CHAPTER II

THEORIES OF PROFITABILITY: A BRIEF STUDY.

"Profit is the reward that accrues to the entrepreneur. Profit is generally taken to be the difference between the total sale-proceeds and total cost of production". But this difference is not the net profit (income), but it is gross in nature. In gross profit, some elements which are not the profit in real sense are also included. They are, (i) First, the rent of the land; (ii) Second, the interest on capital owned by entrepreneur himself; (iii) Third, earnings of management — if he himself is managing the concern. What remains after deducting all the above elements from gross profit, is net or pure profit or net income. Profit includes, (a) the reward for bearing uncertainty and risk, (b) the monopoly revenue due to market imperfections and (c) the windfall or chance gain arising out of sudden change in the market. Thus, profit, unlike the income of other factors of production, is not a contractual income but it is a residual income.

There are different theories of profit propounded by different economists. Consequently, there is no single uniform theory that can be applied in the best way with a generalised conception. Therefore, we have to discuss all the theories that have been propounded.

American economist F.L. Walker thought that profit was the rent of ability. As rent arises due to differential fertility of the superior lands over the marginal lands, so also the profit arises due to the differences between the superior entrepreneurs and the marginal entrepreneurs. Just as the marginal land pays
no rent, so also the marginal entrepreneur earns no profit.

In another theory, American economists Prof. Taussig and Davenport emphasise that profit is also a type of wage paid to entrepreneurs for doing works like business organisation and coordination etc. This income to entrepreneur is not out of a special chance, but it is due to his special skill in organisation and in taking risks.

Hawley tries to tackle the problem from a different angle. He says that the modern production is highly risky as it is carried on only in anticipation of demand, distant in time and space. If the expected remuneration is less than the average return, no entrepreneur will undergo the risk. So any return over the normal level is the entrepreneur's income that accrues to him for bearing risks.

What Hawley's theory lacked, Prof. Knight tries to cover up by propounding his own theory that profit is the reward of risk and uncertainty bearing. In the "risk theory of profit", Hawley assumes that there are some risks which are insurable and guarded against, for example, the payment of insurance premiums for fire, accident, death etc. The entrepreneur gets no profit for these risks. Because these were not the true function of entrepreneur. "The true entrepreneur, the output and price fixer, is the man, who risks losses and earns profits". There are the risks which are unpredictable and hence uncertain. Modern economists, like Stonier, Hague and Cairncross also support this version of theory of profit.

American economist J.B. Clark defines that profit is the excess of the prices of goods over their costs. According to him profit arises due to the dynamic changes in society, or, due to
the fact that society is dynamic. He extends the element of uncertainty in the 'time' factor and distinguishes the static with the dynamic features of the economy. Clark mentions five generic factors which push the static society to move. They are, (i) changes in the size of population; (ii) changes in the supply of capital; (iii) changes in production techniques; (iv) changes in the forms of industrial organisation, and (v) changes in human wants.

Prof. J.A. Schumpeter also follows J.B. Clark in his theory of profit by saying the profit arises only in the dynamic society. But his theory differs in the generic factors propounded by Clark, and develops his theory to the extent that profit is the result of innovation in the productive process. His term, "innovation" is wider than Clarks' view of generic changes. He refers all those changes in the production as innovations, objective of which is to reduce the cost of the products. Therefore, it will create a gap between the existing market price and the new cost; thus, the entrepreneur earns the profit but only for a temporary period even after a risk of uncertainty about the degree of success in adopting the innovation. It is temporary because when the other competitors in the market will come to know about the new technique of the production, the price will tend to equal the cost.

