DEPTT. OF COMMERCE

SEMESTER II

SUBJECT- MICRO ECONOMICS

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PROFIT

We all are familiar with the term 'Profit'. It is quite a common-place word, but different people use it in different senses.

In Economics, however, the term has a precise meaning. Profit may be defined as the net income of a business after all the other costs—rent, wages and interest etc., have been deducted from the total income.

Profits are, therefore, uncertain and vary from person to person and from firm to firm. They may become zero, when costs are equal to income, and if the costs are higher, profits may actually be converted into loss.

Entrepreneur's Reward:
Pure profit is the reward of entrepreneurial functions. It is what an entrepreneur gets purely as an entrepreneur. What he gets as a landlord, manager or capitalist is deducted from the total profits. Hence, Pure Profit is an amount which accrues to the entrepreneur for assuming the risk inseparable from business.

It is a reward for assuming the final responsibility, a responsibility which cannot be shifted to anybody else. A practical example will show how profits are calculated. Let us suppose that Mr. S. Chand starts a bookshop with a capital of Rs. 1, 00,000. We further assume that the premises belong to him and his nephew works for him without receiving any wages.

				Rs.
1.		Total sales		10,00,00,000
		Cost of Goods sold		7,50,00,000
		Gross Profit		2,50,00,000
2.		Expenses:		
	(a)	Rent (implicit)[1]		10,00,000
		Wages of salesmen (implicit)		5,00,000
	(b)	Interest on owner's capital at 10% (implicit)		8,00,000
	(c)	Interest on bank loans		20,00,000
			Total	43,00,000
				Rs.
3		Depreciation for soiled goods		20,00,000
		Insurance charges		5,00,000
			Total	25,00,000
4.		S. Chand's wages of superintendence (implicit)		6,00,000
		Total deductions	1,76,00,000	74,00,000
5.		Profit before tax		80,00,000
6.		Taxation		96,00,000
		Net or Pure Profit		

The above account shows the nature of profits. The meaning of gross profits too is clear. There are factors for which S. Chand does not pay. They belong to him, but ordinarily they could not have been obtained without payment. Therefore, these payments, though implicit, must be deducted to find out the net or pure profit of the business.

THEORIES OF PROFIT

1. The Dynamic Theory of Profit:

Prof. J.B. Clark propounded the dynamic theory of profit in the year 1900. To him profit is the difference between the price and the cost of production of the commodity. Profit is the result of progressive change in an organized society.

The progressive change is possible only in a dynamic state. According to Clark the whole economic society is divided into organized and unorganized society. The organized society is further divided into static and dynamic state. Only in dynamic state profit arises.

In a static state, the five generic changes such as the size of the population, technical knowledge, the amount of capital, method of production of the firms and the size of the industry and the wants of the people do not take place; everything is stagnant and there is no change at all. The element of time is non-existent and there is no uncertainty. The same economic features are repeated year after year.

Therefore there is not risk of any kind to the entrepreneur. The price of the good will be equal to the cost of production. Hence profit does not arise at all. The entrepreneur would get wages for his labour and interest on his capital. If the price of the commodity is higher than the cost of production, competition would reduce the price again to the level of the cost of production so that profit is eliminated.

The presence of perfect competition makes the price equal to the cost of production which eliminates the super normal profit. Thus Knight observes, “Since costs and selling prices are always equal, there can be no profit beyond wages for the routine work of supervision”.

It is well known that the society has always been dynamic. Several changes are taking place in a dynamic society.

According to Clark five major changes are constantly taking place in a society. They are:
(1) Changes in the size of the population,

(2) Changes in the supply of capital,

(3) Changes in production techniques,

(4) Changes in the forms of industrial organisation, and

(5) Changes in human wants.

These dynamic changes affect the demand and supply of commodities which leads to emergence of profit. Sometimes individual firms may introduce dynamic changes. For example, a firm may improve its production technique, reduce its cost and thereby increase its profit. The typical dynamic change is an invention. This enables the entrepreneur to produce more and reduce costs, leading to emergence of profit.

Criticism:

1. It is wrong to say that there is no profit in static state because every entrepreneur is paid profit irrespective of the state of an economy.

2. This theory does not fully appreciate the nature of the entrepreneurial function. If there are no profits in a static state, it means there is no entrepreneur. But without an entrepreneur it is not possible to imagine how different factors of production would be employed.

3. Mere change in an economy would not give rise to profits if those changes are predictable. It is only the unpredictable, provision can be made for such changes and the expenditure can be included in the cost of production.

4. This theory assumes the existence of perfect competition and static state. But they are far from reality.

5. This theory states that profit arises because of dynamic changes. But Knight says that it is only unforeseen changes that give rise to profit.

6. This theory associates profit for imitating progressive changes in the economy. But in reality profit is paid to entrepreneur for other important functions like risk taking and uncertainty bearing.

