Saving, Profits, and Speculation in Capitalist Economies

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It seems that the neoclassical concern with “crowding out” has been replaced by hysteria about the “saving shortfall” in the United States. Neoclassical economists tried for decades to find empirical support for their notion that government deficit spending necessarily must reduce private investment spending. President Reagan’s deficits seem to have finally laid that silly idea to rest, since even his enormous deficits failed to generate any measurable crowding out. Neoclassical economists have now apparently shifted their focus to the supposed negative effects federal budget deficits have on the national saving rate.

Many articles have been published recently analyzing the “saving shortfall.” These have ranged from Barry Bosworth’s claim that the United States has been on a “spending binge” to William Nordhaus’s prediction of lower future living standards due to current profligacy [Bosworth 1990; Nordhaus 1989]. Other articles have primarily focused on possible ways to increase saving, such as Laurence S. Seidman’s consumption tax proposal and Charles Schultze’s plan to use the “peace dividend” to increase saving by reducing spending on the military [Seidman 1989; Schultze 1990]. Finally, some articles have argued that the saving shortfall may not actually exist, but might be due merely to temporary glitches or to measurement problems. Robert Eisner, for example, argues that a large part of national saving is never counted, while Robert Blecker shows that the apparently low saving rate is pri-

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marily due to accelerated depreciation and to the trade deficit [Eisner 1990; Blecker 1990].

What is sadly lacking from all these articles (with the exceptions of those by Blecker and Eisner) is theory. Indeed, most of the analyses would presumably flunk any macroeconomics principles class. In any case, they would flunk mine. Given that most of the articles were written by notable economists, one wonders what on earth is being taught by the less notable in macro courses. Until we get the theory straight, there is no sense in arguing about accounting identities or empirical evidence. I will first review some familiar ground, then present some arguments that may seem controversial, even to post Keynesians and institutionalists.

What Do They Mean?

The typical argument made by orthodox economists concerning the saving shortfall begins with the national income accounts and shows that national saving has fallen as a percent of gross national product (GNP) or of net national product (NNP). It is then argued that we must increase saving. Thus, the first question that might be asked concerns what do they mean by “saving?” Surely the least interesting definition of saving would be that of the national income and product accounts, for saving thus defined could be increased by exporting all of a nation’s output. That is, the national saving rate could approach 100 percent through a modern Mercantilist policy that imposed draconian austerity on the domestic population so that it was unable to consume anything. This does not seem to be what the neoclassical economists have in mind, for it is difficult to see how this would in any sense make the current population any better off, and there would be no future generations to enjoy higher living standards since everyone would soon be dead—even in the short run.

Sometimes the definition of saving used by neoclassicalists seems synonymous with not spending. Again, they cannot really mean this, for not spending would be maximized with a GNP, and therefore, national income, of zero. It is difficult to see how the current or future generation could possibly enjoy higher living standards through not spending.

Alternatively, saving could be defined as spending on nonconsumables. Thus, saving would be defined as spending on investment goods, on net exports, and on those goods and services purchased by the government that are not available for consumption. Again, this definition
encounters the contradiction that saving might be maximized by exporting all of a nation’s output. Ignoring this problem, saving might be increased through government spending on nonconsumables. Exactly what might count as a nonconsumable may be debatable (are nuclear bombs consumables?). However, since many neoclassical economists have argued that reductions of government spending will increase saving, government spending on nonconsumables must not be included in the definition of saving they have implicitly adopted.

In the final analysis, what the neoclassicalists appear to mean by saving is investment in plant and equipment that will increase productive capacity. I have never quite understood why they refuse to say so. Throughout the rest of this article, I will assume that the “saving shortfall” is actually an “investment shortfall,” and that the goal of the various neoclassical proposals is to increase investment. In fact, Blecker has shown that gross investment has not been inordinately low relative to recent decades, but that net investment has suffered due to rising depreciation rates [Blecker 1990]. However, I intend to focus only on theory and will start with the assumption that we need to stimulate investment, for this seems to be what the hysteria is all about.

How Can We Rectify an Investment Shortfall?

There are two basic ways to encourage private investment. The first is to attempt to reduce the supply price of investment goods, which includes the cost of production plus finance costs. Production costs can be reduced by lowering wages, by favorable tax treatment of investment goods producers, by reducing materials costs, or by increasing productivity in the investment goods sector. Finance costs can be reduced by lowering interest rates. Finally, tax expenditures (such as investment tax credits) can also reduce the supply price of investment goods. Of these, Reaganomics relied on policies that lowered taxes and wages as a method of inducing more investment. On the other hand, extremely tight money and high interest rates over the past decade have kept finance costs high.3

The other way to induce investment is to raise the demand price of investment goods. This can be achieved by raising the marginal efficiency of capital (MEK). The MEK is both forward-looking and backward-looking. If capacity utilization rates and profit rates have recently been high, investment is encouraged. Thus, high current (and recent) aggregate demand will be a fundamental determinant of the demand price of investment goods. In addition, however, investors must
be concerned with expected future aggregate demand, since newly produced investment goods will be used in the future rather than in the past. Given that the future cannot be known with certainty, investors must estimate the MEK of new investment based on extrapolations of recent and current outcomes, as well as upon expectations, rules of thumb, and animal spirits.

The demand price of investment goods can be raised by increasing current aggregate demand and by raising animal spirits. Reaganomics was partially based on the belief that tax cuts for the wealthy would raise their spirits and encourage them to invest. According to Blecker [1990], the rich chose instead to consume their tax cuts. In any case, however, the tax cuts probably stimulated aggregate demand and increased capacity utilization rates, so they probably did help to increase the demand price of investment goods. Alternatively, the government could raise aggregate demand directly through purchases of goods and services, or indirectly by encouraging private consumption. Thus, social spending could raise consumption by the poor, while favorable treatment of unions could raise wages and consumption by workers. Of course, Reaganomics was comprised of social spending cuts and attacks on unions, both of which would tend to lower the MEK. On the other hand, Reagan’s massive deficits helped to generate aggregate demand and raise the demand price of investment goods [Wray 1989].

