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FINANCIAL PROFIT:

PROFIT FROM PRODUCTION AND PROFIT UPON ALIENATION

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Abstract

Financial profit is prevalent in contemporary capitalist economies, yet its nature and sources remain unclear. In classical political economy, and for Marx, profit is conceptualised in two distinct ways. First, it is a newly produced flow of value (profit from production). Second, it is a share of either money revenue or existing sums of money, accruing through transactions in financial or real assets (profit upon alienation or expropriation). Both dimensions are vital to the analysis of financial profit, but the distinction is of particular relevance to profit from trading in financial assets, which has a dual nature. In immediate terms, profit from trading in financial assets arises from redistributing loanable money capital; when mediated, it represents the accrual of future surplus value. If, however, the mediation is incomplete, such financial profit remains redistributed loanable capital and is unrelated to newly produced value. In sum, financial profit is normally profit from production, but retains elements of profit upon alienation or expropriation.

Key-words: capital gains, exploitation, financial profit, loanable capital, profit

JEL Classification: B12, B14, B51, G00

1. Theoretical problems posed by financial profit¹

Rising financial profit is characteristic of contemporary mature capitalist economies. In the USA the share of financial profit (taken as the profit accruing to financial institutions) in total domestic profit has averaged a little more than 10 per cent from 1945 to the end of the 1960s. The average rose to more than 30 per cent in the 1990s and 2000s; during this period, financial profit grew considerably faster than both non-financial profit and GDP. These phenomena obviously require empirical and historical analysis, but also pose major theoretical problems which have to be resolved at the outset.

The first problem has to do with the multiplicity of the forms of financial profit. Financial profit accrues to financial institutions, but also to industrial corporations and even individuals that engage in financial transactions. It arises from transactions that are both greatly varied and qualitatively different from each other. Thus, financial profit could result from lending money, but also from merely handling monetary transactions, from trading in a huge range of financial assets, or from plain increases in the price of financial assets (capital gains). There is no comparison with industrial profit which arises from a great variety of particular transactions but always relates to productive activities.

The second theoretical problem has to do with the macroeconomic sources of financial profit. The significance of this issue can be clearly seen from the perspective of Marxist political economy which has a developed and highly specific theory of profit. In general, the source of capitalist profit is surplus value created by industrial capital in production which is then subdivided in circulation. However, financial profit by definition arises in circulation and thus its link with profit generated in production is not immediately apparent. Given the multiplicity of forms of financial profit, this link is likely to be different among particular instances of financial profit. It is shown in this paper that, for some forms of financial profit, the link with profit in production could disappear altogether. On those occasions, financial profit would become pure profit of circulation. This possibility is demonstrated below for profit made from trading financial assets, a prominent form of financial profit in recent years.

¹ Thanks are due, first, to members of Research on Money and Finance who have discussed these ideas in seminars and elsewhere. Thanks are also due to Gerard Dumenil, Duncan Foley, and Xiao Jiang for helpful comments. All errors are the authors' fault.

The paper tackles these theoretical issues by, first, briefly reviewing approaches to profit in classical political economy and in Marx's work. It is shown in section 2 that the fundamental form of capitalist profit is typically that of a newly produced flow of value arising in production; however, capitalist profit can also be a share of either money revenue or existing stocks of money, accruing through transactions in financial or real assets and is then called profit upon alienation or expropriation. To demonstrate the significance of this distinction for financial profit, section 3 examines loanable capital as a special form of capital traded in the financial system. On this basis, section 4 considers the forms of financial profit and shows that they represent both profit from production and profit upon alienation. Section 5 then focuses on the most complex form of financial profit, namely profit from trading financial assets (capital gains). It is shown that such profit has a dual nature which is mediated by the repayment of loanable capital. If the mediation is complete, this profit represents a newly produced flow of value inter-temporally distributed; if the mediation is incomplete, it becomes profit upon alienation or expropriation. Section 6 concludes.

2. Profit as a newly produced flow of value and profit as a share of either money revenue or existing stocks of money

The analysis of profit by classical political economy received its clearest form from Ricardo (1951: ch. 6; also pp. 48-51) for whom profit is a newly produced flow of value that accrues to capitalists as a residual. Put differently, profit is the net output remaining in the possession of capitalists once workers have claimed the share corresponding to wages, and landlords the share corresponding to ground rent. Marx adopted the view that profit is a newly produced flow of value, but radically altered Ricardo's analysis. Namely, for Marx (1976: ch. 7-9) the flow of profit (surplus value) emerges as workers labour for longer than the equivalent they receive in the form of wages (value of labour power).

For Marx, then, profit is the unpaid part of the flow of net output that is created afresh in the sphere of production through the exploitation of workers. Particular types of profit as well as other forms of income are created subsequently as the flow of surplus value is subdivided in the sphere of circulation. The most fundamental subdivision is into ground rent, i.e. into the income of the landlord class that accrues purely due to property rights over land. But surplus value is also subdivided according to capitalist function - primarily into industrial

and merchant's profit.² Both of the latter are further subdivided into interest and profit of enterprise, which accrue, respectively, to the owners of money capital available for lending and to capitalists actively engaged in production or trade. These complex subdivisions of surplus value are the point of departure for the theoretical analysis of financial profit.

Classical political economists, however, identified further forms of profit that are unrelated to the newly produced flow of value accruing to capitalists as part of net output. An important concept here is 'profit upon alienation', originally formulated by Sir James Steuart. For Steuart (1995: Vol. I, book II, chap. IV) the price of a commodity contains 'real value' and 'profit upon alienation'. The former is determined by three factors, namely, the normal labour required for production, the cost of subsistence of workers, and the cost of materials. The latter is determined by any excess of price over 'real value', and constitutes the profit of the manufacturer. It is clear that Steuart's formulation of 'real value' excludes the regular profit of the capitalist, or rather conflates it with remuneration from work. Regular profit (not the excess over 'real value') is implicitly subsumed under 'real value' by Steuart.³ All capitalist profit is assumed to be 'profit upon alienation'.

