Chapter 3
Profit, investment and inequality: a preliminary view

Matthieu Méaullé

Introduction

According to the standard national accounting definition, the value created in the economy is equal to the amount by which the factors of production are rewarded. In other words, the ‘G[ross] D[omestic] P[roduct] [which] measures the monetary value of final goods and services – that are bought by the final user – produced in a country in a given period of time (say a quarter or a year)’ (Callen 2018) is equal to the sum of profits and the total amount of compensation of employees. On the other hand, national accounting also defines gross domestic product as the sum of final consumption, investment and exports minus imports. For now, our intention here is to disregard government intervention.

It is now an established fact, according to the International Labour Organization (ILO 2016), the International Monetary Fund (IMF 2017a), the Organisation for Economic Co-operation and Development (OECD 2018) and the European Commission, among others, that the share of profits in gross domestic product, despite experiencing a fall during the crisis followed by a period of gradual recovery, has been increasing since the 1980s.

For the past 30 years, we have been told that wage increases could be detrimental to investment – not necessarily with regard to profit and competitiveness, but mainly because they generate uncertainty, especially about the evolution of inflation rates. Wage development had to be relegated to an impediment to growth rather than a stimulus for investment. Wage constraints became the rule, while the primacy of profit-making for investment became the norm.

Our intention is to determine whether this increase in profits as a share of domestic income has been translated into new investment for production. As we shall see, the increase in profit shares does not translate into an increase in private investment as a share of GDP, as expressed in a famous quote by former German Chancellor, Helmut Schmidt: ‘today’s profits are tomorrow’s investments and the day after tomorrow’s jobs’. In fact, it appears that more and more profits are either distributed to shareholders or diverted towards financial assets. We would argue that such a move, combined with below-productivity wage increases, is also detrimental to inequality development, particularly at the expense of the middle class. Continuing to engage in such economic development – favouring profit increases at the expense of wage development – leads

1. Taken from a speech delivered on 3 November 1974.
to a vicious circle, for as wages decrease as a share of domestic income, the expected demand for new investment also decreases, while the shift towards financial market operations becomes somewhat more rewarding.

The conclusion to be drawn from these preliminary considerations is that the curbing of inequality cannot exist as a stand-alone social policy but must be complemented by the curbing of financial developments and an increase in the scale and progressivity of the tax system. Any action based on social policy alone could run the risk of causing the disappearance of the middle class and the development of a large low-income class, all for the benefit of the few richest households. Increasing financial regulation should prevent pure financial operations and limit the increase in financial incomes, for the benefit of the real economy. Increasing the scale and progressivity of the tax system would reduce inequality and make social policies more effective.

1. Profit and investment developments

Investment is of central importance to economic development, not only because investment, as a monetary magnitude, is a share of the value created each year, but also because fluctuations in productive investment are good indicators of future economic development. Investment in the necessary tools for production is, therefore, an essential ingredient for value creation in the future. In this respect, it provides a bridge between our current activities and our preparations for the future.

First, we needed to ascertain whether the returns on investment are sufficient to warrant the launch of new investment projects. To that end, we used a measure of the profit rate in order to assess the profitability of investment projects. The rates of profit are measured as profits and mixed income, over the net capital stock, plus employees’ compensation. Although some Member States recorded a decline in profit rates and volatility, the rates remained fairly stable at between 11% and 15%. With the exception of Spain and Italy, profit rates were all increasing before the crisis, even across the European Union as a whole, and trends thereafter show a gradual recovery (Figure 1).

Gross profits are defined as the gross operating surplus of the total economy. According to the national accounting definition, the gross operating surplus of the total economy, or total profits, can be compiled as the gross domestic product at current market prices minus employees’ compensation, which includes wages and salaries and employers’ social contributions and taxes linked to imports and production minus subsidies.