Given that deficit spending by the government will tend to raise the demand price of capital, why do neoclassicalists argue that reduction of the deficit is a necessary precondition to closing the “investment shortfall”? The answer must be that they have returned to the denigrated crowding out hypothesis: government deficits raise the supply price of capital by increasing finance costs, and this effect outweighs any beneficial impact of deficits on the demand price of capital. It is believed that if the deficit were reduced, this would somehow generate more finance available to be used by private investors.

Before this view can be challenged, it will be necessary to examine the nature of the workings of a capitalist system. Neoclassicalists argue that saving by households can help to finance investment, and that when households refuse to save, capitalists cannot invest. This ignores the function of the capitalist in a capitalist society: the capitalist provides income to workers, then must separate them from it. A capitalist economy does not, and cannot, function like a collection of Robinson Crusoes bartering consumables. Neoclassicalists like to believe their approach applies to all societies, including that of Martians and goldfish, and so are loath to explicitly analyze an economy with specifically
capitalist institutions. However, this is necessary to understand the relations among spending, finance, saving, and investment.

Finance, Spending, and the Logic of Capitalism

As Basil Moore rightly argues, a capitalist credit economy is not a commodity barter economy [Moore 1990]. In a "corn" economy, one can postpone consumption by saving seed corn for planting. This "investment" can then raise future consumption if nature cooperates. Intermediaries might develop to come between savers and investors by accepting savings deposits of seed corn and making corn loans to borrowers. Savers retain deposits, which can be used later to purchase the output of investors, who can retire debt after the sale takes place. Investors realize profits in the form of corn and pay corn interest to banks if nature has been sufficiently bountiful.

This hypothetical corn society bears no resemblance to a capitalist economy. In a capitalist economy, workers receive money wages, not corn, and production is undertaken to generate profits in money form. The income of workers is determined by capitalist expenditures on wages, thus, in the aggregate, capitalist expenditures on wages will determine the maximum that can be spent by workers on consumption goods (if we make the simplifying assumption that workers receive all their income from wages). Furthermore, in a capitalist economy, profits are accumulated in money form—not corn—and are generated by capitalist spending. Finally, interest is paid in money out of the gross profits generated by capitalist spending.

In a simple model in which there are only workers and capitalists, and in which only capitalists earn profits and only workers earn wages, capitalists can recapture all labor costs if workers spend all their wages on consumption goods. The prices of these consumption goods must be high enough to ensure that aggregate wages are not sufficient to purchase all produced goods. In other words, capitalist consumption and accumulation are made possible only to the extent that wage income can purchase only a portion of society's output. Capitalist purchases of the remainder of aggregate output will generate the income received by capitalists—that is, gross profits.

If workers choose to spend only a portion of wage income, then capitalists cannot recapture all expenditures on the wage bill through sales of consumption goods to workers. In this case, a portion of expenditures by capitalists on aggregate output will be required just to recover labor costs. Thus, if workers save, only a portion of capitalist purchases
will generate profit income. However, if the savings of workers are somehow returned to capitalists, the wage bill can be covered by worker consumption plus worker saving.

One of the methods of returning saved wages to capitalists is to sell nonproduced goods to workers. That is, capitalists can recapture the portion of the wage bill saved by selling paper and other nonproducibles (which we can assume require no wages in their production) to workers. Thus, by selling shares, bonds, or other nonproducibles to workers, “saved” income is returned to capitalists to cover the original expenditures on wages required to produce aggregate output.

Capitalist expenditures on output can be classified as consumption or investment (capital accumulation), either of which will generate profit income since these are expenditures in excess of the wage bill (assuming that all the wage bill has been returned to capitalists). Capitalist spending on nonproducibles (paper, such as shares or bonds) must also generate profit income. On the other hand, capitalist “nonspending” or “saving” clearly cannot generate income if it takes the form of hoards of money income.

In short, a capitalist economy is one in which spending by capitalists determines worker income as well as capitalist income. In turn, capitalists can recover wage costs only if workers can be induced to spend all their income on consumer goods or on nonproducibles (“paper”) offered by capitalists. Finally, any attempt by workers or capitalists to “not spend” must reduce capitalist income by the same amount, unless there are others who compensate for this nonspending by spending more than their income—that is, by deficit spending.

Given that all income is a result of spending, income in this period can exceed income of the last period only if spending this period is greater than spending of last period. This means, of course, that the growth of spending between the two periods must be deficit-financed. Thus, in the absence of nonspending (that is, if all capitalists and workers spend all received income on producibles and nonproducibles), “net” deficit spending must generate income growth. In a capitalist economy, deficit spending fulfills two functions: it compensates for nonexpenditure of income, and it allows economic growth.

All spending must be financed. Since income is generated by spending, income cannot be the ultimate determinant of spending. In an economy that is not growing, worker income (wages) and capitalist income (profits) can finance expenditures on final goods and services (investment and consumption). This is J.M. Keynes's notion of the “revolving fund of finance” in which income spent returns to the re-
volving fund to finance a constant level of spending [Keynes 1973, p. 208]. However, this does not explain the source of these incomes—which must have been generated by spending. It is the spending by capitalists, primarily during the production process (and primarily on the wage bill) that generates the income to be spent on final output.

It is simplest to begin with the assumption that capitalist expenditures on wages (and other production costs) are financed through short-term credit. In reality, some portion of expenditures by individual capitalists will be financed internally by sales receipts. However, the "genesis" of these internal flows can only be explained by credit creation since all incomes were initially generated by spending—which had to be financed. Thus, we may assume that all spending during the production process is financed through short-term loans, created as banks issue money, which can be retired at the end of the production process when goods and services are sold. As discussed above, capitalists can recapture all production costs (and thus retire short-term loans) as long as all generated income is spent.