The true importance of Steuart's argument, however, becomes clear when he draws the further distinction between 'positive profit' and 'relative profit' (1995: Vol. I, book II, chap. VIII). The former derives from the general 'augmentation' of value and output, and improves the 'public good'; the latter derives from a 'vibration of the balance of wealth between parties', i.e., from trade, and has nothing to do with the general increase in output. Steuart believed that 'profit upon alienation' - which is independent of 'real value' - constitutes 'relative profit'. Namely, it is profit that derives from trade and represents the loss of another party in the sphere of circulation. In effect, capitalist profit - 'profit upon alienation' - arises from a zero-sum game relative to output.

Marx (1969: ch. I) pointed out that Steuart was wrong to identify capitalist profit in general with 'profit upon alienation' that derives purely from circulation. But he was also impressed by Steuart's insight that the profit of one party in circulation could be the loss of another. This is a source of profit that differs from the newly produced flow of surplus value. On this basis, Marx deployed the concept of 'profit upon alienation' (or 'upon expropriation')

² In Marx, merchant's profit includes commercial profit (Marx, 1977: chap. 17) and profit from money-dealing (Marx, 1977: 322).

³ Aspromourgos (1996: 135-141) rightly stresses this aspect of the treatment of profit by classical political economy, taking his cue from Marx.

in his work, particularly in analysis of financial transactions relating to the personal income of workers. Marx considered such transactions to be, first, exploitative and, second, unrelated to surplus value. But the exploitation which occurs in financial transactions is qualitatively different from that which creates surplus value in production. To be precise, exploitation associated with financial transactions amounts to a direct transfer of value from the income of workers to the lenders, i.e., it is a re-division of money revenue streams, which typically takes the form of interest. Marx regarded such ‘profit upon alienation or expropriation’ as a form of profit that was prevalent prior to the domination of the sphere of production by capital.

It is worth quoting at length from Marx on the nature of financial profit arising from lending to borrowers other than capitalists, particularly as this dimension of his work is not widely appreciated. Marx (1972: 487, emphasis in original) claimed that in the course of lending unproductively:

[i]nterest may be a mere transfer and need not represent real surplus-value, as, for example, when money is lent to a “spendthrift”, i.e. for consumption. The position may be similar when money is borrowed in order to make *payments*. In both cases it is loaned as money, not as capital, but it becomes *capital* to its owner through the mere act of lending it out ... In this case interest, like profit upon expropriation, is a fact independent of capitalist production – the production of surplus value. It is in these two forms of money – money as means of purchase of commodities intended for consumption and as means of payment of debts – that interest, like profit upon expropriation, constitutes a form which, although it is reproduced in capitalist production, is nevertheless independent of it and [represents] a form of interest which belongs to earlier modes of production.

Along similar lines, lending to workers represents exploitation. Yet, such exploitation takes place in the sphere of circulation rather than production. For Marx (1977: 609) ‘the lending of houses, etc., for individual use’ is ‘secondary exploitation’:

That the working-class is also swindled in this form, and to an enormous extent, is self evident; but this is also done by the retail dealer, who sells means of subsistence to the worker. This is secondary exploitation, which runs parallel to the primary exploitation taking place in the production process itself.

Moreover, for Marx (1973: 853) secondary exploitation - or exploitation arising in the sphere of circulation - has an ancient historical dimension and represents a historical 'left-over' in developed capitalism:

The relation in which on one side the worker still appears as independent, i.e. not as wage labourer, but on the other side his objective conditions already possess an independent existence alongside him, forming the property of a particular class of usurers, this relation necessarily develops in all modes of production resting more or less on exchange ... Where this relation repeats itself within the bourgeois economy, it does so in the backward branches of industry, or in such branches as still struggle against their extinction and absorption into the modern mode of production. The most odious exploitation of labour still takes place in them ... What takes place is exploitation by capital without the mode of production of capital. The rate of interest appears very high, because it includes profit and even a part of wages. This form of usury, in which capital does not seize possession of production, hence is capital only formally, presupposes the predominance of pre-bourgeois forms of production.

To recap, for classical political economy, profit is a newly produced flow of value; for Marx, moreover, profit is a newly produced flow of value that is generated in production through the exploitation of workers. However, for both classical economists and Marx, there is also 'profit upon alienation or expropriation' resulting from zero-sum transactions that relate to money revenue or existing stocks of money, accruing through transactions in financial or real assets.⁴ Such profit emerges in circulation and is often associated with financial transactions which, for instance, involve workers.

This insight is deployed below in analysis of financial profit, including profit from lending to individuals and profit from trading in financial markets. It is shown that financial profit typically results from subdividing the newly produced flow of surplus value. However, financial profit also results from expropriating others through the operations of the financial

⁴ There is a parallel here with the theory of ground rent, most clearly seen in relation to trade in 'real assets'. The issue cannot be fully analysed in this paper as its focus lies on financial assets and profits, but a brief reference can shed some light. Land (and house) prices are capitalised future rents, and therefore vary with interest rates. Fluctuations in interest rates could result in price changes, even if prospective rental flows were unchanged. Consequently, gains and losses might arise for those who engage in land transactions that are not directly related to surplus value, and might even be exclusively connected to redistribution of future money revenues or existing stocks of money held by the transacting parties. Such gains and losses represent pure transfers among transacting parties, and are a form of 'profit upon alienation'. The intermediaries in the real estate market are also able to draw profit out of these transfers.

system. Demonstrating the complex interaction of these two aspects of financial profit takes up much of the rest of this article. The first step in this regard is to consider more closely the nature of lending relations, and in particular the characteristics of loanable capital.

3. Loanable Capital: Interest and tradability

Loanable capital is an independent form of money capital that is available for lending and is remunerated through interest. This concept is one of Marx's key innovations in economic theory. Marx (1977: chap. 21) commenced his analysis of loanable capital at a highly abstract level by first developing the category of interest-bearing capital. The latter represents the fundamental relationship of money lending occurring within a specifically capitalist framework, which makes it distinct from usurious lending that is common in pre-capitalist societies. The following two aspects of interest-bearing capital give it a specifically capitalist economic content.

