Profit

Whatis Profit?

Profit is the income of an entrepreneur for utilizing his entrepreneurial abilities and running a business.

Profit is nothing but the surplus amount left with the entrepreneurafter paying all the factors of production. An entrepreneur utilizes the services of other factors of production namelyland, labor and capital and pays them in the form of rent, wagesand interest, respectively. In return, the entrepreneur gets products, which he sells in the market with a view to gainincome from it. If the income earned by him is in excess of thecosts incurred on the factors of production, then the income canbe called as profit. Therefore, profit can also be defined asthe difference between the total value of output (total revenues received by the businessman) and the total value of inputs(total costs incurred by the businessman) of a business.

Profit= Value of Outputs – Value of Inputs

Profit is said to be one of the most controversial subjects in economics. The term profit is defined differently by different economists. Some economists believe that profit is the earningsof a businessman for management of business. Profit is alsoviewed as a reward earned by the entrepreneur for performing theentrepreneurial function in a business. There are othereconomists who believe that profit is the reward for makinginnovations in business. Economists are yet to discover adefinition of profit that is universally acceptable.

Basic concepts

Profit consists of two major components – gross profit and netprofit. Let us now briefly discuss the concepts of gross and net profits to understand the concept of profit better.

- **Gross profit**

Generally,people consider profit as the residual income left with theentrepreneur after making all the payments to other factors ofproduction. However, it should be noted that this is grossprofit. The gross profit is arrived at after excluding all theexplicit costs from the revenues received by the business. Itdoes not exclude implicit costs such as rent forgone byentrepreneur for utilizing his own land for business purposes,interest forgone on his own capital, etc.

Gross Profit = Total Revenues – Total Explicit Costs

Gross profit thus includes those costswhich go unrecorded in the books of accounts, but which arenevertheless important to determine the profit made by thebusiness.

- **Net profit**

The net profit can be arrived at by subtracting the implicit costs from gross profits. This is alsosometimes referred to as 'pure profit'. Net profit is thesurplus leftover after deducting explicit and implicit costsfrom the sales receipts of a business.

Net Profit = Gross Profit – Implicit Costs

Thus, it can be observed that net profit isa portion of the gross profit. When a business gets zero netprofit, it means that the profit attained is just enough to meetthe explicit costs of the business. In other words, the entrepreneur's revenues could not pay off his efforts (orimplicit costs) such as utilizing his own resources, undertaking risk and uncertainty of business, etc.

Normal profit

It is the minimum return that anentrepreneur receives for performing entrepreneurial functionssuch as bearing risk and uncertainty, managing other factors ofproduction, etc.

Abnormal or super profit

The income remaining with the entrepreneurafter subtracting all costs (both implicit and explicit) fromthe revenues received from the business. It is an excess overthe normal profit.

THEORIES OF PROFIT

Though there are several theories of profit that attempt to explain the emergence and growth of profit, none of the theories give acomprehensive picture on profit. Hence, even though several economists tried to interpret profit in several ways, still there is no universally acceptable definition of profit.

Traditional Theories :

Theclassical economists like Adam Smith did not distinguish betweenownership of capital and management of business, hence theytreated profit as a business income that is available aftermaking payments to land and labor.

F.A.Walker one of the prominent non-classical economists, propoundedthe 'rent theory of profit', which was similar to DavidRicardo's (Ricardo) 'theory of rent'. Later, Taussig andDavonport developed the 'wage theory of profit' and proposedthat like a laborer works physically and earns his wage, anentrepreneur works mentally and earns his wage called profit.According to Karl Marx, profit is a 'surplus value' thatcapitalists procure by exploiting workers. He opined that profitwas socially unjustifiable and was an unearned income of entrepreneurs.

1 Walker's rent theory of profit

The 'rent theory of profit' was developed by Francis. A. Walker(Walker). He advocated that different lands earned differentrents depending upon the fertility of land. In the same way,businessmen earned 'rent of ability' called profit. Heopined that some entrepreneurs earned higher profits because oftheir greater ability to run business when compared to otherentrepreneurs. According to him, the rent earned by more fertileor intra-marginal lands was the difference between the totalproduction of intra-marginal and marginal lands. He furtherexplained that there existed both intra-marginal entrepreneursand marginal entrepreneurs and that the former are abler thanthe latter. Hence, the intra-marginal entrepreneurs earned rentof ability called profit. He opined that rent and profit are nodifferent from each other. He explained, just as there is ano-rent or marginal land, there is also a no-rent entrepreneuror marginal entrepreneur.

Walker's definition of profit bears similarities to Ricardo's 'theoryof rent.' Ricardo proposed that the difference in productivitylevels of two lands determined the rent of the superior qualityland. Therefore, rent is the 'differential surplus', overthe costs incurred on the marginal land. Walker too, likeRicardo felt profit to be a differential surplus like rent.

Limitations

The following are the criticisms leveled against the 'rent theoryof profit':

•Critics said that comparing profits with rent is impracticable. Rent can never be zero and is always positive. However, the sameis not the case with profits, as profits can be negative or zero.

•One of the main opponents of Walker's 'rent theory ofprofit', J.B. Clark, opined that profits occur only underdynamic conditions. However, rent can be earned under bothstatic and dynamic conditions.
•Thet heory assumes the existence of marginal entrepreneur i.e.entrepreneurs who do not earn any profit. This is an absurd concept because any businessman who does not earn profitswould pull back from business. Further, critics said that just as there cannot be a 'no-rent land', there alsocannot be a 'no-profit entrepreneur'.

Modern Theories :

The modern theories of profit include Clark's dynamic theory, Schumpeter's innovation theory, Hawley's risk theory,Knight's uncertainty-bearing theory among others. We will now discuss some of the prominent modern theories of profit.