Actually, a large portion of these short-term credits is likely to be rolled-over (or renewed) at the end of each production period so that capitalists may engage in production again. Thus, outstanding short-term debt provides the revolving fund for finance of the circular flow of production. The stock of outstanding credit money at any point of time represents, for the most part, the number of short-term loans that have not been retired.

As discussed above, some portion of capitalist expenditures on final output will be on investment goods so that capitalists can accumulate capital. Production of investment goods must generate sufficient income received by capitalists to purchase these goods (as long as all expenditures on the wage bill return to capitalists). However, it is extremely unlikely that this income will be received by those who wish to accumulate the specific goods that have been produced. Normally, the investment goods purchaser has received only an infinitesimal portion of this income, so will have to fund the purchase by issuing debt. One possibility is that the purchaser can sell paper to those capitalists who have received the generated profit income. This requires that these capitalists who have received profit income in the form of short-term credits (used by the investment goods producer during the production process) are willing to exchange them for the paper issued by the investment goods purchaser. In this case, the short-term credits can be retired as long-term paper is substituted. The "savings" of capitalists who purchase paper (rather than produced output) "fund" the investment
goods purchase. It is clear, however, that these “savings” were generated by the production of the investment good. Thus, capitalist profits and saving merely represent the “pecuniary accountancy of investment” [Ranson 1983, p. 906].

Alternatively, the capitalists who received the profit income may refuse to buy the long-term paper, preferring instead to hold the short-term credits. In this case, the “savings” cannot fund the purchase of the produced investment good. However, if intermediaries develop who issue the sorts of short-term credits preferred by savers and willingly take-up the long-term paper sold by investors, then investors will be able to fund their purchases. It must be made clear that the “savings” are generated by the short-term credits that initially made production of the investment goods possible. To the extent that savers do not want to fund purchases of the produced investment goods, however, intermediaries must step in. In a sense, the quantity of outstanding short-term credits (“money”) is also a measure of the willingness of intermediaries to take up paper, as well as a measure of the unwillingness of savers to do so (that is, a measure of the liquidity preferences of savers and intermediaries).

*Can Saving Promote Investment?*

Of course, the savings of workers cannot be an additional source of funding for the purchase of investment goods. If workers save, then capitalists cannot cover all production costs through the sale of consumption goods to workers. In this case, some of the expenditures of capitalists will be required just to meet production expenses, so that profit income will fall short of capitalist expenditures on final goods and services. Thus, the “savings” (or profits) of capitalists will not be sufficient to fund the purchase of final investment goods. However, if workers can be separated from their liquid savings (held in the form of credit money) by being induced to purchase long-term paper, the investment goods can be funded through the combined “savings” of workers and capitalists. If, on the other hand, workers prefer to hold savings in the form of short-term credits, capitalists will be faced with a situation in which some of the consumption goods cannot be sold, some production costs cannot be recovered, and some investment goods purchases cannot be funded. This problem can be solved only by selling consumption goods to capitalists and by selling paper to intermediaries. Even in this case, the problem is not fully “solved”, since profits will be reduced by the amount of worker saving.
A high propensity to save by workers necessarily makes it more difficult for capitalists to recover production costs through the sale of consumption goods. However, a high worker propensity to purchase paper out of saved income will allow capitalists to recapture expenditures on the wage bill, even if workers save. The question is this: would capitalists prefer to sell consumer goods or paper to workers? Are the "animal spirits" of capitalists better stimulated by sales of consumer goods or by sales of paper?

There are two main reasons to believe that sales of consumer goods are more likely to be stimulative than are sales of nonproducing. First, worker income is generated by production, so worker saving (purchases of nonproducing) must represent inventory accumulation (or falling prices of consumer goods). Unless capitalists had desired rising inventories, this will depress future production. Second, the sale of paper to workers normally establishes a continuing commitment that the sale of consumer goods does not. When workers buy consumer goods, they are permanently separated from their income. However, when workers "save" by purchasing shares, bonds, or other paper, firms are committed to making dividend or interest payments—and may have to repay the purchase price on some specified date. Given the uncertainty about the future a firm faces when selling paper, it must be assumed that firms will usually prefer to sell consumption goods (whose cost of production is known) rather than engage in a commitment to make payments in the uncertain future. That is, we assume that firms prefer the liquid position that results from sales of consumption goods over the illiquid position resulting from sales of paper. Furthermore, it must be remembered that the sales of new paper to capture worker saving merely represents the "pecuniary accountancy" of inventory accumulation (or falling prices of consumer goods). Thus, it must be presumed that capitalists are better situated if workers consume, rather than save, even if all savings are used to buy paper.

Alternatively, we might assume that workers don't save, but that capitalists have a high propensity to save. If this means that they won't purchase consumption goods, then all consumer goods must be sold to workers to prevent inventory accumulation. (This, in turn, means that the prices of consumption goods must be low enough that wages can purchase all of them.) If all capitalist savings are used to buy investment goods (either directly, or indirectly through the purchase of paper issued by purchasers), then all the produced investment goods will find funding. If, however, some portion of savings is held in liquid form (in the form of short-term credits), than a portion of the investment goods
will not find funding. Again, intermediaries might step in to allow sav-
ers to remain liquid by buying the paper required to fund investment
goods purchases. In any case, capitalist saving cannot help fund in-
vestment if it takes the form of hoards of short-term paper, but a high
propensity to save in the form of purchases of investment goods or
long-term paper issued by investment goods purchasers does help fund
capital accumulation. Again, however, these savings must be generated
by the spending that is financed initially through short-term credits.

