CHAPTER FIVE

NEW DEVELOPMENTS IN ECONOMICS AND THEIR IMPACT ON THE THEORY OF PROFIT
The Great Depression of 1930's distorted the image of a self adjusting competitive system with which nothing could be wrong for very long. What compelled many to doubt the traditional thinking was the stark reality that almost every thing was wrong with the system and it exhibited no signs of return to normalcy unless something was done about it. The rethinking thus forced resulted in great changes in the views handed down to the economists by the classical tradition on money and prices, employment and output, savings and investment, wages and interest and the theory of value and distribution in general, besides the radical changes which ensued in such fields as fiscal policy and state participation in economic activity.

This is not to suggest that the economic theories of John Maynard Keynes and Edward Hastings Chamberlin owed themselves directly to the depression. The genesis of the new ideas can no doubt be traced back to the thinking of their authors and others going back to a period earlier than 1929. But the formulation these ideas got and the wide acceptance they received were greatly the result of the changed conditions.

The theories of monopolistic competition and the 'new economics' of J.M. Keynes were the two outstanding
developments of the thirties. These theories touched the very fundamentals in economics and, taken one with the other, called for a revision of thinking on every subject of some importance. In this study our interest in them is, however, limited. We shall note what these economists have to say on the subject of profit, directly as well as by implication, and what impact they actually had on the theory of profit.
Writing as early as 1926 Piero Sraffa had noted that: 'Every day experience shows that a very large number of undertakings — and the majority of those which produce manufactured consumers' goods — work under conditions of individual diminishing costs .... The chief obstacle against which they have to contend when they want gradually to increase their production does not lie in the cost of production — which, indeed generally favours them in that direction — but in the difficulty of selling the larger quantity of goods without reducing the price, or without having to face increased market expenses'.

This is a far cry indeed from the idea of a competitive equilibrium with firms at the footsteps of increasing costs and perfectly elastic demand curves for the firm's produce, there being no difficulty of selling and no need to face increased market expenses. But, like Marshall's oblique references earlier, the article remained neglected till the point was taken up in the early thirties by its powerful exponents.

perfectly competitive equilibrium (F.H. Knight). In such a state of the economy from which monopoly was assumed away in the first instance and later introduced as a special case to be treated separately and in isolation from the rest of the system, the competitive forces ensured a distribution of the product of industry among the cooperating factors of production according to their marginal productivities. By marginal productivity of a factor was meant the value of its marginal product and it was demonstrated that, under certain restrictive assumptions, the total product was just exhausted by the factorial rewards leaving no surplus and causing no deficit. Led by Marshall, the English tradition dealt with the problem of distribution at the industry level adopting partial equilibrium technique as contrasted to the Walrasian general equilibrium technique which dealt with the economy as a whole seen as comprising individual firms and households. The conclusions, however, were not dissimilar. An industry comprised individual firms, small in relation to the market and competing with one another. No single firm exercised any control over the price; the demand for firm's product was perfectly elastic at the going market price, as all the firms in one industry produced the same product. There was no occasion for selling activity as there was no difficulty in marketing the output of a firm, that output being the greatest the
Central importance amongst monopolistic competition theories must be attached to the contribution of E.H. Chamberlin whose *The Theory of Monopolistic Competition* appeared in 1933. This in no way belittles the contribution of Mrs. Joan Robinson whose *Economics of Imperfect Competition* appeared simultaneously. But Chamberlin's theory has had more to do with the subsequent impact on the profit theory. Another contribution made soon after is that of the German economist H. Von Stackelberg. \(^1\) Pareto's *Manual* had dealt with the subject much earlier but partly due to his failure to fully emphasise monopolistic competition as distinguished from monopoly, and largely due to the predominance of the particular equilibrium approach of Alfred Marshall the swing in favour of the new theory had to await the new contributions in the thirties.

It has been noted above that all the theories of profit propounded hitherto started from the position that there was a certain state of the economy in which profits in the sense of unimputed surpluses did not exist. This state was variously described by the terms General Equilibrium (L. Walras), Static state (J.B. Clark), Circular Flow of Economic Life (J.A. Schumpeter) and the

---

firm found it profitable in the light of its internal conditions to produce. At or near equilibrium output the firm was faced with a rising cost curve which served as a brake on further expansion.

This picture was made realistic by allowing for divergent conditions surrounding individual producers, by admitting indivisibilities, immobilities and inelastic supply of certain factors which accounted for surpluses in the nature of rents and quasi-rents. The enterpriser was rewarded by 'normal profits' which were generally explained in terms of opportunity cost — the highest reward which the organiser of production in one industry could expect in any other employment or enterprise outside the industry. Heterogeneity amongst individual entrepreneurs was looked after by rent of ability.

