UNIT 4 : PROFIT

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Basic Concepts in Profit

- 4.3.1 Meaning of Profit
- 4.3.2 Gross Profit
- 4.3.3 Net Profit
- 4.3.4 Differences between Gross Profit and Net Profit
- 4.3.5 Nature of Profit

4.4 Theories of Profit

- 4.4.1 Uncertainty Bearing Theory of Profit
- 4.4.2 Innovation Theory of Profit

4.5 Let Us Sum Up

4.6 Further Readings

4.7 Answers to Check Your Progress

4.8 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- put forward the definition of profit
- distinguish between net profit and gross profit
- discuss the nature of profit
- discuss the Innovation Theory of Profit
- explain Uncertainty Bearing Theory of Profit.

4.2 INTRODUCTION

We have already discussed that the four factors of production viz., land, labour, capital and entrepreneur get rewards for their contribution to production. Land gets rent and labour gets wages as rewards for their

services. Similarly, capital gets reward for its services which is termed as interest. This unit discusses the other such reward, i.e., profit.

Profit is the factor income of the entrepreneur. It is the difference between the income of the business and all its costs/expenses. It is normally measured over a period of time. Profit is called the reward to the owners of the business. They have taken risks with their money and time. If there were no profit, then there would be little point in starting up or putting more money into the business; they might as well put the money into a bank and earn interest on the deposit.

4.3 BASIC CONCEPTS IN PROFIT

Before we discuss profit in detail, it will be helpful for us to discuss the meaning and nature of the term 'profit', and the concepts of gross profit and net profit.

4.3.1 Meaning & Nature of Profit

We have already stated that profit is the factor income of the entrepreneur. The entrepreneur collects the three factors of production – land, labour and capital and coordinates their activities and undertakes risks of production. Profit is the difference between the income of the business and all its costs/expenses. It is normally measured over a period of time.

The nature of income earned by the entrepreneur is different from that earned by the other factors of production. The important differences are:

- First, rent, wages and interest are known beforehand; profit is unknown.
- Secondly, rent, wages and interest cannot be zero, far less negative; profit may be zero or even negative as well (loss).
- Thirdly, incomes earned by the other factors of production are not residual income, but profit is what remains after making payment to the other factors of production. Thus, profit is a residual income.

4.3.2 Gross Profit



Explicit Cost : Cost paid to those factors of production, which are hired from utside sources.

Gross profit is the difference between the revenue earned from the sales of products and the total ***explicit costs*** incurred by the entrepreneur. Thus, costs of purchasing factors of production from the factor markets are excluded from gross profit.

Thus, Gross profit = Total revenue – Total Explicit Cost

Gross profit is used as a performance indicator to help the business make decisions over its pricing policies and use of materials.

Gross profit is composed of a number of elements. These elements are:

- **Wages of Management:** When the entrepreneur himself manages the business, his gross profits will include wages for his management. In reality, wages are not a part of his profits because he can earn them even if he work in some other firm as a manager. That is why wages for his self management of the business is included in his gross profit; however, the same will be subtracted to derive the net profit.
- **Rent on entrepreneur's own land:** The entrepreneur may start his business on his own land. For utilisation of his land in the business purpose, he is paid rent. Just like wages, rent is also not a part of his profits because he can earn them even if he leases out that piece of land to other entrepreneur as well. That is why rent on entrepreneur's own land for business is a part of gross profit; however, the same will be subtracted to derive the net profit.
- **Interest on his own capital:** When the entrepreneur invests his own capital in the business, he earns interests on them. Just like the above two, interest is also not a part of his profits because he can earn them even if he lends his capital to other businesses. That is why, interest on his own capital is included in his gross profit; however, the same will be subtracted to derive the net profit.

- **Windfall profit:** The un-expected rise in the price of the commodity produced generates larger profit for the entrepreneur. This additional profit will be included in gross profit.
- **Monopoly profit:** The entrepreneur who enjoys copyright and patent right and who enjoys monopoly right over the quantity and price of the commodity produced will be enjoying a higher income. This income will be a part of gross profit.
- **Production differentiation:** Advertisement, customer service like home delivery of goods and such other factors cause product differentiation. It may lead to an increase in the demand for the commodity and add to the profits of the entrepreneur. This profit will be included in gross profit.