*Deficits, The Multiplier, and Growth*

There is one final area that must be analyzed: the relation between
economic growth and deficit spending. The Keynesian multiplier story
may be a useful pedagogical device, but it is entirely misleading as an
explanation of income growth. In this scheme, investment spending
raises income until saving rises to equality with the higher level of in-
vestment. Thus, investment creates the saving that is necessary to fund
it. There are two problems with the story: first, investment and saving
are always equal, so their equality cannot require the operation of a
multiplier process that takes time. Some have argued that the multi-
plier must, therefore, operate instantaneously. This is less than satisfy-
ing. Second, the story ignores the initial finance of investment
spending, which is necessary until the saving has been generated by the
spending. Again, this problem can be solved, albeit unsatisfactorily, by
arguing that the process is instantaneous.

A better approach, as Moore suggested, is to drop the multiplier and
to admit that all spending must be financed [Moore 1990]. In a circular
flow of given size, as long as all income is continually returned to the
circular flow, spending and income are equal and constant. In such an
economy, one could argue either that spending determines income or
that income determines spending, for if we ignored how that particular
flow was initially determined, it really makes no difference. A large
flow, however, is made possible only by deficit spending. This deficit
spending will then raise income. The casual connection is thus made
clear: it is spending that must determine income.

Each act of deficit spending must generate a surplus elsewhere, if for
no other reason than the necessity of keeping aggregate balance sheets
straight. Any given size of circular flow of spending and income can be
associated with a variety of levels of deficit spending. For example, we
might compare two societies, one in which each individual spends all
income received and the other in which no one who receives income
will spend. In the first society, there will be no deficits and no surpluses. In the second, all spending must be deficit financed. These two societies might have the same levels of aggregate spending and income, even though they have very different levels of deficits, surpluses, and saving. Note, however, that neither society is growing.¹⁸

In order for the first society to grow, it must engage in deficit spending because spending that is constrained by income must be static. In this case, deficit spending is a necessary and sufficient condition for (nominal) income growth. In the second society, although deficit spending equals aggregate spending, all deficits merely represent "intermediated" spending: those who receive income lend it to those who spend. This is the sort of society orthodoxy has in mind, in which financial institutions intermediate between savers and investors. Clearly, however, this society cannot grow on the basis of intermediated saving. Growth is made possible only by deficit spending that is not intermediated spending—that is, by deficits which are not constrained by prior saving. I will call this "net deficit spending," for want of a better term. Net deficit spending must, of course, generate surplus balance sheets elsewhere. At the same time, it must generate growth of income and spending at the aggregate level. In summary, deficit spending is a necessary, but not sufficient, condition for growth. Only net deficits lead to growth.

Thus, a decision to engage in deficit spending that is not matched elsewhere by a decision to reduce spending must generate growth. How can this deficit spending be financed? It can only be financed by net credit creation—not by intermediation. Intermediation can occur only after the deficit spending has raised income and generated surpluses. Intermediation is never a source of economic growth; only credit creation can generate growth. On the surface, it may appear that releases of money hoards can also generate growth. A release of hoards may represent the purchase of paper issued by those who want to deficit spend. However, hoards represent the surpluses received as others used deficit spending in the past, and so represent debts that have not been retired. Thus, intermediation of released hoards cannot be the source of sustained growth.

Neoclassical economists begin with a fixed level of income. A shift out of consumption and into saving allows for more investment and supposedly generates growth. While this might work in a corn society, it cannot work in a capitalist economy. In capitalist societies, declining consumption must lower profits. Even if the fall of consumption is matched by rising investment, profits and aggregate income are (at best) merely restored to previous levels. Thus, in a capitalist economy, the
process must work as follows: 1) Banks *create* short-term credit to increase purchasing power (intermediation merely transfers a given level of purchasing power across individuals); 2) The short-term credit finances the wage bill so that investment goods can be produced; 3) Expenditures by workers in the investment goods sector on consumption goods create surplus income received by consumption sector capitalists; 4) This surplus income may be used to purchase the produced investment goods directly, or may be intermediated through the financial system as those who receive surplus income loan it to those who purchase the investment goods (so that investment is funded on the basis of long-term debt); 5) If the purchases of consumption goods by workers generate additional production in the consumption goods sector (the "multiplier effect"), this must also be financed through the creation of short-term credits that can be retired when the additional goods are sold.

In a capitalist society, production decisions rest primarily with capitalists. Their decision to spend on employment in the consumption sector and the investment sector will determine incomes: Under the simplifying assumptions that workers don't save and capitalists don't consume, spending on investment sector workers determines capitalist income while spending on consumption sector workers determines worker consumption. In reality, most investment goods are produced on order, so the decision to invest is also a capitalist decision to save. Worker saving can never be beneficial, since it necessarily lowers revenues from the sale of consumption goods. Investment is more likely to be stimulated if workers never save.\(^{19}\)

*Profits From Production, Paper Profits, and Instability*

There has been a long running debate over "productive" versus "unproductive" spending, which has been renewed in a recent concern with the transformation of the U.S. economy to a "casino" society in which speculative behavior has replaced "productive" investment.\(^{20}\) An understanding of the working of the capitalist system will help to clarify the issues.

As Keynes argued, the sole goal of capitalist production from the perspective of capitalists is "to end up with more money than it started with" [Keynes 1979, p. 89]. When there are alternatives to production for earning profit, capitalists need not engage in production. Profits can be generated by capitalist purchases of producibles or nonproducibles—capitalist spending on anything other than the wage
bill in the consumption goods sector necessarily returns to capitalists as profit. For this reason, the national income accounts, which focus only on spending on producibles, can be misleading. Capitalist purchases of Rembrandts, real estate, or paper also must generate gross profit, and if these purchases represent net deficit spending, they will increase aggregate profits. I will call profits resulting from purchases of nonproducibles "paper profits."³¹

Net deficits used to finance purchases of nonproducibles will lead to growth of capitalist income. There is nothing within the workings of the capitalist system that guarantees that credit is created only to finance production. While there have always been admonitions regarding the practice of loaning for such purposes (such as the Real Bills Doctrine), financial innovations have continually expanded the types of activity that are deemed acceptable.³² Thus, in the current period, credit is freely extended to finance speculative booms in the prices of everything from real estate to stocks to foreign exchange futures.

