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Profits Shares Hit Record High
In 2003
By Dean Baker

THE TAX SHARE OF CORPORATE
PROFITS IS NEAR ITS POST-WAR
LOW.

The after-tax capital share of corporate income (profits plus interest) hit a record high of 14.8 percent in 2003. This is more than a full percentage point above the previous peak of 13.7 percent reached in 1965 during the Vietnam War boom. The 2003 record capital share was driven by a 15.3 percent increase in before-tax capital income from 2002.

However, the 18.7 before-tax capital share of 2003 is well below the 21.8 percent share reached in 1965, and even further below the 23.3 percent capital share of 1950. The record after-tax share is attributable to the extraordinarily low tax rates on capital income in 2003. Taxes were equal to just under 21 percent of capital income in 2003, compared to the 37.0 percent tax share in 1965 and 51.7 percent tax share in 1950. By comparison, in 1997, the peak profit year of the nineties business cycle, the tax share of capital income was 28.9 percent.

The non-financial corporate sector, which had been hard hit by the downturn, experienced an extraordinary 27.5 percent increase in before-tax capital income. While most non-financial sectors experienced strong profit growth in 2003, manufacturing led the way with a 31.8 percent gain. Profits in the financial sector, which had continued to grow rapidly through the slump, rose by 14.7 percent in 2003.

Corporations owe their record profitability to both extraordinarily favorable tax treatment and their success in securing the bulk of recent productivity gains. Nominal employee compensation has reportedly risen by just 2.9 percent from the third quarter of 2001, when the recession officially ended, to the fourth quarter of 2003. Nominal wage growth was even lower over this period, rising by a total of just 1.5 percent, for an average annual rate of just 0.6 percent.

The Commerce Department's data probably overstates the bleak picture on wage growth to some extent. In the third quarter of 2001, the statistical discrepancy in the National Income and Product Accounts was equal to –$104.1 billion. This discrepancy is the gap between GDP
measured by adding up the components of GDP on the output side (consumption, investment, government expenditures and net exports) and GDP as measured by adding up the components of income (primarily wages, profits, and interest).

Typically the output side measure is larger, which is usually attributed to the fact that people may be hiding income for tax purposes. However, in the late nineties the income side measure of GDP began to exceed the output side measure, by an ever growing amount. While no one has determined the precise cause of this shift, it is generally believed that capital gains income was showing up in wage income – for example if gains on stock options were not properly
accounted.

In the most recent quarter, the statistical discrepancy was $18.3 billion, meaning that output side GDP again exceeded GDP measured on the income side. If this shift back to the normal pattern in the statistical discrepancy was attributable in part to the elimination of capital gains wrongly imputed as wage income (in other words, the wage data reported for 2001 was inflated by the inclusion of capital gains income) then actual wage growth would have been somewhat better over the last nine quarters than the official data show.

While the restoration of corporate profitability in 2003 is impressive, it is not clear that it is providing a sustainable path for growth. Investment has been rising at an 11.0 percent pace over the last two quarters, but this will not be sufficient to sustain the economy if weak wage growth leads to weak consumption growth. The consumption share of the economy is seven times as large as the investment share, so if consumption stagnates, investment growth cannot fully offset the effect.

Tax cuts and debt have fueled consumption over the last two years, but with savings rates near record lows, and further tax cuts unlikely, it is not clear that consumers will be able to sustain spending growth unless the wage and job growth pick up very soon.

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