The first is the 'productive' purpose of the credit transaction. Marx assumed that money lending occurs typically for the purpose of embarking on a circuit of industrial capital. Since the capitalist mode of production is defined through the production of value and surplus value, it follows that the character of interest-bearing capital results from its association with the production of value and surplus value. Interest is then a share of surplus value produced by industrial capital which accrues as the remuneration of the owner of interest-bearing capital (Marx, 1977: 339).⁵ The second is the systematic generation of interest-bearing capital when the capitalist mode of production becomes dominant. Marx (1978: 158-159, 163-166) showed in Volume II of Capital that the circuit of industrial capital systematically releases temporarily idle funds (money hoards).⁶ These funds provide a foundation for the regular formation of interest-bearing capital. The financial system is a set of social mechanisms that systematically convert temporarily idle funds into money capital available

⁵ This is an argument that would not be accepted by the Uno School of Marxism, for which the capitalist character of interest-bearing capital is based on merchant's capital and the profit that the latter earns through trade (Itoh, 1988: 98-100). There is a degree of formal validity to this point which is strengthened by interest-bearing capital historically predating industrial capital. But, as the Uno School also recognises, in order for the discussion of credit to go beyond the formal analysis of lending, it is necessary to assume that surplus value is created systematically in production. Only then would a social basis exist for the regular remuneration of lending in the form of interest. This is *prima facie* evidence that the content of interest-bearing capital should not be defined independently of industrial capital, even if the former takes historical precedence.

⁶ A process that has been further analysed by Hilferding (1981: 67-81), Itoh (1988: 259-260, 401), and more formally by Lapavistas (2000).

for lending. The capitalist dimension of money lending thus also results from the regular leaks of value from the circuit of capital, which provide a basis for the functioning of the financial system.

The third is the inherent tradability of interest-bearing capital. The advance of interest-bearing capital is formally similar to the sale of money as a commodity, and interest is formally similar to its price. Furthermore, credit transactions generate instruments that could be bought and sold, thus facilitating trade in interest-bearing capital. The ‘buying and selling of money’ typically takes the form of trading financial assets, i.e. of promises to pay, or claims on future flows of surplus value.⁷ Purchase and sale are generic forms of transacting in loanable capital, whether in the original transaction of issuing a security and exchanging it for money, or in subsequent transactions. The original transaction can be thought of as the first act in a series of trades in loanable capital. Naturally, loanable capital acquires different forms as subsequent transactions take place.⁸ Thus, tradability is already present in the most elementary forms of credit, such as commercial credit between capitalist enterprises. Commercial credit gives rise to a variety of financial instruments, for instance, bills of exchange and promissory notes, which can be sold to others in exchange for loanable capital (commercial discounting). Selling commercial credit instruments gives to the seller command over loanable capital while providing the buyer with a claim over future flows of surplus value expected to be created by the original issuer.

Loanable capital represents a developed form of interest-bearing capital, or of money capital available for lending, both in theory and in the actual operations of the capitalist economy.⁹ It is instructive to note that heavy use of the term ‘loanable capital’ by Marx (1977: chap. 30-32) occurs only in the later chapters of volume III of Capital, which deal with more concrete financial phenomena. Loanable capital rests on the advanced functioning of the financial system, and thus corresponds to a lower level of theoretical abstraction than interest-bearing capital. Its creation depends on the financial system being able to collect idle funds across society as well as on financial institutions generating their own promises to pay

⁷ Needless to say, not all types of financial assets are tradable.

⁸ Engels’ distinction between discounting of trade securities - treated as purchase/sale – and the actual advance of fresh credit is misleading (Marx, 1977: 428, 455, 515). Any advance of fresh credit can be reduced to a purchase and sale of loanable capital, or to a change in the form of loanable capital.

⁹ There are also non-monetary forms of loanable capital, for instance, the lending of machinery and equipment, for example, in leasing. As Marx (1977: 344, 393) argued, however, the generic form of loanable capital is monetary, and the other forms derive from it. In this article only the monetary form of loanable capital is considered.

(liabilities). In this light, loanable capital takes the form of financial assets – cash, deposits with financial institutions, and securities – and its character depends on the functioning of the financial system. Consider the following to demonstrate this point.

First, the operations of the financial system spontaneously lessen the importance of the ‘productive’ purpose of borrowing. Casual observation alone shows that in advanced financial systems money is systematically lent by financial institutions for purposes of consumption, or for undertaking financial transactions by other institutions. The basis for such expansion of lending is provided by the functioning of the financial system itself. As Marx (1977: 372-379) showed, the quantitative division of surplus value into interest and profit of enterprise tends to become a qualitative division of capital into, respectively, capital-as-property and capital-as-function. Thus, the receipt of interest appears to be a property of any sum of money and mere parting with money appears capable of generating interest, regardless of the purpose for which money is lent. Thus, the qualitative division of capital makes the purpose of lending of secondary importance, and forms a basis for the creation of loanable capital in advanced capitalism.

Second, the financial system does not passively await the accrual of idle funds but actively encourages their mobilisation. This occurs in part through the mobilisation of idle funds held outside the circuit of industrial capital, for instance, the private hoards formed out of personal income. More complexly, however, it occurs through the financial institutions actively creating their own liabilities in the expectation of future returns, as well as in the expectation of the future accrual of idle funds, which would post-validate the creation of liabilities.¹⁰ By so doing financial institutions enlarge the circuits of industrial capital, thus indirectly expanding the potential sources of further idle funds as well as weakening the direct dependence of productive capital on the value generated in previous rounds of accumulation.

Third, the financial system accentuates the inherent tradability of interest-bearing capital by extending the range of potential counterparties in financial transactions far beyond the participants in the narrow circuits of commercial credit. Moreover, the financial system expands the variety of tradable credit instruments, which no longer need to be directly linked

¹⁰ Following de Brunhoff (1978: 46-47), Campbell (2002: 218-219) argues that bank credit prevalidates value realisation. The argument in the present paper is not related to this type of prevalidation, but rather refers to supporting the creation of bank liabilities.

to particular industrial sectors. The financial system also homogenises the types and methods of trading securities.¹¹ At the same time, the financial system sharpens the need to trade financial assets. The reason is that means of payment (liquidity) are required by financial institutions to settle obligations, and the demand for liquidity is exacerbated as they engage in actively issuing their own liabilities. The financial system itself becomes a major source of demand for liquid funds at short notice. Trading in financial assets and loanable capital is not an arbitrary phenomenon, but rather an integral part of the character of loanable capital.