Credit created to finance purchases of nonproducibles can lead to a speculative boom of the prices of such assets. As long as new flows of spending are continuously entering the market for paper, prices of assets will continue to rise and reward speculation. As long as the boom continues, speculation generates income. However, given that the boom can continue only as long as new spending on nonproducibles generates new income (rewarding the speculation by creating paper profit), it will come to an end as soon as spending stops rising. Every speculative boom will end, although the timing of the end is unpredictable. As soon as spending falls, prices and income fall.

Although there are no automatic mechanisms to ensure that capitalist activity is directed toward production, the inherent instability of speculation drives capitalists back to the productive sphere in search of profits. The productive sphere is made more stable by the spending habits of workers. Workers must spend most of their income to acquire the necessities of life—through the purchase, primarily, of producibles. Advertising and the propensities of conspicuous consumption and pecuniary emulation help to ensure that even if wages are in excess of the income required to satisfy biological necessities, workers will still spend most wages on producibles.³³ It is this consumption behavior of workers that "grounds" capitalist economies by imparting stability to the production of consumer goods. This production, in turn, requires capital and so imparts some stability to capitalist purchases, also. Thus, because workers do not "save" (hoard or purchase nonproducibles) much of their income, capitalist activities are forced into the produc-
tive sphere precisely because of its relative stability. The greater the worker propensity to save, the less the capitalist orientation toward production.24

Joan Robinson once asked what would happen if robots replaced labor [Robinson 1962, p. 19]. When the wage bill falls to zero, all capitalist spending will represent profit since costs of production will fall to zero. Capitalist spending on consumer goods would represent the only spending on consumption, and would generate an equivalent amount of profit income. Additional profit income would be generated by capitalist purchases of investment goods and by capitalist purchases of nonproduibles. Given the small scale of production of consumption goods, profits from capitalist consumption and capitalist purchases of investment goods would have to be small. Thus, most profits would come from nonproduibles, and would fluctuate widely as a result of speculative activity. Without the stabilizing influence of worker consumption, this society would cycle between boom and bust due to "whirlwinds of optimism and pessimism." There is no reason to believe that capitalists would be better off if the wage bill could be reduced to zero, for their profits would have to come largely from speculation in a "casino" society.

The stability of the marginal propensity to consume out of the wage bill in the consumption goods sector helps to ensure that capitalists can recover costs of producing consumption goods, while the necessity of using capital to produce consumption goods together with the stability of the marginal propensity to consume out of the wage bill in the investment goods sector ensures profit income. To the extent that workers are convinced that they should abstain from consumption, capitalist incomes are jeopardized and the system becomes more unstable as capitalists are forced to look for profits in nonproduibles.25 However, as the market for nonproduibles is inherently unstable, it can suddenly become unprofitable. This forces capitalists back into the productive sphere, which is more stable due to the stabilizing nature of worker propensities. Profit "maximizing" behavior of capitalists is necessarily destabilizing, but the consumption behavior of workers is stabilizing.

*Speculation and Reaganomics*

Reagonomics shifted the dynamics of the U.S. economy away from the relative stability created in postwar society and toward the casino society. The postwar institutions and government activities that helped to increase stability included: 1) various measures that would direct
capitalist efforts toward the production of consumer goods, including a redistribution of income from rich to poor, establishment of the "welfare state" (unemployment compensation, poor relief, social security), the development of scientific methods of control of consumer behavior by "megacorps," expansion of consumer finance, and growth of union power; and 2) constraints placed on speculative behavior, including a progressive income tax and a capital gains tax, countercyclical government surpluses (which would reduce profits during a boom as the budget moved to surplus), and regulations placed on the financial system (separation of investment banking from commercial banking, supervision of bank balance sheets, regulation of interest rates). Furthermore, the air of financial conservatism that normally follows a general debt deflation, such as that experienced during the 1930s, as well as the "robust" balance sheets that resulted from government deficit spending during World War II, also contributed to the stability of the postwar period [Minsky 1986; Wray 1989].

All of this began to change by the mid-1970s, and the degeneration to an economy based on speculation accelerated with the implementation of Reagonomics. Falling real wages, redistribution of income from poor to rich, tax cuts for the wealthy, diminished social spending, rising social security taxes (and the accumulation of a huge social security trust fund), deregulation of financial institutions, financial innovations, and attacks on unions all reduced the profitability of production relative to the profits to be made in speculation. Deregulation of interest rates and tight money policy pushed interest rates to record levels, rewarding those who bought paper ("saved"). The government created tax advantages to reward those who saved, and reduced capital gains taxes to reward speculative behavior. Exploding government deficits generated profits and fueled the "longest peacetime expansion of U.S. history" [Wray 1989]. The spirit of "anything goes" made heroes of the likes of Michael Milken.

In this atmosphere, saving and speculation became the favored activities, while productive activity was scorned and consumption was viewed negatively (particularly consumption by the lower classes—the conspicuous consumption of the wealthy was never seriously challenged). We were told that the virtuous sacrifice consumption in order to save, and are rewarded with interest income and tax breaks. High interest rates and the development of auction-like money markets shifted the source of income away from productive activities and toward speculation, and away from wages and entrepreneurial income and toward interest income. Retirees became adept players in finan-
cial markets, shifting their liquid wealth in search of the highest possible returns. Professional money managers took control of pension funds, and computer-program-generated decisions could instantly cause a boom or bust in the price of an asset. Thus, the "high consumption form of capitalism of postwar society was replaced by "money manager capitalism," characterized by huge volumes of financial wealth continually on the move in search of interest income and short-term asset appreciation.

