The Realisation of Profits and Financial Instability

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Marx, Luxemburg, and Kalecki (amongst others) presented analyses of the realisation of surplus value that stress the interrelationships between the revenue and the expenditure accounts of the various departments in an economy. Building upon that foundation, Hyman Minsky has recently provided a policy-oriented analysis of the relationships between the aggregate level of activity, the profits and cash-flow position of trading enterprises, and the mechanisms by which financial difficulties are transmitted to other firms through the financial sector. In this article I draw out the significance of Minsky's work on financial stability.

Although Minsky and other writers with similar ideas are often termed post-Keynesian, their analysis is probably best described as post-Kaleckian. Consequently, I begin with a discussion of the theory of profits presented by Kalecki. I then move on to examine Minsky's views on financial instability.

THE MACRO THEORY OF PROFITS

Kalecki has made available to us a theory of the aggregate level of profits in the economy as a whole.[1] In considering this theory it is important to note four points. Firstly, the theory is a theory of the **level** of profits, not of the share of profits in national income (although it can be used to study such shares). Secondly, the theory pertains to the **total** level of profits in the economy; it is not, in the first instance at least, a theory of the profits of an individual firm. This is a macro-economic theory of profits, although it should be emphasised that it:

> ... is not 'macro-economic' in the sense of representing a first simplified rough step towards a more detailed and disaggregated analysis. It is macro-economic because it could not be otherwise.[2]

Thirdly, the theory is not dealing with the origin of profits, only with the **realisation** of (surplus labour in the form of) profits. Finally, although the theory refers to 'profits' and 'wages', it is necessary to regard the word 'profits' as shorthand for 'all non-wage income'(excluding transfer payments such as pensions, unemployment benefits, etc.) or, better still, 'all non-contractual income,' and the word 'wages' as shorthand for 'wages and salaries'.

I begin by presenting an outline of an economic model in which the causal or behavioural aspects of Kalecki's theory is laid bare. I do this because Kalecki (and Marx) are often criticised on the grounds that their theory of (the realisation of) profits is tautological. It is not. In fact it has the same behavioural content as does the Keynesian theory of savings and investment.

A SIMPLE TWO SECTOR MODEL

Consider a two-sector model of an economy in which some workers are employed in firms (or on farms) producing consumer goods and services (we shall refer to those firms collectively as the consumption sector)[3], whilst some workers are employed in firms or activities producing capital goods. Thus, total employment will equal the sum of employment in the consumer goods industries and employment in the capital goods industries. Likewise, output in the economy will be made up of the output of the consumption sector and of the capital goods sector. Aggregate income (which will be equal in value to output) will be made up of wages and profits. Profits will accrue to firms in the consumption sector and to firms in the capital goods sector. Similarly, the total wages bill may be divided into the amount paid to workers in the consumption sector and the amount paid to workers in the capital goods sector.

I will now introduce a simplifying assumption[4] and assume that each of the two sectors is fully integrated, i.e. that all of the raw materials, fuel, power, stationery, etc. used in each sector are themselves produced within that sector. The model can be most easily understood if there is no depreciation. If depreciation is to be taken into account profits must be calculated prior to the deduction of depreciation.

It is possible to define (loosely) profits for any firm in any sector as equal to the difference between revenue and costs. Costs from the point of view of the firm will be made up of wages and costs of materials. From the point of view of all the firms in a sector taken together, under the assumption of full integration, the charges for raw materials will themselves be able to be fully resolved into their wage and profit components within that sector. Therefore, from the point of view of all of the firms in each sector taken together:

Value Added in the sector
= Total Profits in the sector
+ Total Wages paid in the sector

From which it follows that:

Total Profits in that sector
= Value Added in that sector
− Total Wages Paid in that sector

To start with I shall focus attention on the consumption sector and investigate the determination of the level of profits for (all of) the firms in that sector taken together. Under the full integration assumption, the value of profits received in the sector will equal the difference between value added in the sector (that is to say, the value of consumption output) and the value of the wages bill paid out by the firms in the sector.

At this point we can introduce a convenient simplification concerning the savings behaviour of wage earners and profit recipients. This involves two rather extreme and simplistic assumptions. First, we assume that workers or their dependants spend all of their wages on consumption goods and services, in other words that the workers do not save.[5] Secondly, we assume that all income received as profits will be saved. Given these assumptions, which are often referred to as the classical savings assumptions, it follows that all income received as wages will be spent on consumption goods, and further that there will be no spending on consumer goods apart from spending out of wages.