4. Forms of financial profit

The forms of financial profit can now be analysed by drawing on the distinction between, on the one hand, profit as a newly produced flow of value and, on the other, as a share of either money revenue or existing stocks of money, accruing through transactions in financial or real assets. The analysis also rests on the characteristics of loanable capital, particularly on its ability to earn interest without being necessarily related to productive purposes as well as on its inherent tradability. Three broad categories are deployed: first, profit from money-dealing and productive lending, second, profit from unproductive lending and, third, profit from trading and handling financial assets.

4.1 Financial profit from money-dealing and from 'productive' lending

An elementary form of financial profit accrues to money-dealing capital. According to Marx (1977: chap. 16, 19) money-dealing capital is a type of merchant's capital which specialises in handling, transferring, safe-keeping, and remitting money, as well as engaging in foreign exchange transactions. It could either form an independent enterprise, e.g., a money-remitting firm, or be part of a broader financial enterprise, for instance, a bank. It earns profit by providing monetary services that are integral to the sphere of circulation but which are unrelated to the lending of money. In this light, money-dealing profit is a form of financial profit that represents a share of the newly produced flow of surplus value.

¹¹ As noted by Hilferding, securities have a peculiar nature – they are qualitatively identical. Even when there are qualitative differences, they are all reduced to mere quantitative differences – those of the rate of return (Hilferding, 1981: 144).

In general, however, financial profit is closely related to money lending, and hence to interest. In so far as lending takes place for ‘productive’ purposes, the source of financial profit presents few analytical difficulties. Interest from ‘productive’ loans originates in the associated flow of surplus value that is subdivided into industrial and commercial profit, out of which payments are made to the provider of loanable capital.¹² The only difficult question in this respect is whether the accrual of such financial profit defines a separate type of capitalist. Is there an analogy with the financial profit that accrues due to provision of purely monetary services and thus defines money-dealing capitalists? There is a certain tension in Marx’s discussion of this issue, as has been discussed elsewhere (Itoh and Lapavistas, 1999: 60-62). A strand of his work asserts that interest accrues to ‘monied capitalists’, who are a section of the capitalist class possessing interest-bearing capital. This particular form of financial profit, then, appears to define a separate ‘monied’ stratum among capitalists.

It is apparent, however, that interest also accrues to financial institutions that handle loanable capital (even if only as a spread between a lending and a borrowing rate). Financial institutions are not ‘monied’ capitalists but rather enterprises that specialise in mobilising loanable capital belonging to others as well as facilitating financial transactions. Thus, financial profit accruing in the form of interest cannot be the defining income of a separate ‘monied’ section of the capitalist class. Moreover, in mature capitalist economies, loanable capital is mobilised across social classes by pension funds, insurance companies and other financial institutions, giving rise to associated interest payments. It follows, again, that financial profit accruing in the form of interest cannot define a separate capitalist stratum.

4.2 Financial profit from ‘unproductive’ lending

Matters become considerably more complicated with regard to financial profit that arises from lending for unproductive purposes to workers and other social classes.¹³ This is a prominent form of financial profit in contemporary economies not least due to the prevalence of personal mortgage borrowing. An early reference to the issue from a Marxist perspective was made by Harris (1976). An alternative Marxist approach is summarised below.

¹² Interest can also represent a part of the capital of the borrower, if interest rates rise to usurious levels. However, this would be an unusual occurrence, possibly related to crisis, and need not detain us further.

¹³ Lending for ‘unproductive’ purposes also includes loans to petty commodity producers, for instance, family farms. The economic (and social) relations thereby created are particularly important for developing countries, and could be significant even in mature capitalist economies. But they do not shed additional light on the conceptual relations examined in this article and are best left out of account.

Marx – as was shown in section 2 – considered the payment of interest on personal borrowings to be a pure income transfer.¹⁴ In the case of workers’ borrowing for housing or personal consumption, the transfer represents ‘profit upon alienation, or expropriation’. This is the gist of the concept of ‘financial expropriation’, which has recently been proposed as characteristic of contemporary finance, or more accurately, of financialised capitalism (Lapavitsas, 2009).¹⁵ Financial expropriation results from the increasing involvement of workers - and other non-capitalist social layers – in the activities of the financial system. At core, financial expropriation is based on re-dividing existing flows of money income, and thus amounts to a zero-sum game, or in Marx’s terms, ‘secondary exploitation’.

There is a peculiar exploitative dimension to financial transactions involving workers (and other non-capitalist strata) which results from the non-capitalist character of the circuits of personal income. Unlike loans made to capitalists for productive purposes, loans to households support unproductive consumption and hence do not create surplus value, i.e., the source of their own repayment (dos Santos, 2009: 191). Workers approach financial transactions in order to obtain use-values, be they current wage goods or future pensions. In contrast, financial institutions are capitalist enterprises that approach transactions with the aim of making profit. Thus, there are systematic differences in information, organisation and social power between financial institutions and the holders of personal income, which allow the former to engage in ‘secondary exploitation’ of the latter. The extreme form of this process is ‘predatory lending’ (Dymski, 2009).

In historical terms, financial profit arising from ‘unproductive’ lending represents the re-strengthening of ancient forms of profit-making that were independent of the flow of surplus value. However, in contemporary capitalism such profit-making no longer represents a survival of backward, pre-capitalist relations. On the contrary, it is consistent with the spontaneous creation of essentially usurious relations within the capitalist mode of production, as individual workers and other non-capitalist strata are drawn into the financial system in order to secure access to the goods in the wage basket, or to manage savings. Far

¹⁴ It is apparent that, if personal loans were advanced to capitalists or others who earn rents, the income transfer represented by interest would simply be a way of redistributing surplus value. The latter would first accrue to the rent-receivers as personal income and would be subsequently paid as interest to lenders. There are few analytical difficulties in this connection.