Profits proper were then shown to arise from dynamic changes, innovation, and uncertainty bearing (largely attendant upon change and development). The argument must by now be too familiar to bear repetition.

As noted above monopoly appeared on the scene as an isolated case. The monopolist exercised a degree of control on supply which enabled him to charge a price
higher than competitive conditions would permit. Monopoly position was held intact by keeping out competitors by artificially created scarcities where natural ones were lacking. Though loosely described as profits it was recognized that the permanent income of the monopolist was of the nature of rent to be imputed back to the scarce factors.

THE IMPERFECT MARKET

The entire argument was controverted by the new theory which destroyed the very image of the economy on the basis of which it proceeded. To begin with, the idea of a perfectly competitive system was declared as not only unrealistic but theoretically inadmissible. Modern economy did not consist of industries comprising firms producing homogeneous products. They produced goods which were close but less than perfect substitutes for one another. The product of an industry was not homogeneous, it was differentiated. As a result the demand curve for each individual producer was not horizontal.

but downward sloping. Each single seller was in a position to manipulate his sales volume by changing his price. Then it was rewarding to persuade the customers by indulging in selling activity to believe that the firm's product was superior to that being offered by its close competitors. This new picture of closely competing monopolists was entirely different both from that of pure competition and of pure monopoly. It envisaged a new significance for the problem of interdependence of various firms. The number of firms within an industry and the relative size of these firms came in for special consideration because of their direct bearing on the issue of interdependence.

With selling costs as a means to manipulate demand so as to increase the total revenue, profit maximisation could no longer be interpreted as a matter only of price-output adjustment. An yet another dimension to this problem was added with the concept of product as a variable. Product variation, with price constant, was a new subject for maximisation principle to apply. Thus there were at least four variables which had to be considered in studying the firm's behaviour in maximising its profit. They were price, product, output and selling cost. Needless to point out that the traditional analysis was seriously handicapped by limiting itself to a study of price-output relations only.
The concept of product differentiation also struck at the very roots of the concept of industry. With homogeneity of product gone, this concept lost its analytical import. Chamberlin sought to replace it by a group of firms producing close substitutes. But it was soon realised, and later exponents like Triffin were quick to point out that the criterion of close substitutability, upheld both by Mrs. Robinson and Chamberlin, cuts across the conventional industries. Chamberlin suggested the additional criterion of technological similarity. But even this criterion is not very suitable where sharp differentiation of product exists and 'has only a very indirect and distant bearing on the comparison of their demand curves .....'1 There may be keener competition between such dissimilar commodities as radio sets and bicycles than between two makes of the same commodity like motor cars. The theoretical problem is that of general competitiveness between goods, and no groupings are useful where substitutability is imperfect all along the line.

Differentiation of the product being the rule rather than the exception the new theory discarded the idea of a no-profit state of the economy. Widespread prevalence of monopoly elements in the circular flow or the static state was established beyond doubt, due to

differentiation of product and the encouragement to selling activity thus afforded. Economic surpluses followed the presence of monopolistic elements in the economy in the manner described below.

Given the usual U shaped average cost curve it is not possible for a downward sloping average revenue (i.e., demand) curve to be tangent to it at the point of minimum average cost. It has to cut it, or to be tangent to it, at some point higher than, and to the left of, the position of minimum cost. The equilibrium output of the firm is indicated by the intersection of the marginal revenue curve and the marginal cost curve, for only then will total profits of the firm be maximum. And 'no matter in what position the demand curve is drawn, its negative slope will define maximum profits at a point further to the left than if it were horizontal, as under pure competition.' Whether the demand curve is tangent to the cost curve at the equilibrium point or cuts it above that point depends on the number of close competitors in the group and is linked up with the problem of 'entry' into the group, which we shall discuss below.

But an equilibrium to the left of the bottom of the U means decreasing costs as output is expanded. There are increasing returns to scale and it will require more than the total product to reward all factors with the

values of their marginal products. It follows that factorial rewards cannot equal the values of their marginal products. At best they can be given rewards equal to their marginal revenue products, which in this case are necessarily less than the values of their marginal products.

If the demand curve is not tangent to the cost curve but cuts it from above, the firm is earning supernormal profits, and the income of the hired factors may rise above their marginal revenue productivities.\(^1\) The rise will depend on the bargaining strength of the factors concerned, and it is limited by the extent of the monopoly profits being earned. In any case, the reward is always less than the value of the marginal product of the factor.

It is possible to force an agent of production to accept a reward less than its marginal revenue productivity if there is monopsony in the factor market — there being only one buyer of that factor. The analysis of monopsony owes itself primarily to Mrs. Joan Robinson.\(^2\)

Thus, in so far as it was still applicable, the marginal productivity theory came to be reformulated in terms of marginal revenue productivity, and the

---

1. Ibid., pp. 181-83.
possibility of monopoly profits was established in all cases other than those of tangency of demand curve with the cost curve. The rejection of *Marginal Value* productivity theory was further necessitated by the fact that it failed to explain the income of the factors engaged in selling activity.  

