

to capital has been substantially higher than would be expected from the average relationship between corporate incomes and capacity utilization which has prevailed over the span of years 1929-50. Moreover, the attached analysis does not take into account the shortened depreciation guidelines announced by the Treasury last month. The effect of these new guidelines will be substantially to increase income to capital, although, most probably, to reduce corporate profits, since relatively less of the cash flow to corporations will be counted as profits and relatively more will be counted as depreciation.

One minor refinement in the formula which has been derived for the average relationship between corporate incomes and capacity utilization might be noted: Historically, it is found that corporate incomes are determined not solely by the rate at which capacity is used, but, also, to a lesser extent, by the rate at which output is increasing. In other words, corporate incomes tend to be higher when output is increasing very rapidly than when capacity is used to the same degree, but there have been no recent increases in output.

CORPORATE PROFITS IN HISTORICAL PERSPECTIVE

One of the most widely discussed aspects of the state of the economy is the so-called profits squeeze. In using this phrase, observers commonly have referred to a decline in corporate profits, after taxes, as a percentage of the gross national product—from about 8 percent in 1950 to about 4.5 percent in 1961. The reduction in this ratio is then used as an explanation of the reduced level of investment, which, in turn, is then used as an explanation for the lack of vigor in the economy in recent years. From the initial premise that corporate profits have been squeezed, there has developed a whole complex of arguments for changing the income shares in favor of corporate profits, as a means of encouraging increased investment.

It is the purpose of this brief analysis to develop a consistent procedure for measuring the magnitude of corporate cash flow after taxes of corporations, and then to use this procedure to test whether corporate cash flows are indeed lower in relation to economic conditions than would be consistent with past relationships existing prior to 1950.

At the very outset, it must be pointed out that the usual procedures of dividing corporate profits, after taxes, by the GNP, is not a valid measure of whether the corporate income share is too high or too low, or is rising or falling. There are four reasons for this:

(1) Corporate profits, after taxes, are net of depreciation while the GNP is, on the other hand, as the name indicates, gross of depreciation;

(2) Corporations account in good years for about half the GNP, and significantly less than this in recession years, so that dividing profits by GNP means that much economic activity is included in the denominator of the fraction which does not relate directly to the profits in the numerator of the fraction;

(3) A corporation can pay dividends or make investments in its business out of its total cash flow regardless of whether or not this appears on its books in the form of profits, after taxes, or in the form of tax free charges for depreciation on capital. From the standpoint of investment analysis it is this cash flow to the business that counts, not the form in which it is received; and

(4) The cash flow of a corporation is influenced not merely by the level of the GNP in a particular year, but also by the difference between the GNP and what it would be at high levels of employment—which we call potential GNP—and by the speed with which economic activity is changing; i.e., is the economy growing rapidly, slowly or falling.

An inspection of the ratios of profits and corporate cash flows to actual and potential GNP, which are shown on the accompanying chart, reveal two points:

(1) Profits fluctuate very much more widely than does GNP;

(2) There appears to be a modest downward trend in the ratio of corporate profits to the GNP over the period from 1929 to date; but

(3) There is little evidence of a decline in the cash flow ratio, except for comparison with 1929, which seems out of line with all the following years.

Not quite so obvious from the chart, but which can be detected if one examines the data carefully by statistical means, is the fact that the various corporate profits ratios tend to be highest (and tend to rise the most over the