¹⁵ In earlier work the process was called ‘direct’, or ‘financial exploitation’ (Lapavitsas, 2008). To avoid semantic debates with Marxists unfamiliar with Marx’s concept of ‘secondary exploitation’, the term was subsequently dropped in favour of ‘financial expropriation’.

from being a pre-industrial remnant, modern ‘profit upon alienation or expropriation’ reflects the sharpening of the predatory character of finance under conditions of mature capitalism.

4.3 Financial profit from trading financial assets

The most complex form of financial profit, however, arises from trading financial assets, and accrues to financial institutions, other capitalist enterprises, or even individuals. Despite its significance in contemporary capitalism, its sources are not immediately clear and establishing them takes up much of the rest of this paper. Several points can be made at this stage to set the parameters of further analysis.

First, there are two forms of financial profit associated with financial assets. Despite exhibiting great variety, financial assets typically assign to the holder a claim on a flow of value that the issuer expects to generate in the future. In this respect, financial assets give rise to profit that originates in the future flow of surplus value. However, financial assets also generate a further form of financial profit that accrues immediately from the sale of financial assets and lacks a direct connection to future flows of value. Thus, financial institutions, non-financial enterprises and even individuals earn financial profits by simply trading financial assets. Moreover, financial institutions draw fees and commissions by handling financial assets.

Second, the purchase of a financial asset is typically undertaken by committing loanable capital. Consequently, the financial profit that is made immediately by the seller or the handler of financial assets originates, in the first instance, in the loanable capital advanced by the buyer. But, at the same time, the buyer acquires the right to a future flow of value. Thus, the financial profit made by the seller is ultimately mediated by the return of the loanable capital advanced by the buyer.¹⁶ The complexity of profit from trading financial assets is, therefore, due to the interplay between the immediate and mediated forms of financial profit and to their association with loanable capital.

Third, then, profit from trading financial assets can be conceptualised in terms of a structured and mediated process. It has an immediate form that derives from the re-division of loanable capital, namely the seller of the asset acquiring a part of the buyer’s loanable

¹⁶ Resale of the asset makes no difference to this argument but merely adds another layer of mediation.

capital.¹⁷ But it also has a mediated form, which derives from the flow of future value restoring the buyer's loanable capital and also affording an increment. If the mediation was complete, even the original seller's profit would ultimately derive from the flow of future value, since the loanable capital of the buyer would be fully restored. In effect, there would be an inter-temporal allocation of surplus value mediated by the loanable capital of the buyer. But if the mediation was incomplete and the flow of future value did not materialise, there would remain only the immediate form of financial profit drawn by the seller out of the buyer's loanable capital. Trading in financial assets would then be a zero-sum game, and the financial profit of the seller (or the handler) would correspond to the loss of the buyer. 'Profit upon alienation or expropriation' would again emerge in connection with financial profit, though this time it would be related to the monetary wealth of the buyer of financial assets. The predatory character of finance would be reasserted in yet another context. The rest of this article focuses on the complexities of this structured and mediated process.

5. Profit from trading financial assets:

'Profit upon alienation or expropriation' and a share of surplus value

Fully to establish the character of profit made by trading financial assets, three types of assets are considered below, namely, first, a bill of exchange arising through commercial credit, second, a bond representing the advance of loanable capital (debt) and, third, a share in a capitalist enterprise (equity).

5.1. Profit from Trading Instruments of Commercial Credit

The logical and historical origin of modern credit relations can be found in spontaneously arising commercial credit.¹⁸ The elementary form of trade in financial assets is thus provided by trade in commercial credit instruments, above all, bills of exchange. Despite their apparent simplicity, these securities can provide important conclusions regarding the redistributive outcomes of trading financial assets in general, including more complex financial instruments, considered in the next section.

¹⁷ The same holds for the handler of financial transactions who receives a fee or a commission out of the loanable capital of the buyer.

¹⁸ Substantiation for this claim can be found in Itoh and Lapavistas (1999, ch. 4).

Assume that a bill of exchange is generated through the sale of commodity output, and is then successively discounted by other capitalists lying upstream of the original seller of commodities. The property that matters for our purposes is that the eventual holder of the security is not the sole receiver of interest payments. Rather, the payments made by the issuer are distributed among all participating capitalists, depending on the period of holding the bill as well as on the rate of interest (Itoh 1988: 266, see also Itoh and Lapavistas 1999: 94).¹⁹ This insight can be elaborated through a simple numerical example.

Assume capitalist A buys commodities from capitalist B, with cash price of £100, issuing a bill of exchange amounting to £110 due in 2 months. Suppose that, after a month, B sells the bill to capitalist C for £105. When the bill matures, there can be two broad analytical outcomes.

The first is that A generates the expected flow of surplus value, which is then distributed among the bill holders, mediated by transfers of loanable capital.²⁰ Thus, when the bill falls due, C receives £110 from A, and in effect the total interest of £10 is equally distributed between B and C. In this case, B's gain has a dual nature. Ultimately, it is part of the interest paid by A, originating in the surplus value created by A. But in immediate terms it comes directly from the loanable capital of C advanced in exchange for the bill. Note that it is the tradability of the debt instrument that opens up the possibility of inter-temporal distribution of flows of value.

The other possible outcome is a pure redistribution of the loanable capital of the ultimate holder. This would occur if A failed to generate the expected surplus value and paid only p_a when the bill fell due. Three analytically important cases are evident.