Where saving and speculation are held in high esteem, instability necessarily follows. As Keynes argued, "[w]hen the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" [Keynes 1964, p. 159]. To the extent that households followed the advice of their President and responded to the incentives to save, speculative activity was rewarded and industry suffered. Of course, an attempt to increase saving will not raise saving as measured in the national income accounts. In the income accounts, reduced spending resulting from attempts to save must lower income. In the flow of funds accounts, more paper assets will be purchased by those trying to save, but these will be exactly offset by necessities borrowing. Since the flow of funds accounts subtracts the increase in household debt from the increase in financial asset holdings to obtain figures for household saving, there would be no reported increase in national saving to the extent that the debt is issued by households. However, if firms faced with rising inventories must issue more debt to finance them, and if this is purchased by household savers, then savings as measured in the flow of funds accounts will increase. (This probably accounts for some of the divergence of national income accounts saving from flow of funds saving, as reported in Block [1990].) Thus, an increase in the propensity to save will not increase flow of funds saving if the necessities borrowing is undertaken by households, but will show up as flow of funds saving if the borrowing is undertaken by firms. No matter who does the borrowing, however, an increase of the propensity to save (even if measured saving is unaffected) will shift spending away from producibles and toward nonproducibles: consumption sector firms are faced with unsold inventories even while the market for nonproducibles booms. If speculators enter secondary markets and use net deficits to fuel the boom, capital gains can be realized. (Again, capital gains will not show up in national income accounts unless they are used to buy producibles, or in flow of funds accounts unless they show up as net household purchases of assets.) This fuels speculation and further diminishes productive activity.
We have moved closer to the sort of society analyzed above, in which those who receive income do not spend, so that those who do the spending must borrow. This, by itself, would not necessarily lead to less spending. However, due to the existence of "lender's risk" and "borrower's risk," the types of activities that can be deficit financed are limited. When one borrows to purchase an asset, the expected return must be greater than that which would be required if one used internal funds, due to the risk of bankruptcy. Similarly, the lender must incorporate a premium to cover default risk. This means that the risk premium is double-counted when borrowed funds are used to buy assets, which also means that assets purchased with borrowed funds must carry higher expected returns than assets purchased with internally generated funds. As society moves toward the type of economy in which most assets are purchased with borrowed funds, prospective returns must rise. Unless the returns to productive activity rise as fast as those of speculative activity, profit-seeking behavior will be directed toward the "casino."

However, income redistribution has tended to reduce the amount of consumption that can be financed out of worker income, so has tended to lower the amount of profits to be made from productive activity. Furthermore, to the extent that some households had to rely on consumer debt to maintain living standards in the face of falling real wages, consumer spending in the future will be cut once a point of "credit saturation" is reached. At the same time, consumer deficits lead to the creation of financial assets that can be traded in secondary markets, becoming the object of speculative activity. Thus, falling real wages and the redistribution of income from poor to rich and from wage income to interest income contributed to falling consumer demand, which could only be offset by rising consumer debt. As soon as consumers stop borrowing, the incentives to engage in productive activity must fall.

This effect is enhanced where deregulation of interest rates, tight money policy, and high competition in money markets have raised interest rates. A market interest rate of 15 percent may not reduce borrowing, but will channel borrowed funds only into those markets that can earn returns greater than this. One must be very careful about the use of profit rates voluntarily reported by firms, but the average profit rate (before tax profits as a percent of sales) reported by manufacturing firms during 1988 was only 8.3 percent, while the return on equity (before tax profits as a percent of owner's equity) was only 3.7 percent. In contrast, the Moody Baa bond rate averaged nearly 10.2 percent, and
the return in the stock market (price increases plus reinvested dividends) was 16.5 percent in 1988. Given a yield on bonds that was nearly three times the return on equity, it is probably safe to conclude that the "profits to enterprise" did not compare too favorably with "rentier" yields. Furthermore, the run up of stock prices certainly had more to do with speculation than with the profitability of the underlying firms.

What is the solution to the current stagnation of the productive sphere? The economy must be reoriented toward production, which requires a high consumption society. This, in turn, requires a combination of policies to redistribute income toward the poor, to shift the source of income away from interest and toward wages and entrepreneurial income, to reduce the rewards to speculation, to deregulate the financial system, and to raise the capital gains tax. Increased social spending and increased progressivity of income taxes would help. Payroll taxes should be reduced: the Social Security trust fund should be eliminated because it acts as a huge leakage of potential consumption. Low interest rates would not only encourage "enterprise," but would also reduce the incentive to engage in socially disruptive "saving." This would help to rectify the "investment shortfall" and would also increase saving as measured in national income accounts and in flow of fund accounts—which would allow the hysteria about the national saving rate to subside.

Notes

1. A number of good articles on the relation between saving and investment, however, have appeared in previous issues of the Journal of Economic Issues. See, for example, William Dugger [1984], Louis Junker [1967], Gladys Foster [1987, 1990], and Baldwin Ranson [1983]. In addition, see the following articles from the Journal of Post Keynesian Economics: Paul Davidson [1986], J.A. Kregel [1984-85; 1986], and Andrea Terzi [1986-87]. Also, see L.R. Wray [1988; 1989].

2. See Paul Davidson for a discussion (and criticism) of modern "Mercantilist" policies, which purposely restrain domestic living standards to promote export-led growth [Davidson 1988].

3. William Greider argues that real interest rates in the US during the 1980s were ten times higher than those of the period 1950-1980, and averaged three to seven percentage points higher than those of Japan during the 1980s [Greider 1989].

4. We need not, however, view the Reagan years as a period of anything close to full capacity utilization. The peak capacity utilization rate reached during the 1980s was lower than 84 percent. Indeed, the average capacity uti-
lization rate of the 1980s was lower than that of the sluggish 1970s. (Source: *Economic Report of the President*, 1990.)


