BSM 477

DR. GEORGE REISMAN **SYLLABUS SUPPLEMENT 5**

IX. THE NET CONSUMPTION, NET INVESTMENT THEORY OF AGGREGATE PROFIT: THE POSITIVE THEORY

All business activity is carried on for the purpose of earning a profit. What determines the average rate of profit in the economic system? Is the rate of profit too high (Marx and the exploitation theory) or too low (Keynes and the doctrine of unemployment equilibrium). Do technological progress and improvements in business efficiency raise the average rate of profit?—or, on the contrary, do they lower it by enlarging the supply of goods and thereby causing falling prices and alleged deflation? Do saving and capital accumulation imply a falling rate of profit? Does additional saving place business in the contradictory position of having more money available to invest at the very time its sales revenues are reduced because the consumers are saving instead of spending? Can there be such a thing as *too much* of an increase in production or *too much* saving? The following weeks' classes will answer these questions and satisfactorily resolve the implied paradoxes.

A. Net Consumption and the Generation of an Excess of Sales Revenues Over Productive Expenditure and Costs

1. The Nature and Problem of Aggregate Profit
    a. The treatment of interest.
    b. Profits at the macro level determined by different factors than at the micro level.
    c. Profits as the result of differential demand, not demand for and supply of capital.
    d. The problem of aggregate profit: productive expenditure and the generation of equivalent sales revenues and costs.
2. Net Consumption—i.e., consumption in excess of the wage payments by business, which is financed by dividends, draw, and interest payments.
3. Net Consumption and the Generation of an Excess of Sales Revenues Over Productive Expenditure (see Tables 16–1 and 16–2, on pp. 726 and 727; Figure 16–1, on p. 729; Table 16–3 on p. 730 and Figure 16–2 on p. 732).
4. The Rate of Net Consumption and the Rate of Profit
5. Net Consumption: Its Other Sources, Wider Meaning, and Relationship to the Saving of Wage Earners
6. Confirming the Critique of the Exploitation Theory
   See Table 16–4, on p. 736 for the implicit basis of the primacy of profits doctrine presented in Chapter 11.

B. The Net Consumption Theory Further Considered

1. Why Businessmen and Capitalists Cannot Arbitrarily Increase the Rate of Net Consumption and the Rate of Profit
2. Implications for the Gravitation of Relative Wealth and Income
3. Accumulated Capital as a Determinant of Net Consumption
4. An Explanation of High Saving Rates out of High Income
5. Net Consumption and Time Preference
6. The principle of time preference
7. The foundations of time preference
8. Time preference, rationality, and freedom

C. Net Investment as a Determinant of Aggregate Profit and the Average Rate of Profit

See Tables 16–5, p. 745; 16–6, p. 747; and 16–7, p. 749; see also the equations on p. 748, which show why aggregate profit equals the sum of Net Consumption plus Net Investment.

1. The Net Investment Rate as a Determinant of the Average Rate of Profit
2. Net Investment Versus Negative Net Consumption (see Tables 16–8 and 16–9 on pp. 751 and 752)
3. The Prolongation of Net Investment Under an Invariable Money
4. Net Investment as the Result of the Marginal Productivity of Capital Exceeding the Rate of Profit
5. Net Investment as a Self-Limiting Phenomenon
6. Capital Intensification and the Tendency Toward the Disappearance of Net Investment Under an Invariable Money
7. The process of capital intensification (see Table 16–10, p. 760)

D. The Addition to the Rate of Profit Caused by Increases in the Quantity of Money

See Figures 16–2 and 16–3 on facing pages 764 and 765.

1. The Impact of Increases in the Quantity of Money on the Net Investment and Net Consumption Rates (see Tables 16–11 through 16–15)
2. Increases in the Quantity of Money and the Perpetuation of Net Investment
3. The Tendency of the Rate of Net Investment to Equal the Rate of Increase in the Quantity of Money and Volume of Spending
4. Summary Statement of the Determinants of the Rate of Profit

E. Increases in the Real Rate of Profit Dependent on Increases in the Production and Supply of Goods

1. Net Investment Without Increasing Capital Intensivity
2. Capital Saving Inventions

F. The Inherent Springs to Profitability

1. The Net Consumption Spring to Profitability. So long as net consumption exists, the only way an aggregate profit will not exist is if there is equivalent *negative net investment.* This situation is necessarily temporary.
2. The Indirect Net Investment Spring—Via Net Investment and Greater Capital Intensivity Causing a More Rapid Increase in the Quantity of Commodity Money in Conjunction with the Resulting More Rapid Increase in Production
3. The Direct, Net Investment/Greater Capital Intensivity Spring.
   The potential for additional net investment represents a further "inherent spring toward profitability," in that whenever aggregate profitability is lacking, all that need occur to restore it is further net investment. At the same time, net investment *is positively encouraged by the fact that the lower is the rate of return on capital, the greater is the degree of capital intensivity that pays.*
4. Why net investment is encouraged by a lower rate of return (Note: beware the fallacy of composition in confusing this case with the case of an individual industry, in which a low rate of profit *relative to the rate of profit in other industries* discourages investment, in fact, encourages *dis*investment.)
5. The railroad tunnel case as an illustration of the rate of return as the standard for cost savings that are necessary to make more capital intensivity pay.