Case 1: $p_a < 100$. The total loss of B and C would be equal to $100 - p_a$. This would be less than the loss of the ultimate holder, C, which would amount to $105 - p_a$, arising from A's

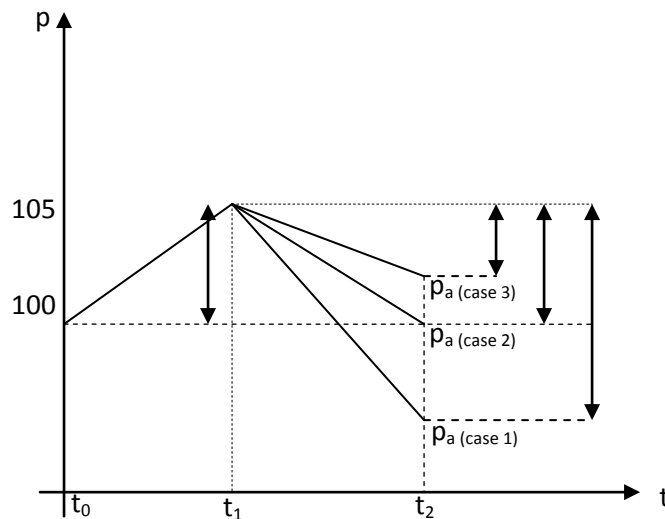
¹⁹ For commercial credit, interest is the difference between the credit price and the cash price. This severely constrains analysis of the impact of interest rates on financial profits, even though some conclusions can still be drawn. For this reason, it is best to examine the role of interest rates in the determination of financial profits when we consider bonds. That is also the natural terrain to analyse the relationship between interest rates and capital gains. Accordingly, for the rest of this article, the discounting of trade credit instruments at a price higher than their cash price will be interpreted as simply the result of approaching maturity. It is nonetheless conceivable that a promissory note could be immediately resold at a price higher than it was bought. This would be analogous to a change in the interest rate, thus providing an explicit link between, on the one hand, simple trade credit and, on the other, bonds and equities.

²⁰ Formally speaking it should be 'idle funds' and not 'loanable capital' of C since the category of loanable capital simply does not exist at the level of abstraction of commercial credit among capitalists. But to put it in these terms would be merely to complicate expressions without offering any analytical benefits.

underpayment but also from reallocating C's loanable capital in favour of B. By the same token, there would be a gain of £5 for B originating in the appropriation of C's loanable capital.

Case 2: $p_a = 100$. Total losses of B and C would be equal to zero, but B would make a gain of £5 from the redistribution of C's loanable capital. This is a pure zero-sum game.

Case 3: $100 < p_a < 105$. Total gains of B and C would be equal to $p_a - 100$, with the ultimate source of these gains being surplus value produced by A. Nevertheless, C would still have losses amounting to $105 - p_a$. This implies that B's gains are the sum of some of C's loanable capital and some of the flow of surplus value. Thus, even when a flow of surplus value is produced and distributed, there exists the possibility that profit would exceed surplus value by appropriating a part of the loanable capital of another capitalist. In immediate terms, B's gain arises from C's loanable capital. Once mediated by the (inadequate) return of loanable capital to C, some of B's gain would arise from the flow of surplus value, but some would still be a part of C's original loanable capital.



All three cases represent the redistribution of the ultimate holder's loanable capital in favour of the intermediate capitalist, B, and each represents a different degree of total loss. The gain from selling the bill comes either completely from C's loanable capital, or from a combination of C's loanable capital and the surplus value created by A.²¹ A further relevant insight is that financial profit associated with debt instruments (such as bills of exchange)

²¹ Some caution is necessary here since joint liability, characteristic of commercial bills, could limit the reallocation of C's loanable capital in favour of B, thus modifying the redistributive results.

could originate in lack of repayment of par value, as is more clearly shown below for bonds. This outcome is evidently impossible in the case of equity instruments.

5.2. Financial Profit from Trade in Bonds

Consider now a bond, that is, a debt instrument not directly related to trade in commodities. This is typically a security promising to repay a specified final amount, i.e. the face value, or par value. A coupon bond also pays a fixed periodic payment (coupon), whereas a discount bond (a zero-coupon bond) does not.²²

In general, the bond price is the net present value of coupon payments and face value. This is a classic instance of Marx's (1977: ch. 25) 'fictitious capital', that is, an imputed sum of loanable capital that would result in the promised coupon payments at the going interest rate:

$$P = \sum_{t=1}^n \frac{C}{(1+i)^t} + \frac{F}{(1+i)^n}$$

where P – bond price, C – coupon, F – face value, i – ongoing interest rate, n – number of years to maturity.

The distribution of coupon payments is irrelevant for the purpose of analysing financial profit from trading financial assets, because a coupon obviously represents a part of the newly created value. For this reason only discount bonds are considered here. Furthermore, the change in bond price as maturity approaches represents a trivial distribution of future value, and could also be disregarded. In short, to analyse profit arising from pure trade in bonds suffice it to focus on a one-year discount bond, the price of which is given by:

$$P = \frac{F}{1+i}$$

Assume now that a capitalist buys such a bond and sells it before maturity, making a financial profit from the difference between the price of purchase and sale (capital gains). What is the source of this profit?

²² Treasury and corporate bonds are examples of coupon bonds; US Treasury bills and US savings bonds are examples of discount bonds.

Given the assumptions of fixed face value, no coupon payments and no rise in prices due to approaching maturity, the only source of a change in the bond price would be a change in the rate of interest. Assuming that the rate of interest fell after the initial purchase of the bond, the bond price would go up, generating financial profit (capital gain) on resale.²³ Since the face value of the bond would not change, it is apparent that this financial profit would arise, in the first instance, from the redistribution of the loanable capital of the buyer. The basis for this redistribution would be the expectation of a future flow of surplus value.²⁴

Thus, financial profit from trading bonds is similar to financial profit from discounting bills of exchange in two fundamental ways. First, the seller's financial gain derives immediately from the loanable capital of the buyer. When the bond matures, this gain becomes in effect a part of the surplus value produced by the bond originator, which is distributed throughout the life cycle of the bond.²⁵ Put differently, the tradability of the bond allows for the inter-temporal allocation of the value-to-be-created among consecutive holders of the financial asset. In case of default and non-repayment of the face value (or repayment only in part) any initial gain from selling the bond would ultimately derive from the loanable capital of the bond buyer (and partly from surplus value, to the extent that the face value has been repaid). It is apparent that several distributive outcomes are possible, identical to those considered in the case of a bill of exchange.²⁶ It is equally apparent that 'profit upon alienation or expropriation' would characterise all outcomes.

