THEORIES OF PROFIT

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Theories of profit

- The Marginal Productivity Theory of Profit
- The Dynamic Theory of Profit
- the Risk Theory of Profit
- Knight’s Theory or the Uncertainty-Bearing Theory
- Prof. Schumpeter’s Innovation Theory of Profit or “Profit is the Reward for Successful Innovation”
The Marginal Productivity Theory of Profit:

• This theory was propounded by Prof. Marshall. According to him, “Profit is equal to the marginal productivity of the entrepreneur. He has said that the amount which the community is liable to produce with the help of entrepreneur over and above what it could produce with his help.”

• Stigler and Stonier and Hague have said that “Profit is the reward of an entrepreneur which is determined by its marginal revenue productivity, the higher are the profits and lower the marginal revenue productivity, the lower are the profits of an entrepreneur.”
Important criticisms given by various economists are as follows:

a. This theory is based on unrealistic assumptions:
   These unrealistic assumptions are homogeneity of entrepreneurs in an industry. As entrepreneurs’ efficiency differ, therefore it is not possible that there will be one marginal revenue productivity curve for all entrepreneurs. So Profit cannot be same.

b. This theory fails to determine profit accurately:
   Because efficiency of entrepreneurs differs, systems and methods of doing work differ, therefore. Profit cannot be calculated accurately.

c. The concept of marginal revenue productivity of entrepreneurship is a meaningless concept:
   Because unlike other factors, there can be only one entrepreneur in a firm.

d. It is one sided theory:
   This theory takes into account only the demand for entrepreneurs and do not take into account the supply or availability of entrepreneurs.

e. This is a static theory:
   Where all entrepreneurs earn only normal profits, they have not considered that the world is dynamic also where some entrepreneurs can earn more than normal.
The Dynamic Theory of Profit:

- Prof. J. B Clark propounded this theory in the year 1900. According to him—"Profit is the difference between the price and the cost of the production of the commodity". But Profit is the result of dynamic change. Further, Prof. Clark was of this opinion that in a stationary state having static economic conditions of demand and supply, there can be no real or pure profit as a surplus. In a stationary economy, the quantum of capital invested, methods of production, managerial organisation, technology, demand pattern etc. remain constant.
- Under competitive conditions, price tends to equal average costs; hence, the surplus is zero. So, no pure profit but there may be some frictional profits emerging due to frictions in the system. But, this cannot be regarded as real Profits.
- **Profit is the result exclusively of six dynamic changes i.e.:**
  - (1) Changes or increase in population,
  - (2) Changes in tastes and preferences,
  - (3) Multiplication of wants,
  - (4) Capital formation,
  - (5) Technological advancement and
  - (6) Changes in the form of business organisation.
- On account of these changes the economy tends to be dynamic. Demand and supply conditions are altered. Some entrepreneurs may get advantageous business positions against others and may reap surplus over costs, as a real profit. In short, those who takes advantage of changing situation can earn real profits according to their efficiency.
- Producers who fail to move with dynamic changes may not get any real profit and may even incur losses. Thus, Clark’s dynamic theory of Profit has an element of truth as it emphasis the dynamic aspect of Profit.
Criticisms:

- Clark’s dynamic theory of Profit has been severely criticised by Prof. Knight and others on the following grounds:
- a. All changes are not foreseen:
  - Clark’s theory fails to make any difference between a change that is foreseen and one that is unforeseen in advance. If the six changes as assumed by Prof. Clark are to be foreknown in advance then the effects of changes will not hold at all. In reality, all changes are not foreseen. Some are foreseen and some are not. So, to have a clear understanding of the problem, it is essential to separate its effects from those of change as such.
- b. This theory gives artificial dichotomy:
  - In this connection Taussig has said that Clark’s theory gives an artificial dichotomy of ‘Profit’ and ‘Wages of management’.
- c. All changes do not lead to Profit:
  - Clark’s theory suggests that all dynamic changes lead to Profit. But critics are of this opinion that only unpredictable changes would give rise to profits. Predictable changes will not cause surplus to emerge on account of precise adjustments.
- d. Here, the concept of frictional Profit is vague:
  - Clark’s theory indicates that in a stationary state, there is only a frictional profit. But the concept of frictional profit is vague. But it is the normal profit which is earned in a stationary state.
- e. Element of risk involved in business:
  - Clark’s theory of Profit do not stress the element of risk involved in business due to dynamic changes. The best course is to combine elements of risk dynamic changes to understand the true nature of profit in a modern economy.
F.W. Hawley’s the Risk Theory of Profit:

- This theory of Profit is associated with F. B. Hawley who has considered the risk-taking as the important function of an entrepreneur. The entrepreneur exposes his business to risk, and in turn he receives a reward in the form of Profit because the task of risk-taking is tedious.
- It is definite that no entrepreneur will like 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.
- Further, it has been said that more risky the business, the higher is the expected Profit rate. “riskier the industry or firm, the higher is its Profit rate.”
Like other theories, the risk theory of profit has also been criticised on the following grounds:

a. There cannot be functional relationship between Risk and Profit:
   Those persons who dare to take high risks in certain businesses may not necessarily earn high profits.

b. Profit is not based on entrepreneur’s ability:
   In this connection Prof. Carve has said that “Profit is not based on entrepreneur’s ability to undertake the risks of the business, but rather as his capability of risk avoidance.”

c. It is an incomplete theory:
   From business point of view, all enterprises are risky and an element of uncertainty is present there. But every entrepreneur aims at making large profits which is also uncertain. Therefore, Hawley’s Risk Theory can also be called as an incomplete theory of Profit.

d. Amount of Profit not related to size of risk involved:
   The amount of Profit is not in any way related to the size of the risk undertaken. If it were so related then every entrepreneur would involve himself into huge risks in order to earn larger profits.

e. Concentrates mostly on risk and not on anything else:
   This theory mostly disregards many other factors attributable to Profit and just concentrate on risks and risks alone.
Prof. Knight’s theory of uncertainty bearing theory of Profit is an improvement and refinement theory of Profit over Hawley’s risk-bearing theory of Profit. Here, Profit according to Knight, is the reward of bearing non-insurable risks and uncertainties. It is a deviation arising from uncertainty.

Uncertainty prevails in the entire society and profits, positive or negative, in a way accrues to all factor services. In other words, there is profits element in all types of income. But the division of social income between Profit and contractual income depends on the supply of entrepreneurial ability.

Uncertainty bearing is the most important function in a dynamic state. It is the entrepreneur who either delegates this function among different personnel or assumes it himself. The expectation of Profit is, in a way, the supply price of entrepreneurial uncertainty-bearing. In a competitive economy where there is no risk, every entrepreneur will have a minimum supply price.

In short Knight’s theory implies that:

(i) Profit is reward for uncertainty-bearing.

(ii) The un-measurable risks are termed as uncertainty. These un-measurable risks are true hazards of business.

(iii) Pure Profit is, however, a temporal and unfixed reward. It is turned with uncertainty. Once the unforeseen circumstances become known, necessary adjustment would be possible. Then pure Profit disappears.
Criticisms:

- a. This theory does not give clear notion of entrepreneurship therefore it has been called unrealistic:
  - In this theory there is no indication as to who are the real owners because owners are shareholders and policy decision-makers are salaried people.

- b. Difficulty in the distribution of profit:
  - This theory does not solve the problem of distribution of profit among the controlling and ownership group, therefore, this theory keeps the problem of the determination of Profit unsolved.

- c. This theory fails to expose the phenomenon of monopoly profit:
  - The theory does not suit well to expose the phenomenon of monopoly profit. When there is least uncertainty involved in a monopoly business.

- d. This theory has not said anything on monopoly profit:
  - This theory does not throw any light on the monopoly profit. As we have studied that monopoly firms earn much larger profits than competitive firms and they are not due to the presence of uncertainty.

- f. Above all, the uncertainty element cannot be qualified to improve profits.
Schumpeter’s Innovation Theory of Profit or “Profit is the Reward for Successful Innovation”:

- Schumpeter deemed Profit as the reward to enterprise and innovation. In his opinion, the entrepreneur initiates innovation in the business and when he succeeds, he earns Profit as his reward. Now, the question is what is innovation? “Innovation means commercial application of new scientific inventions and discoveries.”
- An innovator is, therefore a businessman with vision, foresight, originality and is bold enough to bear high risks involved in undertaking new activities on a new basis. The innovator is not a scientist, but he successfully introduces new inventions on a commercial basis.

**Innovation is of two types:**
- (i) Product innovations, and
- (ii) Market innovations.

Product innovations affect the cost and quality of the product while market innovations include discovery and exploitation of new market, introducing new variety of products and product improvement, modes of advertising and sales propaganda etc. It has been said that any form of innovation leads to a Profit. It is called as innovational profit. This Profit is uncertain and unpredictable. It is temporary in nature.
Criticisms:

• **Schumpeter’s innovation theory** has been criticised on the following grounds:
  
  a. **Schumpeter has never considered Profit as the reward for risk-taking:**
  
  He is of this opinion that risk-taking is the function of the capitalist and not of the entrepreneur. It is the shareholders who undertake risks and thus earn profits.
  
  b. **There is no place of uncertainty in Schumpeter’s innovation theory:**
  
  Profit is not the reward of uncertainty it is simply the wages of management.
  
  c. **This theory is incomplete:**
  
  Profit accrues to the entrepreneur for his organisational ability and nothing else. Therefore, this theory has been called as an incomplete explanation of the emergence of profits.