Although profits decreased during the crisis, they subsequently recovered and resumed the upward trends that they were experiencing before the crisis. Despite the fall in profits during the crisis, new investment projects were still launched in addition to the maintenance of the capital stock, thus implying an increase in total profits (Figure 2).

---

2. Defined as the net capital stock at date t-1 plus gross fixed capital formation at date t minus consumption of fixed capital at date t.
Profit, investment and inequality: a preliminary view

Figure 1 Rates of profit

![Rates of profit graph](image1)

Source: AMECO and Eurostat Databases, own calculations.

Figure 2 Gross operating surpluses (billion euros)

![Gross operating surpluses graph](image2)

Source: AMECO Database.
Expressed as percentages, the figures are striking. In line with the call for profit development as a driver of growth, profits have increased as a share of GDP. Here, gross domestic product is calculated at current factor cost, which involves calculating GDP at market price minus taxes on production and imports plus subsidies, so as to produce a more accurate picture of income distribution patterns between labour and capital (Figure 3).

Profits developed at a faster pace than gross domestic product, since the share of profits in gross domestic product – which ranged from 24% to 33% in 1980 – has now increased to between 32% and 40%. For the European Union as a whole, in its different settings, it moved from around 28.5% in 1980 to about 37%. Although profit shares decreased during the crisis, they are slowly recovering their pre-crisis levels. This means that an increasing proportion of productivity growth was devoted to profits at the expense of wage developments.

Since profits in monetary terms have almost continuously increased, along with the share of GDP, it is possible to assess whether this rise in profit was subsequently translated into further investment or diverted to other sources of revenue. As a share of GDP, we can see that annual gross investment is on a decreasing trend, casting doubt on the role of profit as an engine of economic growth (Figure 4).
Moreover, if we look at new investment and not only gross investment spending, which includes capital depreciation, the figures are even more striking. We can therefore safely conclude that the increase in profit shares did not lead to further new investment. This means that corporations are still spending money to maintain the value and profitability of their capital stocks, which crystallises past investments, but they are spending less as a share of GDP on new investment projects (Figures 5a and 5b).

At corporate level, the share of net investment in net profit after capital depreciation, is on a decreasing trend (Figure 6), along with the additional fixed asset to operating income ratio after dividend payments for publicly listed non-financial companies (Tori and Onaran 2017). This means that, while profit as a share of GDP is increasing, the share of profit devoted to physical means of production is on a decreasing trend. In this respect, profit and investment figures show that we are failing to prepare our economic system for the challenges it will face in the future.
Figure 5a  Net fixed private investment as a share of GDP

Source: AMECO Database, own calculations.

Figure 5b  Net fixed private investment as a share of GDP

Source: AMECO Database, own calculations.
Figure 6  Net investment as a share of net profit

Source: AMECO Database, own calculations.

Figure 7  Additions to fixed assets/operating income

Figure 8a  Distributed income of corporations as a share of total net profits

![Graph showing distributed income of corporations as a share of total net profits.](image)

Source: Eurostat Database, own calculations.

Figure 8b  Growth in European Union net profits and distributed income

![Graph showing growth in European Union net profits and distributed income.](image)

Source: Eurostat Database, own calculations.
A discrepancy emerges between the development of profit and that of private net investment, both as a share of GDP: one is increasing while the other is decreasing. This could mean that the profit increases were not translated into new investments but were distributed as dividends (distributed income) or used for the acquisition of financial assets. Since profits developed at a faster pace than GDP, as the figures for profit shares confirm, there is a likelihood that the increase in non-invested profits as a share of total net profits (Figures 8a and 8b) and GDP (Figure 9) are both increasing. Here, distributed income represents dividend payments made by corporations.

Since we already know that profits have increased as a share of GDP, along with dividend payments as a share of net profits, we are likely to see an increase in dividends as a share of GDP (Figure 9).

Figure 9  Growth of European Union distributed income and GDP

Source: Eurostat Database, own calculations.
At the same time, the share of financial assets acquired by non-financial corporations as a share of GDP is on the rise (Figure 10).