Second, fluctuations in interest rates could generate redistributive outcomes for bond holders similar to those caused by non-repayment of the face value of bills of exchange. Financial gain arising from the reallocation of loanable capital due to fluctuations of interest rates has been important in the historical evolution of capitalism. Sudden and violent changes in interest rates have historically caused sizeable wealth transfers between buyers and sellers

²³ This relationship to interest rates makes financial profit on bonds similar to capital gains on equities, as is shown below. A fall in the rate of interest is similar to the bond buyer accepting a lower rate of return. The difference with shares is that, in the case of bonds, the rate of return is determined by conditions in the markets for loanable capital, whereas for shares the discount rate would be related to, but not identical with, the interest rate.

²⁴ Incidentally, Marx noticed that fluctuations in interest rates generate capital gains, the origin of which was the redistribution of loanable capital. In analysis of cyclical fluctuations in the capital market he claimed that, if securities are bought when interest rates are high, hence stock prices low, and sold when stock prices regain their level, "a portion of the money-capital of the public is thus appropriated" (Marx, 1977: 502).

²⁵ There is no qualitative difference between private and public bonds in this respect. For public bonds the promised payments arise out of tax income, which ultimately results from taxing surplus value, even when it involves taxing personal income or consumption.

²⁶ Absence of joint liability for bond, as distinct from bills of exchange, would make financial gains irreversible. Once a bond is sold and the loanable capital of the buyer is appropriated, there can be no reversal.

of financial assets, especially state bonds. In contemporary mature capitalism, the money market has become a key site for determination of financial profits. Low and falling interest rates have created a favourable environment for extraction of capital gains during particular periods. The role of the state is particularly important in this respect. Monetary policy that lowers interest rates could be beneficial to financial institutions not only through providing cheap funds but also by generating capital gains which could also improve trading revenues.

5.3. Financial Profit from Trade in Equities

Consider, finally, financial profit from trade in shares (equity). A share is a claim on the future surplus value of a corporation; unlike debt instruments, it is a title of ownership which does not presuppose repayment of the principal amount invested. The foundation for a Marxist analysis of equity was laid by Hilferding (1981: chap. 7, pp. 107-129), who also put forth the concept of founder's (or promoter's) profit (Gründergewinn). This is a fundamental form of financial profit associated with equity that arises from the difference between the stock price of an incorporated enterprise and the value of the capital invested. Following Marx (1977: 358) who proposed that the rate of interest tends to be below the rate of profit, Hilferding (1981: 109-110) argued that shareholders accept a rate of return below the average rate of profit. Consequently, the market value of a corporation is bid above the value of the capital invested resulting in founder's profit.

In a little more detail, consider a corporation that generates surplus value given by:

$$S = r \cdot K$$

where S is surplus value, r is the average rate of profit, and K is capital invested.

In making this investment, the individual owner can be considered as discounting the future returns at the rate r. It is trivially true that the present value of the corporation would then be equal to value of the industrial (or commercial) capital invested:

$$\frac{S}{r} = \frac{r \cdot K}{r} = K$$

However, Hilferding claimed that shareholders discount the same future stream of surplus value with the rate of interest, i . Consequently, the present value of shareholder investment, which is also the market capitalisation of the enterprise, would be equal to:

$$\frac{S}{i} = \frac{r \cdot K}{i}$$

Since shareholders accept a lower rate of return than the original owner, $i < r$, the share price would be bid over and above the value of the capital actually invested, i.e.

$$\frac{S}{r} < \frac{S}{i}. \text{ This difference in price constitutes founder's profit:}$$

$$FP = \frac{S}{i} - \frac{S}{r}$$

For Hilferding (1981: 110), the shareholder accepts a rate of discount equal to the rate of interest because a purchase of shares is akin to investing loanable capital.²⁷ His analysis of this issue is not entirely consistent since at times he assumes that the discount rate is equal to the rate of interest, while at other times he allows for a risk premium to raise the discount rate above the rate of interest. On the whole, however, Hilferding lays aside the risk premium, thus preserving Marx's division of the flow of surplus value into interest and profit of enterprise. In this light, founder's profit is the profit of enterprise accruing to the seller of shares in a lump sum. Hilferding's insight, namely that differences in rates of return can be a source of financial profit, is of decisive importance for the theory of financial profit, even though there are problematic aspects to his analysis, pointed out below.

To demonstrate the broader significance of Hilferding's insight, take an enterprise founded at cost K and expected to generate surplus value, Π^e , to infinity. The net present value of this investment for the founder would be:

$$\frac{\Pi^e}{i_0} - K$$

where the discount rate would be equal to the average rate of profit ($i_0 = r$).

²⁷ Throughout the rest of this section we will ignore the possibility that the shareholder might be investing plain money arising from personal income, rather than loanable capital. This assumption makes the analysis simple without loss of content. In general, however, financial profit in capital markets could also arise from the re-division of plain money held by investors, particularly small buyers.

If the enterprise was incorporated, founder's profit would be equal to:

$$\frac{\Pi^e}{\dot{i}_1} - \frac{\Pi^e}{\dot{i}_0}$$

where the discount rate of the initial buyer of shares would be \dot{i}_1 .

If the shares continued to be traded, they could result in capital gains for the i th seller equal to:

$$\frac{\Pi^e}{\dot{i}_{i+1}} - \frac{\Pi^e}{\dot{i}_i}$$

Meanwhile, net present value for the ultimate shareholder would be:

$$\frac{\Pi^e}{\dot{i}_t} - \bar{S}$$

where \bar{S} would be the price paid for the shares by the ultimate shareholder.