**PROFITS AND OBSTACLES TO ENTRY**

The level of profit in the individual firm within a group of firms producing closely competing goods depends on two factors:

a) the conditions surrounding the individual firm determining the shape and position of its cost curve; and

b) the number of firms in the group.

If we assume individual cost curves to be identical in shape and position (as Chamberlin does, as an expositional device) we are left with only one factor.

---

If the producers in one group are earning profits that are higher than an outsider can expect anywhere else, the enterprise will attract new firms which will enter the group and share the existing demand with the existing firms, thus shifting their demand curves to the left till they are tangent to the average cost curves. This will leave all firms only the competitive level of normal profits—defined as the opportunity cost of enterprise in the economy. If, on the other hand, those inside the group are earning less than they feel they can get elsewhere, some firms will leave the group, thus making it possible for the remaining firms to expand their sales and reach the competitive level of profits. But all this happens when there are no obstacles to entry into and exit from the group. Given such obstacles, whether natural or man made, the insiders may continue earning supernormal profits or incurring losses for sometime. The 'obstacles to entry are an institutional datum, incapable of being determined by deductive theorising.'¹ In reality demand curves within the group are not adjusted uniformly to a position of tangency to the cost curves. As a result of various obstacles to entry, some (or all) of the curves

¹ Robert Triffin: op. cit., p. 162.
may lie at various distances to the right of the point of tangency, leaving monopoly profits throughout the group and throughout the price system. ¹

The key concept in the 'entry theory of profit', as Triffin rightly calls it, is that of the 'group'. But the concept is not valid, as we have seen above. Differentiation of product with the degree of fineness observed in modern economy, and the fact that goods which are physically very dissimilar may yet be close substitutes of one another in the eyes of the consumer, knock the bottom off this concept.

Chamberlin realised this weakness and has since modified the theory presented above. The modified version does away with the concept of group or industry and does not refer to 'entry'. Writing in 1937 he observes:²

'The enjoyment of large profits by any particular firm is evidently an indication that others by producing close substitutes may be able to compete some of them away. The result may be very simply described without any concept of freedom or restriction of entry, without even the concept of an 'industry': some firms in the economic system earn

---

no profit in excess of the minimum counted as costs, others earn more than this and in various degrees'.

Once the concept of group or industry is shorn of theoretical significance the emphasis on restriction to entry in the explanation of profits becomes pointless. Triffin rightly points out that these profits should be imputed back to those economic factors which are responsible for their accrual. Then he also points out that these surpluses may not accrue to the entrepreneurs, or may not be long retained by them in case they appropriate these surpluses in the first instance. ¹

Thus the monopolistic competition theorists have failed to produce a distinct theory of profit, besides underlining the widespread existence of certain surpluses (of the nature of monopoly rent) in the system.

TRIFFIN'S EVALUATION

Robert Triffin, evaluating these theories in 1941, tries to spell out the salient features of the profit theory as it emerges after the impact of the

new contributions. He examines Chamberlin's 'entry theory' and finds little substance in it, once the concept of industry is discarded. From Schumpeter's emphasis on innovations also only a trail of rents is left in the system. It is in the uncertainty accompanying dynamic changes that the real explanation of genuine profits lies. But this explains only the emergence of profit. Its sharing out or accrual is determined by the institutional arrangements in the economy.

'The distribution of profit among the entrepreneur and the owner varies in each case with the institutional set up governing their mutual relationship and under which production is taking place.'

Triffin proceeds to examine the typical owner-entrepreneur relationships. Of these the case of the owner-entrepreneur is obvious. The property-less entrepreneur on the other hand, who controls, but does not own the enterprise, receives 'wages' which contain a differential element which can be characterised as a part of the profits of enterprise. Of greater interest are the mixed cases combining ownership and control in various degrees. Among these cases he places Knight's entrepreneur — the key concept of his profit theory — who delegates control

1. Ibid., p. 179.
but retains the right of dismissing the controlling manager. ¹

HARROD'S APPROACH

A.F. Harrod, trying to remove 'some confusion' that has arisen 'since the elaboration of the doctrines of imperfect competition'² rightly argues that these doctrines did not and could not prove the existence in the system of a new kind of profit over and above those explained by the uncertainty theory. A monopolistic position is surrounded by uncertainty both in its creation and its continuance. There is, for example, the fear of fresh entry and of changes in rivals' policies, etc. The supernormal profits enjoyed in this case are explained by the element of uncertainty. The whole monopoly element in profits as revealed by the new analysis 'is capitalised when uncertainty comes to an end (more or less), and goes in the form of a capital gain to the original owner who bore the uncertainty'.³

¹. Ibid., p. 184.
³. Ibid., p. 203.
Harrod concludes that 'monopoly profit is not a separate and additional element in the system, but one part of the global reward in the economy for uncertainty bearing'.

