Where Do Profits in the Financial Sector Come From?

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Abstract. The paper aims at answering the question “Where Do Profits in the Financial Sector Come From?” It discusses the sources of profitability of the financial sector at an empirical level, and addresses this question at a theoretical level trying to reveal the nature of this profit. An attempt is made to relate these issues to the functions performed by the financial sector with respect to the process of production, and to single out the corresponding dimensions of profit from financial activity.

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This is a very preliminary version of a research project at a very early stage of its development. Most of the ideas presented have a character of hypotheses rather than proved results. Please, keep it in mind while reading this material, and do not quote without author’s permission.

The ultimate goal of the present study is to answer the question “Where Do Profits in the Financial Sector Come From?” But before turning to the core issue of the research, we find it necessary to establish the boundaries of the financial sector, define what we mean by its profit, and find a measure in which it manifests itself. The first two issues will be considered in the present part of the paper, and the last question will be the focus of Part 2. The core question will be directly addressed in Part 3.

In macroeconomic studies and statistical databases, the conventional understanding of profit of the financial sector is that of all the establishments making up the financial sector, which is to be found in NIPA (National Income and Product Accounts). We find this measure inappropriate for the purposes of the present analysis, because it does not include capital gains and dividends that are a substantial part of profit, and because it is based on a “sectoral” approach to an economy, by contrast to that allowing for differentiation among types of activity.

At the same time, a closer examination of functioning of modern economies reveals that financial activity spreads far beyond financial corporations only. Thus, to serve the purposes of the present study the financial sector should be redefined on basis of differentiation between financial enterprises and financial activity.

The financial sector extends beyond financial corporations. In a narrow sense, the financial sector represents all types of financial activity of both financial and non-financial corporations. Put differently, the financial sector is the corporate sector in its financial activity. In a broad sense, in addition to that, it also includes financial activity of households and government sector. An analysis below will proceed at both levels. To begin with, we will consider financial activity of the corporate sector by focusing on the nature of its profit from
financial activity. After that, we will turn to an analysis of an economy as a whole, and will try to analyze the nature of profit from financial activity on an economy-wide level.

Thus, a first step in answering the main question of the present study is to overcome limitations of the NIPA methodology. We can do it by taking into account the following facts.

Firstly, given a rising involvement of non-financial corporations in financial activity in the period of financialization and given sophisticated relationship between the financial and non-financial dimensions of the process of capitalist reproduction in general, it is reasonable to distinguish between profits coming from different types of activity (i.e. financial and non-financial), by contrast to sectors.

Secondly, capital gains is a form of profit from financial activity – from holding financial assets. Hence, it should also be included, if one is to analyze financial profit in its totality.

Thirdly, although dividends are always treated as a part of already existing profit which is to be redistributed among shareholders, and hence are not added to the total profit to avoid double-counting, it is crucial to remember that by their very nature dividends represent a payment for lending money-capital. It is exactly what Marx called capital-property, by contrast to capital-function. Hence, dividends are also to be taken into consideration in understanding the relative shares of profit from financial and non-financial activities.

These considerations make it necessary to use the IRS (Internal Revenue Service) data on corporate profits.¹ It is the primary source of data for NIPA, and it is more adequate for the purposes of the present study, for it allows for distinguishing between different categories of

¹ The IRS data on corporate profits is available online only for the period 1994-2004. After the author will make sure that the methodology suggested in the next part of the paper is correct and free of even minor pitfalls, we will use this methodology to construct longer time-series by finding the data series which is not available online. For now, all the calculations are performed only for 1994-2004.
income, especially those purposefully eliminated by NIPA methodology (such as capital gains and dividends).\textsuperscript{2} It can serve a basis for an activity-based approach suggested above.

Such an understanding of the boundaries of the financial sector allows us to raise a question of what we mean by profit from financial activity. Given that we defined the financial sector in a narrow and in a broad sense, profit from financial activity can also be defined at these two levels.

\textbf{1.1. Profit from Financial Activity: Corporate Sector}

In a narrow (and also commonly used) sense – that of the corporate sector only – we can proceed in the following way to find profit from financial activity. If one uses the IRS data, the \textit{total profit} for the US economy as a whole (meaning as always the corporate sector only) can be found as total receipts less total deductions, less dividends received from domestic corporations:

\[
\pi_{\Sigma/C} = \sum \text{receipts} - \sum \text{deductions} - \text{div}_\text{rec}
\]  

(1)

where

\(\pi_{\Sigma/C}\) – total profit of the corporate sector

\(\text{div}_{\text{rec}}\) – dividends received by the corporate sector from domestic corporations (paid out of their total profits)

The last term is necessary in order to avoid double-counting, given that dividends represent redistribution of the already existing profit. Incidentally, this is one of the many adjustments made in NIPA. But the resulting profit measure, \(\pi_{\Sigma/C}\), differs from the standard definition of profit by NIPA in the way, that the former includes net capital gains and dividends received from foreign corporations. The other differences are discussed in Appendix 1.

\textsuperscript{2} A detailed discussion of NIPA definitions of profit of the financial sector can be found in the Appendix 1.
The methodology above suggests that the total profit for the economy as a whole can be also understood as a sum of profit from financial and non-financial activities.

*Profit from financial activity* can be found as a sum of profit from financial activity of the non-financial corporations, profit of the financial corporations, and dividends received from domestic corporations paid out of profit from their non-financial activity.

\[
\pi_{FA/C} = \pi_{FA/NFS}^{bd} + \pi_{FS}^{bd} + div_{rec/NFA}
\]

(2)

where

\( \pi_{FA/C} \) – profit from financial activity of the corporate sector

\( \pi_{FA/NFS}^{bd} \) – profit from financial activity of non-financial corporations (adjusted for dividends received from domestic corporations that are subtracted from total receipts less total deductions of these corporations, as it was in (1) for the economy as a whole)

\( \pi_{FS}^{bd} \) – profit of financial corporations (adjusted for dividends received from domestic corporations that are subtracted from total receipts less total deductions of these corporations)

\( div_{rec/NFA} \) – dividends received by the corporate sector paid by domestic corporations out of their profit from non-financial activity

Incidentally, the present measure of profit of financial corporations, \( \pi_{FS}^{bd} \), should not be confused with that in NIPA definition, for the former also includes dividends received from foreign corporations and net capital gains. It resembles the situation discussed above, where the same was the case with the total profit for the corporate sector, \( \pi_{\Sigma/C} \). *Profit of the financial corporations*, \( \pi_{FS}^{bd} \), can be directly calculated from the IRS data, by analogy to the total profit
for the economy as a whole – as total receipts of the financial sector less total deductions of the financial sector, less dividends received by the financial sector from domestic corporations.

*Profit from financial activity of the non-financial corporations*, $\pi_{\text{FA/NFS}}$, can, in turn, be found as a sum of net interest, dividends received from foreign corporations, net capital gains, and net gains on non-capital assets for the non-financial corporations. Alternatively, it is equal to the total profit from financial activity of the entire corporate sector (sum of net interest, dividends received from foreign corporations, net capital gains, and net gains on non-capital assets) less profit from “financial activity of the financial corporations” (sum of the same items for the financial sector only).

