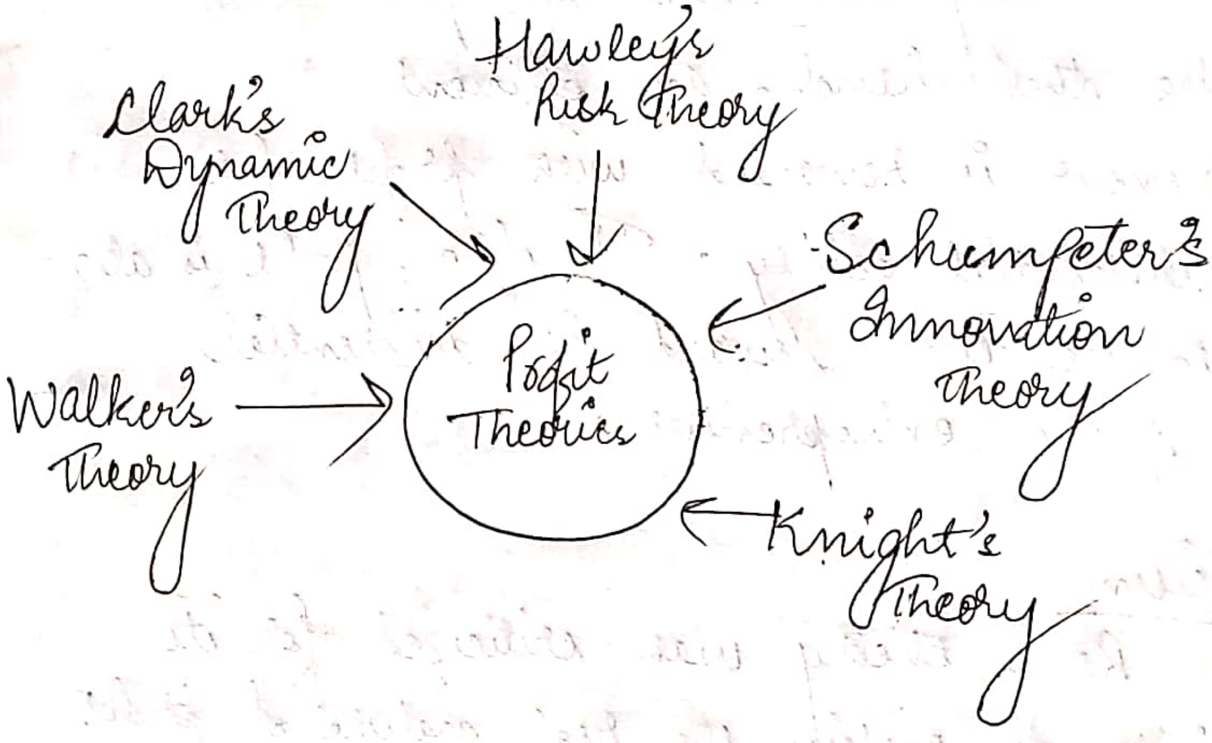
THEORIES OF PROFIT



Walker's Theory

Prof. F. A. Walker, an American economist profounded the rent theory of profit.

According to him – "As rent is the difference between least and most fertile land Similarly, profit is the difference between earnings of the least and most efficient entrepreneurs."

Walker explained that profit is the difference between the earnings of the least and most efficent entrepreneurs. An entrepreneur with the least efficiency generally strives to cover only the cost of production. On the other hand, an efficient entrepreneur is rewarded with profit for his differential ability. Therefore, profit is also said to be the reward for differential ability of the entrepreneur.

Criticism

1) The Rent theory was criticized for its inability to explain the real nature of profit

2) The second criticism was out of the assumption of the theory. It assumed that profit arise because of the superior or exceptional ability of the entrepreneur, which is not always true. Profit can also be the result of the monopolistic position of the entrepreneur.

Clark's Dynamic Theory

J.B. clark, an American economist introduced the Dynamic theory of profit.

According to clark, the role of entrepreneurs in a dynamic environment is to take advantage of changes that help in promoting businesses, expanding sales, and reducing costs. In a dynamic economy, entrepreneurs who successfully take advantage of the changing conditions ~~in a dynamic~~ make pure profit. Basically there are 2 factors - internal and external factors that make the world dynamic.

The internal changes are changes that take place within the organisation which include layoff & hiring of employees, changes in infrastructure and product changes. The external changes include both regular and irregular changes such as, fluctuations in trade, contingencies, earthquake etc.

Thus, according to clark,
profits are generated in case of static economy.

Criticism

Prof. Knight criticized the dynamic theory on the ground that only those changes that cannot be forseen yield profits. According to him "It cannot then, be change, which is the cause of profit, since if the law of change is known, no profit can arise".

Knight's Theory

Prof. Knight profounded the theory known as Uncertainty-bearing theory of Profits. According to this theory, profit is the reward for the uncertainty bearing and not the risk taking.

Knight explained the theory by dividing the risks into calculable and non-calculable risks, in which calculable risks are those risks whose probability of occurrence can be easily estimated with the help of the given data, such as risks due to fire and theft. These risks can be insured.

Whereas, non-calculable risks cannot be accurately calculated and insured such as shifts in demand of a product. These are uncertain therefore cannot be anticipated.

Thus, according to the theory, risk taking is not a function of an entrepreneur but of insurance organisations.

Therefore, an entrepreneur gets profit as a reward for bearing uncertainties and not for risks that are borne by insurance organizations.

Criticism on Knight's Theory

i) The assumption of the theory was criticised as it said that profit is the result uncertainty bearing ability of an entrepreneur, which cannot be true always. Profit can also be the reward for other aspects.

2) The second criticism was on the ground that it failed to show any relevance with the real world.

Schumpeter's Innovation Theory

The Innovation theory propounded by Joseph Schumpeter regarded profit as the reward for innovation. Schumpeter advocated that - innovation is the introduction of a new product, new technology, new method of production and new sources of raw materials.

In general, innovation can take place in two ways -

(a) Reducing the cost of production and earning high profit.

(b) Stimulating the demand by enhancing the existing improvement or finding new markets.

According to this theory profit acts as a necessary incentive for making innovation or in simple words profit is the cause and effect of innovations.

Criticism

1) Schumpeter's innovation theory was criticized on 2 aspects, one amongst which was that it ignored uncertainty as a source of profit

2) Second criticism was on the ground that it denies the role of risk in profit.

Hawley's Risk Theory

F. B. Hawley in 1893 gave the risk theory of profit.

According to Hawley, "profit is the reward of risk taking in a business". Hawley was of the opinion that, the greater the risk, the higher is the expected profit. The risks arising in the business activity occur due to various reasons, such as non-availability of crucial raw materials, falling market prices, obsolete technology etc. One cannot predict risks as they are inevitable, which is why entrepreneurs are rewarded for undertaking risks.

Criticism

1) Profits arise not because risks are borne, but because the superior

entrepreneurs are able to reduce them. Better management and good supervision by entrepreneurs accumulate profits.

② Another criticism was that — profits can never be in proportion to the risks undertaken. They may be more in entreprises with reduced risks and less in enterprises with increased or high risks.