4.3.3 Net Profit

It is to be noted that there is no unanimous agreement among the economists regarding the components of gross profit and net profit. While some include the elements of windfall profit, monopoly profit, profits arising out of entrepreneur's abilities to bear risk and uncertainties, innovative spirit and product differentiation as parts of gross profit, some include them as part of net profit. However, it has been observed that modern economists often tend to accept the American view of profit as being the reward for purely entrepreneurial functions, i.e., functions which cannot be performed by paid employees. Thus, entrepreneurial abilities viz., risk bearing, uncertainty bearing, bargaining skill, innovation, etc. result in his net profit.



Implicit Cost : Cost paid to those factors of production, which come from within the firm.

In terms of ***explici***t and ***implicit costs***, net profit can be shown as:

Net Profit = Gross profit – Implicit costs of production – Depreciation.

Net profit consists of a number of elements. These are:

- **Bearing risks and uncertainties:** The entrepreneur starts production of a commodity in anticipation of its future demand.

The future demand may fall or may not rise up to the desired level. For undertaking this risk and uncertainty, the entrepreneur will earn an income which will be a part of his net profit.

- **Gains as superior bargainer:** The entrepreneur may also gain from bargaining with labourers, capitalists, landlords, suppliers of raw materials and consumers. These gains arise because of his superior skill in bargaining.
- **Innovation:** According to Schumpeter, the innovator entrepreneur will earn a higher income than the ordinary entrepreneur. This extra income will be a part of net profit.

It is noteworthy that the joint stock company earns pure profit as the share-holders are the owners of this company and they do not supply land, labour and capital to the company.

4.3.4 Differences between Gross Profit and Net Profit

We have already stated that there is no unanimous agreement regarding the components of gross profit and net profit. Hence, clear cut differentiation between the two is not always beyond criticism. However, based on our above discussion, the following distinctions between the two have been shown in Table 4.1.

Table 4.1: Distinction between Gross Profit and Net Profit

Sl	Gross Profit	Net Profit
(1)	(2)	(3)
1	Gross profit is a wider concept	NP is in fact a part of gross profit
2	Gross profit excludes only explicit costs	NP excludes both explicit and implicit costs
3	*Formula*: GP = TR – Explicit costs	*Formula*: NP = TR – TC



TR = Total Revenue
TC = Total Cost
GP = Gross Profit
NP = Net Profit

4.3.5 Nature of Profit

We have already discussed profit as the difference between total revenue (total value of sales, or sale proceeds) and total cost

(total cost of inputs). It should be remembered here that revenue or sale proceeds are determined by the demand conditions in the market (i.e., physical volume of sales and price of the products), while cost is determined by the supply conditions in the market (supply of inputs). When we say, profit is a surplus, we must also remember that profit is credited to the owner/entrepreneur and is calculated at the last (as a residue), after payment to all other factors of production are paid.

While discussing the nature of profit, the following points must be kept in mind:

- Profit is a residual income, and hence its size varies. However, other factors of production get contractual income and are thus fixed.
- At times, profit may be zero or even negative. Wages, interest and rent are however always positive.
- Profits depend on the level of business activities. Innovations and continuous upgradation brings more profit to the business. On the contrary, profits would be low if there is a lack of innovation. In loose terms, profit may be viewed as a performance indicator of the business.
- In a free market economy profit plays a significant role. It serves as an incentive to undertake risks and entrepreneurial activities.
- Profits also serve as a guiding principle in undertaking business activities in the most efficient ways.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true (T) or false (F).