Thus, we can see that profit from financial activity in the present definition includes not only the traditionally calculated profit of the financial sector (see, for instance, NIPA’s measure), i.e. profit of the financial corporations, but also net capital gains (received by both financial and non-financial corporations), dividends received from foreign corporations, and dividends received from domestic corporations paid out of their profit from non-financial activity.\(^3\)

*Profit from non-financial activity* is the difference between the total profit of the non-financial corporations and the profit from their financial activity, less dividends received paid out of profit from non-financial activity.

\[
\pi_{\text{NFA/C}} = \pi_{\text{NFS}} - \pi_{\text{FA/NFS}} - \text{div}_{\text{rec/NFA}}
\]  

(3)

where, in addition to the notations above,

\[\pi_{\text{NFA/C}} \text{ – profit from non-financial activity of the corporate sector}\]

\(^3\) One can notice that the role of dividends and capital gains in distinguishing between profit from financial and non-financial activities stems from analysis done by Marx in Capital Volume 3, where he distinguished between the two components of profit – interest (in our case, dividends and capital gains), which corresponds to capital-property, and profit of enterprise (here, corporate profit in the standard NIPA definition), corresponding to the functioning capital.
\( \pi_{NFS}^{bd} \) – profit of the non-financial corporations (adjusted for dividends received that are subtracted from total receipts less total deductions)

Hence, a sum of profits from financial and non-financial activities is equal to the total profit of the corporate sector:

\[
\pi_{FA/C} + \pi_{NFA/C} = \pi_{FS}^{bd} + \pi_{NFS}^{bd} = \left( \sum \text{receipts}_{FS} - \sum \text{deductions}_{FS} - \text{div}_{rec/FS} \right) + \\
\left( \sum \text{receipts}_{NFS} - \sum \text{deductions}_{NFS} - \text{div}_{rec/NFS} \right) = \pi_{\Sigma/C}
\]

One can easily see that dividends received from domestic corporations paid out of profits from non-financial activity cancel out, which implies that their magnitude does not affect the magnitude of the total profit in the economy, but does affect the magnitudes of profit from financial and non-financial activities, i.e. their relative shares. It is exactly the reason why we emphasized above that, although this type of dividends should be excluded while calculating the total profit, it plays a crucial role in determining the magnitudes of different components of the total profit.

Three remarks about dividends are in order.

First of all, the fact that a part of dividends received from domestic non-financial corporations is paid by other domestic non-financial corporations does not undermine the considerations above. One could argue that, if two corporations pay dividends to each other, these dividends, or at least a part of them, cancel out, hence, one does not have to add to the profits from financial activity the total amount of dividends received by domestic non-financial corporations, and this magnitude should be adjusted for these cross-payments that cancel out. Although from a purely quantitative viewpoint these amounts do cancel out, it does not undermine the methodology suggested above, because these mutual payments of dividends are qualitatively distinct from profits from productive activity, and hence should be treated
separately. This seeming lack of a quantitative change masks a qualitatively different nature of the underlying parts of profit. Put differently, dividends received by non-financial corporations from other non-financial corporations still represent profit from financial activity, for this part of profit stems from lending money-capital, i.e. from financial activity of non-financial corporations. If the total profit of the corresponding corporations does not change after these mutual payments of dividends, a certain part of this profit stems from financial activity, hence, should be treated as such. Nevertheless, this phenomenon of mutual dividend payments raises an interesting question: if it is generally accepted that corporations issue equities in order to attract capital, does the fact of their simultaneous holding financial assets that can be easily converted into tangible assets (but not the other way around) undermine this understanding of issuing equities? That is, if corporations were to issue equities to attract funds, why do not they just sell the financial assets of other businesses they hold? It suggests a possible answer that they hold financial assets for some other reasons, and/or issue equities for reasons other than raising funds for expanding the process of production.

Secondly, the category “dividends received” includes dividends paid out of total profits, hence, out of profits from both financial and non-financial activities. Dividends paid out of profit from financial activity represent a pure change of form of the profits already included as those from financial activity, i.e. a change from profits from performing financial services to profit from owning and lending money-capital (i.e. dividends). In order to be consistent in the methodology suggested in the present study, we should add only dividends paid out of profit from non-financial activity to profits from financial activity (before dividends). If we add total dividends received, we would add dividends received and paid out of profit from financial
activity twice – as a part of profit from financial activity (before dividends), and as dividends, which will result in double-counting.

To find dividends received from domestic corporations paid out of profits from their non-financial activity, we can assume that they are related to total dividends received as total profit from non-financial activity (before dividends are taken into account) is related to the total profit:

\[
\frac{div_{rec, NFA}}{div_{rec}} = \frac{\pi_{NFA}}{\pi_{\Sigma/C}} \tag{5}
\]

then

\[
div_{rec, NFA} = div_{rec} \cdot \frac{\pi_{NFA}}{\pi_{\Sigma/C}} \tag{6}
\]

Thirdly, in adding and subtracting dividends received to find the relative proportions of profit from financial and non-financial activity, we used the following criterion: out of profit from what type of activity these dividends are paid. This is the core question to be answered. It is crucial to notice that this criterion is necessary and sufficient for establishing proportions between profit from financial and non-financial activity, and who receives these dividends (i.e. whether the dividends paid out of profit from non-financial activity are paid to financial or non-financial corporations), does not matter. It is exactly for this reason that we used the total amount of dividends received by the corporate sector as a whole to find the correct proportions in (5) and (6). One might think that we should focus only on dividends received by non-financial corporations. But it is not the case. Consider dividends received by non-financial corporations. These dividends received are a part of profit from two types of activity – financial and non-financial. As we showed above, dividends received by non-financial corporations paid out of profit from financial activity should not be added to profit from financial activity, because this part of profit has already been counted. By contrast, dividends received by non-financial
corporations paid out of profit from non-financial activity should be added to profit from financial activity. Now, consider dividends received by financial corporations. Like above, these dividends received are paid out of profit from financial and non-financial activity. The former represents a pure change of form of profit from financial activity – from profit from, say, providing financial services to profit for lending money-capital. The latter is profit from financial activity, although it seemed to be a part of profit from non-financial activity. Hence, it should be added to profit from financial activity to find its actual magnitude, and should be subtracted from profit from non-financial activity, because it was paid out of exactly this part of profit, which should obviously be reduced by this amount. Thus, we can see, not all the dividends received by non-financial corporations are a part of profit from financial activity. And not all the dividends received by financial corporations should be viewed as already counted. At the same time, profit from non-financial activity should be reduced by the amount of dividends paid out of this profit – no matter who is the recipient. The criterion of distinction is not who receives dividends, but out of profit from what type of activity they are paid.

Below, we will construct time series reflecting the methodology suggested above and compare results with the conventional measures of profitability of the financial sector. The figures below will reflect the sources of profit received by the corporate sector in the US economy. In order to turn to a broader question of the nature of profit in general, we need to consider the financial sector in a broad sense.

