Are Returns to Capital Hitting New Historic Highs?

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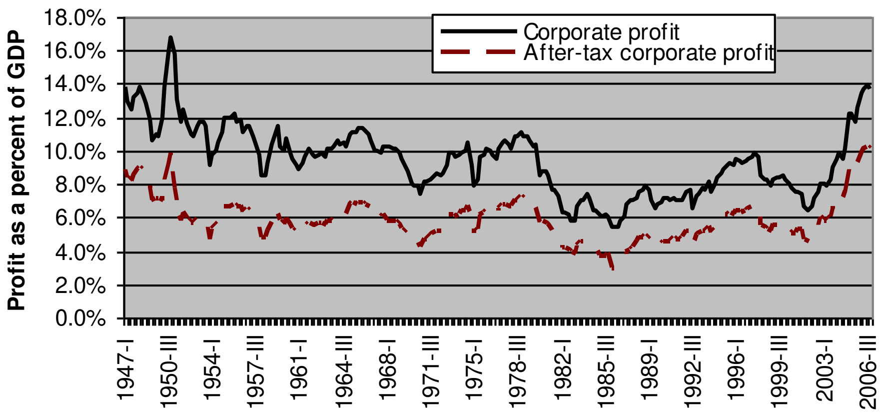
Some analysts believe that earnings of owners of capital are booming, setting new records. The basis of this view is that corporate profits, both before and after taxes, have been climbing in recent years as a percent of GDP. This has contributed to the view that workers are falling behind as the share of compensation declines, reflecting the rising share going to owners of corporate capital. Chart 1 shows that corporate profit, which is actually a return to capital and risk taking, has risen sharply. In late 2001, this share was only 6.4 percent of GDP, but by the end of 2006 it had more than doubled to 13.8 percent, a share not seen since early 1951. After-tax corporate profit shows the same sharp acceleration and to a level not seen in the historical record, since corporate tax is a smaller share of GDP than in 1947-51.

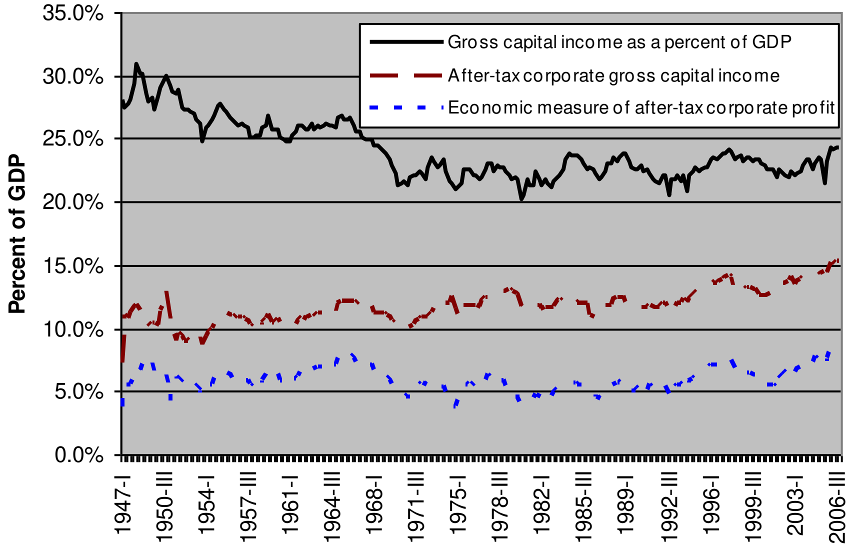
Chart 1: Corporate profit has boomed recently



Thus, it appears plausible that the return to capital and its share in GDP are unusually high, which would imply that the share of labor compensation is unusually low.

The difficulty with this conclusion is that corporate profit is not the only payment to owners of capital. Interest, rent and profit of unincorporated business are also payments for the services of capital. In addition, in assessing corporate income as a share of GDP it is important to account for the fact that GDP is "gross." To maintain comparability, consumption of fixed capital should be added to the numerator as well. After all, the gross return to capital includes the cash flow from "true," as opposed to accounting, depreciation. The sum of these components as a share of GDP is called capital income in Chart 2 and is measured relative to GDP. This is plotted in the second chart along with an economic measure of the gross corporate income owned by stockholders, which equals after-tax corporate profits (with inventory valuation capital consumption adjustments) plus corporate consumption of fixed capital. This is referred to as adjusted after-tax gross corporate income in the Chart 2. The third measure shown in the chart is the economic measure of after-tax corporate profits, which is gross corporate income, after tax, less consumption of fixed capital. It is the correct measure of corporate capital income that can be compared with the aftertax "accounting" measure show in Chart1.

