THEORIES OF PROFIT AND MANAGEMENT

There has been a strenuous effort on the part of thinkers and economists to comprehend the notion of 'profit' and develop their views. This endeavor to explore the sources of profit has led to the emergence of various theories of profit in economics. It would be wise to understand the gist of the main theories.

1. Walker's Theory of Profit (Profit as Rent of Ability): One of the extensively recognized theories of profit was stated by F. A. Walker who conceived 'profit' as the rent of "exceptional abilities that an entrepreneur may possess" over others.

F. A. Walker believes that profit is the difference between the earnings of the least and the most efficient entrepreneurs. Walker assumes a state of perfect competition, in which all firms are presumed equal managerial ability. In Walker's view, under perfectly competitive conditions, there would be no pure or economic profit and all firms would earn only marginal wages, which is popularly known in economics as 'normal profit'.

Walker argued that profits of the profit-making firms arise from what a more efficient firm is able to produce over and above what the least efficient firm is able to produce with the same amount of capital and labour.

2. Clark's Dynamic Theory:

Dynamic Entrepreneurship is the Source of Profit: J. B. Clark advocated his theory of profit in 1900. J. B. Clark is of the opinion that profits arise in a dynamic economy, not in a static economy. Astatic economy is defined as the one in which there is absolute freedom of competition; population and capital are stationary; production process remains unchanged overtime; goods continue to remain homogeneous; there is freedom of factor mobility; there is no uncertainty and no risk; and if risk exists, it is insurable. In a static economy therefore, firms make only the 'normal profit' or the wages of management.

A dynamic economy on the other hand, is characterized by the generic changes. In the dynamic world the factors undergo a process of change.

The generic changes include:

(i) The size of population increases;
(ii) Amount of capital increases;
(iii) Enhancement in production method;
(iv)The forms of business organizations changes; and,
(v) Increase of consumers' wants.

The major functions of entrepreneurs or managers in a dynamic environment are in taking advantage of the generic changes and promoting their businesses, expanding sales, and reducing costs. The entrepreneurs who successfully take advantage of changing conditions in a dynamic economy make pure profit.

From Clark's point of view, pure profit is momentary. In the long-run with the passage of time competition forces other firms to imitate changes made by the leading firms, leading to a rise in demand for factors of production. Consequently, production costs rise, thus reducing profits, especially when revenue remains unchanged.

The gist of Clark's theory is that profit is a reward for inventing products and techniques of production and for managing the functions of entrepreneurs under dynamic conditions. Profit is recognition of dynamic entrepreneurship.

3. Hawley's Risk Theory of Profit: Risk Theory of Profit: F. B. Hawley in 1893 advocated the risk theory of profit. According to Hawley, risk in business may arise due to such reasons as obsolescence of a product, unexpected collapse in the market prices, non-availability of essential raw materials, introduction of improved substitutes by competitors, risk due to fire, war and the like.

Risk taking is considered as an inevitable precondition of dynamic production, and those who take risk have a sound claim of a separate reward, termed 'profit'. Hawley simply refers to profit as the price paid by society for assuming business risk.

He suggests that businessmen would not assume risk without expecting adequate compensation in excess of actuarial value, that is, premium on calculable risk. Hawley opined that profit consists of two parts: The first part is the compensation for the average loss accompanying to the various classes of risks necessarily assumed by the entrepreneur and the other part is the inducement to suffer the prospect of being exposed to risk.

4. Knight's Theory of Profit: Bearing Uncertainty is the basis of Profit: Frank Knight considered profit as a residual return to uncertainty bearing, not to risk bearing as in the case of the theory of Hawley. Knight segregated risk into calculable and non-calculable risks. In this process he tried to distinguish risk and uncertainty. Calculable risks are those risks whose probability of occurrence can be statistically estimated on the basis of available data Examples of these types of risks are risks due to fire, theft, accidents, and the like. Calculable risks are insurable.

Those areas of risk in which the probability of its occurrence is non-calculable, such as certain elements of production cost that cannot be accurately calculated, are not insurable. The incalculable risks are represented by 'uncertainty'. The entrepreneur has to take decisions in this region of uncertainty. He earns profit if he takes right decisions.