1.2. Profit from Financial Activity: Corporate Sector and Households

As it was shown above, financial sector in a broad sense represents financial activity of the corporate sector, households, and the government sector. For now, we abstract from financial
activity of the government. Thus, to discuss profit from financial activity at the economy-wide, or at least private-sector wide, level, we need to enrich the analysis above by understanding the nature of financial activity of households and by deriving a corresponding measure of its profit.

From our perspective, income of households has two major constituents – wages and salaries, that reflect the role of households as wage-labor, and the so-called “rentier income” (Epstein), reflecting involvement of households in financial activity. If, by contrast to the usual statistical definitions, we understand profit as a category encompassing all kinds of non-labor income (reduced by the corresponding costs) of the corporate sector and households, and consider profit created by the corporate sector and paid to households as returns on their financial activity, this rentier income can, in turn, be viewed as a part of profit at the economy-wide level. Thus, profit of households (their income from financial activity) comprises dividends received by households, net capital gains, and net interest:

$$\pi_{HH} = \text{cap.gains} + \text{interest} + \text{div}_{rec}^* = \pi_{FA/HH}$$  \hspace{1cm} (7)

Then, profit from financial activity for the economy as a whole consists of profit from financial activity of the corporate sector and that of households:

$$\pi_{FA/\Sigma} = \pi_{FA/C} + \pi_{FA/HH}$$  \hspace{1cm} (8)

where \(\pi_{FA/C}\) is from (2), and \(\pi_{FA/HH}\) is from (7).

Total profit for the economy as a whole can be presented as a sum of the corporate profit and a sum of net capital gains and net interest received by households. As in case with the corporate sector above, to find total profit we have to abstract from dividends received, because they represent merely redistribution of the already existing profit, hence, are already added to the total profit as a part of the profit created by the corporate sector. Hence,

$$\pi_{\Sigma} = \pi_{\Sigma/C} + \pi_{HH} - \text{div}_{rec}^*$$  \hspace{1cm} (9)
where

\[ \pi_\Sigma \] – total profit for the economy as a whole

\[ \pi_{\Sigma/C} \] – total profit of the corporate sector found in (1)

Like with profit from financial activity of the corporate sector, a word of caution about dividends received is needed. Dividends received by households represent dividends paid by the domestic corporate sector out of its total profit, hence, profit from both financial and non-financial activity. As a result, to find profit from financial activity for the economy as a whole we need to add to the corporate profit from financial activity only those dividends received by households that are paid out of profit from non-financial activity of the corporate sector. The other part of dividends received by households – paid out of profit from financial activity – is already a part of profit from financial activity of the corporate sector, hence, should not be added to profit from financial activity of households in order to avoid double-counting.

To find dividends received by households paid out of profit from non-financial activity, we can use the same assumption as above with respect to dividends received by the corporate sector. That is, that dividends received by households paid out of profit from non-financial activity are related to total dividends received by households as total profit from non-financial activity of the corporate sector is related to its total profit:

\[
\frac{div_{rec}^*}{div_{rec}} = \frac{\pi_{NFA/C}}{\pi_{\Sigma/C}} \tag{10}
\]

then

\[
div_{rec}^* = div_{rec} \cdot \frac{\pi_{NFA/C}}{\pi_{\Sigma/C}} \tag{11}
\]
These ideas and methodological considerations allow us to construct the corresponding time-series, depicting profit from financial activity in a broad sense. The methodology suggested with respect to the financial sector in a broad sense has not yet been applied to the empirical data, for this reason now we will focus on the empirical results for only the financial sector in a narrow sense that will be discussed in the Part 2 below. These results are to be augmented in future.

2. Structure of Profit from Financial Activity

The traditional definition of profit of the financial sector by NIPA yields the following results for the magnitude of profit of the financial sector and its share in the total profit (Appendix 2, Figures 1 – 4). Financial sector profit in the US economy has increased from a little over $100 billions in 1994 to $275 billions or $400 billions in 2005 for corporate profit before tax and profit with IVA, correspondingly (Figure 1). The share of the financial sector profit in the total domestic profit with IVA was rising from 25 per cent in 1994 to the record level of 45 per cent in 2002, after which declined to 33 per cent in 2007 (Figure 3).

It is interesting to compare these results with results that can be obtained by using the methodology suggested above, based on analyzing the IRS data.

2.1. Financial Sector in a Narrow Sense: Corporate Sector

Total profit from financial activity of the corporate sector amounted to $600 billions in 2004 (Figure 5). The share of profit from financial activity in the total domestic profit has been rising for the last decade, and increased from 27 per cent in 1994 to 57 per cent in 2004, reaching a record level of almost 70 per cent in 2002 (Figure 6).
Profit from financial activity of the corporate sector has the following structure (Figures 7-14). Note that in Figures 8-11 “other (from FS) profit” is found as a residual, by means of subtracting dividends received paid out of profit from non-financial activity, net capital gains, foreign dividends, and net gains on non-capital assets from the total profit from financial activity. Thus, this residual, i.e. “other (from FS) profit”, represents profit from services of financial corporations (including net interest) and from lending activity of non-financial corporations, resulting in their interest receipts. Due to lack of data on the structure of costs of financial corporations, at the present level of analysis we can’t distinguish between profit from financial activity yielding interest and non-interest income. We can speak of either structure of revenue, and in this case distinguish between interest and non-interest income, or of profit from financial services combining both types of income receipts.

Nevertheless, there are some interesting conclusions that can be drawn from the graphs below. Firstly, as Figure 12 shows, since 1997, the non-financial corporations have been constantly receiving positive profit from financial activity. Moreover, since 1998, financial activity of non-financial corporations has amounted to about one third of the total financial profit (Figure 7). This tendency reflects the often debated increasing involvement of non-financial corporations in financial activity, associated with financialization. In 2004 this value reached a record level of 40 per cent, indicating the continuation of this trend.

Secondly, the structure of profit from financial activity of non-financial corporations is of special interest. In this sense the major observation is that, since 2003, the non-financial corporations have been net-creditor (Figure 13). Nevertheless, the major source of profitability of their financial activity has always been net capital gains, reaching its maximum level of $150
billions in 2000. Foreign dividends is the second leading source of profit from financial activity of non-financial corporations.

Thirdly, as Figures 8-11 indicate, since 1994, profit from financial activity has been rising through two major channels – through a rise in net capital gains and profit from financial services (the so-called “other” on the graphs). If the former played a crucial role in 1997-2000, with an afterwards decline in the absolute and relative value of net capital gains, the latter has been steadily rising through the entire period of 1994-2004, and has become the only source of rise in financial profit since 2001. Net capital gains as a share of profit from financial activity has increased from 40 per cent in 1994 to 50 per cent in 2000, with an afterwards decline to about 25 per cent in 2004. At the same time, the corresponding share of profit from provision of financial services has doubled – from 30 per cent in 1994 to almost 60 per cent in 2004. This indicates a dramatic rise in profits from financial activity stemming from provision of financial services. The other components of profit from financial activity – dividends received from foreign and domestic corporations, net gain on non-capital assets – have remained relatively stable.

