Introduction: Mainstream Theories of Profit/Interest

- The Conventional Time Preference Theory
- The Productivity Theory

Conventional Time Preference Theory

- Future goods are worth less than present goods of the same kind and quantity.
- Thus, e.g., 10 apples to be available one year from now are worth less than 10 apples available now; they are equal in value to, say, only 9 present apples.
- The totality of the means of producing 10 apples to be available one year from now is valued as 10 future apples and thus has a value of only 9 present apples.
- The year passes and means of production initially worth 9 present apples are physically transformed into the 10 apples, which are now 10 *present* apples.
- Profit/interest is explained by the growth of 9 present apples into 10 present apples.

The Productivity Theory

- A primitive fisherman gathers 3 fish per day with his bare hands.
- If he reduced his consumption to 2 fish per day for 100 days, and saved 1 fish per day during that time, he would accumulate a stock of 100 fish.
- 100 fish would be sufficient to support his labor for 50 days, in which time he could construct a boat and net.
- With the boat and net he could catch 30 fish per day instead of only 3 fish per day, i.e., 27 extra fish per day.
- If the boat and net last for 100 days, the fisherman is enabled to produce an additional 2700 fish.
- He gains 2700 extra fish at the price of the temporary sacrifice of 150 fish (the fish he could have gathered if he had not constructed the boat and net)—a profit of 2550 fish.

The Productivity Theory

- *"In the most general sense, this yield—more future consumption in return for forgone present consumption—is the return on capital." Paul Samuelson.*

The Common Denominator of the Time Preference and Productivity Theories

- Both view profit/interest, which is an excess of ***money*** received over ***money*** expended, as explainable on the basis of *a physical surplus of consumers' goods,* e.g., a net gain of 1 present apple, a net gain of 2550 fish.
- In order for either of these explanations to hold up, it must be assumed that the *monetary value* of a present apple will be the same next year as it is this year and that the monetary value of a fish will be same even though 10 times as many fish are being produced.

The Unstated Assumption of the Two Mainstream Theories

- The quantity of money and volume of spending in the economic system somehow automatically grows to keep pace with any increase in the overall supply of consumers' goods over time, so that their prices can be assumed to be unchanged.

Breakdown of the Mainstream Theories

- The formulas of both mainstream theories break down as explanations of profit/interest in terms of money, if the assumption is made that the quantity of money and overall volume of spending in the economic system is unchanged.

Breakdown of the Mainstream Theories

- In that case, 10 times the fish (read 10 times the supply of consumers' goods in general) would result in prices being reduced to a tenth of their initial level and thus in no additional monetary profit/interest whatever coming into existence.
- The same point applies to the time preference theory. The formula of the time preference theory implies that if means of production worth 9 units of present goods could produce 20 units of future goods to be available in a year, the rate of profit/interest should be as 11 to 9. But if the substitution of 20 units of future goods for 10 is the result of a doubling of the supply of future goods and a corresponding halving of their prices, the actual rate of profit/interest will be no greater than before.

Making the Role of Money Explicit

- Both the time preference and productivity theories implicitly take for granted an increase in the quantity of money and volume of spending commensurate with increases in the supply of consumers' goods.
- But they do not explicitly credit an increase in the quantity of money and volume of spending with any actual role in determining the rate of profit/interest in terms of money. They take it for granted, ignore it, and simply credit time preference or productivity, their preferred explanations, as though it were they, and not the increase in the quantity of money and volume of spending, that was essential to the money rate of return.

On the Role of Money Growth as a Cause of the Rate of Profit/Interest

- The increase in the quantity of money and volume of spending is the *actual cause* of a substantial portion of profit/interest in terms of money.
- Until now it's influence has been acknowledged only in periods of inflation, when its effect has been recognized as "overstating" profits.
- Yet it is present almost always, and would be present even under the purest gold standard.
- *Recognizing this fact is the starting point of my own theory of profit/interest.*

The Monetary Component Under a Gold Standard

- The 1, 2, or 3 percent annual increase in the quantity of money that would occur under a gold standard would operate to raise sales revenues over time and thus to systematically widen the spread between sales revenues and the earlier expenditures that show up as costs, thereby adding to the rate of profit/interest.
- This addition to the rate of profit/interest would exist alongside falling prices to the extent that the increase in the production and supply of goods took place more rapidly than the increase in the quantity of money and volume of spending.
- This elevation of the rate of profit/interest argues against calling the gold standard and falling prices due to increased production “deflation.”

Beyond the Monetary Component: Invariable Money

- The increase in the quantity of money and volume of spending, not differences between supplies of consumers' goods at different points in time, is an actual determinant of the rate of profit/interest expressed in money.
- To identify *other,* more fundamental determinants of the rate of profit/interest, it is necessary to put increases in the quantity of money and volume of spending aside and assume that the quantity of money and volume of spending in the economic system are rigidly fixed, which is what I call "invariable money."
- Economic analysis in the framework of an invariable money is the next step in my theory of profit/interest.

