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FOR Comment:

How greed did not drive the inflation

Why are prices rising? Because someone raises them. Why do they raise them? Because they are greedy. And who sets the prices? Entrepreneurs. This is the brief presentation of the "greed-based" theory of inflation, which has been gaining popularity among hostile to business, left-leaning economists and journalists. A well-expressed advocate of this theory is also the president of the National Bank of Poland, who uses the argument that recent price increases are due to greed, backs it up by a personal study of allegedly inflated prices of butter by retail chains.

However, this theory has one fundamental flaw – it doesn't explain why inflation suddenly soared in the second half of 2021 to the levels unseen in developed economies for decades. Were entrepreneurs less greedy before? It's hard to believe – after all, philosophers, priests, and moralists have been warning of the dire consequences of unrestrained greed since ancient times. So why did prices rose slower just a few years ago, and why do they sometimes not rise at all or even fall?

Because entrepreneurs are restrained in raising prices by the greed of consumers. Entrepreneurs are not a group characterized by extraordinary greed compared to others – it's the same greed that drives an employee who asks for a raise in a company or changes job when they get a better-paid offer. The same greed drives a customer who refrains from making a purchase altogether due to a too high price or looks for a store where he can buy the item cheaper.

To make it possible for business' owners to increase prices, the demand or supply circumstances must shift. This has happened lately for two main reasons: firstly, the monetary and fiscal authorities have implemented extensive policy relaxations, and secondly, Russia's aggression against Ukraine has led to a surge in fuel and energy costs.[1]

Contrary to what its proponents claim, the "greedflation" hypothesis (inflation resulting from greed) has not been scientifically confirmed in a recent analysis by economists from the International Monetary Fund[2], which shows that in 2022, 45% of the consumption deflator (one of the indicators of price level changes) in the euro zone was "attributed" to companies' profits. This analysis does not indicate that profits are causing rapid price growth recently.

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[1] However, this does not mean that the government and the National Bank's of Poland propaganda, attributing the causes of inflation solely to these factors, is correct. See D. Filar, *Wysoka inflacja w Polsce to dzieło RPP* [PDF]', FOR Communication 4/2023, Civil Development Forum, February 6, 2023. https://for.org.pl/pl/a/9336,komunikat-for-4/2023-wysoka-inflacja-w-polsce-to-dzielo-rpp.

[2] N.-J.H. Hansen, F.G. Toscani, J. Zhou, *Euro Area Inflation after the Pandemic and Energy Shock: Import Prices, Profits and Wages* [PDF], Working Paper No. 2023/131, International Monetary Fund, June 23, 2023, https://www.imf.org/en/Publications/WP/Issues/2023/06/23/Euro-Area-Inflation-after-the-Pandemic-and-Energy-Shock-Import-Prices-Profits-and-Wages-534837

Analysis published by the IMF shows only that in the euro zone, entrepreneurs' nominal incomes (profits) grew more than workers' (wages). Interestingly, in the United States and Canada, wage growth was stronger[3]. However, this does not mean that in these countries wages were "responsible" for inflation. The authors of the analysis do not claim this either; they do not attribute the causes of inflation in the euro zone to business greed.

The correct interpretation of their analysis, as noted by another IMF economist, Gon Huertas, is that in the euro zone, companies adapted faster to the nominal shock than workers did[4]. This can be read directly from the analysis: "prices are more flexible than wages - companies can quickly adjust their prices to protect their profitability, while wages are subject to greater rigidity resulting from earlier negotiations."[5]

At the same time, profitability from sales (margin) did not increase in the euro zone. So why the share of profits in GDP increased? As economists from the Bank of Italy demonstrate, this can happen even with an unchanged margin[6]. Let's illustrate this with an model company, leaving out the issue of taxes, which is irrelevant for this discussion.

Let's assume that for so-called intermediate consumption (goods and services, excluding fixed assets, used as expenses in the production process), the company spends 12 million PLN in a year, and on wages – 9 million PLN. It sells its annual production for 30 million PLN, achieving a profit ("gross operational surplus" or "gross mixed income") of 9 million PLN. The value added, which is the sum of wages and profits, produced in such company is 18 million PLN, and the share of profits in added value is 50%. The margin, that is profit divided by revenue, is 30%.