Under the classical savings assumptions, the value of consumption expenditure will equal the value of wages paid in the economy as a whole. Thus, the wages paid by the firms in the economy, all taken together, become the revenue of the firms in the consumption sector. We have already noted, given the assumption of full integration, that the costs of the firms in the consumption sector will consist solely of their labour costs. For these firms to receive revenue in excess of their costs, that is, over and above the wages they **themselves** have paid out, there must be spending in excess of the spending undertaken by their own workers, and the size of their profits will equal the magnitude of that
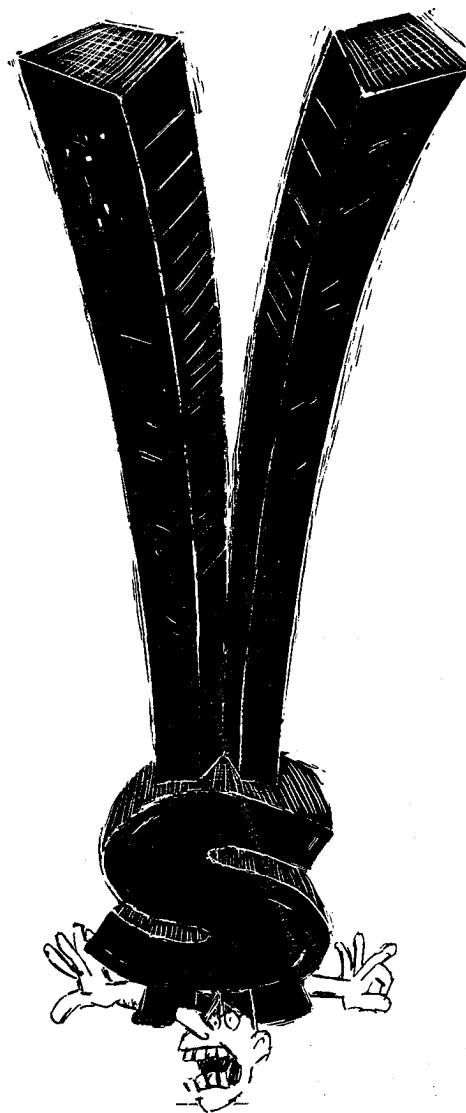
spending.[6] Given the classical savings assumptions, it is the spending of wages earned in the industries outside the consumption sector which provides the firms in the consumption sector with revenue in excess of their own wages costs, i.e. which provides them with their profits.[7] To the extent that profits in the consumption sector depend on spending out of wages (albeit wages paid outside that sector), the profits of some firms are no more than the costs of production of some other firms. There can be no profits **in the aggregate** on this account. Clearly, from the point of view of all firms in the economy taken together, there can only be profits in the aggregate if money, which has not already been entered into business accounts as a cost of production, is spent on goods.

In the simple classical two-sector model the only spending that does not merely return to firms as revenue funds that have previously been paid out as a cost of production is the spending by firms or individuals on **investment expenditure**. It is this spending, whether it is

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financed by borrowing or retained earnings, which generates revenues to the firms in the economy in excess of costs, and it is the value of this expenditure which determines the size of profits in the economy as a whole.

The simple model provides an intuitive explanation of this. Suppose that firms or individual capitalists in the economy use their retained earnings or borrow funds in order to finance investment expenditures. The value of their purchases from the firms in the capital goods sector will be divided (within the capital goods sector) between profits and wages. Thus, part of the investment expenditure yields profits directly to the firms producing capital goods. The part that does not constitute the profits of the firms producing capital goods will (under our assumption of full intergration) constitute the wages paid to the workers in the capital goods sector. It is the wages of these workers which, when spent on the products of the consumption sector, generates revenue in the consumption sector in excess of that sector's own costs of production. In other words, it is the wages component of investment expenditure which becomes the profits of the firms in the consumption sector. Thus, we see that investment expenditure generates an equivalent value of profits in the economy as a whole, because part of it generates profits directly in the capital goods sector itself and the remaining part of it indirectly generates profits in the consumer goods industries. A neat way of summarizing this result is provided by a saying attributed to Kalecki: "workers spend what **they** get, and capitalists get what **they** spend".

It is now possible to turn to a more general theory of profits. This theory, which we may attribute to Kalecki himself, relaxes the classical savings assumptions in order to take account of savings out of wages and consumption out of profits, while also explicitly introducing foreign trade and the activities of government. With repect to the last two, it is possible to note that net government expenditure and net exports (i.e. exports less imports) perform the same role as private investment in that they also facilitate the realisation of profits and thus the generation of a flow of cash receipts to firms, over and above their payments for wages, raw materials, and other operating expenses.