3. Nature of Profit of the Financial Sector

So far we only defined what we mean by the financial sector and considered some empirical measures of profit of the financial sector that can be appropriate for the purposes of the present study. We regard these definitions and empirical results, although being of independent interest, as merely auxiliary and by no means an end in itself. Thus, we have to turn to the core issue and the main goal of the present analysis – to establish where profits in the financial sector come from. In the present part of the paper we will present some first thoughts and author’s hypotheses that represent the lines along which we plan on doing the research.
The financial sector is usually considered in its relationship to the so-called real economy, which is basically the process of production of goods and non-financial services. It is the case for both mainstream theories speaking of the so-called classical dichotomy and emphasizing functions of the financial sector with respect to the process of production, consumption, and growth and heterodox theories in their long-lasting debates about the relationship between the financial sector and the real economy, “decoupling” hypothesis (Menkhoff and Tolksdorf, Heine and Herr, and other participants of these debates in Europe), etc. Although this distinction between the two spheres of economy has become a common knowledge, we think it is necessary to stress that these debates as such do not really give an explicit answer to the question why we usually compare and contrast these two spheres, and why the financial sector is usually treated in its relation to the rest of the economy.

Within a Marxian perspective this question can be answered in the following way. The financial sector historically emerged as a sector producing a specific use-value – specific services for the needs of the process of production, such as accumulation of dispersed savings to finance the process of production, facilitation of the process of payment, etc. There existed demand for these services, which brought about genesis of these services that have gradually crystallized in a specialized sphere of production. This specific use-value, explaining the emergence of the financial sector as a separate branch of production, explains why the financial sector is usually treated not as such, on its own, but in its relationship with the process of production of goods and non-financial services.
3.1. Of the dual nature of the financial sector

These considerations are relevant not only because they provide an answer to the question raised above, but also because they offer a link to some further thoughts in understanding the nature of the financial sector. From a Marxian perspective, the financial sector can be treated as a sphere having a dual nature. On the one hand, as we considered above, it emerged as a sector producing a specific use-value. On the other hand, it is actually an independent realm of profit extraction, as any other sphere of capitalist reproduction. Thus, it exists regardless of any specific use-value, with focus only on exchange value as the main goal of its functioning, and any use-value being subordinated to this primary goal. Thus, there is an inherent contradiction between the financial sector as a sphere producing a specific use-value and aiming at production of exchange value, i.e. a new level of contradiction between use-value and value.

This contradiction manifests itself in the following way. To the extent that the financial sector produces a specific use-value, there is a need for surplus value creation through the process of production for the possibility of profit extraction. On the other hand, to the extent that the major goal of the financial sector is exchange value, the financial sector is a realm of quest for alternative means of profit extraction, which brings about development of mechanisms of profit extraction without an underlying process of immediate surplus value creation, or even creation of conditions for surplus value production. Thus, the financial sector in its second dimension strives to overcome the need for surplus value creation as a sole source of profit. In light of this we can argue that the financial sector is a realm of profit extraction, with a criterion of distinction between its two dimensions being the means of profit extraction. In the first ("traditional") case, we have a need for the financial sector to facilitate surplus value creation in
the real economy, which gives a rise to the specific functions of the financial sector. The second case reflects strive of the financial sector for “other” sources of profit, without a need to facilitate the process of production and, thus, to perform any “productive” functions.

This dual nature of the financial sector has relevant implications for the nature of its profit. A part of profit of the financial sector corresponding to the financial sector as a mechanism facilitating the surplus value creation and performing specific functions represents a form of surplus value. By contrast, profit of the financial sector stemming from its quest for other sources of profit is merely a “pure form”.

It is exactly according to the criterion above that functioning of one dimension of the financial sector has a “useful” by-product, while the other aiming at profit extraction by other means has no useful by-product, or can even cause damage.

To make such a “purely philosophical” understanding and dialectical treatment of the financial sector somewhat useful for an analysis of an economy and for understanding of the ongoing processes and trends in the development of modern economies, we should establish how these philosophical considerations are reflected in the reality, what are the concrete forms taken by the dual nature of the financial sector and its profit. Thus, we have to answer the following questions. What are the concrete productive functions of the financial sector that facilitate value creation and what are the mechanisms and sources allowing the financial sector to overcome the need for surplus value creation as a sole source of profit? What is the relationship (if any) between those and the empirically observable structure of profit of the financial sector and its components as in Parts 1 and 2? In what empirically observable phenomena do these mechanisms of “unproductive” profit extraction and productive functions manifest themselves? What are their magnitudes, hence, what are the quantitative characteristics of the two
components of profit of the financial sector? What is the dynamics of these quantitative characteristics, i.e. the evolution of the relative shares of the two dimensions of profit of the financial sector? These are the questions that represent our research agenda. The present chapter aims at coping with each of these issues.

Addressing the first question just raised, we can argue that the dual nature of the financial sector manifests itself in functions performed by the financial sector with respect to the real economy, on the one hand, and in concrete mechanisms and sources of profit extraction by other means, on the other hand.

As far as functions of the financial sector are concerned, the general function of the financial sector can be understood as production of a specific commodity, i.e. a commodity with a specific use-value – conditions for the surplus value production and/or appropriation. This general function takes a form of a series of specific functions performed by the financial sector in modern economies. These functions will be considered below in a greater detail.

By contrast, the other sources of profit of the financial sector include not only redistribution usually emphasized by Marxists, but probably also other mechanisms of profit extraction without an underlying process of immediate value creation. Among them can be emergence of the so-called “imaginary (notional) profit”, endogenous creation of demand for the services of the financial sector, and overpriced financial sector services.

3.2.1. Manifestation of the dual nature of the financial sector: Concrete functions

An analysis of current literature on functions of the financial sector allows us to single out the following functions of the financial sector with respect to the process of production.4

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4 For the most comprehensive discussion of functions of the financial sector within the mainstream literature, see Tobin (1984), Merton and Bodie (1995), Levine (1997), Hellwig (1997, 2000a), Menkhoff and Tolksdorf (2001),
1. **Payment function.** The financial sector facilitates transactions through several channels. Depositary financial intermediaries accomplish it through issuing liquid deposit accounts (checking accounts), wire transfers, credit/cash cards; money market mutual funds – through transaction-draft accounts, cash management accounts; other financial intermediaries – through issuing credit cards; plus, derivatives through substitution for trading in cash instruments (Merton and Bodie 1995, p. 12-13). As a result, the financial sector allows for reduction in the number of actual financial transactions and reduces demand for cash, raising velocity.

2. **Financing function.** The financial sector finances economic activity, i.e. funds investment projects of businesses and households. It

   ✓ mobilizes saving;
   ✓ pools/agglomerates saving (needed due to economies of scale in production, Levine 1997, p. 698-699), on the one hand, and creates “small denomination instruments” (Levine 1997, p. 699), thus, allowing for diversification, on the other hand;
   ✓ allocates saving and transfers funds (Merton and Bodie, Hellwig), i.e. allows for intertemporal exchange (Hellwig 2000a, S. 2);
   ✓ originates loans and debt instruments.