Figure 10  **Non-financial corporations’ financial assets as a share of GDP**

Source: Eurostat Database, own calculations.

We conclude this section by contesting the belief that increased profit is the right driver for economic development. As we have already seen, the increased profits were not translated into further new investments, while an increasing proportion of funds were diverted from productive activities toward financial operations and distributed income. According to Tori and Onaran (2017), these are ‘funds [diverted] from real investment towards the accumulation of non-operating financial assets.’

## 2. Inequality issues

Inequality also warrants some attention. It has often been said that inequality is the price we have to pay for economic growth. We have doubts on this issue since, as we highlighted earlier, the increased share of profit in GDP was not translated into increased investment as a share of GDP but was diverted towards financial assets and dividends. Inequality was also considered to be one of the main causes of the financial crisis. It will be interesting to see whether this situation has changed and whether poverty levels have decreased as a result of the expected growth generated by the increase in profits as a share of GDP.
Income inequality

While the figures show an increase in profit shares in GDP at current factor cost, they also show a decrease in wage shares in GDP at current factor cost (Figure 11). However, the wage share is not a tool as such for assessing inequality between people; it is more a means of measuring the capital/labour income distribution in production.

This means that wage developments did not keep in step with productivity developments. Wage earners participate in the production process but receive a decreasing relative share of the pie. On the other hand, it also means that capital owners receive an increasing share, as shown in the previous section.

If we analyse the development of income shares in European income, it becomes evident that the poorest saw their wage share remain the same between 1990 and 2016, while the richest 1% and 10% saw their share increase at the expense of the middle class (Figure 12). In this respect, it can be said that inequality has increased, even after the financial crisis. However, it is also clear that the main issue lies in the increase in income shares of the richest 1%. In Europe, while the full population experienced an income growth of 40% between 1980 and 2016, the bottom 50% income group saw its income rise by 26%, the top 10% by 58%, the top 1% by 72%, the top 0.1% by 76%, the top 0.01% by 87% and, finally, the top 0.001% by 120%.³

³ World Inequality Lab (2018).
If we compare the increase in the share of income received by income level since 1980 and the growth in real income per adult, as shown in the World Inequality Report 2018 (Figure 13), it appears that, at global level, 27% of the real wage growth was received by the 1% richest (this figure is 28% according to the US-Canada and Western Europe calculations by the World Inequality Lab (2018)), while the poorest 50% received only 12% (this figure is 9% according to the US-Canada and Western Europe calculations by the World Inequality Lab (2018)).
As stated in the World Inequality Report 2018, ‘In western continental Europe, inequality has also been on the rise since the late 1970s.’

**Wealth inequality**

Wealth refers to any income stream that is accumulated and not consumed. This corresponds to the total amount of assets owned by an individual or household, which includes both real assets (such as property or land) and financial assets (such as bonds, stocks and private pension rights). Wealth inequality therefore refers to the unequal distribution of assets in a group of people. As high-income households save a higher proportion of their income compared to poor families, wealth inequality is greater than income inequality.\(^4\) Wealth is also accumulated faster than labour income, as interest rates tend to outpace the growth rate.

Julius Bär (2014) estimates that the wealthiest 10% of European households, with a net wealth of at least EUR 850 000, own 52% of total wealth, while the wealthiest 1% of European households have a net wealth of at least EUR 1.5 million and own 27% of total European wealth. In addition, it can be seen that the wealth accumulated by the richest households is concentrated in financial wealth compared to that in the lowest quintile, and this implies an even greater level of inequality (Figures 14 and 15).