Kalecki points out that:

the gross national product is equal to the sum of gross investment, consumption, government expenditure on goods and services, and the surplus of exports over imports....Since the total value of production is divided between capitalists and workers or paid in taxes, the value of gross national

product on the income side will be equal to gross profits net of taxes, wages and salaries net of taxes, plus all taxes direct and indirect. We thus have the following balance sheet of the gross national product:

Gross profits net of (direct) taxes	Gross investment Export surplus
Wages and salaries net of (direct) taxes	Government expenditure on goods and services
Taxes (direct and indirect)	Capitalists'consumption Workers' consumption
Gross national product	**Gross national product**

We can take away from the left-hand side wages and salaries (net of taxes) and taxes, and from the right-hand side their equivalents: workers' consumption (plus workers' savings) and government expenditure (less any budget deficit). This produces the following equation:

$$
\text{Gross profits net of taxes} = \begin{array}{l} \text{Gross investment} \\ +\text{Export surplus} \\ +\text{Budget deficit} \\ -\text{Workers' saving} \\ +\text{Capitalists' consumption} \end{array}
$$

Thus, this equation differs from the equation of the simplified model in that instead of investment we now have investment plus export surplus plus budget deficit plus capitalists' consumption minus workers' saving.

The relationship alluded to here does not merely assert a direct link between an increase in any

"There's nothing wrong with the U.S. dollar that having enough of them won't cure."
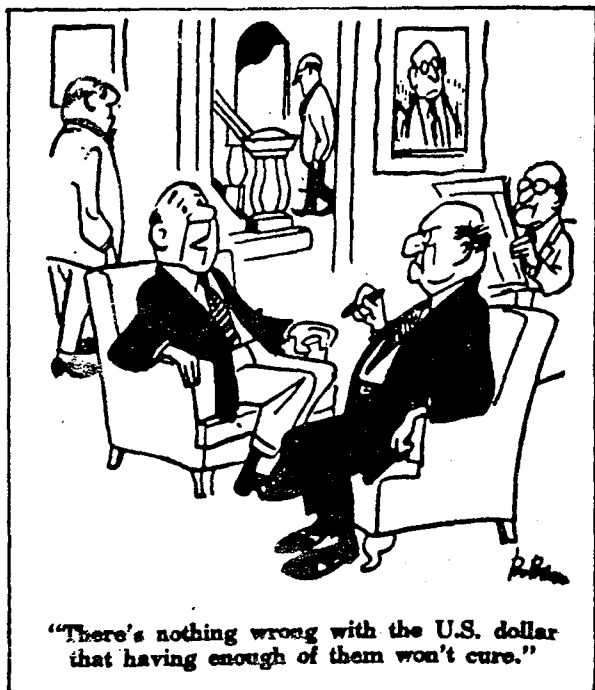
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component of expenditure and an increase in aggregate profits. For example, if exports increase, there will be a direct increase in profits by virtue of the extra profits of the exporters themselves. But aggregate profits will also be affected indirectly, because the wages received by workers in the export sector will, when spent on domestically produced consumer goods, generate revenue to firms in the consumption sector in excess of their costs. Thus, aggregate profits will tend to increase by an amount equal to the total value of the increased export sales (although we would have to take into account any leakages into higher taxes and imports and increased savings and we would also have to allow for the possibility that some of the extra profits may be re-spent).

Kalecki's approach reveals the (proximate) determinants of the size of the cash flow received by firms in excess of their current outlay on wages, materials and taxes. If these insights were combined with some statements about the obligations of firms to repay debt, it would be possible to gain some understanding about the circumstances in which a mis-match between cash surplus and payments obligations occurs and about the possible consequences of this. This is the task that Minsky tackles.

MINSKY ON PROFITS, CASH FLOW AND DEBT REPAYMENT[9]

Firms operate today with cash payment commitments inherited from the past. In addition, the current acquisition of assets necessitates financing, which in turn establishes payment obligations for the future. To meet these needs and to ensure the smooth running (i.e. the replication, perhaps on a larger scale) of their activities, a continued flow of profits is necessary. This in turn can only occur, as Marx and Kalecki have shown, if a steady expansion of capital accumulation (or a persistent trade surplus or fiscal deficit) is occurring. Furthermore, profits today not only enable business to honour payment commitments on financial intruments, but also influence views on the magnitude of future profits. Minsky points out that "business invests today because business is expected to invest in the future".[10] Continued expansion, by generating profits and a satisfactory cash-flow position for firms, enables contractual obligations to be validated and allows the provision of finance for new ventures.

Clearly, a capitalist economy is fragile (to use Minsky's very apt word). It is susceptible to swings in mood and outlook which affect expected profitability. Moreover, it exhibits positive feedback in the event of a disturbance, since a redirection in the pace of accumulation will result in both a reduced ability to repay debt and a drying up of finance and cash for new

projects. Furthermore, according to Minsky, the instability is - at least in part - endogenous, since there is a tendency in the upswing, with credit shortages present, for new instruments and practices to arise that are considerably more risky than those present before, thereby rendering the situation even more precarious than it might otherwise have been.