3. **Information function.** The financial sector serves as a basis for allocation through providing information about the cost of capital, nature of expectations (Cole and Slade 1995, p. 95), etc. It happens through open trade on the stock market, through activity of specialized firms, such as Bloomberg, Reuters, etc.

4. **Screening and monitoring (control) function.** The financial sector allows for two-fold control of economic activity:

Control and prevention/minimization of opportunistic behavior in a form of moral hazard, adverse selection, informational asymmetries, and financial intermediaries’ dealing with incentive problems (i.e. the financial sector overcomes the incentive frictions, Galetovic 1996).

Macroeconomic monetary policy (Cole and Slade 1995, p. 95).

High verification costs of monitoring are reduced by financial system through (Levine 1997, p. 696-697):
- collateral and financial contracts directly lowering verification costs;
- economizing on monitoring costs by reducing duplicate monitoring, if it is undertaken by one intermediary for all its agents – the so-called “delegated monitoring” (Diamond 1984);
- long-run relationship between financial intermediaries and firms;
- stock-markets’ “linking stock performance to manager compensation”, hence, aligning interests of owners and managers and “easing takeovers of poorly managed firms”.

5. Insurance function. The financial sector performs this function through:

- allocation of risk (trading risk, for risk becomes a commodity)
- managing risk (risk diversification, intertemporal smoothing, hedging against risk through derivatives – options, swaps, dynamic trading strategies)
- providing the so-called liquidity services, i.e. liquidity transformation [Levine 1997], or maturity transformation [Winkler, p. 6]. The need for this function arises due to the fact that, under uncertainty, individuals are willing to invest in fixed capital only if liquid capital on short notice is available. It is the financial sector that provides individuals with opportunity to borrow funds while engaged in a long-term
investment project or withdraw financial assets by making financial investment reversible. Moreover, “by exploiting the fact that they have large numbers of depositors, and hence predictable withdrawal demand, banks can economize on liquid reserve holdings” by reducing investment in liquid assets (“improving the composition of savings”, p. 197) and reducing liquidation of productive capital (Bencivenga and Smith 1991, p. 195-196).

6. Asset transformation. Finally, the financial sector transforms assets, by allowing claims and assets they are funding to have different characteristics (payments, liquidity, default risks), i.e. financial intermediaries transform their “illiquid assets into liquid liabilities” (Diamond and Dybvig 1983, p. 402). As a result, it improves the willingness to invest.

According to the mainstream literature, by means of performing these six functions, the financial sector not only contributes to the process of reproduction, but also does so with the reduced corresponding transaction costs related to each function due to specialization and economies of scale.

3.2.2. Manifestation of the dual nature of the financial sector: Concrete mechanisms and sources of profit extraction without underlying process of immediate value creation

As we suggested above, the other dimension of the financial sector, the one aiming at profit extraction without an underlying process of immediate surplus value creation, takes a form of redistribution, possible emergence of the so-called “imaginary profit”, endogenous creation of demand for the services of the financial sector, and overpriced financial sector services. Consider these mechanisms in greater detail.

Redistribution in favor of financial capitalists can exist in different forms and have different sources and mechanisms. It can represent a redistribution of the surplus value from
industrial capitalists and from workers – both in and outside of the financial sector. This kind of redistribution, obviously, has a power nature. At the same time, it is important to note that the productive functions of the financial sector can be a lever for redistribution, as well as the very fact that circuit of capital M-C-M’ starts with money, thus, giving the financial sector more power. As for the specific mechanisms of redistribution, there are plenty of them. For example, redistribution can take a form of direct deduction from profit of the industrial capitalists. It can also be mediated by a specific role of the financial capital in raising the rate of exploitation in the sphere of production, as it might have been the case with neoliberal expansion and spread of corporate takeovers. Notice that a rise in profit of the financial sector due to a rise in the rate of exploitation can (though does not necessarily) co-exist with rising profit of industrial capitalists. Finally, we can also look at a hypothesis of “redistribution in time” – a situation when a rise in profits of the financial sector represents a reason of a later-on decline of this profit, and the other way around.

We are also going to work with a hypothesis of existence of the so-called “imaginary profit”, which can be understood as profit of the financial sector that exists only “ideally”, i.e. as a corresponding record in balance-sheets. We suspect that a part of the profit from financial activity can be a purely accounting phenomenon, “pure form”. It implies that it exists only within the sphere of circulation and only to the extent that it is not channeled back into the process of production, simply because it cannot be channeled back due to lack of liquidity and, even more important, surplus value behind it. We assume that a proxy for this notional profit can be a change in the level of unappropriated retained earnings per period. (Notice that profit of the financial sector for some periods has similar dynamics and even magnitude as a change in
retained earnings, which obviously requires a careful analysis of reasons behind it.\(^5\) The emergence of this imaginary profit becomes possible due to development of “cybercash” (Guttman), and electronic money, which has a potential to exist without an underlying process of liquidity creation, let alone creation of surplus value. Another relevant link here is financial innovation which brings about money endogeneity, hence, allows the financial sector to endogenously provide means for its profit, i.e. to “create” money for its own profit. A deeper root of it can be traced back in ideal money in Marx. Nevertheless, we need to stress again that the notion of “imaginary profit” is merely a hypothesis which will not necessarily be proved in the course of the present research project.

\[
\begin{array}{|c|c|c|c|c|c|c|c|c|c|c|}
\hline
\hline
\text{Change in retained earnings} & -2,000 & -1,500 & -1,000 & -500 & 0 & 500 & 1,000 & 1,500 &  &  &  \\
\hline
\text{Profit from financial activity} &  &  &  &  &  &  &  &  &  &  &  \\
\hline
\end{array}
\]

Source: calculations by author based on the IRS data

\(^5\) The only major exception for the available data is 2000 – 2002 when one can observe a dramatic decline in change in retained earnings, implying that the absolute magnitude of retained earnings was declining. This decline co-existed with relatively stable and only slightly declining profit from financial activity. A possible explanation of this phenomenon is that retained earnings could be used in production to compensate losses and decline in profits from non-financial activity, which were taking place at this time period.
The other two sources of profit extraction – endogenous creation of demand for the services of the financial sector and overpriced financial sector services – are two reflections of monopolistic nature of the financial sector. The former reflects the capacity of the financial sector to create demand for its own services. As a result, the corresponding elements of the financial sector are “kind of productive” – they are made to be necessary by the financial sector itself, hence, they are productive not only within capitalism, but only under conditions artificially created within capitalism. The other aspect, i.e. overpriced financial services, also reflects monopolistic nature of the financial sector in its ability to set prices for its services thanks to market power. A caveat in understanding these two mechanisms of profit extraction is that empirically it is extremely hard, or maybe even impossible, to find the degree to which the demand for services of the financial sector is endogenously created and what the “true value” of these financial services is that is exceeded by prices.