7. According to Taussig, “dynamic theory has created unnecessary and artificial distinction between “profits” and wage of management”.

2. Risk Bearing Theory of Profit:

This theory is associated with American economist Hawley. According to him profit is the reward for risk-taking in business. Risk-taking is supposed to be the most important function of an entrepreneur. Every production that is undertaken in anticipation of demand involves risk. According to Drucker there are four kinds of risk. They are replacement, obsolescence, risk proper and uncertainty.

The first two are calculated and therefore they are insured. But the other two are unknown and unforeseen risks. It is for bearing such risk profit is paid to entrepreneur. No entrepreneur will be willing to undertake risks if he gets only the normal return.

Therefore the reward for risk-taking must be higher than the actual value of the risk. If the entrepreneur does not receive the reward, he will not be prepared to undertake the risk. Thus higher the risk greater is the possibility of profit.

According to Hawley the entrepreneur can avoid certain risks for a fixed payment to the insurance company. But he cannot get rid of all risks by means of insurance. If he does so he is not an entrepreneur and would earn only wages of management and not profit.

Criticism:

1. Risk-taking is not the only entrepreneurial function which leads to emergence of profits. Profits are also due to the organizational and coordinating ability of the entrepreneur. It is also reward for innovation.

2. According to Carver profit is paid to an entrepreneur not for beaming the risk but for minimizing and avoiding risk.

3. This theory assumes that profit is proportional to risk undertaken by entrepreneurs. But this is not true in practical life because even entrepreneurs who do not take any risk are paid profit.

4. Knight says that it is not every risk that gives profit. It is unforeseen and non-insured risks that account for profit. According to Knight risks are of two types viz., foreseeable risk and unforeseeable risk. The risk of fire in a factory is a foreseeable risk and can be covered through insurance. The premium paid for the fire insurance can be included in the cost of production. The entrepreneur can foresee such a risk and insures it. An insurable risk in reality is no risk and profit cannot arise due to insurable risk.

5. There is little empirical evidence to prove that entrepreneurs earn more in risky enterprises. In a way all enterprises are risky, for an element of uncertainty is present in them and every entrepreneur aims at making large profits.

3. Uncertainty Bearing Theory of Profit:

This theory was propounded by an American economist Prof. Frank H. Knight. This theory, starts on the foundation of Hawley's risk bearing theory. Knight agrees with Hawley that profit is a reward for risk-taking. There are two types of risks viz. foreseeable risk and unforeseeable risk. According to Knight unforeseeable risk is called uncertainty beaming.

Knight, regards profit as the reward for bearing non-insurable risks and uncertainties. He distinguishes between insurable and non-insurable risks. Certain risks are measurable, the probability of their occurrence can be statistically calculated. The risks of fire, theft, flood and death by accident are insurable. These risks are borne by the insurance company.

The premium paid for insurance is included in the cost of production. According to Knight these foreseen risks are not genuine economic risks eligible for any remuneration of profit. In other words insurable risk does not give rise to profit.

According to Knight profit is due to non-insurable risk or unforeseeable risk.

Some of the non- insurable risks which arise in modern business are as follows:

(a) Competitive risk:

Some new firms enter into the market unexpectedly. The existing firms may have to face serious competition from them. This will inevitably lower down the profit of the firms.

(b) Technical risk:
This risk arises from the possibility of machinery becoming obsolete due to the discovery of new processes. The existing firm may not be in a position to adopt these changes into its organization, and hence suffer losses.

(c) Risk of government intervention:
The government, in course of time, interferes into the affairs of the industry such as price control, tax policy, import and export restrictions, etc., which might reduce the profits of the firm.

(d) Cyclical risk:
This risk emerges from business cycles. Due to business recession or depression, consumer’s purchasing power is reduced, consequently demand for the product of the firm also falls.

(e) Risk of demand:
This is generated by a shift or change of demand in the market.

Prof. Knight calls these risks as ‘uncertainties’ and ‘it is uncertainties in this sense which explains profit in the proper use of the term’. These risks cannot be foreseen and measured, they become non- insurable and the uncertainties have to be borne by the entrepreneur. According to this theory there is a direct relationship between profit and uncertainty bearing.

Greater the uncertainty bearing the higher the level of profit. Uncertainty beaming has become so important in business enterprise in modern days, it has come to be considered as a separate factor of production. Like other factors it has a supply price and entrepreneurs undertake uncertainty bearing in the expectation of earning certain level of profit. Profit is thus the reward for assuming uncertainty.

In the modern days production has to take place In advance of consumption. The producers have to face their rival producers and the future is uncertain and unknown. These are uncertainties. Some entrepreneurs are able to see it more clearly than others and therefore able to earn profit.

Criticism:

1. According to this theory, profit is the reward for uncertainty bearing. But critics point out that sometimes an entrepreneur earns no profit in spite of uncertainty bearing.