6. The distinction between a “barter” or “real” economy and a “monetary” economy is made by J.M. Keynes [1979, p. 66]. Thorstein Veblen distinguished between “industrial and pecuniary employments,” and argued that the pecuniary institutions of capitalism dictate pecuniary employment. [Ranson 1983, p. 905] In other words, the goal of capitalist production is not to provide the “continuing factors” (including the means of production) required by the community, but to obtain pecuniary rewards. Sometimes the capitalist does supply the continuing factors as a means of obtaining profits, but “the accumulation of funds and the growth of real capital are different processes, either one of which may occur without the other” [Walker 1980, p. 653]. In a capitalist economy, as opposed to a corn economy, technical productivity (or the gifts of nature) has nothing to do with the generation of profits. Profits arise solely from the pecuniary activities of capitalists, which are only sometimes directed toward real capital accumulation. Technological considerations are, at most, important only for the distribution of a given quantity of aggregate profits among capitalists. Of course, other variables, such as market share, slick advertising, and luck also play important roles in the distribution of profits. However, none of these has anything to do with the generation of aggregate profits, which is determined solely by capitalist pecuniary spending.

7. As William Dugger notes, the vast majority of private saving takes the form of business saving, and most personal saving is used to purchase housing [Dugger 1984]. Thus, it is not unrealistic to accept the “classical” assumption that workers do not save. However, I will relax this assumption below.

8. I have ignored profits in the investment goods sector. These can be generated by investment sector firms that add a markup to the price of investment goods over the wage bill. In this case, the spending by capitalists in the consumption sector on investment goods will generate profits (equal to the markup) in the investment sector. Thus, it is still true that expenditures on investment goods generate an equivalent amount of profits, but the profits will be greater than the wage bill in the investment sector. Henceforth, I will ignore profits in the investment sector merely to simplify the analysis.

9. I am assuming a closed economy with a balanced government budget. As is well known, in the more complicated economy, net exports and government deficits generate equivalent profit flows.

10. If saving out of wages is negative (that is, workers spend more than their income), profits are increased. As Warren Gramm argued, the development of consumer debt has been a substitute for rising wage shares to keep consumption high [Gramm 1978]. At the same time, since consumer spending that is deficit financed represents capitalist income that was not incurred as a cost (that is, it is not part of the wage bill), it must represent profit.

11. I will more carefully define what I mean by “net deficits” below.
12. It should be emphasized that capitalist expenditures on investment and consumption generate profits in nominal terms. This does not necessarily mean that they have higher real incomes or greater real stocks of capital or consumption goods.

13. Dugger and Alfred Eichner emphasize that the "megacorp" (oligopolist with substantial market power) sets prices at a level sufficient to generate profits that can be retained to finance investment projects internally [Dugger 1984; Eichner 1976]. While this is certainly true for the individual firms, the source of the retained profits is clearly the externally financed spending of other capitalists. (In the aggregate, you can spend less than your income—that is, accumulate a surplus—only if I spend more than mine.)

14. In this process, the investment goods purchaser issuing paper and receives the short-term bank liabilities formerly held by "savers." The bank liabilities then flow to the investment goods producer, who may retire short-term bank debt.

15. This, by the way, could be called low liquidity preference. While the marginal propensity to save is irrelevant for funding investment, the degree of liquidity preference is important.

16. There is a third possibility: firms could sell existing assets to workers, such as financial assets, real estate, or old masters. Thus, rather than issuing new liabilities, capitalists relinquish part of their portfolio. In this case, they do not commit themselves to future payments—they merely reduce their stock of nonproducing goods and obtain money (which will be equal to the value of inventory accumulations of unsold consumer goods if they have captured all worker "saving").

17. That is, if capitalists save, then low liquidity preference of capitalist savers is necessary so that investment can be funded out of capitalist saving. Alternatively, financial intermediaries with low liquidity preference can come between capitalist savers and investors. Finally, we might assume that neither capitalists nor workers want to save—all generated income is consumed. In this case, production of investment goods generates income, which is received as profits by capitalists, but no capitalist is willing to use this income to directly purchase the produced investment goods or to purchase paper issued to fund investment goods purchases. Clearly, this sort of society would be strange: all incomes would compete for consumer goods, driving up their prices. However, no produced investment goods could be sold, so their production would eventually be halted. At this point, capitalist profit income would fall, and would depend entirely on capitalist consumption. No capital would be accumulated by capitalists, who would eventually be exterminated as a class. Even though aggregate demand for consumer goods was high, no capitalist would be willing to purchase investment goods in order to expand production of consumer goods. As the investment goods in the consumption goods sector depreciated, they would not be replaced. Eventually, the production of consumer goods would collapse despite high demand. The lifespan of this society would be short. Ironically, this is similar to the sort of society analyzed by neoclassical economists in which Robinson Crusoes barter to obtain consumer goods. In real capitalist economies, the function of the capitalist is to amass capital in order to increase profit income, rather than to barter in order to consume.
18. While all deficits must generate surpluses, they will not necessarily generate saving as measured in the national income and product accounts or in the flow of funds accounts. The flow of funds accounts only measure net accumulations of assets by households, subtracting new debt from total assets purchased. Thus, even in society number two (where all income is “saved” and loaned to those who do the spending), measured saving would be zero. On the other hand, the national income accounts measure saving as a residual (income less consumption)—so saving would be positive only if some of the spending were on nonconsumables.

19. It is often argued that worker saving can be beneficial if the economy is at full employment. This is false for monetary economies, for it is equivalent to arguing that capitalists would be better off if they were unable to sell some portion of produced goods. Since worker incomes are generated (for the most part) during the production process, capitalists can recapture wage bill costs only if workers do not save—and this is just as true of an economy operating at full employment as it is of one with substantial unemployment. However, at full employment the way resources are directed to the production of investment goods rather than consumption goods is through the markup of consumption goods prices over the wage bill in the consumption goods industry. This ensures that wages in the consumption goods industry are too low to buy all consumer goods, so that workers in the investment goods sector will be able to obtain consumption goods. However, it is always necessary for all wages to be returned to capitalists in the consumption goods industry in order to cover the total wage bill.