Both Harrod and Triffin agree, therefore, that the theories of imperfect competition do not affect the theory that profits arise due to uncertainty. How the surpluses which arise due to monopolistic competition are to be characterised is a problem on which different approaches are possible. On our part we prefer Keirstead's approach who explains them by the uncertainty inherent in an imperfectly competitive situation.

REJECTION OF THE MAXIMISATION 'HYPOTHESIS

One of the offshoots of the discussion on small numbers, interdependence amongst competing firms and differentiation of products, was a new emphasis on limitations of the profit maximisation hypothesis. Interdependence among a small number of firms was seen by Chamberlin as putting a restraint upon the pursuit of

1. Ibid.
profit by the firms because of the possible reaction of rivals to such a policy. In such a situation other objectives like stability and security gain in importance. With the increase in size bigness itself becomes an objective, size being a source of prestige. Various rule of the thumb principles replace the maximisation principle, 'ordinary' or 'reasonable' profits and Full Cost Pricing being amongst them.

Joan Robinson's analysis in the *Economics of Imperfect Competition* proceeds strictly in accordance with the maximisation principle, each firm equating marginal revenue to marginal cost. Writing as recently as 1960 she still regards this assumption a useful starting point, there being no better alternative. At the same time she declares that 'the struggle of a firm to survive and grow cannot be expressed in terms of maximising any precise quantity at a certain moment of time'.

In his *Competition Among the Few* Fellner definitely rejects the simple version of maximisation of profit in favour of maximising 'safety margins' — so far as

3. Ibid., p. 238.
oligopolistic firms are concerned. This he finds necessary because 'profit maximisation in the usual sense is not always the most effective way of acting under the economic incentives'. Safety margins are defined as 'the margins by which the outcome of a venture may fall short of the best guess'. The firm seeks to maximise these margins which turn out to be its actual profits if its best guess comes true. At the same time, in attempting to maximise profits it tries to equate its expected marginal revenue with its expected cost, expected here meaning that relating to the best guess — a vague form of the most probable. Actual behaviour of the firm is a compromise between maximising safety margins and maximising best guess profits.

Attacking the same problem in 1959 Baumol concludes that the businessman's desire to increase his profit lends itself to a translation into a desire to expand the firm. He thinks that 'the typical oligopolist's objective can usefully be characterised, approximately, as sales maximisation subject to a minimum profit constraint....'

2. Ibid., p. 152.
3. Ibid., pp. 146-154.
5. Ibid., p. 49.
The definition of this minimum is, however, a tricky problem. Baumol's conclusion does not differ much from that of others. 'In practice, the determination of a minimum acceptable profit level probably comes down to no more than a rough attempt, again partly by rule of thumb, to provide competitively acceptable earnings to stockholders while leaving enough over for investment in future output expansion at the maximum rate which the management considers to be reasonably safely marketable'.

CONTRIBUTIONS BY MACHLUP, HAHN AND MARCHAL

Subsequent discussion on the subject of profit shows that the new ideas propounded by the theory of monopolistic competition found their way into theory of profit in a number of ways. Some economists lay the main emphasis on the element of monopoly and continue to relate profits to obstacles to entry and to monopolistic practices by producers. The contributions of Fritz Machlup F.H.Hahn and Jean Marchal can be studied in this context.

1. Ibid., p. 53.
Others have tried to incorporate in a broader framework, largely based on the uncertainty approach, the peculiar rents to which imperfect competition gives rise. This approach is represented by B.S. Keirstead whose theory will be taken up in the next chapter. Then there are the eclectic writers who identify various types of profits explained by specific causes, one of which continues to be the elements of monopoly which has now gained in clarity of exposition and also in emphasis.

1

According to Machlup accrual of supernormal profit is caused by absence of perfect pliopoly, i.e. possibility of entry. Given perfect pliopoly profits will be normal. The chief obstacle to entry is offered by immobility, indivisibility of certain factors of production and uncertainty. Machlup discusses the three separately, studies their interaction and notes their widespread existence in the system.

Net profits are defined as the surplus remaining after all opportunity costs of all factors owned or hired are covered. A special problem is posed by fixed resources whose opportunity costs are nil and, therefore, whose earnings are quasi rents to the firms, 'If the quasi rent is exactly sufficient to cover all opportunity costs of

all fixed resources (owned or hired) which would be needed to establish the enterprise if it did not exist then the quasi rent is called 'normal'. This normal remainder after covering the direct costs is often called the normal profit of the industry'. It is equal to zero profit in the economic sense.