Prior to Knight Hawley and Pigou showed that entrepreneurs earned profits because they had to bear the risks of undertaking productions. But F.H. Knight has significantly advanced the theory of profits based on uncertainty. He has distinguished between risks and uncertainty on the one hand and predictable and unpredictable changes on the other. According to Knight, dynamic changes give rise to profit so far as changes and their consequences are unpredictable in character. Only those changes whose happening cannot be known in advance give rise to profit.

If the changes were foreseen and predictable or if there were no changes, there would have been no uncertainty about the future and no profits. Profits crop up because of uncertainty of future. If the future conditions could be completely foreknown in the present, then people would certainly adjust things to the ideal state where all prices would equal costs and profits would not emerge. Ignorance about the future and uncertainty of it gives rise to profits.

We thus observe that entrepreneurs have to carry out the work of production undo– situation of uncertainty. They have to make estimates of the future conditions regarding demand for the product and other factors that affect price and costs in advance. On the basis of their estimates and anticipations, they make contract with the suppliers of factors of production in advance at fixed rates of remuneration.

They visualize the value of the output produced by the hired factors after it has been produced and sold in the market. But a long gap of time is spent in the process of producing and selling the product. A good time gap elapses between the contracts made by the entrepreneur with the factors of production at fixed rates and the realization of sale proceeds from the output made by them.

These contracts are based upon anticipations about the future conditions. But, during this period between the time of contracts and the sale of the output, many changes may take place which may upset anticipations for good or for worse and thereby give rise to the profits, positive and negative.

Now, if the conditions prevailing at time of sale of output could be known or predicted when the entrepreneurs enter into contractual relationship with factors of production about their rates of remuneration, there would have been no uncertainty and, therefore, no profits.

Thus, uncertainty, i.e., ignorance about the future conditions of demand and supply, is the curve of profits. It should be noted that positive profits accrue to those entrepreneurs who make correct estimate of the future or whose anticipations prove to be correct. Those whose anticipations prove to be incorrect will have to suffer losses.

There are two kinds of changes which are responsible for conditions of uncertainty. The first kind of changes refer to the innovations which are introduced by the entrepreneur themselves.

These innovations create an atmosphere of uncertainty for the rivals as well as the entrepreneur himself the entrepreneur is never sure that his/her innovation will be successful. The second kind of change is the uncertainty caused by the external environment. These include changes in policies of the state, wage and labour laws, stage of business cycle, changes in the technology and above all the changes in tastes and preferences of the consumers.

Knight draws a distinction between insurable risk and non-insurable risk. Owing to the changes that take place continuously in the business environment, the entrepreneur feces many risk. But it is important to note that all risks don't give rise to profit. It is only non-insurable risks that involve uncertainty and the entrepreneur earns profit for undertaking these non-insurable risks.

Knight's theory has been criticized for the lack of scientific precision. Uncertainty is not a easy phenomenon. Uncertainty cannot be considered as the solitary cause of profit. The practical situations don't certify Knight's theory. If uncertainty brings profit and higher uncertainty brings more profit. The real life situations don't always conform to this theory.

5. Schumpeter's Innovation Theory of Profit: Innovation is Rewarded with Profit: In 1934, Joseph A. Schumpeter advocated the innovation theory of profit. Schumpeter was of the opinion that factors such as emergence of interest and profits, recurrence of trade cycles are only incidental to a distinct process of economic development; and he believed that certain principles which could explain the process of economic development would also be able to explain these economic variables or factors. Schumpeter's theory of profit rooted in his theory of economic growth.

In his endeavour to explain the process of economic growth, Schumpeter began with the state of stationary equilibrium, characterized by equilibrium in all spheres. Under conditions of stationary equilibrium, total receipts from the business are exactly equal to the total cost outlay, and there is no profit. According to the Schumpeter's theory, profit can be made only by introducing innovations in manufacturing methods as well as in the process of supplying the goods.

Innovation can be of any of the following:

a. Introduction of novel product or an improved quality of good;

b. A new method of production;

c. Finding or developing a new market;

d. Discovery of new sources of raw material; and,

e. Organising the industry more efficiently in a new mode.

