Prepared by: **Prof. Rachna Mujoo, Applied Economics**

For B.Com Semester II

PROFIT

Profit is referred as a residual amount available to entrepreneur as it occurs after payment to other factors of production such as rent on land, wages to labor and interest on capital. The nature of profit is different from other factor incomes as it is uncertain and cannot be ascertained accurately. Also entrepreneur gets profit after the payment to all factors of production and there is possibility of negative profits (loss). This is why profit is regarded as a reward for taking risk. Entrepreneur organizes all the other factor of production and bears risk.

Profit is defined as the difference between the revenue and cost. So profit = Total Revenue - Total Cost. If cost exceeds revenue then entrepreneur faces a loss.

Accounting Profit and Economic Profit

The concept of accounting profit measures cost and revenue on actual basis. On the other hand the concept of opportunity cost is used for ascertaining economic profit. So the accounting profit considers actual cost while economic profit considers imputed cost. The difference can be explained by an example.

Mr. A invested Rs. 5 lakh in a business and at the end of the year profit and loss account showing profit of Rs.1,00,000 is accounting profit. But Mr. A is himself working in the firm and the firm is located in his own premises. In this case if A works somewhere else he can easily get 5000 per month and if he had rented his building, he could have earned 3000 as rent. So here in order to get economic profit we have to subtract 8000 x 12= 96000. So the total economic profit = 100000-96000=4000.

Functions of Profits

Some important functions of profits are as follows-

1. Profits serve as a motivation for taking risk and uncertainty and sometimes to bear losses in the process of earning continuous profits.

2. Profits promote innovation and provide financial support to entrepreneurs to innovate.

3. Profits facilitate expansion of business by providing funds for investments. Expansion also results in increase in employment opportunities.

4. Profit act as an indicator of measuring efficiency and productivity of an enterprise.

5. Government collects corporation tax on profits. So profits are source of tax revenue for government.

6. Profits provide strength to enterprise to bear unforeseen losses and survive in the condition of recession.

PROFIT THEORIES

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 dynamic change in an organized society which is progressive in nature. He was of the view that if cost, demand etc are static then no profit will arise. In the static state entrepreneur would get wages for his labour and interest on his capital and will only cover its cost and will earn normal profit only. Also there will be no risk involved in it. The presence of perfect competition makes the price equal to the cost of production which eliminates the super normal profit. The progressive change is possible only in a dynamic state. In a dynamic economy, following changes takes place ó

(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 organization

(5) Changes in consumer incomes.

Therefore there is risk for an entrepreneur. These dynamic changes affect the demand and supply of commodities resulting in 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.

Criticism:

Though the theory given by Clark was important landmark but economists criticized him and argued that profit also arises in static state because every entrepreneur is paid profit irrespective of the state of an economy. Also this theory undermines entrepreneurial functions as 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. Though the state of economy is important but mere change in an economy would not give rise to profits if those changes are predictable. A provision can be made for such changes and the expenditure can be included in the cost of production. Also the assumption of the existence of perfect competition and static state is unrealistic. Later economists opinedh that only unforeseen changes that give rise to profit.

Risk Bearing Theory of Profit

This theory was given by American economist F.B.Hawley. According to him risk bearing is the primary and most important function of an entrepreneur and profit is the reward for risk-taking in business. If nobody will take risk, production will not take place. Only entrepreneur take risk as the other factor of production get their fixed income termed as contractual payment. Entrepreneurs take risk due to expectation of high profit. Without expectation of profits, entrepreneurs will not take risk. Also the risk increases the expectation of profit i.e. higher the risk more will be the expectation of profit. 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.

Criticism-

This theory was criticized on the grounds that the entrepreneur can avoid certain risks by making a fixed payment to the insurance company; however, there are some risks which are uninsurable. If he does so he is not an entrepreneur and would earn only wages of management and not profit. Later economists like Schumpeter said that Profit is reward for innovation. Many economists said that profit is paid to an entrepreneur not for bearing the risk but for minimizing and avoiding risk. 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. Knight says only unforeseen and uninsured risks that account for profit.