The effect of uncertainty is to make entrepreneurs hesitant. This lowers the demand for productive services and the costs of production fall. 'With the outcome uncertain entrepreneurs calculate with safety margins. They buy or hire resources only at prices which sum up to an amount that falls short, by a safety margin, of the expected gross receipts .... If gross receipts happen to come exactly up to expectations, they will not only cover all costs of all resources, variable and fixed, hired and owned, but they will leave a remainder equal to the safety margin: economic profit'.

Indisibility makes entry into an enterprise impossible despite the attraction of high profits, with the result that the insiders continue to earn supernormal profits. Secondly it may operate indirectly through uncertainty which is enormously increased if indivisible factors permit industrial expansion in jumps only.

1. Ibid., p. 11.
2. Ibid., p. 16.
3. Ibid., p. 18.
Then by causing larger investment requirements indivisibility may aggravate the effect which uncertainty of any given degree is apt to have. And 'in actual practice, imperfect divisibility of certain factors (natural, human or man made) is effective in almost all industries, trades and professions and probably more effective than uncertainty.'

The effect of immobility is to give rise to monopoly rents by effectively differentiating resources which would otherwise be homogeneous and perfectly substitutable for one another.

Machlup then proceeds to examine the impact of uncertainty on oligopoly and its consequences in terms of accrual of profits and rents. Throughout the discussion he emphasises the point that different concepts of profit are needed for handling different problems. Also the outlooks on profit of the economist, the insider and the outsider will be different from one another.

Supernormal profits are eliminated by fresh entry into the industry. They are caused by indivisibilities and uncertainties restricting entry. 'With oligopoly absent, pure profits, monopoly rents and excessive factor prices arise and last over extended periods. All three are earnings in excess of opportunity cost.' The three taken

1. Ibid., p. 168.
2. Ibid., p. 21.
3. Ibid., p. 168.
together constitute the gross profits of enterprise.

Despite due emphasis on uncertainty in defining pure profits and on man made scarcities in defining monopoly rents, the central emphasis in Machlup's theory remains on oligopoly — possibility of entry. The impact of Chamberlin is obvious, though Machlup's contribution is more comprehensive than the theories of monopolistic competition would warrant. It is an attempt to reformulate the profit concept and theory in the light of monopolistic competition theories while still assigning the definitional role to the uncertainty theory.

The same is true of F.H.Hahn as well.¹ Market imperfections are seen as increasing uncertainty and uncertainty makes entry more difficult. Indeed 'one of the results of imperfections in the market is to offer new opportunity for undertaking uncertainty and thus for earning the reward for it'.² Competition for entry' and 'the undertaking of the danger of simultaneous entry' are mentioned as the new dimensions of the problem which have a bearing on the nature of the profits earned.³

---

2. Ibid., p. 219.
3. Ibid., pp. 221-224.
That the new impact did not result in an entirely new theory of profit is once again demonstrated by these attempts. One of its reasons, however, must be the deep impression made on the economists' mind by the concept of pure profit in the sense of unimputed surplus, as distinguished from rents and quasi-rents. However much the elements of monopoly are emphasized, they are powerless before this definition of profits. The surpluses they create can always, at least in the long run, be imputed to some factors, natural or artificial.

This was clearly recognised by some who declared it necessary to reject the definition itself for the construction of a realistic theory of profit. Such is the theory of Jean Marchal who relates profits to predatory monopolistic practices. Dismissing 'net profits', wages of management, and interest on the entrepreneur's own capital as the invention of ivory tower economists corresponding to nothing real, he stresses that gross profits are the proper object of study. That is the income category businessmen call profits.

Entrepreneurs secure profits by pressure action. They operate directly on the structure of the market through advertising and innovation, and bring about increase in total money-demand by exerting pressure on public

2. Ibid., p. 550.
authorities to adopt policies leading to that effect. The list of possible types of pressure action they resort to can, of course, never be complete. Pursuit of profit is a struggle, a fight. Existing theories, though pretending to be scientific, are extremely narrow in scope. Profit is both an economic and a political and sociological phenomenon. Current profit theories are inept, insipid and deceptive.

Marchal hardly ever refers to the specific points emerging from the theories of monopolistic competition. Yet his views presuppose the changed image of the market where giant oligopolistic concerns clash, battles are won and fortunes destroyed.
To continue believing in the capability of the capitalist system automatically to maintain full employment at a time when Great Britain was experiencing 10 to 20 per cent unemployment, with the colossal waste and widespread suffering that accompanied it, was almost an impossibility. That the treasury backed by the academic economists — all born and bred in the classical tradition — still argued against the possibility of ameliorating the situation by a policy of public works added only to the irritation of the common man. Little wonder that when Keynes expounded the theory of effective demand and established the possibility of stable underemployment equilibrium it took little time to get wide acceptance.

