounting profession has been reluctant to move in this direction, historically, because they like historic costs; they grew up with it; it is the gospel; and it is easy to determine -- a lot easier than current cost. So, in a sense, the change to reflect or the requirement of additional information to reflect or to endeavor to reflect the impact of inflation has not had a private sector constituency. I would say, to put it bluntly, that its largest constituency probably has been the SEC. But the only way that we are going to be able to change an existing attitude and state of mind in the Country as a whole that is eroding our capital base and will continue to erode it, and the only way we are going to be able to address the kinds of changes in tax policy and the approaches to rebuild the American economy which can only be rebuilt through adequate capital in the commercial and business sector, is, in my judgment, through this kind of disclosure and through telling that story consistently in annual reports, in the financial pages, and finally getting that message out to the public and -- through the public, as well as directly -- to the people on Capitol Hill. When it becomes fashionable to be probusiness, Congress will be probusiness. So, as long as it is fashionable to be anti-business, Congress will be anti-business, and changes in tax policy will come only slowly, reluctantly and probably inadequately.

Thank you.