Debunking Squared

Kakarot-Handtke, Egmont

University of Stuttgart, Institute of Economics and Law

22 November 2013

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Egmont Kakarot-Handtke[*]

Abstract

Steve Keen has debunked a good part of standard economics. However, he has left standing the theory of profit. This is unfortunate, because the theory of profit is the pivot of all of theoretical economics. This tightly focused paper clarifies the factual relation of profit and income, which should be helpful to put Keen's alternative to the standard approach on sound foundations.

JEL B59

Keywords new framework of concepts; structure-centric; consumption economy; Profit Law; market clearing; budget balancing; error detection; four quadrant scheme

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[*]Affiliation: University of Stuttgart, Institute of Economics and Law, Keplerstrasse 17, 70174 Stuttgart, Germany. Correspondence address: AXEC, Egmont Kakarot-Handtke, Hohenzollernstraße 11, 80801 München, Germany, e-mail: handtke@axec.de

Steve Keen has, with the help of his fabulous detector, divined a lot of analytical
blunder and debunked a good part of standard economics. Rightly so, because
to clear the heads is the indispensable preparatory task of heterodox economics.
However, Keen has left standing the theory of profit. This is unfortunate, because
the theory of profit is the pivot of all of theoretical economics. What deserves the
first and foremost attention is in any case the factual relation of profit and income.

Steve Keen has stated the definition of income in two prominent places as: "Total
income = Wages plus Profits" (2011, pp. 366, 146) and "... national income
resolves itself into wages and profits" (2010, p. 12). This, of course, is what we
have heard often from middle-of-the-road economists but also from Keynes (1973,
p. 23). This definition seems to be plain common sense, yet, like most common
sense since Aristotle, it is demonstrably false (2012). Therefore, what is required
for the advancement of Heterodoxy is to debunk the naive definition of total income.

This is done in the following with a straightforward graphical demonstration. For
the rigorous formal underpinning and the full implications see (2013b). Figure 1
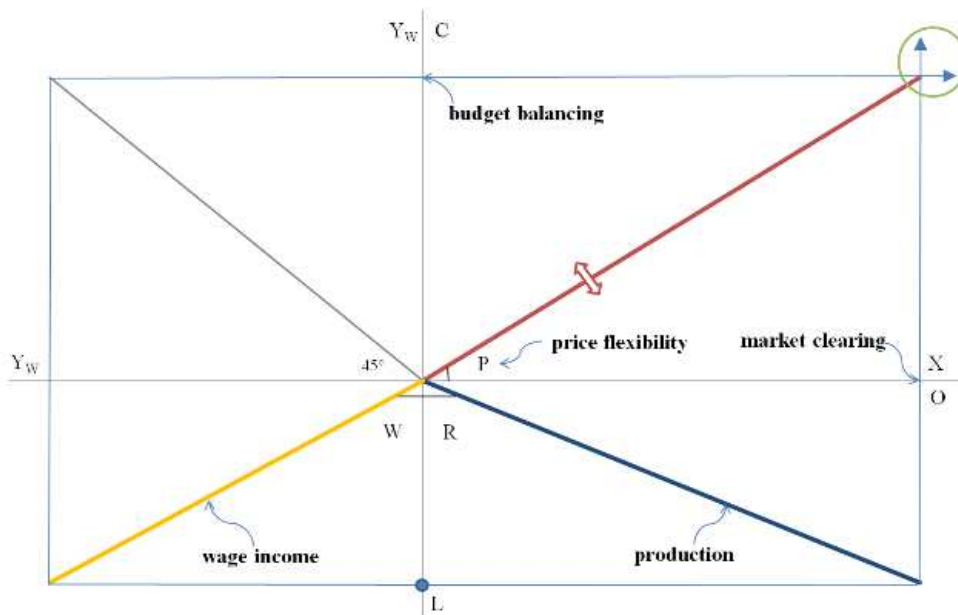shows the simplest possible configuration of the pure consumption economy.

Figure 1: The price in the pure consumption economy in period $t = 1$ is objectively determined by
the conditions of market clearing and budget balancing. Legend: P price, L employment, W wage
rate, Y_W wage income, C consumption expenditure, R productivity, O output, X quantity bought

At any given level of employment L, the wage income Y_W that is generated in the
consolidated business sector follows by multiplication with the (average) wage

rate W. On the real side output follows by multiplication with the productivity. Finally, the price follows as the dependent variable under the conditions of budget balancing, i.e. $C = Y_W$, and market clearing, i.e. $X = O$. Note that the ray in the southeastern quadrant is not a linear production function; the ray tracks any underlying production function. The same holds for the distribution of wage incomes in the southwestern quadrant. All these details are not needed at the moment.

It can be directly read off from the four quadrant scheme that the real wage $\frac{W}{P}$ is always equal to the productivity R, that is, labor gets the whole product, no matter what. If the wage rate is lowered, the market clearing price falls. If the number of working hours is increased the price remains constant, provided productivity does not change. If productivity decreases the price rises. In any case, labor gets the whole product and profit is zero, or in Walras's terms, there is 'ni bénéfice ni perte', neither profit nor loss. So far, all are agreed:

> The consensus to date has been that it is mathematically impossible for capitalists in the aggregate to make profits. (Keen, 2010, p. 2)

There is also explicit assent from economic methodology.