3.3. Dual nature of profit of the financial sector

An analysis of the discussion on the nature of profit of the financial sector reveals an extremely conflicting understanding of the phenomenon in question. On the one hand, according to the mainstream approach, profit of the financial sector, like any other income in the economy, is a reflection of the financial sector’s contribution to the process of production. On the other hand, most of the Marxists argue that the financial sector merely redistributes surplus value created in the sphere of production, thus, its profit is a direct deduction from surplus value. From our perspective, each of these approaches focuses on only one of the really existing aspects,
hence, neither one provides an exhaustive explanation of the nature of profit of the financial sector.

By contrast to these conventional approaches, we suppose that the financial sector has a dual nature discussed above. This understanding allows us to overcome the one-sidedness of the traditional approaches, and to focus on an analysis of the complex nature of profit of the financial sector. As we already mentioned above, the dual nature of the financial sector, concrete manifestations of which we have just discussed, brings about the dual nature of profit of the financial sector, with its part corresponding to functions of the financial sector being a form of surplus value and its part related to profit extraction without an underlying process of surplus value creation being merely a pure form. This dual nature of profit of the financial sector has a more complex manifestation in economic reality, where profit of the financial sector can be presented as a “continuum”.

Under the assumptions that we are abstracting now from redistribution within the financial sector per se (among financial capitalists), from overpriced financial services due to difficulties in measuring their “true value”, and from possible negative effects of the financial sector on the process of production, we can summarize the range of the nature of different components of profit of the financial sector in the following table.

Table 1. Nature of profit of the financial sector

<table>
<thead>
<tr>
<th>Function in general</th>
<th>Functions in capitalism</th>
<th>Redistribution</th>
<th>Imaginary profit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>General</td>
<td>Endogenously created</td>
<td></td>
</tr>
<tr>
<td>Degree to which profit is a compensation for something “useful”</td>
<td>+</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>
Nature of profit | Revenue stems from productive contribution of the financial sector, profit – from exploitation within the financial sector* | Ambiguous: *seems* that revenue comes from productive contribution as it is the case with functions in general, *indeed* it stems from power of financial capitalists to endogenously create the corresponding conditions | Profit stems from power of financial capitalists over industrial capitalists and workers | Becomes possible due to ideal aspect of money as in Capital Volume 1

* - the only difference between functions useful in general and functions useful within capitalism only is the fact that there is a need to understand and preserve the former through alternative mechanisms of performing the same functions, if one aims at a transition beyond capitalism. Among these functions are financing of technical progress (Schumpeter), facilitating a rise in labor productivity, freeing up consumption from the level of current income, minimization of the need for cash/money. Having said that, in empirical part of the present work and in establishing the relative shares of different components of profit of the financial sector we are going to abstract from this difference, and consider both types of functions of the financial sector as somewhat useful, with identical implications for the nature of profit, which is not actually the case, as the table above shows.

Thus, a question arises of establishing the relative shares of the aforementioned dimensions of profit of the financial sector. Given that most of the variables are unobservable, in order to do it, we have to find proxies for all the dimensions in question.

### 3.4. Empirical Issues

After we established the dual nature of the financial sector and its profit, a question arises how one can assess their relative shares. One can think of two possible approaches – measuring
the productive contribution of the financial sector and measuring profit from “other” sources discussed above.

There are certain problems involved in an attempt to measure the degree of productive contribution of the financial sector. Firstly, the magnitude of the “productive” functions of the financial sector is unobservable, hence, one is to find a reflection of these functions as a proxy for each function. Such a task involves making a list of functions of the financial sector and then finding a one-to-one correspondence between those and certain aspects of the real economy. A problem with this approach is that the opponents of this analysis will argue that an effective functioning of the financial sector requires performing certain functions that seem not to contribute to the process of production, although indeed they do – indirectly. For example, our attempt to focus only on financing of non-financial enterprises as the sole “useful” dimension of the financing function of the financial sector (which actually seems to be the only one useful in the financing function) can lead to a criticism that financing of non-financial enterprises is also “useful” because those are needed to perform other useful functions for the economy as a whole. Moreover, profit from questionable types of activity within the financial sector can be attributed by the opponents of the present study to the existence of the informational function of the financial sector. And this criticism can be developed further that this information function is the actual reason of all the profits not explained by the other functions. Thus, such a critique can be generalized to a level when everything what is done by the financial sector is needed for a reason; hence, all the profits come from productive contribution in various forms.

And indeed, a part of services of the financial sector that seems to be performed with respect to the financial sector itself, without a direct effect on the non-financial sector, can be functional, although indirectly. On the other hand, the current level and form of development of
the financial sector can lead to a situation when certain functions of the financial sector are performed with negligible marginal costs, for they represent a pure by-product of the existence of the financial sector on its current level of development. At the same time absence of the financial sector will involve considerable costs of performing the same functions. Thus, this point can be a basis for validation of any magnitude of profit of the financial sector. As we see it now, these two considerations make a one-to-one correspondence between functions of the financial sector and their reflection in the process of production an unreliable way of establishing the relative shares of different components of profit of the financial sector.

Secondly, another possible way of approaching the issue of contribution of the financial sector to the real economy is usually a link between the development of the financial sector and economic growth. There is abundant literature on this issue. But here there are also several caveats involved that are usually neglected. First of all, if anything, one should analyze not economic growth as growth of GDP, as it is usually done in this kind of studies, but rather focus on the growth of non-financial output. For an expansion of the financial sector due to the fact that the financial sector facilitates the expansion of the financial sector and so on represents a “vicious circle”, and says nothing about the productive contribution of the financial sector with respect to the non-financial one. Secondly, such an analysis reflects both productive functions of the financial sector and negative spillovers mentioned above, hence, a focus on growth does not allow us to separate these two effects of the financial sector, consequently, can be used only for an overall assessment of the role of the financial sector, but cannot be used for establishing its productive contribution only. Thirdly, what is more important, even if one focuses on growth of non-financial output and aims at establishing the overall impact of the financial sector, the approach in question neglects the fact that a part of the services of the financial sector is needed
for simple reproduction of the economy, hence, the corresponding functional dimension of the financial sector can’t be captured by this kind of model focusing exclusively on growth.

A third possible solution to the problem of measurement of “usefulness” of the financial sector, resolving the aforementioned problem with growth, can be an approach combining both growth of non-financial output and simple reproduction. Then there is a remaining problem of causality, which is always an issue with this kind of econometric models. Moreover, a possibility of a rising contribution of the financial sector to the process of production, on the one hand, and a possibility of economy of scale, on the one hand, acting in the opposite directions, makes the relation between profit of the financial sector and level of non-financial output ambiguous. Hence, there is a lack of theoretical grounding of this kind of models.

We can see that measuring the productive contribution of the financial sector involves substantial methodological, theoretical, and empirical problems, which makes it not clear how such an approach can be implemented to produce a reliable conclusion and insights. At the same time, as we mentioned above, there is the other way of estimating the relative shares of profit of the financial sector – measuring the profit of the financial sector coming from sources and by means of the mechanisms “other” than facilitation of the process of production. As one can easily see, if we can establish the magnitude of profit coming from “non-functional” dimensions of the financial sector, the residual represents its productive component.