The Seeming Problem of Profit Under Invariable Money

- Taken in the aggregate, business firms are the source of their own sales revenues.
  - Outlays for capital goods are sales revenues to the sellers of capital goods, e.g., GM's purchase of steel sheet is sales revenues to US Steel.
  - Wage payments are the principal source of sales revenues to the sellers of consumers' goods, e.g., wages paid by GM and US Steel are the source of sales revenues to grocers and other sellers of consumers' goods.

The Problem: Costs Must Seemingly Equal Sales Revenues

- Outlays for capital goods and labor, the source of equivalent sales revenues, also result in costs of production equal to those outlays.
  - If the aggregate outlays for means of production were the same, year after year, for assets of the same life, annual costs of production in the economic system would tend to equal those outlays.
- This seems to imply that if expenditures for means of production were the only source of business sales revenues, sales revenues and costs, being equal to the same thing, would be equal to each other and thus that no aggregate profit/interest would exist.

Indefinite Postponement of the Elimination of Profit/Interest

- The equalization of expenditure for means of production and costs can be indefinitely postponed, so long as what we “Austrians” call “a lengthening of the period of production” can take place.
  - For example, the same sum of money annually spent in the purchase of equipment with a 3 year life will be accompanied by equivalent annual depreciation costs in 3 years.
  - To the extent that expenditure for equipment shifted to equipment with a longer life, say, 10 or 20 years, the equalization of expenditure and depreciation costs would take correspondingly longer.
  - There are other examples, such as in connection with buildings, inventories, and construction projects. The basic principle is that a lengthening of the period of production entails a deferral of costs further into the future.

Postponement of the Elimination of Profit/Interest—Net Investment

- So long as expenditure for the means of production exceeds costs of production, sales revenues equal to the expenditure for the means of production exceed those same costs, and aggregate profit/interest exists.
- This aggregate profit/interest equals an increase in the value of the assets of business, i.e., *net investment*. (This is because expenditures for means of production add to the value of business firms' assets, while costs subtract from it. The difference is net investment.)
- The role of net investment is a major aspect of my theory of profit/interest.

The Problem of Profits Equal to Net Investment Alone

- If the only source of profit/interest were net investment, the rate of profit/interest would have to progressively fall.
- Fortunately, there is another cause of profit/interest that can be identified under an invariable money and that does not imply any fall in the rate of profit/interest and that is operative alongside of net investment and if and when net investment is zero.

Net Consumption (1)

- In addition to the expenditures for capital goods and labor, there is a further source of business sales revenues.
- This is *the consumption expenditure of businessmen and capitalists themselves.*
- Their consumption expenditure constitutes sales revenues to the sellers of consumers' goods but does not have any counterpart in the costs of business firms; it is financed by such means as dividend payments to stockholders and by draw payments to partners and sole proprietors.
- I call this consumption, *net consumption*—it is consumption in excess of wage payments.

Net Consumption (2)

- Net consumption brings about the existence of profit/interest in a way that is similar to net investment, namely *by reducing the costs that business firms deduct from their unchanged aggregate sales revenues*.
- Net investment reduces these costs by deferring them to the future. Net consumption reduces them by reducing expenditure for the means of production and thus the point toward which costs are tending.

Net Consumption (3)

- How Net Consumption can originate.
- How it reflects time preference.
- How it influences aggregate profit/interest.
- The effect of more consumption on the profit/interest of individual businessmen is the opposite of its effect on profit/interest in the economic system.

Some Further Implications of the Invariable Money Analysis (1)

- Business in the aggregate is the source of a monetary demand for its products that is sufficient to enable it to operate at a positive rate of profit/interest.
- Falling prices caused by increased production do not reduce the rate of profit/interest.

Some Further Implications of the Invariable Money Analysis (2)

- Capital accumulation does not require or cause a falling rate of profit/interest.
- The relationship of saving to capital accumulation is as force to acceleration, not force to motion.

Some Further Implications of the Invariable Money Analysis (3)

- Nominal net saving/net investment would disappear in the long-run absence of increases in the quantity of money and volume of spending.
- In the presence of continuing increases in the quantity of money, nominal net saving does not reduce the rate of profit/interest, but takes place out of a rate of profit/interest that is elevated by the increase in the quantity of money.
- The importance of saving exists at the level of gross saving, not net saving.

Some Further Implications of the Invariable Money Analysis (4)

- Capital accumulation depends not only on gross saving, but also on anything that serves to increase production in general, such as technological progress, greater efficiency from any cause, a larger supply of labor, above all, and most fundamentally, on economic freedom.
- Government interference undermines capital accumulation by reducing the efficiency of production as well as by reducing gross saving.

Some Further Implications of the Invariable Money Analysis (5)

- Real wages and the general standard of living rise from the side of improvements in production and falling prices, not from the side of rising money incomes.

Some Further Implications of the Invariable Money Analysis (6)

- Overthrow of the Marxian exploitation theory: profits are not a deduction from wages, but wages and other costs are a deduction from sales revenues, which in the absence of capitalists and their expenditures for means of production would be all profit.

Some Further Implications of the Invariable Money Analysis (7)

- Overthrow of the Keynesian unemployment equilibrium doctrine—i.e., the IS curve and the MEC curve: In the context of recovery from a depression, net investment and profit move together, virtually dollar for dollar. Thus, the rate of profit rises, not falls, as economic recovery takes place and unemployment is eliminated.