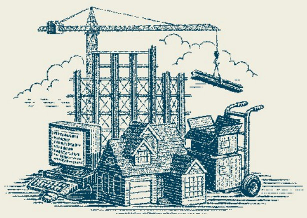
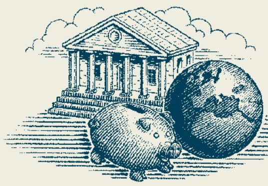
The Profits Perspective Explained

This page is a quick reference for readers interested in the sources of aggregate corporate profits. Profits profoundly influence business decisions about future employment, production, and investment and, therefore, they play a central role in our forecasting.





The Sources of Profits

Every year since 1933, American corporations in aggregate have taken in revenue in excess of their expenses. Where do these profits come from?

Profits are the wealth the business sector accumulates in a given period of time. They are the total new wealth created in the economy less the amount of that wealth accumulated by all the other sectors—households, government, and foreigners.

In economics, the accumulation of wealth is called saving, and the creation of wealth is called investment. *Investment* here refers not to the purchase of stocks or bonds, but rather to activities that increase the total physical wealth in the economy, such as the construction of buildings and manufacture of equipment.

By common sense, the new wealth the economy accumulates equals the new wealth the economy creates. In other words,

Saving = Investment

Total saving equals the saving by business plus the saving by all other sectors, hence

Business Saving + Nonbusiness Saving = Investment

Since business saving is profits after paying business income tax and dividends,

Profits after tax – Dividends = Investment – Nonbusiness Saving

Thus,

THE PROFITS EQUATION*

Profits after tax = Investment – Nonbusiness Saving + Dividends

Where:

Investment is the creation of new wealth including outlays for the construction of housing and nonresidential structures; purchases of new business equipment; and additions to business inventories of materials, parts, and unsold finished goods.

Nonbusiness Saving is the accumulation of new wealth by households (personal saving), the public sector (government surplus), and the foreign sector (U.S. current account deficit).

Profits after tax, or business saving, is the accumulation of new wealth by the business sector, or business saving, before dividends are paid.

Dividends are corporate payments of dividends to shareholders.

The profits equation was derived in 1914 by Jerome Levy (1882-1967).

This equation is an identity, meaning that it always holds true. It says that changes in the profit sources — the components of investment and nonbusiness saving — will be matched by changes in profits. This perspective is a powerful tool for economic forecasting. Since profits heavily influence business decisions about future employment, production, and investment, our profit forecast for one period influences our forecast for the economy in subsequent periods.

To understand not only why the profits equation is true but how it works requires looking at the flows of funds that contribute to profits. For this more complete explanation of the sources of profits, see *Where Profits Come From*. To obtain a copy, call 888-244-8617. For further discussion, see *Profits and the Future of American Society*, by S Jay Levy and David A. Levy (HarperCollins).

The profits perspective has broad applications beyond forecasting. It reveals important dynamics of the business cycle and exposes misconceptions about saving, investment, and profits that permeate economic policy discussions.

* Profits, investment, and nonbusiness saving are all net of depreciation.