(a) The nature of income earned by the entrepreneur is different from that earned by the other factors of production. (T/F)

(b) Rent, wages and interest are known beforehand; profit

is unknown. (T/F)

(c) Net profit does not exclude explicit and implicit costs. (T/F)

Q 2: Mention any two differences between profit and other factors of production? (Answer in about 30 words)

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Q 3: Why is profit called the reward to the owner of the business? (Answer in about 30 words)

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4.4 THEORIES OF PROFIT

There are many theories of profit – rent theory of profit, wages theory of profit, dynamic theory, innovation theory, marginal productivity theory, risk theory, uncertainty bearing theory and the like. Out of these, we shall discuss here two theories, viz.: the Uncertainty Bearing Theory of Profit and the Innovation Theory of Profit.

4.4.1 Uncertainty Bearing Theory of Profit

Prof. Frank Knight explains the uncertainty bearing theory of profit in his book *"Risk, Uncertainty and Profit"*. Knight has made strict distinction between risks and uncertainty. According to him, risks are those which are foreseeable and which can be insured. Thus, the risks like: death, fire and sinking of ships can be mitigated through opting for insurance for them. The payment of insurance premium in such cases is included in the cost of production. Thus, risks on such cases, does not lie on the entrepreneur; rather, they rest with the respective insurance companies. Therefore, he has

argued that a business does not earn profit for mitigating such insurable risks. But, uncertainties associated with the factors like: marketability of the product (e.g., change in demand due to change in customers' tastes and preferences, etc.) can not be foreseen and insured. According to Knight, an entrepreneur earns profit precisely for bearing such uncertainties in business.

Knight has gone further to include undertaking of uncertainty as a factor of production. According to him, like other factors of production, uncertainty-bearing has a supply price; i.e., unless certain returns are expected, no entrepreneur will be motivated to face uncertainty. The extent of such motivations, however depend on a) temperament of the entrepreneur, b) total resources he possesses and c) the proportion of these resources he is inclined to expose to uncertainty.

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Uncertainty may arise because of a number of factors. These factors are:

- The industry may be taken by the government particularly when it enjoys monopoly power and the price charged by it is generally considered to be high.
- The introduction of a new technology may cause a loss to the industries using the old technique of production. This uncertainty is also non-measurable.
- Competition thrown up by the entry of new firms into the industry may also eat into the profits of the existing firms and expose them to uncertainties.
- Cyclical fluctuations also introduce an element of uncertainty and affect the amount of profit.

Criticisms of the Uncertainty Theory of Profit: Knight's theory of uncertainty bearing has been criticised on the following grounds:

- Knight has raised uncertainty bearing almost to the status of

an independent factor of production. Actually, uncertainty bearing is a part of the real cost of production.

- Uncertainty bearing is one of the elements of profit but not the only element. Other elements like monopoly price, product differentiation etc. can also generate profit.
- Knight has overlooked the distinction between the proprietorship and the share-holders who are the owners of the unit and they therefore bear the uncertainties. Thus, although Knight's theory marks an improvement over Hawley's theory, yet it is not free from the defects as mentioned above.

4.4.2 Innovation Theory of Profit

We have already stated that innovation is one of the important elements of profit. This theory is associated with Joseph Schumpeter. According to him, innovation plays a special role in the earning of profit. It is the innovative spirit of the entrepreneur which can yield the highest profit. Schumpeter has considered innovation to be the principal function of the entrepreneur.

Schumpeter has laid a very wide meaning to the term 'innovation'. According to him, innovations refer to any of these:

- introduction of a new product,
- introduction of a new technique of production,
- discovery of a new source of raw materials, and
- discovery of a new market.

Schumpeter points out two types of innovations: *First*, those which bring changes in the production function and, as a result, reduce the cost of production. Innovations in this type include: introduction of new machinery, improved production techniques or processes, exploration of new source or type of raw materials, etc.

Second, those innovations, which change the demand or utility function by increasing the demand for the product. Innovation in this type include: introduction of new product or a new variety

of old product, new and more effective mode of advertisement, entry into new markets, etc.

Effective innovation in any of the above earns more profit, because through innovation either the cost of production is reduced or the product brings a better price. It is to be noted that profits owing to innovations are temporary. Because, introduction of similar product/technology by competing brands may wipe out the advantages of the initial innovator. However, if the innovation gets patented, the gain remains for a considerable period of time. Thus, the superior entrepreneurs in a dynamic economy gain through innovations.