**Figure 14** Shares of financial and non-financial assets for households belonging to different quintiles of the wealth distribution

![Shares of financial and non-financial assets for households belonging to different quintiles of the wealth distribution](source: Balestra and Tonkin 2018)

Since the global economy started to recover from the financial crisis in 2009, asset price developments have, on balance, increased wealth inequality. Owing to the combined impact of bond, equity and house price developments, households have been able to realise capital gains varying from 8% for households in the lowest income group to 48% for the top 5% (Figure 16). But, of course, households that do not own any assets have not benefitted from this at all. This is particularly true for households with lower incomes, as participation in equity and mutual fund holdings generally increases with income.\(^5\)

\(^5\) See ING (2016).
As stated in Balestra and Tonkin (2018), ‘Because of its high concentration at the top of the distribution, ownership of financial assets is the main factor influencing overall wealth inequality, […] which also shows that higher prices of financial assets are associated with a larger share of wealth going to the richest 10% of households.’

Finally, inherited wealth as a share of aggregated private wealth appears to be on the rise, especially in the UK and Germany. After the beginning of the 20th century, the stock of inherited wealth as a share of private wealth was continuously decreasing, reaching a low of around 30% in 1970 and increasing back up to about 55% today, more or less the level it was between the 1920s and 1940s.⁶

Private wealth and national income

A general rise in the ratio between net private wealth and national income has been observed in nearly all countries in recent decades. Public wealth has declined in most countries since the 1980s. Net public wealth (public assets minus public debts) has even become negative in recent years in the United States and the UK, and is only slightly positive in Japan, Germany, and France. This arguably limits government ability to regulate the economy, redistribute income and mitigate rising inequality (Figure 17).

Figure 17  The rise of private capital and the fall of public capital in rich countries, 1970-2016


⁶ See Alvaredo F. et al. (2017).
This means that the net value of the stock of public capital is depreciating and that inequality is therefore increasing, as the poorest households are benefiting less, in proportion to their incomes, from public good and services. Indeed, since 2008, public investment figures as a share of GDP have been continuously decreasing, recently reaching negative net investment levels, especially in the euro area, while public debts resulting from deficit spending have, in part, been feeding the system.

Poverty

While the rate of poverty before social transfers since the crisis has remained at a very high and stable level, it is clear that social transfers have become less effective since at least 2005 (Figures 18a and 18b). The rate of poverty after social transfers has been on the rise in the European Union. This casts doubt on the ‘trickle-down’ effect or theory, which generally refers to the economic proposition that taxes on businesses and the wealthy in society should be reduced as a means to stimulate business investment in the short term and benefit society at large in the long term.

Taxation

As mentioned above, profit development is widely considered to be a driver of economic growth. For this to be the case, any barriers to profit creation have to be removed, and the simplest way of doing that is to reduce corporate taxation. If households are to act as financial investors, then their income taxes should also be decreased, as this creates the knock-on effect of increasing consumption and stimulating investment. However, VAT rates are increasing, and this has somewhat less of an impact on the richest households, who have the lowest propensity to consume.

As shown in the graph below (Figure 19), over the past two decades, top corporate tax rates have been in constant decline in the European Union. This is a global trend, as observed by Gerber et al. (2018).

As illustrated in the graph below (Figure 20), the EU-28 average top personal income tax (PIT) rate was in constant decline until 2009. 2010 was the first year after more than a decade in which more Member States raised the top PIT rate than reduced it. Since then, the average top PIT rate has been relatively stable. This trend is also visible across the world.

---

7. Threshold is at 60 % of national median equivalised disposable income.
Figure 18a  At risk of poverty rate before transfers

Figure 18b  At risk of poverty rate after transfers

Source: Eurostat Database.
Moreover, as stated by the IMF (2017b), ‘Tax progressivity – the degree to which the average tax rate rises with income – has been on a declining trend in recent decades’ in the OECD. ‘Irrespective of the chosen measure, PIT progressivity declined steeply in the 1980s and 1990s’, the report continues. Ultimately, ‘tax systems may be even less progressive than suggested by these measures,’ because wealthy individuals often have more access to tax relief and more opportunities to avoid taxes [...]’, while ‘Many tax

reforms since the 1990s have involved an increase in the exemption threshold together with a lower top PIT rate, causing a shift in the tax burden from very low and very high incomes toward the middle’.