Uncertainty Bearing Theory of Profit:

This theory was propounded by an American economist Prof. Frank H. Knight. This theory, starts on the foundation of Hawleyøs risk bearing theory. Knight agrees with Hawley that profit is a reward for risk-taking. There are two types of risks viz. insurable risk and uninsurable risk. Knight regards profit as the reward for bearing uninsurable risks and uncertainties. He distinguishes between insurable and uninsurable 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. Once the premium is paid entrepreneur finds himself on the safer side as 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. It is the uninsurable risks, or uncertainties, which give rise to profit. These include change in demand, change in technology, change in customers taste, operation of business cycle etc. So profit is due to uninsurable risk or unforeseeable risk. Broadly it includes-

i. Risk arising from competitors- Some new firms enters into the market unexpectedly and act as competitors to the existing firms. This will inevitably lower down the profit of the firms.

ii. Risk arising from change in technology- 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 may have to suffer losses.

iii. Risk arising due to change in policy- 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.

iv. Risk associated with business cycle- This risk emerges from business cycles. Due to business recession or depression, consumer incomes fall; consequently demand for the product of the firm also falls.

v. Risk associated with shift or change of demand in the market.

Prof. Knight calls these risks as ‑uncertaintiesø and ‑it is uncertainties in this sense which explains profit in the proper use of the termø These risks cannot be foreseen and measured, and hence are uninsurable, and therefore, these uncertainties have to be borne by the entrepreneur. As these are uninsurable there is a direct relationship between profit and uncertainty bearing. So, greater the uncertainty bearing, the higher the profit and vice versa. Uncertainty bearing has become so important in business enterprise in modern times. Profit is thus the reward for bearing uncertainty.

Criticism:

Critics point out that sometimes an entrepreneur earns no profit in spite of uncertainty bearing. This indicates bearing uncertainty does not guarantee profit. So uncertainty bearing is one of the determinants of profit, not the only determinant. Profit is also a reward for many other activities performed by entrepreneur like initiating, coordinating and bargaining, organizing etc. Uncertainty cannot be measured in quantitative terms as depicted in this theory. In modern business corporationøs ownership is separate from control. Decision-making is done by the salaried managers who control and organize 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. This theory fails to address monopoly profit as the monopoly firms earn much larger profits than competitive firms and they are not due to the presence of uncertainty.

Schumpeter's Innovation Theory:

This theory was propounded by Joseph Schumpeter. According to this theory profit is the reward for innovations, and innovation is the primary function of an entrepreneur. He uses the term innovation in a sense wider than that of the changes mentioned by Clark. Innovation is different from invention as latter is a scientific activity while innovation is a commercial activity. Innovation is brought about mainly for reducing the cost of production and also for stimulating demand. Thus the main motive for introducing innovation is the desire to earn profit.

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 revenue and 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. Demand of new customers or existing ones can be stimulated by making an intrinsic change in the product, its style or through sales promotion activities, like packaging and advertising.

Schumpeter said that innovations are not possible by all entrepreneurs. Only exceptional entrepreneurs can innovate. They are capable of tapping new resources, technical knowledge to reduce the cost of production. According to him 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. 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:

This theory concentrates only on innovation, which is only one of the many functions of the entrepreneur. This theory neglects the importance of risk bearing and does not consider it a factor for earning profit. According to Schumpeter it is the capitalist not the entrepreneur who undertakes risk. This is wrong perception. He also ignores the importance of uncertainty bearing which is one of the factors that determines profit. He regards innovation as the only function of entrepreneur ignoring other functions. Schumpeter was not able to explain monopoly profits as these are permanent in nature while he says that innovate profits occur temporarily. This theory has presented a very narrow view of the function of the entrepreneur. An entrepreneur not only introduces innovation but he is equally responsible for proper organization of the business. It is an incomplete theory because it has failed to explain all the factors that influence profit. Lastly all the entrepreneurs are not innovators but still they earn profit.

Refer to prescribed text book also.