> ... since it is impossible to have an economy where everyone is making profits. Aggregate profit for an entire (closed) economy must be zero, hence if any firm is making profits, some other firm must be making losses. (Boland, 1992, p. 80)

The weak spot in the otherwise impeccable zero-profit argument is that aggregate profit has been greater than zero for most of the time in most of the known market economies up to the present. Hence Figure 1 is the first but not the last word in the theory of profit.

The crucial point is this: there exists no such thing as an immutable law of budget balancing in the *same* period. Just the contrary. Logically, we have *three* possible cases in the next period: $C_2 < Y_{W2}, \quad C_2 = Y_{W2}, \quad C_2 > Y_{W2}$. The first case means loss, the second zero profit, and the third profit. Figure 2 shows an example for the third case which has, compared to the others, the best evolutionary prospects in the real world.

In the pure consumption economy, profit can at first only be greater than zero if consumption expenditure is greater than wage income. This configuration has historically been realized in various ways, the ordinary way is that the household sector takes up credit from the banking industry (for details see 2013b, Sec. 18). One pertinent example is the purchase of long-lived consumption goods like family homes on credit. The relation between credit expansion of the household sector and profit for the business sector measurable in principle (Keen, 2011, pp. 337-353). The only open question is how long can Figure 2 be reproduced? After all, credit
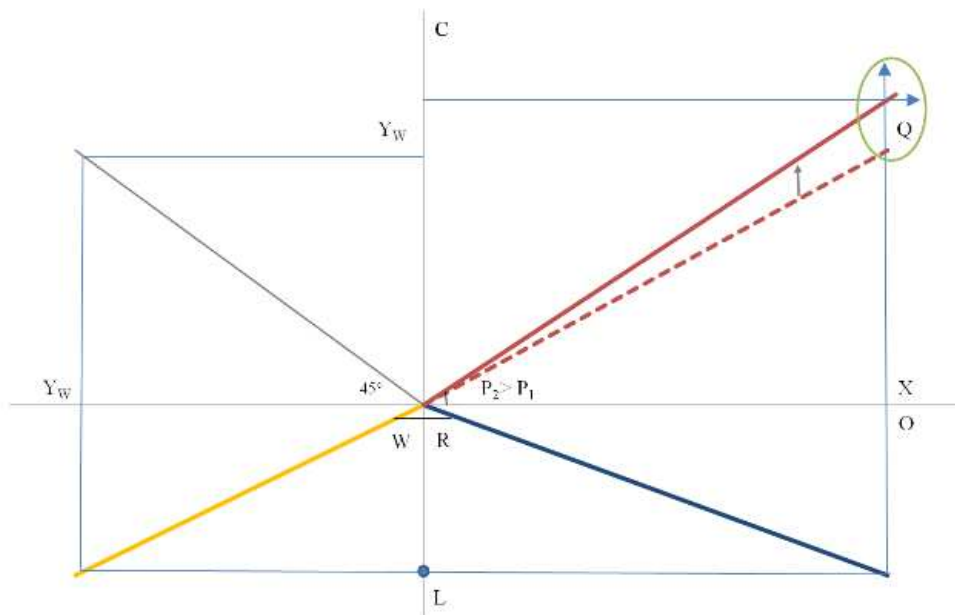
Figure 2: Monetary profit in period $t = 2$ is objectively determined by the difference between consumption expenditure and wage income under the condition of market clearing, irrespective of what the agents optimize or, for that matter, what economists think about profit

has to be redeemed some day. This eventuality is not at issue here (for details see 2013a).

In the case of Figure 2 monetary profit is given as $Q_2 \equiv C_2 - Y_{W2}$ in the northeastern quadrant. Profit takes the form of money in the bank and remains in the business sector in the period under consideration, i.e. profit is retained (this incidentally answers the old chestnut M–C–M+, see Keen, 2011, p. 217). Due to the higher market clearing price the real wage is now lower than the productivity.

In the next period, profit is distributed and the household sector's total income is accordingly: $Y_3 = Y_{W3} + Y_{D3}$. If profit is fully distributed we have $Y_{D3} = Q_2$, i.e. distributed profit in period $t = 3$ is equal to profit in period $t = 2$. Profit in period $t = 3$ is in the general case: $Q_3 \equiv C_3 - Y_{W3} + Y_{D3}$. This solves the long-standing profit puzzle. The Profit Law is the first of the far reaching implications of Figure 2. Note that profit and distributed profit is not the same thing and that both are *never* equal in reality. Note also that the Profit Law, when augmented with investment, foreign trade, and government, is directly testable.

Resume: Total income is the sum of wage income and *distributed* profit and not of wage income and profit. This distinction makes all the difference between good or bad economics. Steve Keen has debunked a good part of Orthodoxy, yet with regard to the foundational concepts income and profit Heterodoxy still subscribes to the conventional error.

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