If Π^e was assumed to remain the same throughout,²⁸ the entire financial profit accruing to all t counterparties (the founder and $t-1$ buyers of the share) would include founder's profit and capital gains made by other buyers. It would be:

$$\sum KG = \frac{\Pi^e}{\dot{i}_1} - \frac{\Pi^e}{\dot{i}_0} + \dots + \frac{\Pi^e}{\dot{i}_t} - \frac{\Pi^e}{\dot{i}_{t-1}} = \frac{\Pi^e}{\dot{i}_t} - \frac{\Pi^e}{\dot{i}_0} = \bar{S} - K$$

By construction, the discount rate of the founder is equal to $\dot{i}_0 = \frac{\Pi^e}{K}$, while the discount rate of the ultimate shareholder is $\dot{i}_t = \frac{\Pi^e}{\bar{S}}$. Given that $\sum KG = \bar{S} - K$, it also

follows that $\dot{i}_t = \frac{\Pi^e}{K + \sum KG}$. A comparison of the two expressions for the discount rates

shows immediately that total financial profit (capital gains) would be positive if and only if the discount rate of the ultimate shareholder was lower than the discount rate of the founder. If a shareholder accepted a rate of return lower than that of the founder, it would result in

²⁸ It is not difficult to relax this assumption allowing for different agents to have different expectations that could, moreover, vary over time. But this would necessarily take us to a more concrete level of analysis, which is beyond the scope of the present paper.

capital gains distributed among the previous holders of the equity. Conversely, if there were capital gains, the actual rate of return for the ultimate shareholder would be below the average profit rate, ex post. At the limit, the sum total of capital gains would be given by the difference between the average rate of profit and the market rate of interest, as Hilferding assumed in deriving founder's profit.

In this light, the source of financial profit (capital gains) from trading shares is apparent. Such profit is a cost for the ultimate shareholder (formally similar to the input cost, K). In immediate terms, therefore, it arises from the loanable capital of the ultimate shareholder. As for other forms of financial assets, capital gains from trading equities represent, in the first instance, a part of the loanable capital of the ultimate buyer, which is distributed throughout the trading history of a share. At the same time, the loanable capital committed is in effect a down-payment on the surplus value that is expected to be produced. Consequently, when mediated by the payment of dividends, capital gains become a part of the future surplus value. As in the case of trade credit and bonds, financial profits arising from trading shares also have a dual nature. In immediate terms, they are due to the re-division of the loanable capital of the final shareholder; ultimately they are a part of future surplus value. If, however, the expected returns do not materialise, the capital gains become pure 'profit upon alienation or expropriation'.

Several corollaries follow. First, as in the case of bonds, a secular decline in interest rates creates favourable conditions for capital gains on equity. Second, Hilferding (1981: 112, italics in the original) was right to stress that financial profit arising from differences in rates of return is "an economic category *sui generis*". However, his founder's profit is merely a special case of financial profit from trading equities, as was shown above. Third, there is no *a priori* reason to assume that the share price of a newly incorporated enterprise would be determined by the interest rate since the discount rate used by the initial buyer could simply be lower than r but still higher than i . By the same token, there is no reason to assume that the financial profit arising from an initial public offering would be equivalent to the profit of enterprise accruing in a lump sum. Hilferding went too far in mapping Marx's distinction of interest and profit of enterprise onto his own distinction of, respectively, dividends and founder's profit. There is no one-to-one correspondence between the two.²⁹

²⁹Itoh (1988: 287) suggests that Hilferding is wrong to treat founder's profit as a part of future surplus value. For Itoh, founder's profit should be understood as a redistribution of the money capital of the buyer. Itoh is right, as

Finally, a simple elasticity analysis can show that small changes in discount rates can produce disproportionately large changes in capital gains. Given that

$$\sum KG = \frac{\Pi^e}{i_t} - \frac{\Pi^e}{i_0}$$

the elasticity of financial profit from trade in shares with respect to its determinants would be given by :

$$E_{KG}(\Pi^e) = 1$$

$$E_{KG}(i_t) = -\frac{i_0}{i_0 - i_t} < -1$$

$$E_{KG}(i_0) = \frac{i_t}{i_0 - i_t} > 0 \text{ and } E_{KG}(i_0) > 1 \text{ when } i_t > \frac{1}{2}i_0$$

Simply put, a one percent increase in expected profits generates a one percent increase in capital gains, whereas a one percent decrease in the discount rate of the final shareholder leads to a more than one percent increase in total capital gains. A one percent increase in the average profit rate results in an increase in capital gains, the magnitude of which depends on the relationship between the profit rate and the interest rate. These results confirm the general intuition that under certain conditions financial profit from trading equity could be more sensitive to fluctuations of returns in the money market than to changes in returns in the sphere of production.

Conclusion

The source of rising financial profit constitutes a theoretical conundrum in contemporary capitalism. Classical political economy posits two main sources of profit. First, profit can be a newly produced flow of value that arises in production. Second, profit can also be a share of either money revenue or existing stocks of money, accruing through

was shown in this section. However, it was also shown that the relationship between the two is more complex, and indeed mediated. In this regard, Hilferding is also right – the re-division of the buyer's money capital is nothing more than a down-payment on future surplus value. But if the surplus value was not generated, we would be back with a pure re-division of money capital.

transactions in financial or real assets and arising in circulation. Marx treated the former as the general type of capitalist profit, associating it with the exploitation of labour in production; he treated the latter as ‘profit upon alienation or expropriation’, associating it primarily with ‘secondary exploitation’ in the sphere of finance. This distinction was deployed in this paper in order to analyse the nature of financial profit.

It was shown that financial profit is an envelope category covering a variety of forms, most of which are closely related to loanable money capital. The several forms of financial profit point to the existence of different sources for it. There is profit from money-dealing or from lending for productive purposes, which is part of the flow of surplus value. But there is also profit from lending for unproductive purposes to workers or other non-capitalist social layers, which represents a redistribution of streams of personal revenue. Such financial profit is, consequently, ‘profit upon alienation or expropriation’. There is, finally, profit from trading in financial assets, which has a dual nature. In immediate terms it represents a re-division of the loanable capital advanced by the buyers of financial assets. When mediated by the repayment of loanable capital, it becomes a share of the flow of surplus value. If, however, the mediation was incomplete and the expected returns did not materialise, this financial profit would remain a zero-sum re-division of loanable capital, and would hence be ‘profit upon alienation or expropriation’. In sum, financial profit in contemporary capitalism originates in surplus value but also has predatory and expropriating elements relating to money revenues and existing stocks of money.

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