20. There was a recent debate in the Journal of Post Keynesian Economics about “paper profits” versus “material profits,” however, paper profits were defined differently than I will define them. In this debate, paper profits were defined as those profits that arise from government deficit spending and net exports, while material profits are generated by investment spending and capitalist consumption. See Peter Erdos and Ferenc Molnar [1980] and the critique by A. Asimakopoulos [1983]. Asimakopoulos argued that their distinction is erroneous; I concur. Also see Seymour Melman [1983] for an analysis of the shift to “profits without production”—high profits in the presence of a collapse of production and a disintegrating infrastructure.

21. Clarence Ayres distinguished between the accumulation of real capital and money funds, and argued that those processes that lead to accumulation of money do not necessarily lead to the accumulation of real capital. Indeed, Ayres believed that capitalist institutions act as impediments to the accumulation of real capital. See Ayres [1946] and Walker [1980]. As discussed above, Vehlen also distinguished between “pecuniary and industrial employments,” and Keynes distinguished between “speculation and enterprise” See Veblen [1961], Keynes [1964], and Ranson [1983].

22. Hyman Minsky [1980] argued that financial innovations expand the types of activities that may obtain funding, increasing the supply of credit and raising the prices of financial assets. Thus, financial innovations are partially responsible for generating speculative booms. Indeed, financial innovations sometimes create the financial assets that become the instruments of speculation.

23. J.R. Stanfield and J.B. Stanfield emphasized that invidious comparison generates an insatiable desire for accumulation of goods [Stanfield and
Stanfield 1980). If the objective of consumption is to consume more than others, wants can never be met. They argued that the purpose of advertising is to inculcate an ideology of consumption—consumption for consumption’s sake. The average American is exposed to 1600 advertising messages daily as modern corporations use scientific methods of consumer control [Stanfield and Stanfield 1980, p. 443]. Through these methods, modern corporations efficiently separate workers from their incomes.

24. As I will discuss below, consumer debt also helps to generate profit. Net deficits by worker households increase capitalist income. While consumer debt grew rapidly during the mid-1980s, most of this represented deficit spending by some households, which was matched by surplus spending of others. In this case, capitalist income is not increased. Indeed, if the debt load of some households becomes too great, the net effect might be a reduction of future capitalist income because burdened households might cut consumption in an attempt to reduce outstanding debt.

25. As I will discuss below, the return in the stock market during 1988 averaged 16.5 percent—a return that was presumably above that on real capital. This would tend to encourage speculation rather than enterprise. See Fred Block [1990].

26. The top marginal tax rate fell from 90 percent in 1960 to only 28 percent by 1986. The capital gains tax was 45 percent in the 1950s and fell to 20 percent during the Reagan administration before being raised to 28 percent in 1986. However, it must also be noted that half of realized capital gains could be excluded from the capital gains tax until 1978, after which 60 percent could be excluded (until 1986, when all realized capital gains became taxable). All data were obtained from John Miller and James Goodno [1990].

27. Minsky argued that the high interest rates of the late 1970s generated the explosion of the money market funds [Minsky 1980]. High returns were available in the money markets without sacrificing liquidity. However, as these funds are not explicitly guaranteed by the government, they may be subject to runs.

28. Albert Wojinilower argued that deregulation of interest rates combined with de facto government guarantees of most financial instruments lead to the creation of “auction-like” money markets in which interest rates are determined by supply and demand. [Wojnilower 1987]. Savers put their funds into the instruments that pay the highest rate without regard for the riskiness of the instruments, since it is assumed that the government will always intervene to prevent default. At the same time, auction markets free borrowers from the credit rationing that was a normal feature of the postwar financial system. Instead, borrowers are only “price rationed,” which Wojnilower believes is ineffective. (He has argued that there is a natural propensity to borrow excessively.) He concluded that auction markets in the financial sphere are inherently unstable and called for a return to a system based on credit rationing.

29. The share of personal income received as net interest rose from only 7.17 percent in 1965 to 14.21 percent by 1988 [Wray 1989, p. 986].

30. Minsky has described the transition to “money-manager capitalism” as a result of the phenomenal accumulation of a vast quantity of financial
wealth in the form of pension funds, insurance funds, money market mutual funds, and bank-managed trust funds [Minsky 1989]. This wealth is managed, for the most part, by professional money managers in pursuit of short-term asset appreciation and short-term yields. These professionals “actively” manage the funds, quickly shifting to any asset that is expected to offer higher returns.

31. Warren Gramm argued that consumers are nearing “credit saturation,” a point beyond which they will no longer be willing to issue debt in order to finance consumption [Gramm 1978]. When this point is reached, the economy will stagnate. Consumer debt was developed as an alternative to redistributing income toward wages in order to maintain high levels of consumption. Consumer spending financed through debt raises the cost of consumer goods (due to the finance charges) and reduces discretionary spending. In some cases, firms actually earn a larger share of their total profits from the finance charges rather than from the sales of the consumer goods. In the absence of debt-financed consumption spending, stagnation would result from chronic under-consumption caused by an insufficient share of national income going to wages.

32. Daniel Fusfeld argued that the market interest rate has been three to four times higher than the real return on capital. Investment in real capital could occur in such an environment only because it was expected that continued inflation would lower the real debt burden [Fusfeld 1980]. Given the fall of inflation since 1983, continued high market interest rates would tend to depress investment more than they would have in the late 1970s when inflation was much higher.

33. The estimate for the return in the stock market is from Block [1990], while all other data are from the Economic Report of the President, 1990.

34. Gramm also calls for a high consumption society for the “mature” phase of capitalism [Gramm 1978].

References


