

INFLATION AND DEPRECIATION

One aspect of the redistribution of income resulting from price movements should receive a little more attention. This is the problem that arises because of the fact that as prices rise, the depreciation fund set aside to replace capital and equipment, tends to be inadequate, and the cost of replacement of inventories increase. The set-aside are related to a price level at the time of purchase; but as prices rise, the resources available to replace the necessary machinery and equipment, are not to be had. In that sense businessmen perhaps believe their profits are higher than they in fact are.

Dean Bach has even stated that the underestimation of depreciation and inventory replacement costs, and the corresponding overstatement of profit costs, may induce business to produce more than they otherwise would. According to Bach:

Partial estimates suggest that this understatement of replacement costs may have approached one-third of corporate reported profits during the decade of the 1940's.¹

In a statement that I made for the Joint Committee on the Economic Report in hearings on corporate profits in 1948, I had this to say on the present issue. At that time, the problem was one of deciding what were high or low profits and, of course, the question of how profits should be estimated for taxes was relevant.

* * * Perhaps the most perplexing one (problem) relates to the valuation of assets. In a period of rising prices, inventories, and capital generally rise in value.

Higher values for inventories mean higher profits. But should inventories be revalued at replacement costs, then profits would be substantially reduced. Profits would have been \$6 billion less in 1946, or about one-seventh of the profits of this year prior to taxes.

In the same year, business depreciation charges were \$8.7 billion. It is clear that had depreciation been at replacement value, profits would have been less by several billion dollars additional. But the tax collector does not generally allow depreciation charges to cover replacement in periods of rising prices as against acquisition or book value.

I cannot enter into the merits of this debate. The accountants under pressure from business, are reconsidering the whole problem. It is well to remember also that with depreciation based on replacement value and with inventories carried at replacement value, if profits would be lower in periods of rising prices, they would be higher in periods of depressions and falling prices.

What business would gain now, they would lose in periods of depression * * *.²

At the same hearings, Professor Slichter took a somewhat different position. He thought that the inventory replacement would absorb a substantial part of the book profits. Assume a gain of \$100,000 from the sale of inventories as a result of higher selling prices. In Slichter's view, these \$100,000 would not be available for release to stockholders because they would have to be used to replace the inventories that had been sold. Similarly, he pointed out that with prices 100 percent above the 1940 level, the replacement of plant equipment would be at a much higher cost than was the price of acquisition. If we assume that the prices of the postwar would be at least 60 percent above prewar in the foreseeable future, then Professor Slichter would

¹ "Relationship of Prices to Economic Stability and Growth," compendium, p. 37.

² Hearings, Joint Committee on the Economic Report "Corporate Profits," 1948, p. 43.