profits are the lifeblood of a market economy. Without them, businesses don’t invest, they don’t spend on research and development, and they don’t put money into new products. Without profits, there’s no incentive for innovation or for the creation of new companies. To a large extent, it was the incredible boom in profits during the 1990s that made that decade feel so vibrant. Reported earnings per share, adjusted for inflation, more than doubled between 1993 and 2000. Federal Reserve Chairman Alan Greenspan repeatedly pointed to higher profits as evidence that productivity growth had accelerated and that the U.S. economy had been transformed. Corporate executives used good earnings to justify their big investments in technology, while investors saw high profits as a sign to jump into the market. And it was the sharp decline in profits in 2001 and the first half of 2002 that made the economy feel so depressed, despite growth in gross domestic product this year.

Now, corporate earnings seem to be coming back, compared with the very weak third quarter of 2001, and Wall Street strategists are predicting that the earnings rebound will continue into next year. Goldman, Sachs & Co. estimates that corporate operating profits in 2003 will increase by 12% to 14% over their 2002 levels. “We’re not in a disaster scenario,” says Tobias Levkovich, equity strategist at Salomon Smith Barney, who is forecasting a 7.7% rise in operating profits in 2003 for companies in the Standard & Poor’s 500-stock index.

But let’s be blunt: Profits may very well rise next year—but it won’t simply be a normal business recovery. The process of boosting earnings is going to be far more difficult than most people expect, and it is going to entail far more pain for workers. Under mounting pressure from investors and corporate boards to get their earnings up—without accounting tricks—executives are going to have to make deep cuts in payrolls and productive capacity.

Part of the problem is that most companies are shooting for a return to the high profit levels of the late 1990s, which were never completely real in the first place. Back then, many companies were finagling their numbers to make the results seem better. What’s more, a staggeringly large pool of profits was actually flowing out the door in the form of stock options, which were not figured into company earnings. BusinessWeek calculates that managers and workers at nonfinancial S&P 500 businesses took home more than $100 billion in net proceeds from exercising stock options in 2000—enough to wipe out most of the increase in operating earnings from 1997 to 2000 (table, page 112).

And while corporate productivity gains have turned out to be real, higher productivity by itself does not guarantee higher profits in a competitive economy. U.S. corporations are 25% more productive than they were in 1992. But by the government’s figures, the aftertax profit rate on corporate investment peaked in 1997. It likely stands at only 5.2% today, no higher than it was a decade ago and well below the long-term historical average (chart). True, there are social gains from higher productivity—in the form of higher real wages and greater consumer spending power—but corporations get very little of it, according to William D. Nordhaus, an economist at Yale University who is examining the link between productivity and profits. Instead, “you just find prices falling more rapidly,” he says.

That is further evidence the road to higher
profits will be a painful one. To meet their profit targets, companies will cut costs again and again, shuttering factories and offices and shedding unprofitable lines of business. "The recent spate of layoff announcements from companies such as IBM, United Airlines, Schlumberger, and Sun Microsystems, as large as they are, is just the start," says George Magnus, chief economist for UBS Warburg.

The risk is that these massive layoffs could trigger a sort of domino effect. While the layoff announcements would cause a temporary rise in operating profits by 12% during the next year, companies in the long run may find it difficult to pass along higher costs to their customers. "There will be a price to pay for the earnings improvement," says Dean Baker, co-director of the Center for Economic and Policy Research in Washington.

What's worse, compared with the recovery of the early 1990s, companies today are facing much weaker global demand, greater overcapacity in many markets, and higher labor expenses. Export figures are at best flat, and all of the world's major industrial countries except Canada are expected to grow more sluggishly than the U.S. next year. Production capacity in manufacturing, already overbuilt, is still increasing, making corporations' pricing power nonexistent.

Above all, corporate labor costs are still 30% higher, nearly $1 trillion more, than they were in 1997—despite a recession, slow growth, and weak profits. Surprisingly, labor costs continue to rise much faster than revenues, with real wages and benefits growing at a 2% rate during the past year.

In addition, the downward pressure on profits is taking place around the world. Profit rates in Britain, France, and Germany are far below where they were at the beginning of the 1990s. And while social-welfare laws make it harder for European companies to cut workers, layoffs are starting to come at companies such as Ericsson and Deutsche Bank.

How did we get stuck in this tough spot? The main cause is a profound misunderstanding of the relationship between productivity and profits. Everyone from Alan Greenspan and Wall Street economists to corporate chieftains and financial journalists mistakenly assumed that higher productivity and new technology would inevitably translate into higher profits.