Thus, the problem is reduced to establishing all the sources and mechanisms through which the modern financial sector can extract profit without an underlying process of facilitating the process of surplus value creation. As we showed above, among these mechanisms is redistribution, possible emergence of the so-called “imaginary profit”, endogenous creation of demand for the services of the financial sector, and overpriced financial sector services. In spite
of some obvious problems with finding appropriate proxies to the last two aspects, we can nevertheless try to estimate the degree of redistribution and imaginary profit.

Two remarks are in order. First of all, by redistribution here and below we mean a change in allocation of surplus value in favor of the financial capitalists, a deviation from its “baseline”, without a change in its productive contribution. It entails that redistribution here is considered in a narrow sense – as a change in the existing and predetermined distribution of surplus value among financial and industrial capitalists and workers. So the major question then is what is to be chosen as this baseline. For now, we do not focus here on the fact that this baseline can also involve a part of profit of the financial sector having a redistributive nature. Put differently, for now we abstract from the fact that the baseline (initial) shares of distribution can involve a part of profit of the financial sector having a redistributive nature, and focus now only on changes in this baseline distribution not accompanied by changes in functions performed by the financial sector.

Secondly, the functional component of profit of the financial sector estimated as a residual after accounting for non-functional elements is actually an upper limit of profit of the financial sector stemming from its productive contribution, because within the specification of the model under consideration there can exist "autonomous" non-functional profit of the financial sector, in addition to the aforementioned endogenously generated and overpriced financial services as a mechanism of “nonproductive” profit extraction.

These considerations can allow us to conduct an empirical test for the nature of profit of the financial sector. The mechanisms of “non-functional” profit extraction have many dimensions, hence, can be captured by several variables summarized in the table below.
Table 2. Mechanisms of profit extraction by the financial sector without an underlying process of immediate surplus value creation and corresponding exogenous variables

<table>
<thead>
<tr>
<th>Mechanisms</th>
<th>Variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redistribution from workers in non-financial sector</td>
<td>↓ w/p (adjusted for a rise in $\pi_{IK}$), ↓ (w/p-MRL), ↑ (MPL’-w/p’)$^6$</td>
</tr>
<tr>
<td>Redistribution from industrial capitalists</td>
<td>↓ $\pi_{IK}$ (mass/share/rate?)</td>
</tr>
<tr>
<td>Redistribution from the state</td>
<td>↓ corporate taxes</td>
</tr>
<tr>
<td>Redistribution from workers in the financial sector</td>
<td>↓ (w/p-MRL), ↑ (MPL’-w/p’)</td>
</tr>
<tr>
<td>Imaginary profit</td>
<td>Change in retained earnings (?)</td>
</tr>
<tr>
<td>Redistribution in time (?), or among FK?</td>
<td>↓ lagged profit from financial activity</td>
</tr>
<tr>
<td>Overpriced services</td>
<td>?</td>
</tr>
</tbody>
</table>

To control for a rise in profit of the financial sector due to a rising need for the financial services to facilitate production, we can include the discussed above level of the material production and its rate of growth, which, coupled with the variables in the table above, overcomes the problems of modeling the functional components of profit discussed above.

In addition to the control for a rise in mass of profit of the financial sector due to a rise in the need for the financial services as the level of output increases, we can introduce in the model other “functional” dimensions of the financial sector, not only as a constant, as it was assumed above, but also as a function of time and possibly some structural changes (through dummy variables).

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$^6$ Here and below, ’ denotes rate of growth.
There is a caveat. We have to abstract from profit of the financial sector received from the foreign sector, because it has questionable nature. It is hard, especially in light of financial globalization, to distinguish to what extent profit of the financial sector from services provided abroad represents its functional contribution to other countries’ non-financial production and to what extent – merely redistribution from labor and industrial and financial capitalists of other countries. For this reason we need to subtract all the profit components received by domestic financial sector from abroad.

There is also a hypothesis to be tested, according to which a rise in profit of industrial capitalists is not likely to lead to a decline in profits of the financial sector, but a decline in profits of the non-financial sector is more likely to be caused and accompanied by a rise in profits of the financial sector. Thus, we might observe a one-sided crowding-out, and asymmetries in the dynamics of profit of financial and industrial capitalists. A way to test it is to introduce a dummy variable: consider not $\pi_{IK}$, but rather $d \pi_{IK}$, where $d$ is equal to one, if profit of industrial capitalists is declining, and zero, if profit is rising.

In general, there is a problem of understanding the relationship between profit of industrial and financial capitalists. On the one hand, one can think of an analogy to an “income effect”: a rise in profit of industrial capitalist can represent a rise in the underlying mass of surplus value to be distributed among industrial and financial capitalists, leading to a rise in profit from financial activity, too. It represents the unity of interests of industrial and financial capitalists. On the other hand, a “substitution effect” brings about a situation when a decline in profit of industrial capitalist can reflect changing balance of power and, hence, a rising profit from financial activity. This dimension manifests a conflict of interest among financial and industrial capitalists. The co-existence of both effects makes the overall effect ambiguous and
depending on the relative strength of these two effects. In light of this, we can restate the hypothesis of asymmetry above in a way that when profits of industrial capitalists are declining the substitution effect is especially strong.

**Conclusion**

The paper discussed some relevant definitions and empirical issues needed to address the question “Where Do Profits in the Financial Sector Come From?” After that, we focused on the question of the nature of this profit, and suggested some theoretical hypotheses and possible empirical tests that might help test these hypotheses. A further research is required to establish what the relevant author’s hypotheses are (if any), and what we can conclude about the nature of profit of the financial sector.
Appendix 1. Financial Sector and Its Profit: NIPA Measures

The conventional understanding of the financial sector and its boundaries is reflected in the commonly used statistic. In National Income and Product Accounts (NIPA), the financial sector is understood as “financial industries”. The category “financial industries consists of “the NAICS industry “finance and insurance” and of bank and other holding companies in the NAICS industry “management of companies and enterprises.” Finance and insurance consists of Federal Reserve banks; credit intermediation and related activities; securities, commodity contracts, and investments; insurance carriers and related activities; and funds, trusts, and other financial vehicles” (BEA 2008, p. 2-20). Such an approach reflects the dominating in the economic theory “sectoral” understanding of the process of reproduction. At the same time, a rising involvement of non-financial corporations in financial activity as a part of the process of financialization, together with a sophisticated relationship between the financial and non-financial dimensions of capitalist production in general, makes the NIPA approach not very useful, if one is interested in an analysis of financial activity and profit stemming from it. A more useful framework could be the one allowing us to distinguish between different types of activity (non-financial and financial), by contrast to sectors.

