Business Ethics: Who Are The Good Guys?

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Abstract

The media often includes much concern about "profits" in business. The term is misunderstood by many lay people and some business people. When the real meaning of the word, and its place in business and society are understood, the question is not whether profits are too high. The question is whether they are high enough, or even exist. Evidence and examples taken from selected common shares show that profit is often too low. In 1980 there was much ado about high corporate profits, especially in the oil business, which was the current scapegoat of the media. A monograph was written that examined corporate profits over a ten year period. The new scapegoats of the late 1980'S are corporate raiders. It seems worthwhile to update the 1980 work and look at corporate profits from the popular "ethics" point of view.

Introduction

In 1987, the Harris organization reported that 79% of Americans thought that businesses do not pay their fair share of taxes. (1987, p. 236) Much of the concern about corporate profits is based upon ignorance, emotions, and personal agendas. It is useful to use other criteria, including "ethics" to consider the issue.

In the late 1970's it was very fashionable among media people to bash corporations, especially the oil companies, because of their "high profits". Such publicity led to an analysis of 32 various and well known common shares. The analysis was printed in the form of a monograph. (1980, Foutz) The 1969-78 data are shown in Table 1. The authors calculate the rise in the Consumer Price Index at 8% per year. (1990, Foutz and Wilson)

The monograph showed that the amounts paid in dividends by nearly all corporations was less than the rate of inflation. Exxon's yield for the 10-year period was 82% or 8.2% per year. The corresponding figures for Mobil, Shell; and the Standards of California, Indiana and Ohio were 5.4%, 2.6%, 8.9%, 9.8% and 2.9% respectively. In terms of yield, the best oil companies in the group were about even with the inflation rate. The other companies were substantially below the inflation rate.

When the portfolio was liquidated (on paper) in 1979, the only positive real return to nearly all of the investors over the ten year period of their investment was from price appreciation. The average yield was 44.8% or 4.5% per year before taxes in current dollars.

Price appreciation comes from three influences. The first is the effect of inflation upon the prices of everything, including common stocks (8% a year in this case). The second effect is that of growth of Retained Earnings, which is roughly equivalent to reinvested profits. A third effect is the expectations of new investors.

No attempt was made in 1980 to sort out the individual effects of these three influences. The conclusion was that dividends were generally inadequate to compensate investors for their loss of purchasing power. The only positive return came from other investors. These other investors were purchasing Retained Earnings, paying in-

flated prices, and/or expressing confidence in the future and the company.

The only conclusions that can be drawn from the real income figures are that the market valued some shares at levels that returned a "profit" to some investors, and that other investors lost purchasing power during the approximately ten year period prior to 1980.

The alarmists were completely wrong in complaining about "high profits" in the cases in which there were no profits at all. The only remaining issue is how much profit is too much profit in those cases in which profit may have been earned.

Update

In the late 1980's, it was very fashionable among media people to bash corporations, especially those dealing in "buyouts" and "restructuring", because of their "high profits". Such publicity led to an update of the 1980 study. This analysis is shown as Table 2. It shows that "restructuring" made several companies so different that their data no longer existed or were not comparable with earlier periods.

During the 1980's, many corporations did very well, according to traditional analyses. Annual returns on investments ranged from negative figures to 504.6%, which should be enough to cause a frenzy among socialists and other business critics.

In order to determine the ethical aspects of all of these "profits", it is valuable to apply some cold logic and a lot less emotion and rhetoric. Table 3 presents the 20-year performance of the surviving shares. In this table, the prices are adjusted for taxes. Then they are adjusted for inflation. Then the raw data regarding "profits" and returns on investments are converted to average annual real return after taxes.

Taxes are difficult to deal with, because if a nice old lady has very few shares and very little other income and many deductions, she may pay no income tax at all upon her dividends or even capital gain. But large investors and funds pay all of these taxes all of the time on these specific investments. We cannot deal here with offsetting losses that sometimes exist. The figures shown are for "the corporations" and "fat cats" who are supposedly getting richer, not for nice old ladies, no matter what tax brackets the ladies are in.

The first column of Table 3 shows the liquidated value of the investment in one share of the issue (proceeds minus original investment). The second column shows the effect of a 50% total tax rate (the actual rate is determined by total income, place of residence, and many other factors). The third column adjusts the after-tax proceeds for inflation. The fourth column shows the average annual rate of return in dollars. The fifth column shows the after-tax ROI on the original investment in constant dollars. No allowance has yet been made for risk or the value of money.