Figure 21 shows the relationship between changes in top marginal tax rates and in the top 1% pre-tax income share in OECD countries, which occurred between the early 1970s and the late 2000s. The correlation is particularly strong: on average, a 2 percentage point drop in the top marginal tax rate is associated with a 1 percentage point increase in the top 1% pre-tax income share. Countries such as Germany, Spain, Denmark and Switzerland, which did not experience any significant top rate tax cut, did not experience increases in top income shares. Conversely, the United States, UK and Canada experienced important reductions in top marginal tax rates and saw their top 1% income shares substantially increase. This graph strongly suggests that top tax rates play a key role in moderating pre-tax top incomes.\(^\text{12}\)

Finally, value added tax rates across Europe are increasing,\(^\text{13}\) which represents a higher share in the poorest income households compared to the richest, as VAT is a proportional tax.

\(^{12}\) See World Inequality Lab (2018).

\(^{13}\) See European Commission (2018b).
Conclusion

By drawing on standard national accounting definitions, we endeavoured to determine whether the call for increased profits led to an increase in investment as a share of domestic income. We observed that profit developments did not take long to recover after the financial crisis, resuming at a similar pace to that in the years preceding the crisis. We sought to determine whether this rise in profit as a share of GDP was translated into new investment projects as a share of GDP. This proved not to be the case, and we therefore contested the view of profit as an engine of economic growth.

We therefore tried to identify where additional profits were being diverted. We observed that an increasing share of net profits, after deduction of capital depreciation, were being distributed as dividends and diverted away from productive activities. Since profits increased at a faster pace than GDP in the period, in view of the rise in profit shares, we deduced and demonstrated that an increasing proportion of profit was being diverted away from the real economy towards financial activities, such as dividends and financial assets. To a certain extent, this is hardly surprising given the returns that can expected from investing in the financial markets compared to the real economy, especially if there is a decline in the wage share of the economy.

We also endeavoured to show that the income and wealth of the richest households increasingly come from financial sources. We therefore tried to establish a link between the lack of investment and the increasing inequality in income and wealth in Europe. In so doing, we sought to demonstrate that wealth inequality is exacerbated by income inequality and that wealth is increasingly inherited, creating a further layer of inequality.

Source: European Commission 2018a.
Since profit development and increased consumption were considered to be the real engines of economic growth, all corporate tax rates were lowered, and the top marginal income tax rates were cut. Meanwhile, progressivity in income tax rates decreased. This was compensated by public intervention, but at the cost of diminishing the value of the public capital stock, a move which comes at the expense of the low and middle classes who are liable to repay the debt to the richest for lending their non-taxed income and wealth. Finally, proportional taxes, VAT especially, were raised.

Therefore, it is possible to conclude that inequality is indeed detrimental to growth, since the additional profits are not reinvested as a means of increasing growth potential. Moreover, we cannot expect social policy alone to resolve the situation. As we have endeavoured to show, this diversion of investment away from the real economy that has been ongoing since the 1980s is creating a vicious circle which could be resolved either by means of fiscal intervention, though public deficit-spending, and/or by means of monetary intervention, through quantitative easing.

Corporate tax rates should certainly be higher (putting an end to the race to the bottom), and personal income tax rates should be more progressive and higher. But there is also an urgent need to reverse the decline in the wage share. Financial regulation also needs to be relaunched, and not only that of the banking system, in order to disincentivise diverting profit towards financial activities and prevent an increase in inequality, and in so doing bring more stability to the financial markets.

In other words, inequality is not merely the result of poor social policies; it is also an integrated ingredient of a degenerative productive system, siphoning away at the bases of the economic system for creating financial wealth.

References


All links were checked on 18.02.2019.