Keynes' argument was simple. In a given situation of technique, resources and factor cost per unit of employment: '... the volume of employment is given by the point of intersection between the aggregate demand function and the aggregate supply function, for it is at this point 1. Joan Robinson: Economic Philosophy, p.71; Pelican Series, 1964.
that the entrepreneurs’ expectation of profit will be maximised.¹

The aggregate supply function, \( Z = \phi (N) \) relates \( Z \), the aggregate supply price of the output for employing \( N \) men, which is 'the expectation of proceeds which will just make it worth the while of the entrepreneurs to give that employment',² to \( N \). The aggregate demand function, \( D = F (N) \), relates \( D \) 'the proceeds which entrepreneurs expect to receive from the employment of \( N \) men'³ to \( N \). The value of \( D \) at the point of intersection is called the effective demand.

Given the productivity per man, Income depends on the volume of employment.

Effective demand \( D \) is the total of what the community is expected to spend on consumption, \( D_1 \), and \( D_2 \) the amount which it is expected to devote to investment. \( D_1 \) is a function of National Income. When income increases, community's consumption also increases but by an amount less than the increase in income. That is to say, the marginal propensity to consume is less than one. Investment is determined at a level which equates the marginal

² Ibid., p. 24.
³ Ibid., p. 25.
efficiency of capital in general with the rate of interest. Savings is the part of income that is not consumed. Thus for the level of employment and income to be in equilibrium, investment should just cover the gap in spending created by saving. When employment increases $D_1$ will increase but not by so much as $D$.

This insufficiency of demand can be made up only if $D_2$ is increasing so as to fill the increasing gap between $Z$ and $D_1$. Thus — except on the special assumption of the classical theory according to which there is some force in operation which, when employment increases, always causes $D_2$ to increase sufficiently to fill the widening gap between $Z$ and $D_1$ — the economic system may find itself in stable equilibrium with $N$ at a level below full employment..."¹

Keynes explained the 'paradox of poverty in the midst of plenty' by the insufficiency of effective demand. Furthermore, the richer the community, the lower the propensity to consume, and the less the inducement to invest in view of the already existing stock of capital.²

Having pointed out this gloomy prospect he proceeded to analyse the Propensity to Consume, the Marginal Efficiency of Capital and the Rate of Interest. For our purpose here

¹. Ibid., p. 30.
². Ibid., p. 31.
it is not necessary to go into the details of this analysis. Keynes' theory of the Rate of Interest introduced the Psychological liquidity preference as a decisive determinant along with the quantity of money and the level of income. His discussion of the Marginal Efficiency of Capital stepped into the fresh air of 'Expectations'.

In this context he distinguished between short term and long term expectations. Short term expectations are concerned with the price which a manufacturer can expect to get for his finished output at the time when he commits himself to starting the process which will produce it, and with the cost of output on various possible scales. These determine the day to day decisions of the businessmen regarding output and employment. Long term expectations relate to the future yield of the new capital goods and equipment which the businessmen are intending to purchase today. They will determine their investment decisions and the employment opportunities thus created. Short term expectations are mostly based on realised results and current prices, costs, etc. Long term expectations, to which Keynes devotes a whole chapter, depend partly on the existing reality regarding the existing stock of capital assets and the state of consumers' demand for goods requiring the use of

1. Ibid., pp. 46-47.
capital assets, and partly on future events which can only be forecasted with more or less confidence, such as the taste of the consumers, future changes in the type and quality of capital assets, the strength of effective demand from time to time during the life of the investment under consideration and the changes in wage-unit in terms of money which may occur during its life.¹

Entrepreneurs are prone not to attach great weight to matters which are very uncertain, instead they are guided to a considerable degree by the facts about which they feel somewhat confident. 'The state of long term expectations, upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the confidence with which we make this forecast — on how highly we rate the likelihood of our best forecast turning out quite wrong.'² The state of confidence is one of the major factors determining the schedule of the Marginal Efficiency of Capital, which is the same thing as the investment demand schedule. In this regard Keynes notes that 'the outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made.'³

1. Ibid., p. 147.
2. Ibid., p. 148.
3. Ibid., p. 149.
In practice, therefore, businessmen follow the 'convention' of assuming that the existing state of affairs will continue indefinitely, except in so far as they have specific reasons to expect a change.

Keynes then proceeds to discuss some of the factors which accentuate the precariousness of autonomous investment — institutions which have become part and parcel of modern enterprise economy. Then there is 'the characteristics of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic,'¹ which contributes further to the instability of investment.

Keynes has also discussed at some length the effects of changes in expectation, noting that these effects take time to work themselves out, meanwhile further changes overlapping, and the whole thing taking a new course.