Analysis

It is difficult to separate the effects of the various price factors in valuing the original investment and the proceeds. Corporations always report total earnings, dividends and reinvested profits. But markets always place discount or premium prices upon shares after evaluating the corporation, its accounting system and its prospects in the real world. These factors are aggregated here.

The average real return per year after taxes is 6.45% to investors. This real return must compensate the investors for their risks of losing part or all of their investments. It must also pay investors for the use of their money.

Good business ethics requires that investors be so compensated. If investors are not so compensated, they are subsidizing the other stakeholders. This subsidy may be a form of graft, extortion or unjust taxation.

Risk is difficult to measure in this context because it is rather subjective. The proper measu-

rement is expected value. The calculation is to estimate, or calculate from past records, the probability of loss by investors. For example, if the probability of total loss of investment is 1% and the probability of all other losses is 2% of the investment, the risk factor is 3% after taxes and inflation.

The best measure of the value of the use of money is opportunity cost. The value of money invested in Albertson's was 31% a year after taxes. The value of the "average" investment in this series was 6.45% per year after taxes in constant dollars. By this standard, 14 of the 20 issues were less attractive for the 20 year period and not "good" investments.

We can measure business' "excess profits" as 6.45% in real terms after taxes. It is interesting to compare this return with personal income in the United States. Such income was reported to be $537 billion in 1969, $1951 billion in 1979 and $4062.1 billion in 1988. Total personal income, therefore, increased 7.56 times or 756% in 20 years. If this is deflated to constant dollars, income increased by 208% If investors are to share equally with the rest of the nation in the national personal income, they should have had 208% more capital after taxes and inflation than they had in 1969.

The second important matter in the ethics of profit is the place of profit in our society. Reinvested profit is spent upon plant and equipment, "human capital", (largely training, education, rehabilitation, etc.) research and development, and providing a growing quantity and quality of goods and services for a growing economy. If society wants more goods and services, more "human capital" and more productive facilities, the surest and best way to see them come about has always been free investors choosing from among the tens of thousands of listed companies in the world. These investors place their money where they think that it will be most productive or "work the hardest". Then they evaluate their decisions regularly and revise them as conditions warrant. Thus far, the critics of business seem not to have presented a better way of doing things.

If all of the profits to original investors come from new investors, it is difficult to see any damage to society or anyone but the new investors as a result of the new and higher prices. If the new investors achieve their objectives with the new issue, it difficult to detect damage to them from the new prices.

Conclusions

Much of the concern in the media, and the public perception of "profit" is based upon misunderstanding. When figures are considered only for one or a few good years, and the only standard is "enough" or "too much", the public can be misled.

Research shows that the oil companies were not necessarily profitable during the 1970's, despite price increases and publicity. What profits were earned by investors came only from selling out their investments.

The update to 1988 showed that business profits were generally better in the 1980's than in the 1970's. In both decades, some companies fared poorly. When the "long run" of 20 years, inflation, and taxes are considered, nearly all of the "high profits" disappear. The total return figures, based upon selling the original investment, show that the best of investments paid a return to investors after taxes in constant dollars. The other investments were very marginal by this standard.

High profits are very valuable to all levels of government, which share approximately equally with the owners in all business profits of the kinds listed above. Some people do not work for a corporation, buy from it, sell to it, or have any relationship other than being fellow taxpayers. If they want a larger share of the profits, one can ask who is greedy: the corporation or the proposed recipients of the "excess profits"?

Administrators and executives have an ethical responsibility to tell the truth about costs. Costs

include provision for taxes, inflation, new technology, and growth in the needs of society. Few critics of "business ethics" and "corporate profits" have good explanations of these issues.

The traditional free enterprise answer to the profits question is that investors, risk takers, and entrepreneurs DESERVE whatever profit they can honestly earn by providing the goods and services that society needs and wants in competitive markets.

Traditional socialist responses to the profits question are to decide how much profit is "too much" and then confiscate the rest for "the benefit of society". We are seeing daily how governments and socialists utilize the resources they control in the Soviet Union and many other countries.

These figures suggest that only the successful investors are better off financially than the general public in terms of income growth. If they are in high tax brackets or make bad investments, they do not share equally in the growth of personal income.