In a suitable and conducive business environment, the entrepreneur who innovates goes ahead to earn the profit.

2. Wage Theory of Profit:

The theory was propounded by American economist Professor Taussig and it was supported by Professor Davenport.

According to Professor Taussig, "Profit is the wage of the entrepreneur which accrues to him on account of his special ability. According to this theory profit is just like a wage which is paid for the services of an entrepreneur. An entrepreneur is just like a labour who puts more of mental labour and less of physical labour. The payment made for the mental labour of an entrepreneur is profit. Thus, profit is just a type of wage paid to an entrepreneur in any business for his labour."

Criticism of the Theory:

The following are the criticisms of wage theory of profit:

(1) The Theory does not Differentiate between the Functions of Worker and Entrepreneur: Workers always get wage but an entrepreneur may not get profit and he may incur losses in a business organisation. Worker does not take any risk while an entrepreneur takes risk.

(2) Wage is Always Positive while Profit may be Negative: The theory does not explain the differences between the remuneration paid to a worker and reward paid to an entrepreneur. Worker gets wages and they are positive while entrepreneur gets the reward in positive or zero or negative.

(3) Profits and Wages in Imperfect Competition have Different Nature: The theory does not explain the imperfect competition under which wages decrease and workers are exploited while profit increases.

(4) Fails to Explain the Profits of Joint Stock Companies: The shareholders of joint stock companies do not put any labour and even then they get the profits. This sort of functioning is not explained by the theory.

(5) The Theory does not Explain other Factors Leading to Emergence of Profit: Profit is not the result of labour on account of the entrepreneur in an organisation. Innovations, dynamic economy, risk bearing are other factors leading to emergence of profit in an organisation.

3. The Socialist Theory of Profit: The theory was propounded by Karl Marx who has written a famous book Das Capital. According to this theory, the value of a product is determined by the units of labour involved in its production. The labour is not paid wage equal to his marginal productivity in a capitalist economy and less wage paid and workers are exploited. On account of it the theory of surplus value of labour was propounded by Karl Marx.

Such surplus value is called profit. The main cause of emergence of profit is the exploitation of workers by capitalists. Karl Marx has called it a "Legalised Robbery". The profit rate will decline as it exploits workers and divides the society into the haves and the have-nots. It is the socialist society in which workers will be paid wages equal to their marginal productivity and the private profit will disappear.

Criticism of the Theory:

The theory has been criticised on the following grounds:

(a) The theory has assumed that profit is the outcome of the exploitation of labour. Profit is the result of risk taking and the uncertainty bearing by an entrepreneur. Hence, profit is not due to exploitation of labour but it is a reward for risk taking and uncertainty bearing by an entrepreneur.

(b) Production of commodity is not by the labour only. It is the result of collective efforts of various factors of production, namely, land, labour, capital, entrepreneur and organisation.

(c) The theory opposes profit but in socialist economies profit is earned by the firms.

8. The Marginal Productivity Theory of Profit:

Edgeworth, Chapman, Stigler and Stonier and Hague have explained the determination of profit on the basis of marginal productivity of an entrepreneur as other factors of production are rewarded on the basis of their marginal productivities.

Demand curve of a factor of production is the marginal productivity curve of the factor. The demand for an entrepreneur is based on its marginal productivity curve while its supply depends upon the opportunity cost or transfer earning of an entrepreneur.

Marginal productivity means an addition to total productivity when an additional unit of a factor of production is employed. We can determine the entrepreneurial ability by employing an additional unit of entrepreneur or withdrawing it.

The determination of profit on the basis of this theory can be explained with the help of the following diagram:

MRP is the demand curve for entrepreneur and SS is the supply curve of entrepreneur. Both the curves cut each other at L point where the OE is the supply and demand for entrepreneurs. OS is the profit level which is equal to transfer earnings of entrepreneurs. In the long run under perfect competition this level of profit (normal profit) will remain as it is. But during short period an entrepreneur may earn abnormal profit as well.

When the supply of entrepreneurs is OE1, the entrepreneur is earning abnormal profit equal to SS1 out of OS profit. This abnormal profit will disappear in the long run when new firms will enter the industry under perfect competition and there will be normal profit only.