It's true that for any single company, higher productivity—that is, output per worker—will increase the profits, at least for a while. That's how innovative companies prosper. But neither theory nor history suggests that such gains should be sustainable over the long or even the medium term. Economists have long theorized that excess profits in a competitive market would be quickly eroded. For example, the economics textbook written by Robert H. Frank and Ben S. Bernanke, recently appointed a member of the Federal Reserve Board of Governors, says that markets in which businesses earn more than a "normal" profit will attract new entrants, driving down prices until those excess profits disappear. "When people confront an opportunity for gain," write Frank and Bernanke, "they are almost always quick to exploit it."

Sure, there were some periods when profits stayed strong. Back in the 1980s, productivity growth was high, and so were profit margins, as U.S. companies took advantage of the lack of real global competition to boost their earnings. But in the 1920s—the decade that most resembles the 1990s in its investment boom and exuberant stock market—the rapid growth of productivity did not lead to big increases in profitability. The share of national income going to profits actually fell from 9.7% in the 1910s to 8.2% in the 1920s. By contrast, the share of national income going to labor soared as compensation rose by some 40% in the boom of the 1920s.

Still, there were plenty of people who believed that the boom of the 1990s was going to be different, and they had a plausible argument. The idea was that the development of strong brand names, rapid technological progress, and the introduction of new products and services would enable companies to stay ahead of competitors. The exemplar was Intel Corp., which was able to keep margins up in the ultracompetitive chip market by investing heavily in research and development and new plants and by repeatedly introducing new generations of faster, more powerful microprocessors at premium prices.

For a few years in the 1990s, Corporate America did indeed defy the somber predictions of economists and dramatically boosted earnings. Starting around 1993, familiar names such as Coca-Cola, Procter & Gamble, Ford, and General Motors, and Merck were reinvigorated, all enjoying skyrocketing profit growth over just a few short years. In 1997, Gillette Co.
There was a mood of remarkable confidence among CEOs that the gains would continue. In 1997, Walt Disney Co. announced record earnings of more than $1.9 billion in 1997, four times what it had earned a decade earlier. "Our core Disney business [is in] remarkably healthy condition," wrote CEO Michael D. Eisner in his letter to shareholders in the 1997 annual report. It is "an era of tremendous success."

What made this economy-wide profit surge especially sweet was that it reversed 25 years of slow earnings growth and sliding profit margins. Earnings per share for the S&P 500, adjusted for inflation, had risen by only 6% between 1968 and 1997, even while the economy doubled in size. The aftertax rate of return on corporate investment, using government figures for profits, had fallen from an average of 7.8% in the 1960s to 7.0% in the 1970s—to only 4.7% in the 1980s.

But there was a problem: After 1997, technology improvements kept coming and productivity kept rising. Profits, however, did not. To be sure, companies reported that earnings per share for the S&P 500 jumped 26% from 1997 to 2000, while operating earnings rose by some 13%. Nevertheless, when government statisticians were at last in a position to collate the tax-return data for those years, they found that profits for all corporations actually fell by 6% from 1997 to 2000, before dropping an additional 10% in the 2001 recession.

What happened? It turns out that the market economy operated much more efficiently than most observers had expected. In industries from telecommunications to retailing to consulting, those with the promise of good profits attracted a tremendous wave of new entrants, along with souped-up capital spending by the industry leaders. The rapid movement of ideas across national boundaries, aided by the Internet, accelerated the entry of competitors in Europe and Asia in industries such as semiconductors and software.

Compounding the profits problem was a dramatic acceleration in wages. In the first half of the 1990s, wage gains re-

--- HIGH WAGES ---

Despite the recession and a year of slow growth, corporate labor costs are nearly $1 trillion higher now than in 1997. Surprisingly, real wages and benefits continue to climb, growing at a 2% rate during the past year.

reported net income of $1.4 billion, five times its late 1980s level.

Earnings per share at S&P 500 companies rose from $22 in 1993 to almost $40 in 1997, an 80% increase. The government's figures for corporate profits, which are based on tax-return data, increased by almost as much. Soaring profits seemed to justify the ever-rising stock prices and attracted higher and higher levels of capital spending.
Economic weakness in Japan and Germany, made life tough for corporations that relied on sales abroad. Exports had been growing by 10% annually until 1997; when growth came to a halt. Today, exports are barely higher than they were five years ago.

Look no further than the published earnings figures of companies such as Disney, Gillette, and Coca-Cola to see the impact: All reported sharply falling net income after 1997. Further, other companies obfuscated their profit decline. WorldCom and Enron engaged in accounting shenanigans to cover up their acute problems. From 1997 to 2000, these two companies alone nearly quadrupled their level of reported operating profits, from $1.9 billion to $7.4 billion—and a considerable chunk of that was probably overstated. In the tech sector, reported earnings did soar from 1997 to 2000, but misleading accounting for stock options concealed a tremendous transfer of wealth from shareholders and companies to workers and managers.