Chart 2: Capital income is not booming, but corporate income is.



The adjustments for inventory and capital consumption take into account that firms over-report or under-report the cost of depreciation and inventory due to accounting rules that they are forced or choose to use. As a result, corporate profits are either under- or overstated, respectively, and that will reduce or raise the tax burden, consequently over- or understating the after-tax economic measure of profit. Adding in an estimate of "true economic depreciation," or consumption of fixed capital, results in a gross measure of the after-tax income of corporate capital. Thus, this is a better measure of the earnings that are owned and therefore discounted by stockholders.

The top line in Chart 2 shows that gross capital income has not changed much in recent years. It has risen as a share of GDP since the recession in 2001, but not unusually so, especially compared with its past history. There is a sharp drop in the historical series from early 1966 to early 1970 that makes gross capital income deviate from a constant, but this decline and earlier ones reflect a sharp decline in the size of business sector output relative to GDP over the earlier period, as the size of government surged relative to the size in the private sector. The shares of labor compensation and capital income relative to income or output in the business sector, about 80 percent of the economy, are remarkably constant over time. When government compensation of labor, the principal measure of government sector, is added to business sector compensation and GDP, the ratio of total compensation as a percent of GDP rises, and its counterpart, the share of capital income, falls.

From 1947 to 1961, the share of business sector output fell from about 84 percent of GDP to about 79.5 percent in 1961 to 1967 and then fell sharply, reaching about 77 percent by 1970. The latter shift is especially apparent in the fall of the share of capital income shown in the top line in Chart 2. Except for variations in the share of the business sector in GDP, the share of capital income, and its counterpart share of compensation, would essentially fluctuate around a constant. This is the case after 1970, including recently. Thus, the share of overall capital income does not show any unusual rise recently, just as the share of compensation has not declined unusually relative to its past performance. This is in strong contrast to claims by some that the share of capital income has climbed recently at the expense of the share of labor compensation.

The principal reason that corporate capital income has remained steady relative to GDP while corporate capital income has risen sharply, is that proprietors' income, rent and especially interest have been relatively weak or declined. In effect, lower interest rates have lowered interest costs and boosted corporate profit without changing the overall share of capital income in GDP. The comparable share of after-tax gross corporate capital income is shown in the middle line in Chart 2. There has been a rise in gross corporate income relative to GDP, but not nearly so sharp a rise as suggested in Chart 1. In fact since early 2001, after-tax gross corporate income has risen about 3.4 percent of GDP, much less than the 7.6 percent rise in total corporate profit, measured on an accounting basis, shown in Chart 1. In the bottom line, the share of after-tax corporate profit, adjusted for profits from understating depreciation or from inventory accounting gains, rose only 3.1 percent over the same period. While this is an impressive gain, it leaves correctly measured corporate profits at a relatively high level, but only in record territory in 2006, compared with earlier peaks in 1965 and 1997. Until 2005 it would be hard to argue that after-tax corporate profits, with adjustments, had reached an unusual level relative to GDP. The extra strength in the gross and accounting measures (Chart 1) arises from a rise in corporate depreciation and taxes relative to GDP.

So, has the return to capital reached unprecedented levels in recent years, supporting the notion of declining worker compensation relative to GDP? No, these shares have been in line with past trends. Nonetheless, it is the case that accounting measures of corporate profit have shown unusual growth over the past 5 years, reaching levels not seen in over 50 years. Adjusted for depreciation underreporting and inventory gains and increases in corporate income taxes relative to GDP, corporate income has not been so strong. It has risen to historic highs, but only in 2006.

A simple accounting of differences shown in the charts reveals the source of the discrepancy between the rise in measured profit and overall capital income as shares of GDP from the end of 2001 to the end of 2006. Over the period, the 7.3 percent rise in accounting profits relative to GDP has been associated with a rise of 2.7 percent of GDP due to the swing to underreporting of true economic depreciation, 1.7 percent rise in taxes relative to GDP, and 0.7 percent rise in true economic depreciation of corporate capital, called consumption of fixed corporate capital. The net result is a rise in after-tax gross corporate income of 2.0 percent of GDP. Overall gross capital income rose only 1.7 percent of GDP over the same period.