But this “sectoral” approach is not the only factor making difficult our understanding of the profit of the financial sector. NIPA’s primary goal is to analyze the so-called current production. As a result, starting with the IRS total receipts less total deductions, several adjustments are made to accomplish the goal of focusing on current production. The table below summarizes these adjustments, leading to the category “profits before tax” (PBT).
<table>
<thead>
<tr>
<th>IRS profit</th>
<th>NIPA profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total receipts - total deductions (IRS measure)</td>
<td>Total receipts – total deductions (IRS measure)</td>
</tr>
<tr>
<td>- dividends received from domestic corporations</td>
<td>- dividends received from domestic corporations</td>
</tr>
<tr>
<td>= total profit, IRS measure (in methodology of the present study)</td>
<td>+ misreporting of corporate income</td>
</tr>
<tr>
<td></td>
<td>+ posttabulation amendments and revisions</td>
</tr>
<tr>
<td></td>
<td>+ bad debts</td>
</tr>
<tr>
<td></td>
<td>+ depletion on domestic minerals</td>
</tr>
<tr>
<td></td>
<td>+ expensing of expenditure for mining exploration, shafts, and wells</td>
</tr>
<tr>
<td></td>
<td>+ State and local corporate profits tax accruals</td>
</tr>
<tr>
<td></td>
<td>+ profits of financial institutions not filling corporate income tax returns (Federal Reserve banks, federally sponsored credit agencies, and other)</td>
</tr>
<tr>
<td>- interest payments of regulated investment companies</td>
<td></td>
</tr>
<tr>
<td>- costs of trading or issuing corporate securities</td>
<td></td>
</tr>
<tr>
<td>- taxes paid by domestic corporations to foreign governments on income earned abroad</td>
<td></td>
</tr>
<tr>
<td>- dividends received from foreign corporations</td>
<td>- net capital gains</td>
</tr>
<tr>
<td></td>
<td>+ rest-of-the-world profits</td>
</tr>
<tr>
<td>= profits before tax, NIPA measure</td>
<td></td>
</tr>
</tbody>
</table>


Note: NIPA adjustments of magnitude exceeding 10 per cent of the IRS total receipts less total deductions, i.e. “relevant” adjustments, are underlined. Adjustments made by NIPA but conflicting with purposes of the present study are in italics.

A link between further NIPA measures based on profits before tax – such as profit with inventory valuation adjustment (IVA) or with IVA and capital consumption adjustment (CCAdj) – and the IRS measures of profit is even more obscured. One would tend to think that NIPA IVA, at least for the financial sector, is a NIPA proxy for net capital gains originating in the
financial sector. It would raise an issue whether it is really necessary to use the IRS data for the purposes of the present study, instead of the commonly used NIPA tables.

A comparison between NIPA IVA for the financial sector and financial sector’s capital gains in the IRS measure makes it clear that this hypothesis is misleading. Not only do the two measures have different magnitudes, but also sometimes they even move in opposite directions, which makes it impossible to establish a clear link between IVA for the financial sector and net capital gains. It is exactly the reason to work with the IRS data, if one is interested in the nature of profit from financial activity, because it allows for singling out different categories of income from financial activity, such as capital gains, for instance.

![Financial sector net capital gains and NIPA IVA](chart)

In the methodology paper quoted above one can find the following description of IVA:

“As prices change, businesses that value inventory withdrawals at original acquisition (historical) costs may realize inventory profits or losses. In the NIPA’s, inventory profits or losses are removed from business incomes. The IVA converts the value of inventory withdrawals from a mixture of historical and current costs used by business in tax accounting to a strict
current cost basis by removing the capital-gain-like element or the capital-loss-like element that results from valuing inventory withdrawals at prices of earlier periods.” (BEA 2002, p. 2) Thus, “The IVA is the difference between the cost of inventory withdrawals as valued in determining PBT and the cost of withdrawals valued at current cost.” (BEA 2002, p. 3).

We find this description quite inconsistent. Let’s assume that there is an increase in price level of inventories. If one bases the IVA on the idea that one is to remove “the capital-gain element”, one is to think of IVA as of a positive value. If one treats IVA as “the difference between the cost of inventory withdrawals as valued in determining PBT and the cost of withdrawals valued at current cost”, then IVA is negative.

Finally, there is the other adjustment made in NIPA – capital consumption adjustment (CCAdj). “The CCAdj converts the value of depreciation used by business in tax accounting from a mixture of service lives and depreciation patterns specified in the tax code to a consistent accounting basis—that is, to uniform service lives and empirically based depreciation patterns. Like the IVA, the CCAdj also converts the measure of depreciation to a current-cost basis by removing from profits the capital-gain-like or capital-loss-like element that arises from valuing depreciation of fixed assets at the prices of earlier periods.” (BEA 2002, p.2) Thus, “CCAdj. The difference between depreciation used in determining PBT and depreciation on the basis of consistent accounting and valued at current cost.” (BEA 2002, p. 3)
Appendix 2

Figure 1

Financial sector profit, various NIPA measures

Source: NIPA, Tables 6.16, 6.17.

Figure 2

Total profit and profit of the financial sector in the US economy (NIPA measures)

Source: NIPA, Table 6.16. Note: pretax profit with inventory valuation adjustment.
Figure 3

Share of the financial sector profit in the total domestic profit in the US economy

Source: Calculations by author based on data from NIPA, Table 6.16. Note: pretax profit with inventory valuation adjustment.

Figure 4

Share of the financial sector profit in the total domestic profit in the US economy, various NIPA measures

Source: Calculations by author based on data from NIPA, Tables 6.16, 6.17.
Figure 5

Total profits and financial profits in the US economy

![Graph of total profits and financial profits in the US economy](image)


Figure 6

Share of profit from financial activities in total profits in the US economy

![Graph of share of profit from financial activities in total profits](image)

Figure 7

Share of financial and non-financial sector profits in the total financial profit


Figure 8

Components of the total financial profit

Figure 9

Components of the total financial profit


- foreign dividends
- net capital gains
- net gain, noncapital assets
- prop dividends received from NFA
- other (from FS)

Figure 10

Shares of different components of the total financial profit, in %


- other (from FS)
- net capital gains
- foreign dividends
- net gain, noncapital assets
- prop dividends received from NFA
Figure 11

Shares of different components of the total financial profit in the total profit, in %


- other (from FS)
- net capital gains
- foreign dividends
- net gain, noncapital assets
- prop dividends received from NFA

Figure 12

Total profits of the non-financial sector and its major constituents


Total profits of the non-financial sector
- profit from production
- profit from financial activity, incl.
Figure 13

Total profit of the non-financial sector from financial activity, and its constituents

Source: Calculations by author based on IRS data: 1) SOI Bulletin, Historical Statistics. Table 13; 2) Corporation Source Book, Finance and Insurance.

Figure 14

Constituents of the total profits of the non-financial sector

Source: Calculations by author based on IRS data: 1) SOI Bulletin, Historical Statistics. Table 13; 2) Corporation Source Book, Finance and Insurance.
Figure 15

Relative share of the constituents of the total profits from financial activities of the NNCB


- net interest (received less paid) - foreign dividends - net capital gains - net gain, noncapital assets
References


