THE ROLE OF PROFITS IN ECONOMETRIC MODELS

BY

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1 INTRODUCTION

The dramatic fall in the relative size of profits during the Seventies has received much attention, both internationally and in the Netherlands. An abundance of articles about and contributions to this subject has appeared since Okun and Perry observed a profit squeeze in the United States. In the Netherlands especially Smulders and Van der Zwan have analysed the issue of declining profits explicitly. However, many other authors can be mentioned who have touched upon this phenomenon in analysing the employment problem.

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Initially, the discussion in the Netherlands on the stagnation of employment during the Seventies and, connected closely to that, the squeeze in profits, centered around the question of whether or not this fall was due to a lack of sufficient demand. The adherents to this (Keynesian) demand-orientated diagnosis indicated that there was a general saturation in many markets, which gave rise to heavy competition among suppliers and consequently resulted in low prices and low profits. As a remedy it was recommended that the public sector should raise its share in national income in order to expand those activities which were hampered by insufficient means of financing. As long as the balance of payments on current account could bear it, the public sector share should be raised by enlarging the budget deficit. In doing so the rate of capacity utilization should rise and both employment and profits could recover.\(^5\)

In contrast to this demand-orientated explanation there is another school of thought that puts a heavy weight on real labour costs. From the mid-Sixties onwards the increase of the real wage rate has surpassed the growth of labour productivity. This is explained by referring to a steep rise of the burden of taxes and social premiums in the Sixties and Seventies, a burden which for a large part has been shifted to the enterprises by claiming additional wage increases. At the same time fear about unemployment gradually lost its impact on wage bargaining behaviour, because the system of social security was improved and social attitudes with respect to unemployment became more tolerant. Due to this the international competition position deteriorated, the average life-span of capital decreased, labour was shaken out and profits were squeezed. The profits squeeze in turn was followed by a decline in investments, which also affected employment negatively.\(^6\)

Yet one more explanation should be mentioned, which can be labelled as the ‘long wave approach.’ This explanation attempts to combine elements from the demand and supply orientated approaches. The upward swing of the long wave is characterized by many innovations and by much confidence on behalf of entrepreneurs and consumers. Investment activities are expanded and the ratio of investment to national income is rising. The trend in labour-productivity is accelerating (innovations!) and with some lag the growth rates of real wages and consumption also accelerate. Nevertheless, investment growth is still leading and

\(^5\) An explanation in this sense can be found in W. Driehuis, *Capital-Labour Substitution and other Potential Determinants of Structural Employment and Unemployment*, Research Memorandum 7708, University of Amsterdam, 1977.

\(^6\) This approach has been most clearly expressed by Den Hartog, Van de Klundert and Tjan, *De structurele ontwikkeling van de werkgelegenheid in macro-economisch perspectief*, Preadvies van de Vereniging voor Staathuishoudkunde, 's-Gravenhage, 1975. Although demand factors have not been neglected, these authors put much emphasis on the supply side.