On the other hand, marginal productivity theory explains, profit, like the other remunerations, is the result of the marginal net product of one unit of enterprise. Marshall says that "the marginal net product of the employer is the amount which the community is able to produce with his help over and above what is can be produced without his help".
There is again a separate controversy which theory is to be called as the modern version. Some economists refer marginal productivity theory as the modern version, whereas another group of economists refer to the "demand and supply theory" as the modern version. Profit is determined like the prices being determined in the competitive market by the forces of demand and supply. The demand side constitutes the factors like, (a) level of industrial development; (b) the element of uncertainty; (c) the scale of production; and (d) the marginal revenue productivity of entrepreneurship, whereas the supply side is determined by several factors, such as, (i) the availability of capital; (ii) the existence of managerial and technical personnel; (iii) the size of population; (iv) the number of entrepreneurs; (v) the element of uncertainty in the industry; (vi) the distribution of income; (vii) industrial experience and lastly (viii) the condition of society.

In the above theories, although all the relevant factors are discussed by the concerning economists, but the technological aspect is totally ignored. Prof. P.N. Mathur analyses the side as the profit is income for superior technology over marginal technology. This analysis is similar to the theory of rent given by Ricardo in the proposition that rent is income from the superior lands to that of the marginal lands. In this analysis, Dr. Mathur stresses the point that there are some marginal firms which are able to just to cover the total cost of production at the prevailing prices. In the case of marginal land, these marginal firms do not earn any profit. But the superior firms with higher degree of efficiency due to their superior techniques of production can produce at a much lower cost per unit, but the
market price remains unchanged due to the existence of marginal firms. So the gap between market price and lower costs yield a high return, which in this case is the profit for technologically superior firms.

In a inter-industry analysis of Leontief Model, the total income generated is just equal to the total value of commodity available for immediate and final use, and the unit price of a commodity is equal to the material cost plus the value added. Hence, the prices of the various goods can be obtained from the following in identities.

\[ p_i = \sum_{j=1}^{n} p_j a_{ij} + v_i \quad (i = 1, 2, 3, 4, \ldots, n) \]

The income generated, or, the value added in each industry can be divided into two components, wages and profits. In this case,

\[ V = (W + \Pi) \text{ Where,} \]
\[ W = \text{raw vector of wages per unit of output or per Rupee worth of output.} \]
\[ \Pi = \text{raw vector of profits per unit output or per Rupee worth of output.} \]

Hence, \[ P = (W + \Pi) (I - A)^{-1} \]
If we assume zero wages, \[ P = \Pi (I - A)^{-1} \]
At the other extreme, if we assume profit is zero, \[ P = W (I - A)^{-1}, \text{ or } P = WL (I - A)^{-1} \]
Where \( L \) is the vector of labour.
\( (\text{or, } W = WL \text{ or } L = \frac{W}{W} ). \)
Profitability in economics means the rate of profit that a firm earns at a given time. It is not independent of other factors in the sense that it does not affect other factors in the process of production. But the profit is the main and the most important motivating factor that induces the individuals to take up risks and uncertainty. Profit of any firm at any given time depends mainly on the firm's level of technology or its size. When high level of technology is adopted, production cycle becomes cheaper and quicker. So the chance of fulfilling rising demand increases and the decline in cost yields more profit. The size of the production unit also plays an important role. A large sized firm is enabled to produce more by its higher installed capacity, whereas the small-sized firms, with the limited capacity cannot produce on a large scale even if they can get the ready market. Besides, the large firms enjoy some other advantages also which the small firms do not enjoy. These advantages are, (i) large firms can accumulate capital in a much easier way. Because of their capacity to market their products, large units frequently get the loans from the banking institutions at a much lower rate than what small firms happen to get; (ii) large firms enjoy external and internal economies of large scale production. More and more production of any particular product tends to lower the cost of production per unit of output which enable these units to get a higher return on their investment which raises their amount of profit.

Prof. Hicks defines the profit as follows:

Net receipts = Surplus— changes out of past contracts.

Profit (or, income) = net receipts — depreciations( or + appreciations).
Again, Stoniar and Hague define the profit in the following way:

Profits = Total Revenue — Total cost.

= Average Revenue × Output — Average cost
  × Output.

= Σ Marginal Revenues — Σ Marginal Costs.

But profit is treated as a part of value added in input-output analysis. Value added is derived as follows:

Value added = Total value of Output — Total value of intermediate inputs.------(@)

Profit = Value added — Wages and Salaries. -------(b)

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