This refreshing discussion of the state of expectations, of which only a very brief summary has been presented above, serves to highlight the imponderables

¹. Ibid., p. 161.
involved in the determination of investment demand, which itself is the decisive factor in the determination of Effective Demand, Income and Employment. As we shall note later on it is upon these aggregates that the magnitude of total profits in the economy depends, hence the relevance of this discussion to our subject of study. As a matter of fact Keynes may well be regarded as having pioneered the probe into 'expectations' which later grew to sizable proportion as we have already witnessed in studying Shackle, and shall soon be finding in the profit theory of B.S. Keirstead. But Keirstead has definitely drawn more on Keynes than Shackle might have, as Keynes did not analyse how entrepreneurs made decisions on the basis of multiplicity of expectations held with varying degrees of confidence. In so far as he is specific, Shackle's views are not in sympathy with his approach. Keynes says: 'An entrepreneur who has to reach a practical decision as to his scale of production, does not, of course, entertain a single undoubting expectation of what the sale proceeds of a given output will be, but several hypothetical expectations, held with varying degrees of probability and definiteness. By his expectation of proceed I mean, therefore, that expectation of proceeds, which, if it were held with certainty, would lead to the same behaviour as does the bundle of vague and more various possibilities which actually

1. Ibid., p. 24 fn. 3.
makes up his state of expectations when he reaches his decision.'

For one thing this a method of arriving at a definition (of expectation of proceeds) and does not propose to explain how decision is reached, or how this translation of 'vague and various possibilities' into one held with certainty is effected — something that Shackle's theory presumably does. Then behind the reference to 'probability' in the above note lurks the same 'orthodox' approach which Shackle so vehemently attacks.

As we shall see later, Keirstead's inspiration is of an entirely different nature. He explains windfall profits on Keynesian lines and draws on Keynes' discussion of Expectations in his own distinction between Particular and General expectations.

The General Theory was not intended to cover distribution of income, its sole concern being its determination. In fact, Keynes took the distribution of income as given and did not specifically discuss its break-up into various functional shares, except for a reference to the profit share as increasing at the cost of rentiers with the rising level of prices which generally accompanied the increasing volume of employment and output. It's greatest

1. Ibid., p. 24 fn. 3.
2. Ibid., p. 290.
impact on the theory of distribution in general, and the theory of profit in particular, was the extension into this field of the aggregative approach adopted in discussing the determination of income and employment. The seeds of a macro-analysis of distribution are already there if the General Theory is read alongside the Treatise on Money. These ultimately blossomed into the macro-theories of profits which we shall discuss in a subsequent chapter.

PROFITS IN THE 'TREATISE'

Even in the Treatise (1930) Keynes was discussing profits at the aggregate level. Indeed he did not even touch the micro-economic theory of profit as this was not warranted in a study on Money and the Price Level. Profits result from movements in the price level due to disparity between Savings and Investment, with the policy of the Banking system at the back of it. From his Fundamental Equations it followed that total profits $Q$, which were the sum of profits in the consumer goods industries $Q_1$ and profits in the investment goods industries $Q_2$ equalled the difference between the value of increment of the new
investment goods I and the volume of savings S.
\[ Q_1 = I' - S \] whereas \( I' \) is the cost of production of new investment and \( Q_2 = I - I' \), hence \( Q = Q_1 + Q_2 = I - S \).

Equilibrium required that \( Q_1, Q_2 \) and \( Q \) should be zero. Profits were the result of the system's departure from equilibrium.

Profits were so defined as to exclude the normal remuneration of the entrepreneurs, which was 'the rate of remuneration which, if they were open to make new bargains with all factors of production at the currently prevailing rates of earning, would leave them under no motive either to increase or to decrease their scales of operation.' They are, to be brief, 'windfall' profits. Having so defined profits, Keynes excludes them, both from Income and from Savings, irrespective of whether they are spent on consumption or not. They do, however, from part of the value of current investment which is the value of the increment of capital during any period.

In this context, he emphasises the existence of long term contracts with the agents of production as a
basis for the entrepreneurs earning profits or incurring losses.\(^1\) Contracts lend a time dimension to equilibrium adjustments, thus perpetuating the fruits of disequilibrium—profits.

The windfall profits, which are the result of disequilibrium, themselves initiate changes in the system in form of expansion (or contraction, in case profits are negative) of the scale of operation of the entrepreneurs.\(^2\) This account of the role of profits in the Treatise is later revised in the General Theory to become 'more accurate and instructive'.

'In my Treatise on Money the concept of changes in the excess of investment over saving, as there defined, was a way of handling changes in profits, though I did not in that book distinguish clearly between expected and realised results. I there argued that change in the excess of investment over saving was the motive force governing changes in the volume of output. Thus the new argument, though (as I now think) much more accurate and instructive, is essentially a development of the old.

---

1. This point is of special interest in view of the important place given it by Sidney Weintraub in his theory of profit (see below: chapter seven and above chapter four).