Criticism of the Theory:

The marginal productivity theory of profit has been criticised on the following grounds:

(1) The theory assumes that all the units of entrepreneurs are identical. But in actual practice we see that all the entrepreneurs are not identical in risk bearing, uncertainty, decision-making and organisation capacity, etc.

(2) The theory is based on the assumption that there is perfect competition in factor market. Perfect competition is an imaginary and unrealistic market structure.

(3) The theory assumes that there is full employment in the economy. But even Professor J.M. Keynes has pointed out that there is always less than full employment situation even in highly developed economies.

(4) The theory emphasises on the demand side of an entrepreneur and it does not explain the sources of supply of entrepreneurs. Thus, it is one sided theory for the explanation of profit which is not correct.

(5) The marginal productivity of an entrepreneur cannot be calculated. We can neither employ an additional unit no withdraw the additional unit of an entrepreneur from an organisation. There is always one entrepreneur only in an organisation.

(6) The theory determines profit during long period and does not apply during short period. Professor J.M. Keynes has rightly pointed out that we all are dead in the long run and there is no economic problem. Hence, the theory is not useful for the short run determination of profit.

(7) The theory does not explain various types of profits— normal profit, monopoly profit and windfall profit. Hence, it is not a comprehensive theory of profit.

Modern Theory of Profit:

This theory of profit is also called the demand and supply of profit. As the reward of other factors of production is determined by the respective demand and supply, in the same way profit is determined by the demand and supply of an entrepreneur. The point at which the demand curve cuts the supply curve of an entrepreneur the profit will be determined. It is the point of equilibrium where an entrepreneur earns normal profit. It is also called opportunity cost of the entrepreneur.

Demand for Entrepreneur:

The demand for an entrepreneur depends on its marginal revenue productivity (MRP). If the MRP is higher than the demand for and entrepreneur will be high and profit will also be higher and contrary to it when the MRP is lower than the demand for the entrepreneur will also be less and the profits will also be lower.

It is difficult to determine the marginal revenue productivity of the entrepreneur because in any organisation or firm there is always single entrepreneur. As the units of entrepreneur increase in an industry the MRP will decrease and vice versa.

Marginal revenue productivity (MRP) and demand for entrepreneur are shown on OY-axis and OX-axis respectively. There is negative relationship between the demand for entrepreneur and the MRP as shown by MRP curve.

Supply of Entrepreneur:

The supply of entrepreneur depends on the rate of return or profit and there is direct and positive relationship between the profit and the supply of the entrepreneur. If higher the rate of return or profit more will be the entrepreneur and vice versa as shown in the following diagram-

The rate of profit and supply of entrepreneur are shown on OY-axis and OX-axis respectively. As the profit increases the supply of entrepreneur increases and vice versa. The supply of entrepreneur is not only affected by rate of profit but also by the social conditions in the country, availability of entrepreneurs, distribution of income and wealth, risks and uncertainty prevailing in the business and government policies.

Determination of Profit:

Under perfect competition the profit will be determined at the point where the demand for entrepreneur curve intersects the supply of entrepreneur curve.

Marginal revenue productivity (MRP) and profit are shown on OY-axis while demand and supply of entrepreneur are shown on OX-axis. The point of equilibrium is at E where DD is equal to SS. Their profit is OP and the demand and supply of entrepreneur are OQ.

Profit and price are shown on OY-axis and demand and supply of entrepreneur on OX-axis respectively. E is the point of equilibrium where the DD intersects the SS curve. OQ is the demand for the supply of entrepreneur. OP is the profit. The firm will earn supernormal profit during short run and long run under imperfect competition because the goods are sold at more than its average cost (AC) which means average revenue (AR or Price) is greater than its average cost (AR/P>AC).

There is monopoly, element under this type of market structure and the entrepreneur will be benefited and will earn more than the normal profit as shown by the shaded area PSE.

Thus,

Total Profit = Normal Profit + Supernormal Profit

= OQES + SPE

= OPEQ

Entrepreneur is earning supernormal profit equal to PSE under the imperfect market structure while OQES is the normal profit of an entrepreneur.