2. Uncertainty bearing is one of the determinants of profit and it is not the only determinant. Profit is also a reward for many other activities performed by entrepreneur like initiating, coordinating and bargaining, etc.

3. It is not possible to measure uncertainty in quantitative terms as depicted in this theory.

4. In modern business corporations ownership is separate from control. Decision-making is done by the salaried managers who control and organise the corporation. Ownership rests with the shareholders who ultimately bear uncertainties of business. Knight does not separate ownership and control and this theory becomes unrealistic.

5. Uncertainty bearing cannot be looked upon as a separate factor of production like land, labour or capital. It is a psychological concept which forms part of the real cost of production.

6. Monopoly firms earn much larger profits than competitive firms and they are not due to the presence of uncertainty. This theory throws no light on monopoly profit.

Knight’s theory of profit is more elaborate than other theories, because it combines the conception of risk, of economic change and of the role of business ability.

4.Schumpeter's Innovation Theory:

This theory was propounded by Schumpeter. This theory is more or less similar to that of Clark's theory. Instead of five changes mentioned by Clark, Schumpeter explains the change caused by innovations in the production process. According to this theory profit is the reward for innovations. He uses the term innovation in a sense wider than that of the changes mentioned by Clark.

Innovation refers to all those changes, in the production process with an objective of reducing the cost of commodity so as to create gap between the existing price of the commodity and its new cost. Innovation may take any shape like introduction of a new technique or a new plant, a change in the internal structure or organizational set up of the firm or change in the quality of raw material, a new form of energy, better method of salesmanship, etc.

Schumpeter makes a distinction between invention and innovation. Innovation is brought about mainly for reducing the cost of production and it is cost reducing agent. Profit is the reward for this strategic role, Innovations are not possible by all entrepreneurs. Only exceptional entrepreneurs can innovate. They are capable of tapping new resources, technical knowledge and reduce the cost of production. Thus the main motive for introducing innovation is the desire to earn profit. Profit is therefore the cause of innovation.

Profits are of temporary nature. The pioneer who innovates earns abnormal profit for a short period. Soon other entrepreneurs, "swarm in clusters", compete for profit in the same manner. The pioneer will make another innovation. In a dynamic world innovation in one field may induce other innovations in related fields.

The emergence of motor car industry may in turn stimulate new investments in the construction of highways, rubber, tyresm and petroleum products. Profits are thus causes and effects of innovation. The interest of profit leads entrepreneur to innovate and innovation leads to profit. Thus profit has a tendency to appear, disappear and reappear.

Profits are caused by innovation and disappear by imitation. Innovational profit is thus, never permanent, in the opinion of Schumpeter. Therefore it is different from other incomes, such as rent, wages and interest. These are regular and permanent incomes arising under all circumstances. Profit on the other hand is a temporary surplus resulting from innovation.

Prof. Schumpeter also explained his views on the functions of the entrepreneur. The entrepreneur organizes the business and combines the various factors of production. But this is not his real function and this will not yield him profit. The real function of the entrepreneur is to introduce innovations in business. It is innovations which yield him profit.

Criticisms:

1. This theory concentrates only on innovation, which is only one of the many functions of the entrepreneur and not the only factor.

2. This theory does not consider profit as the reward for risk-taking. According to Schumpeter it is the capitalist not the entrepreneur who undertakes risk.

3. This theory has ignored the importance of uncertainty bearing which is one of the factors that determines profit.

4. This theory attributes profit only to innovation ignoring other functions of entrepreneur.

5. Monopoly profits are permanent in nature while Schumpeter says that innovate profits occur temporarily.

6. This theory has presented a very narrow view of the function of the entrepreneur. He not only introduces innovation but he is equally responsible for proper organisation of the business. As such profit is not merely due to innovation. It is also due to organizational work performed by the entrepreneur. As it is well known, every entrepreneur does not innovate and yet he must earn profit if he is to stay in business.

7. It is an incomplete theory because it has failed to explain all the factors that influence profit.

Functions of Profit:

In practice, as pointed out by Peter Drucker, profit serves three main purposes:

(1) Measure of performance:

It measures the net effectiveness, and soundness of a business effort. A higher profit is an indicator that the business is being run successfully and effectively. It is true that profit is far from being a perfect measure of business efficiency but it is probably the best indicator of the general efficiency of a firm. It is certainly the only one which allows quick and easy comparison of performance between firms.

(2) Premium to cover costs of staying in business:

Profit is the premium that covers the costs of staying in business—replacement, obsolescence, market and technical risk and uncertainty. Seen from this point of view, it may be argued that there is no such thing as profit; there are only the costs of being and staying in business. The management of business has to provide adequately for these costs by generating sufficient profit.

(3) Ensuring supply of future capital:

Profit ensures the supply of future capital for innovation and expansion, either directly, by providing the means of self-financing out of retained profits, or indirectly, through providing sufficient inducement for new external capital which will optimize the company's capital structure and minimize its cost of capital

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