The final conclusion is that the fortunate investors who bought Abbott Laboratories and Albertsons supermarkets in 1969 have made substantial profits in spite of taxes and inflation. Hapless investors who bought General Motors, or any of the thousands of other companies that have not done as well as the most successful corporations, have not shared in the national growth. They are fortunate if they have not lost money after taxes and inflation.

The investors are presumed to have paid a 50% income tax total to all levels of government. If all US personal income were taxed at that rate, which it is not, the nation's income would be 104% after taxes, compared to the investors' 108% increase. Thus the average investor did not earn an appreciably larger share of the national income during the period than the average american.

References

1 Authors' calculations from data in various issues of *The Survey of Current Business and Business Statistics*. United States Department of Commerce. Washington, D.C.

2 Foutz, Kent L. *Business Is Profitable?*. Denver, Colo: Rocky Mountain Institute of Useful Arts and Sciences. 1980

3 Harris, Lou, *Inside America*. New York: Vintage Books, 1987. p. 236.

TABLE 1
GROSS RETURNS FROM SELECTED COMMON STOCKS
(1968-78)

Company	Col.1 Buy Price	Col.2 Divi-dends	Col.3 Shares Change	Col.4 Sale Price	Col.5 Proceeds	Col.6 ROI*
Abbott Lab.	$12.25	$4.32	100%	$37.00	$41.32	23.8%
Alberto Culver	24.25	2.94	---	7.00	9.94	loss
Albertson's	9.50	4.24	10	26.68	30.82	22.6
Alcoa	48.00	15.12	50	75.29	90.41	8.8
Amer. Broadc.	13.43	4.71	---	27.75	32.46	14.7
Amer. Cyanam.	28.13	13.53	---	25.38	38.91	3.8
AT&T	53.31	31.91	---	60.88	92.79	7.4
Anheuser Busch	32.63	10.62	100	45.50	56.12	4.1
Arco	52.19	17.15	100	101.00	118.15	12.6
Avon	75.83	29.06	100	106.88	135.94	7.9
Bankamerica	17.19	15.50	200	101.00	116.50	58.8
Boeing	14.63	5.09	100	67.25	72.34	39.5
Burlington Nor.	51.25	16.58	---	40.75	57.33	1.2
CBS, Inc.	42.75	16.97	6	56.97	73.94	7.3
Delta Airlines	29.00	5.45	---	47.75	53.20	8.4
DuPont	44.44	18.15	---	36.31	54.46	2.3
Exxon	36.50	30.02	100	106.63	136.65	27.4
Ford	37.62	25.70	25	58.00	83.70	12.3
General Motors	74.44	44.95	---	60.44	105.39	4.2
General Elec.	43.06	28.15	100	101.50	129.65	20.1
General Foods	39.44	24.84	100	62.25	87.09	12.1
Handy & Harman	10.31	3.38	50	22.44	25.82	15.0
Hilton Hotels	14.25	4.58	100	44.13	48.71	24.2
IBM	67.44	17.68	20	75.60	93.28	3.8
Levi Strauss	23.68	3.73	100	65.83	69.56	19.4
Mobil	28.25	15.49	---	37.19	52.68	8.6
Sears	33.44	10.07	100	48.88	59.95	7.6
Shell Oil	57.75	15.13	100	65.88	81.01	4.0
Shell Trans.	19.38	5.70	---	20.75	26.45	3.7
Standard Calif.	30.56	27.11	100	75.13	102.24	23.5
Standard Ind.	27.50	26.99	100	101.75	128.74	36.8
Standard Ohio	34.00	9.82	100	73.38	83.20	14.5
Totals	$1126.40	504.68	1861	1822.29	2388.75	460.4
Averages	35.20	15.77	58	58.82	75.64	14.85

SOURCE: Moody's Handbook of Common Stocks Winter 1979-80 ed. New York: Moody's Investor's Service.
*Calculated: Col.2 + Col.4 = Col. 5. Col.5 - Col.1 x 100/10 = Col. 6. This is the average annual percentage return not compounded.