There are different ways to measure the cost of stock options, including assigning a value to options at the time when they are granted. However, the simplest—and the one used by government statisticians—is to count the net proceeds of exercised stock options as a payment by companies to labor. This method has the advantage of measuring actual cash going to workers. For example, if a manager exercises 100 stock options with a difference of $50 between the market price and the exercise price and then sells the shares, he walks away with $5,000 in cash. In many cases, the company opts to buy back those shares and thereby effectively pays out $5,000 in cash to the employee.

Figured this way, the effective wealth transfer from options was huge. Although the numbers for those net proceeds are not reported by most companies, BusinessWeek was able to estimate them based on data from annual reports. Look at what happened to Cisco Systems Inc. during this period. In fiscal year 1997, operating profits at Cisco, before tax, were $2.1 billion and net proceeds from exercised stock options were between $700 million and $1 billion, according to our estimates. By 2000, the picture had reversed dramatically: Op-
Operating profits had risen to $4.6 billion—but our estimates show that workers and executives got at least $5 billion and likely as much as $8 billion in proceeds from exercising options. The bottom line: Labor took away far more than the business was making.

Cisco is an extreme case. But because the overall stock market was so frothy in 2000, there were plenty of other companies where managers and workers took stock-option gains in excess of $1 billion that year. By our calculations, the list includes such blue chips as General Electric, Dell Computer, Microsoft, Pfizer, and Intel, not to mention Yahoo! and Lucent Technologies. In 2000, Enron checked in with stock-option gains in excess of $1 billion as well. Once these gains are subtracted from profits, as the government does and as companies do on their tax returns, much of the high reported profits melt away.

Not all the gains in the late '90s were illusory. In the financial sector, operating profits are up 24% since 1997. Earnings fell on Wall Street, but commercial banks have had spectacular success. They benefited from a combination of low interest rates and the consumer-spending boom, which boosted credit-card usage and mortgage financing. In addition, financial-services outfits are the most intensive users of information technology outside the tech sector, which helped increase productivity.

Yet, even in banking there remain dangerous threats to profitability. For one, consumer lending will fall off if unemployment rises. Some analysts also argue that the banking profits during the past few years were built on aggressive lending. That could easily lead to more defaults if households find themselves stretched too thin. "High levels of risk will come back to bite them in 2003," cautions Michael Mayo, a banking analyst at Prudential Securities.

Perhaps most disturbing, labor costs at commercial banks are still rising at a rapid rate. These banks have actually added jobs over the course of the past year, and data from the Federal Deposit Insurance Corp. show salary and benefit payments rising at a 7% rate. As a result, as their earnings start to fall off, even banks will need to make sharp workforce cuts. The same is true for the entire economy. While the unemployment rate has risen from a low of 3.9% in 2000 to the latest figure of 5.6% in September, it still hasn't been high enough to push down wages in most industries. The last time the unemployment rate was at this level for a sustained period was the first half of 1996—and that's when wage gains actually began to accelerate.

There's already an excess of U.S. industrial capacity, and more is on the way—making it almost impossible for corporations to raise prices.

Moreover, much of the country is still enjoying unemployment rates well below the 1996 level. Despite the devastation in the tech sector, the September unemployment rate in California is only 5.3%, below the 7.2% average of 1996. Similarly, unemployment rates in New Jersey and New York are lower than they were in 1996, despite the terrorist attacks and the recession—in part because the banking and pharmaceutical sectors have remained strong.

Even as wages keep rising, companies still find it very hard to raise prices. The latest figures from the Bureau of Labor Statistics show consumer prices up by 1.5% over the past year. However, that overestimates the pricing power of companies, because it includes noncorporate sectors such as housing, medical-professional services, and education tuition. If you exclude them, BusinessWeek calculates that the "corporate consumer price index" rose by only 9.2% in the year ending September. That's not enough to fuel profits.

And there's no relief for profits coming from overseas demand. Japan, the second-largest economy in the world, is still mired in its long slump. Economic forecasters in Germany, the third-largest economy, have recently lowered their forecasts for economic growth next year, from 2.4% to 1.4%. And while U.S. exports to China, one of the remaining bastions of global economic strength, have been rising, imports are growing even faster. As a result, the trade deficit with China is up 20% during the past year.

The next couple years could be the ultimate test of the flexibility of the U.S. economy. Businesses will need to remake themselves for a world where profits are much harder to come by. Consumers will need to adjust to an economy where jobs are much more vulnerable and incomes less assured. Such is the hard truth about profits.

With Margaret Popper in New York