IMPLICATIONS

Minsky's analysis has many implications, but three in particular are worth pointing out here. First, there is the explanation for stagflation:

> Once the doctrine of salvation through investment becomes deeply ingrained into our political and economic system the contraints on foolish investments are relaxed. This is especially so if the government stands ready to guarantee particular investors or investment projects against losses....In the aggregate the foolishness of bankers, businessmen, and government guarantors is floated off by massive government deficits that lead to profits which validate aggregate past investment and overall business liabilities, albeit at a price in inflation and increasingly inefficient business techniques. The inefficiency of the chosen techniques is reflected by the unemployment that accompanies inflation.[11]

Secondly, and also argued by Minsky, the "financial instability hypothesis suggests that a simplification of financial structures is a way of achieving greater stability, although being rooted in an analysis of the historical dynamics of the financial structure, it also

recognizes that the enforcement of simplicity in financial arrangements will be difficult."12 Elsewhere, in a commentary on Keynes, he writes:

> The current institutional structure offers us unappetizing alternatives; we need to alter it, recognizing that the essential critical flaw in capitalism is instability, and that instability is due to the way capital asset holding and accumulation are financed. Banking, that is, the financing of capital asset ownership and investment, is the critical destabilizing phenomenon. But control of banking - money, if you wish - is not enough; the liability structures available to units that own the massive capital assets of the economy must be constrained. The fundamental dilemma in economic organization is how to preserve the vitality and resilience of decentralized financial markets. Keynes's solution - the socialization of investment - may be a way of attenuating, although not eliminating, financial instability by removing the financing of the most capital-intensive processes and expensive capital assets from private debt markets. The substitution of government for private financing of capital-intensive investment, along with limitations on the liability structure of private business, could decrease the domain of instability of a capitalist economy.13

Thirdly, we can note that the Marx-Kalecki macro-theory of (the realisation of) profits provides an interesting insight into the nature of competition between capitals. In the absence of a marked and sustained effect upon aggregate investment, it is necessary to view the changes in the organisation of industry, in the system and degree of regulation, in the degree of monopoly, in the ownership of firms or licenses, etc. as involving a transfer of profits, or an attempt to transfer profits, away from some other area, and not as the creation of profits which would not otherwise exist.

In conclusion, it can be stressed that we should always recognise the interrelationships between financing and the realisation of profits. These in turn are related to the growth and structure of output and expenditure in the economy. In order to control, or even to partially influence, the one, it is necessary to control, and to bear in mind the consequences for, the other.

NOTES

1. An excellent and brief exposition can be found in M. Kalecki, Selected Essays on the Dynamics of the Capitalist Economy Cambridge: Cambridge University Press, 1971, pp. 78-92. (In his Treatise on Money, published in 1930 J.M. Keynes presents a similar model.)

2. L. Pasinetti, Growth and Income Distribution Cambridge: Cambridge University Press, 1974.

3. Ideally, it would be useful to expand theories in in this genre in terms of 'wages goods ' and 'non-wages goods'. Sadly, these notions are familiar to very few these days.

4. I say 'assumption ', but it is probably best thought of as a 'definition' - we will define the sectors so that they are fully integrated. In principle, we can do this using input-output tables.

5. This assumption is made solely in order to simplify the exposition of our model, and it is relaxed in the following section. It has been claimed, however, that the statement that workers do not save is actually a realistic assertion about people's behaviour. (See Kaldor, 1966.) The realism of the assumption is usually argued on two grounds. First, it is argued that workers' households save such a low proportion of their income that their savings can, for all intents and purposes, be regarded as zero, or that the return on workers' saving is so low that their property incomes are negligible. A second argument is that the amounts of money saved by one group of workers (and placed in savings banks, etc.) are borrowed by another group of workers and used to purchase consumer durables, such as cars, television sets, houses, and land. It is asserted that, on balance, the two amounts roughly cancel out.

6. To the extent that workers in the consumption sector spend their wages on consumer goods, the firms in the consumption sector will be receiving back as revenue no more than they have already paid out as a cost of production.

7. Readers familiar with Marx will recall the inter-sectoral ties exhibited by the schemes of reproduction presented in Capital Volume Two.

8. M. Kalecki op. cit.,p.81f.

9. By far the best exposition can be found in H. Minsky, 'The Financial Instability Hypothesis', in C. Kindleberger ed., Financial Crises Cambridge: Cambridge University Press, 1982, pp. 14 - 39. The interested reader might also consult H. Minsky, Inflation Recession and Economic Policy Brighton: Wheatsheaf Books, 1982; idem., John Maynard Keynes London: Macmillan, 1976; idem., The The Financial Instability Hypothesis London: Thames Papers in Political Economy, Autumn 1978.

10. H. Minsky, 'The Financial Instability Hypothesis,' op.cit., p. 19.

11. H. Minsky, Inflation, Recession and Economic Policy, op. cit., p. 112.

12. Ibid.

13. Ibid., p. 86.