TABLE 2
GROSS RETURNS FROM SELECTED COMMON STOCKS
(1979-1988)

Company	Col.1 Buy Price	Col.2 Divi-dends	Col.3 Shares Change	Col.4 Sale Price	Col.5 Proceeds	Col.6 ROI%*
Abbott Lab.	$9.13	$6.04	300%	$190.50	$196.54	205.3
Alberto-Culver	2.62	1.86	200	88.30	90.16	334.1
Albertson's	4.94	3.20	700	251.00	254.20	504.6
Amer.Cyanamid	15.00	9.22	100	97.88	107.10	61.4
Anheuser Busch	7.76	3.34	500	190.14	193.48	139.3
Avon	46.63	22.72	---	23.50	46.22	loss
Bankamerica	27.44	9.90	---	12.94	22.84	loss
Boeing	19.50	10.77	238	46.04	56.81	19.13
Burling. Nor.	11.31	11.28	300	272.76	284.04	241.3
Delta Airlines	20.81	8.63	100	91.12	99.75	37.9
DuPont	42.62	29.10	200	252.93	282.03	56.2
Exxon	13.69	16.12	300	169.00	185.12	125.2
Ford	8.31	8.33	350	209.25	217.58	251.8
Gen. Motors	28.75	20.31	---	37.00	57.31	9.9
Handy & Harmon	14.00	5.70	100	34.00	39.70	18.4
Hilton Hotels	15.00	8.21	100	90.00	98.21	55.5
IBM	70.81	39.17	300	468.00	507.17	61.6
Mobil	23.62	20.16	300	176.24	196.40	73.2
Sears	19.19	16.10	---	39.25	55.35	18.8
Shell Trans	14.00	12.91	300	147.24	160.15	104.4
Totals	$415.13	264.07	4388	2887.09	3150.16	2318.9
Averages	20.76	13.20	219	144.35	157.51	115.9

SOURCE: Moody's Handbook of Common Stocks New York: Moody's Investor's Service
*Calculated: Col.2 + Col.4 = Col.5. Col.5 - Col.1 x 100/10 = Col.6. This is the average annual percentage return not compounded.

The following companies were deleted from the previous list because the comparable data were not available: Alcoa, American Broadcsting, AT&T, Arco, CBS, General Electric, Levi Strauss, Shell Oil; and the Standard Oil companies of California, Indiana, and Ohio.

TABLE 3
RETURNS TO SELECTED COMMON STOCKS 1969-88

Company	Col.1 Return	Col.2 After Tax	Col.3 After Inflat.	Col.4 Real Net/yr	Col.5 Real AT Ann.ROI
Abbott Lab.	$225.61	$112.81	$36.70	$1.88	15%
Alberto-Culver	75.76	37.88	12.63	.63	3
Albertson's	275.52	137.76	45.95	2.30	31
Amer.Cyanamid	117.88	58.94	19.65	.98	3
Anheuser Busch	216.97	108.49	36.16	1.81	6
Avon	106.33	53.17	17.73	.89	1
Bankamerica	122.15	61.08	20.36	1.07	6
Boeing	114.52	57.26	19.09	.95	6
Burling. Nor.	290.12	145.06	48.35	2.42	5
Delta Airlines	123.95	61.98	20.66	1.03	4
DuPont	292.05	146.03	48.68	2.43	5
Exxon	285.37	142.69	47.56	2.38	7
Ford	263.66	131.83	43.94	2.20	6
Gen. Motors	88.26	44.13	14.71	.74	1
Handy & Harmon	55.21	27.61	9.20	.46	4
Hilton Hotels	132.67	66.34	22.11	1.11	8
IBM	533.01	266.51	88.84	4.44	7
Mobil	220.83	110.42	36.81	1.84	7
Sears	81.86	40.93	13.64	.68	2
Shell Trans	170.25	85.13	28.38	1.42	2
Totals	$3791.98	$1896.05	$632.05	$31.61	129
Averages	189.60	94.80	31.60	1.58	6.45%
% Orig. Cost**	652%	326%	108%		

SOURCE: Moody's Handbook of Common Stocks New York: Moody's Investor's Service.
*Calculated: Col. 1= Col. 5, Tables 1 and 2 combined minus Col. 1 Table 1. Col.2 = Col.1/2. Col.3 = Col.2/3. Col.4 = Col. 3/20. Col. 5 = Col.4/Col.1, Table 1. This is the average annual percentage return, not compounded, after taxes in constant dollars.

Consumer Price Index, 1969 = 100; 1988 = 335.
Authors' calculations from Survey of Current Business and Business Statistics, United States Department of Commerce, Washington, D.C.

Comparable figures for other investments:

6% Bond	$120.00	$60.00	$20.00	1.00	1
6% sav. Acct.	202.56	101.28	33.76	1.69	2

**Column 1, TABLE 1