Now, let's assume that, for example, due to rising energy costs, expenses for intermediate consumption increased to 14.1 million PLN, and wages remained unchanged. If the company maintains its margin, it will increase its revenue to 33 million PLN, and profit to 9.9 million PLN. The nominal value added will increase to 18.9 million PLN. As a result, the share of profits in the added value will increase to 52.4%.

		Before the increase in expenses for intermediate consumption	After the increase in expenses for intermediate consumption
1	intermediate consumption	12,0 mln zł	14,1 mln zł
2	wages	9,0 mln zł	9,0 mln zł
3	revenues	30,0 mln zł	33,0 mln zł
4	profit (=3−2−1)	9,0 mln zł	9,9mln zł
5	added value (=2+4)	18,0 mln zł	18,9 mln zł
6	**profit share in added value (=4÷5)**	**50,0%**	**52,4%**

[3] Hansen, Toscani, Zhou, *Euro Area Inflation after the Pandemic and Energy Shock*, p. 9–10.
[4] https://twitter.com/GonHuertas/status/1673479169156726784.
[5] Hansen, Toscani, Zhou, *Euro Area Inflation after the Pandemic and Energy Shock*, p. 5.
[6] F. Colonna, R. Torrini, E. Viviano, *The profit share and firm mark-up: how to interpret them?*[PDF], Questioni di Economia e Finanza (Occasional Paper), no. 770, Banca d'Italia, may, 2023, https://www.bancaditalia.it/pubblicazioni/qef/2023-0770/QEF_770_23.pdf?language_id=1.

7	sales profitability (=4÷3)	30,0%	30,0%

Furthermore, attention must be drawn to the specific definition of profits. In the case of businesses without legal entity (sole proprietorships, civil partnerships), the earnings are referred to as the "gross mixed income". This is rightfully so because it essentially stems from two sources: the labor of the owners, which involves managing the company (and in the case of smaller businesses, also performing tasks similar to regular employees), and from capital. Additionally, for both businesses without legal entity and capital partnerships, profits are presented in gross terms, without deducting depreciation[7].

Business owners cannot spend all such profits on consumption if they aim to reproduce their productive assets and maintain their ability to generate income in the future. To determine what part of the "gross operational surplus" or "gross mixed income" entrepreneurs can "safely" consume, one would need to reduce it by depreciation allowances. However, in an environment of elevated inflation, this isn't so simple. Depreciation is calculated based on the historical value of fixed assets. If the prices of these assets have increased in the meantime, reproducing them may be costlier, implying that the real net profit of entrepreneurs would be even lower.

Moreover, when analyzing profitability, one also needs to consider changes in costs incurred by businesses. Companies value their inventory at the purchase price. If these are sold at higher prices, profitability might temporarily increase, but this "excess" profit will serve to finance the replenishment of inventory[8]. For these two reasons mentioned above, even a potential increase in sales profitability cannot be linked to greed.

The analysis by IMF economists, therefore, does not validate the "greed-driven" theory of inflation. It merely demonstrates how inflation has recently impacted profits and wages in the Eurozone. Most importantly, according to the authors, the fact that profits in the Eurozone have increased more than wages does not imply that there's room to ease monetary policy. On the contrary, they argue that "there's a need for a restrictive policy to anchor expectations and suppress demand".[9]

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In this brief comment, we were not able to address all aspects. Therefore, we encourage readers to also refer to other commentaries on the 'greed-based' explanation of the current high inflation: works by Mateusz Machaj from the Mises Institute, Piotr Kalisz and Arkadiusz Trzciołek from the Bank Handlowy Maciej Zdrolik from mBank, Mikołaj Raczyński and Grzegorz Siemiończyk in „Parkiet".

[7] See M. Machaj, *Spadający udział płac w trzeciej RP a ekonomiczna sytuacja siły roboczej* [PDF], „Optimum. Studia Ekonomiczne", No. 2(86), p. 29–30. http://optimum.uwb.edu.pl/index.php/osj/article/view/38.
[8] K. Sobolewski, *Co dalej z gospodarką? Jak głęboka i trwała będzie recesja? A może to tylko spowolnienie?* [PDF], Miesięczny Przegląd Ekonomiczny Pracodawców RP, August 2022, p. 6,
[9] Hansen, Toscani, Zhou, *Euro Area Inflation after the Pandemic and Energy Shock*, p. 19.

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