Another important consideration here is that profit is both the cause and effect of innovation. Prospecting profit serves as an incentive of innovation; hence, profit is the cause of innovation. Again, profit is resulted out of successful innovations; hence profit is also the effect of innovation.

Criticism of the Innovation Theory of Profit: The innovation theory of profit has been criticised on the following grounds:

- The innovation theory of profit ignores uncertainty as a source of profit.
- The role of bearing risk in profit has also been ignored.



CHECK YOUR PROGRESS

Q 4: State whether the following statements are True (T) or False (F).

(a) F.B. Hawley is associated with the Uncertainty-bearing Theory of Profit. (T/F)

(b) According to Knight, an entrepreneur earns profit for bearing unpredictable uncertainties, and not for undertaking insurable risks. (T/F)

Q 5: How does an innovation bring profit to the entrepreneur? (Answer within 30 words)

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4.5 LET US SUM UP

- Profit is the income of the entrepreneur.
- Profit is a residual income.
- Net profit is a part of gross profit.
- When the total explicit cost of the entrepreneur is deducted from total revenue, we get gross profit.
- Similarly, when the total cost (explicit cost and implicit cost) is deducted from total revenue, we get net profit.
- Effective innovation earns more profit, because through innovation either the cost of production is reduced or the product brings a better price.
- Profits owing to innovations are temporary. Because, introduction of similar product/technology by competing brands may wipe out the advantages of the initial innovator.
- However, if the innovation is patented, the gain remains for a considerable period of time. Thus, the superior entrepreneur in a dynamic economy gains through innovations.
- Another important consideration here is that, profits are both the cause and effect of innovations. Prospective profits serve as an incentive of innovation; hence, profit is the cause of innovation. Again, profit is the result of successful innovations; hence profit is also the effect of innovation.
- Uncertainty, on the other hand, is associated with the factors like marketability of the product (e.g., change in demand due to change in customers' tastes and preferences, etc.) which can not be foreseen

and insured.

- According to Knight, an entrepreneur earns profit precisely for bearing such uncertainties in business.
- Knight has gone further to include undertaking of uncertainty as a factor of production. According to him, like other factors of production, uncertainty-bearing has a supply price; i.e., unless certain returns are expected, no entrepreneur will be motivated to face uncertainty.



4.6 FURTHER READINGS

1) Ahuja, H. L. (2007). *Advanced Economic Theory: Microeconomic Analysis*. New Delhi: S.Chand & Company Ltd.
2) Chopra, P. N. (2008). *Micro Economics*. Ludhiana: Kalyani Publishers.
3) Dewett, K. K. (2005). *Modern Economic Theory*. New Delhi: S.Chand & Sons.
4) Sundharam, K. P. M., & Vaish, M. C. (1997). *Microeconomic Theory*. New Delhi: S. Chand.



4.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (a) True (b) True

Ans to Q No 2: The nature of income earned by the entrepreneur is different from that earned by the other factors of production. The important differences are:

- First, rent, wages and interest are known beforehand; profit is unknown.
- Secondly, rent, wages and interest cannot be zero, far less negative; profit may be negative as well (loss).

Ans to Q No 3: Profit is called the reward to the owners of the business. They have taken risks with their money and time. If there is no profit, then there would be little point in starting up or putting more money into the business; they might as well put the money into a

bank and earn interest on the deposit.

Ans to Q No 4: (a) False (b) True

Ans to Q No 5: Effective innovation brings higher profit to the entrepreneur, because through innovation either the cost of production is reduced or the product brings a better price.



4.8 MODEL QUESTIONS

A) Short questions (Answer each question in about 150 words)

Q 1: Write short notes on:

(a) Gross profit & Net profit (b) Innovation & earning of profit

Q 2: Show the differences between gross profit and net profit

B) Long Questions (Answer each question in about 300-500 words)

Q 1: Critically discuss the Innovation Theory of Profit.

Q 2: Discuss the Uncertainty-bearing theory of profit. Why has the theory been criticised?

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