Dynamic theory of profit :

J.B.Clark (Clark), an American economist propounded that profitsarise due to the dynamic changes in economic conditions .According to him, profit is the difference between the cost ofproducing goods and the prices of these goods. In a stationary state, there is always equilibrium between demand and supply of goods. Hence, there is no difference between the prices of goodsand their costs, and therefore net profits do not accrue to the entrepreneur. Under dynamic conditions, however, there isdisequilibrium between demand and supply conditions of economy.In such a state, there are often changes in the determinants ofdemand and supply. Clark proposed that profits arise due tothese dynamic changes.

Clark said that in reality, however, there exists a dynamic economy. He said that there are bound to be unforeseen changes in demand and supply. According to Clark, the dynamics in demand and supply conditions could be a result of:

- Changes in the quality and quantity of human wants
- Changes in governmental rules and regulations regarding trade
- Changes in technology that effect the production process
- Rise in population
- Adjustments with regard to amount of capital stock with the economy.

Limitations :

- Clark's dynamic theory distinguishes between wages and profit. However, Taussig criticized it because there is no distinction between wages of the businessman and profits.
- The theory fails to explain the determination of size of profits.
- The definition of the dynamic society as given in this theory is too narrow. Clark overlooked various other changes that actually occur in real situations.
- Clark also overlooked the element of risk-taking in entrepreneurship, which also contributes to profits

Innovation theory of profit :

Joseph Schumpeter (Schumpeter) propounded the 'innovation theory of profit'. He proposed that profit is the reward for the innovative abilities of entrepreneurs. According to him, an

entrepreneur who introduces innovation in businesses process reaps benefits in the form of profits, if the innovation proves successful in the market. Schumpeter defined innovation as any new process or policy adopted by the businessman with a view to obtain reduction in cost of production, or to improve the demand for the product in the marketplace.

Limitations

Economists have criticized that Schumpeter's definition of the functions of an entrepreneur was too narrow. They opine that profits are a result of various activities of an entrepreneur and not just innovation. According to them, an entrepreneur is responsible for organizing and management of all the functions of business apart from innovation.

Schumpeter's theory holds that profits are temporary in nature. However, this is not true because profits may continue to accrue to business if certain businesses enjoy uneven advantage in the form of patents, trademarks, etc. Although the theory was criticized on several grounds, it nevertheless threw light on one of the vital functions (viz. innovation) that contributed to profit generation.

Uncertainty-bearing theory

According to Frank H. Knight (Knight), the most important function of an entrepreneur is to bear uncertainties in business in the form of risks that cannot be insured against. Risk can be defined as the measurable probability of the occurrence of profit or loss situation. With a view to differentiate between risk and uncertainty, Knight divided risks into:

- Insurable risks
- Non-insurable risks

Insurable risks

According to Knight, insurable risks are those risks which the entrepreneur can avoid through insurance. These risks can be in the form of loss of assets due to fire, accident, theft, etc. An entrepreneur gets cover for these losses by paying a premium to the insurance companies and reclaiming the same in the event of mishap. Therefore, he does not have to bear uncertainties for insurable risks.

Non-insurable risks
Uncertainty arises for non-insurable risks. Non-insurable or unpredictable risks are those risks which are unforeseen and for which no information is available to estimate or forecast. Also, non-insurable risks cannot be covered under insurance coverage.

The following are the different kinds of non-insurable risks as given by Knight:

- Risk of competition: It arises out of the unforeseen changes in the business related policies of competitors.
- Risk arising out of changes in technology: It arises when the present technology that is being used by the entrepreneur becomes obsolete with the advancements in technologies in an economy.
- Market conditions risk: It arises due to the changes occurring in the economy as a result of changes in trade cycles.
- Government policy risk: It arises when changes in policies of government affect the business of the entrepreneur adversely. The policies can be in the form of changes in foreign trade policy, tax laws, etc.

Limitations :

•The theory touches on only one function of the entrepreneur viz. uncertainty-bearing. It must be noted that the other functions such as innovation, estimating market demand, etc .are also vital to the successful running of a business.

•Economists opined that Knight laid too much emphasis on uncertainty-bearing function to the extent that he attempted to raise it to the status of a factor of production.

•It was also criticized that the theory defines profit only in a micro perspective. The theory failed to determine profit sharing among large group.

PROFIT POLICIES :

Profit policies give entrepreneurs a clear picture about the rate of profits the business ought to earn and what should be the profit performance of the business in the long-term. Profit policie sshould be such that they reflect the goals and objectives of the business. Primarily, a profit policy must take into consideration two main issues. They are:

•Standards of Reasonable Profits, and

•Reasons for Limiting Profits

Standards of Reasonable Profits :

In setting standards of reasonable profit, an entrepreneur selects a specific concept and measure of profit earned by the business. The entrepreneur uses these standards to compare the expected and achieved results of the business. The entrepreneur also is required to determine adequate rate of profit for the business. The adequate rate of profit can be determining by analyzing the profits earned by the firm in the past, profits earned by other businesses in the same industry, etc.

Reasons for Limiting Profits :

Unto now, we have been discussing about profit in the context of an entrepreneur or a businessman. However, in today's business environment ownership is separated from management. Therefore, profit no longer is restricted to individual wealth maximization. Managers manage the business on behalf of the shareholders. It is no longer feasible for firms to aspire to profit maximization because business houses today are answerable to shareholders, creditors, employees, government, customers and to the society at large. Hence, business houses are obliged to limit their profits.

Following are some of the reasons for limiting profits of businesses:

- Discourage or avoid competition
- Maintain firm's goodwill
- Control demand for higher wages
- Maintain liquidity of firm
- Avoid risk