6. The case of methods A, B, and C, requiring different capital intensivities—see Table 16-16, p. 781 of *Capitalism*.
7. The case of the older and younger scotches
8. The effects of a lower rate of return on the profit margins and prices of more and less capital intensive industries; why it favors the expansion of the more capital intensive—see Table 16-17, on p. 782 of *Capitalism.*
9. Wage Rate Rigidities and the Blockage of the Springs
10. Note: a higher rate of return reflecting a more rapid increase in the quantity of money and volume of spending need not discourage investment. The scotch case as a demonstration: the rising volume of spending operates equally on the price and profit of the younger scotch and the older scotch, thus the less capital intensive product is not favored here. (See the subsection "Capital Intensiveness and the Monetary Component in the Rate of Profit).

X. The Net Consumption/Net Investment Theory and the Leading Alternative Theories

A. Exposition and Critique of the Productivity Theory in Its Traditional Form.

1. The meaning of the productivity theory and its illustration in terms of Roscher's famous boat and net example.
2. Why the productivity of capital by itself can't explain the rate of profit: lower prices of products. A case of increased output, and thus increased productivity, but no change in aggregate profitability if the aggregate monetary magnitudes are the same. Presence of the fallacy of composition.
3. *But* productivity in form of cost savings or quality improvements could induce *net investment* and in that way raise the rate of return.
4. The productivity theory's mistaken view of technological progress as the source of demand for capital and a higher rate of profit, rather than as a source of supply of capital goods; Ricardo's insights here.

B. Exposition and Critique of the Time Preference Theory in Its Traditional Form.

1. An example of the formula of the time preference theory: 10 present apples are equal in value to 11 apples to be available one year later, and to the total of the means of producing those 11 apples; in one year, the means of producing these 11 future apples become 11 present apples. Hence, factors of production worth 10 present apples become products worth 11 present apples.
2. Problems of a pure time preference theory: confusion of real and money rate of profit; the formula and the doctrine of the purchasing power premiums; the discounting approach; the marginal future unit is more valuable than the first sub-marginal present unit—Böhm-Bawerk's concession. Omission of the role of net investment and the quantity of money.

C. The Classical Basis of the Net Consumption Theory

1. Ricardo on profits rising as wages falling, and vice versa. Can be interpreted as net consumption rising or falling and productive expenditure or wage payments moving in the opposite direction in the context of invariable money.
2. John Stuart Mill on "demand for commodities is not demand for labor." Net consumption represents a demand for consumers' goods over and above the demand for labor, and a demand for commodities over and above the demand for factors of production to the same extent; this is the most fundamental source of profit—the only long-run source in an economy with a constant quantity of money.

D. Some Problems to Test Your Understanding

1. Adam Smith and Karl Marx postulated a simple state of affairs in which manual laborers produced and sold products, kept the whole sales proceeds, and did not act as capitalists, i.e., did not buy for the sake of subsequently selling. They believed that in such circumstances all income was wages and no income was profits. They held that profits came into existence only with the development of "capitalistic circulation" (i.e., buying for the sake of selling) and were a deduction from what was originally all wages. To determine what the effect on the rate of profit would be if there were no capitalists, but just sellers of products, you are given the following information, which will test their propositions in the light of the net consumption theory: Receipts from the sale of products are 1000, all of which is consumed by the sellers and constitutes a fresh 1000 of receipts from the sale of products in the next period. Using Figure 16–2 and Tables 16–1 through 16–4 as your framework of analysis,

    a. State the amount of productive expenditure present.

    b. State the amount of wages paid in the production of products.

    c. State the amount of money outlays to be deducted from sales revenues as costs.

    d. State the amount of profits earned on the sales revenues.

    e. State the amount of nominal capital in existence.

    f. State the rate of return on capital.

2. Productive expenditure for buildings and equipment by business is 1000, while total annual depreciation charges are 820, and productive expenditure for labor materials, and supplies is 2000, while cost of goods sold is 1980.

    a. Find net investment.

    b. Find total business sales revenue from the above data, on the assumption that all wages have a counterpart in consumption expenditure.

    c. Find aggregate profit in the economic system, on the assumption that net consumption is zero and thus that sales revenues equal productive expenditure alone.

    d. Find net investment on the assumption that 50 of wages show up as an additional demand for capital goods accompanied by an equivalently reduced demand for consumers' goods. (You may want to use Table 16–9 as a guide to your answer.)

    e. Find aggregate profit on the preceding assumption.

    f. Find net investment and aggregate profit in questions (a) and (c) on the assumption that total costs are 400 higher.

Answers to questions 1 and 2: 1a) zero, 1b) zero, 1c) zero, 1d) 1000, 1e) zero, 1f) infinite, 2a) 200, 2b) 3000, 2c) 200, 2d) 250, 2e) 200, 2f) -200, -200.