2. J.M. Keynes, A Treatise on Money, p. 158.
Expressed in the language of my *Treatise on Money* it would run; the expectation of an increased excess of Investment over Saving, given the former volume of employment and output, will induce entrepreneurs to increase the volume of employment and output.... the volume of employment is determined by the estimates of effective demand made by the entrepreneurs, an increase of investment relatively to saving as defined in my *Treatise on Money* being a criterion of an increase in effective demand.¹

Thus increase in effective demand replaces the increase in windfall profits as the motive force behind change. The relationship between changes in effective demand and profits is studied separately by bringing in the elasticities of output and prices. It is important, however, to note that profits as defined in the *General Theory* do not exclude 'normal remuneration of the entrepreneurs'. They are simply the income of the entrepreneurs, so that Factor Costs plus Profits equal National Income. Profits are a part of income and therefore not excluded from savings either.

Changes in effective demand affect profits by changing the level of prices to the extent they fail to change the volume of employment and output. Keynes

¹ J.M. Keynes: *The General Theory of Employment, Interest and Money*, pp. 77-78
demonstrates that 'the sum of the elasticities of price and of output in response to changes in effective demand (measured in terms of wage units) is equal to unity. Effective demand spends itself, partly in affecting output and partly in affecting price, according to this law.'

Measuring values in money instead of wage units:

'If W stands for the money wages of a unit of output as a whole in terms of money, and p for the expected price of a unit of output in terms of money, we can write $e_p( = \frac{Ddp}{pdD})$ for the elasticity of money prices in response to changes in effective demand measured in terms of money, and $e_W( = \frac{DdW}{WdD})$ for the elasticity of money wages in response to changes in effective demand in terms of money. It is then easily shown that $e_p = 1 - e_o \left( 1 - e_W \right)$.

Changes in profits are related directly to changes in prices and inversely to changes in money wages. If $e_W = 1$, rising prices will leave profits unaltered. If money wages are constant and $e_W = 0$, the rise in price level will depend on the value of $e_o$, and will increase profits to that extent. If $e_o = 0$, total output not increasing at all in response to an increase in effective demand in terms of money, the entire effective demand is expected to

1. Ibid., p. 285.
2. Ibid., p. 285 — $e_o$ is the elasticity of output as a whole in response to changes in effective demand.
accrue to the entrepreneurs as profits. Profits will be less if \( e_0 \) is positive, being zero when \( e_0 = 1 \). Ordinarily \( e_0 \) will have a value intermediate between zero and unity. Money wages are sticky, so that \( e_\omega \) is far below unity. Though 'a portion of any increase in effective demand is likely to be absorbed in satisfying the upward tendency of the wage unit',\(^1\) Yet rising prices are generally accompanied by increasing profits.

Much, however, would depend on the content of the increase in effective demand — the particular goods whose demand has increased.\(^2\) Windfall gains due to rise in prices of the products of specific industries will wholly accrue to the entrepreneurs in those industries. Moreover the profits thus accruing do not stimulate entrepreneurs to expansionary action, because of their windfall character.\(^3\)

To sum up: Profits arise due to movements in prices. Such movements are caused by changes in effective demand which occur mainly due to changes in businessmen's expectations leading to changes in the rate of investment. At the back of changes in the rate of investment are

---

1. Ibid., p. 301.
2. Ibid., p. 267.
3. Ibid., p. 288.
interest rate changes which are linked up with the quantity of money and liquidity preference. Changes in the propensity to consume may also initiate changes in effective demand. The elasticities of output and money wages enter the picture in the manner described above.

It is interesting to mark a 'peculiarity' of profit which Keynes noted 'in passing' in his *Treatise on Money*. There he argued that:

'If entrepreneurs choose to spend a portion of their profits on consumption (and there is, of course, nothing to prevent them from doing so) the effect is to increase the profits on the sale of liquid consumption goods by an amount exactly equal to the amount of profits which have thus been expended. This follows from our definition.'

That this conclusion is based on the peculiar definition of profits (and of income and savings) adopted in the *Treatise* is too obvious to need elaboration. If profits were not included in National Income, their expenditure on consumption is, in the language of the *General Theory*, an increase in effective demand (causing an equal increase in profits if the elasticities of output and money wages are zero). But in the terminology of the *General Theory* entrepreneur's profits are a part of National Income and their expenditure on consumption is

already accounted for. The above 'peculiarity', therefore, cannot be ascribed to profits as defined in the *General Theory*. Given zero elasticity of output and money wages, any increase in effective demand will swell profits by an equal amount. It is immaterial whether this increase takes the form of additional investment or additional consumption expenditure and whether it is financed out of profits or past savings or is the result of a decrease in the liquidity preference. It should not, it follows, be incorporated, much less made the basis of, a theory of aggregate profits which is constructed in terms of the *General Theory* categories. Strangely enough, this is exactly what some macro-theories of profit seek to do.