J D Women's College

Course Name- MBA (PG)

(1st semester)

Subject-Managerial Economics

Topic- Theory of Profit (part-2)

Faculty Name – Anjali

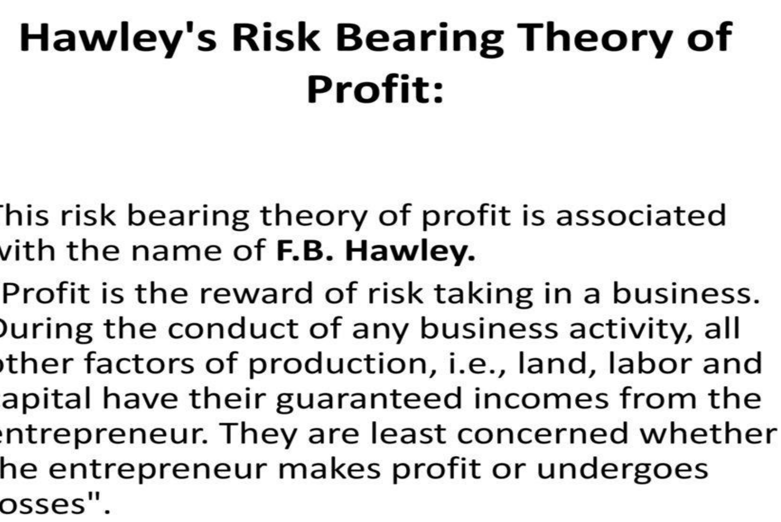
Faculty member

Department of Management study

Theory of Profit (continues…)

Lecture -2

2. Risk Bearing Theory of Profit



The risk bearing theory of profit is established by Hawley. It suggests that entrepreneur's profit depends on his risk taking behavior. That is, how much risk the entrepreneur will bear during the production determines the amount of profit enjoyed by him. During production the entrepreneur may not know the exact demand for his product in the market or change in consumers' taste and preferences that affects the market demand. If the entrepreneur's production exceeds the demand, he will incur loss for not selling his entire output. This implies that there is a demand side risk associated with production. If there is no compensation or reward for risk, there will be no incentive for taking risk. The nature of risk and the riskbearing capacity vary across industries. The higher the risk under taken, the more will be the profit earned. However, it should be noted that, the amount profit actually depends on how efficiently risk is managed by the entrepreneur not the amount of risk borne by him.

According to risk bearing theory an entrepreneur envisages with various types of risks. An entrepreneur faces risk in production when technology becomes obsolete. When more rivals enter in to the production, or when new products or new process of production are launched, a firm will meet competition risk. When there is drastic fall in prices due to economic recession, business cycle risk will arise. A firm also faces risks related to macroeconomic policy changes. For instances, if government adopts policies like price control, tax policy, import or export restriction etc., which may produce risk. An entrepreneur may be gainer or looser at this situation. These risks cannot be avoided by buying insurance or in any other way. Therefore, entrepreneurs have to undertake these risks and claim profit as a reward of bearing these risks. Hawley states profit is the reward for risk-taking in business, risk-taking is supposed to be the most important function of an entrepreneur. Every production that is undertaken in anticipation of demand involves risk.

According to Drucker there are four kinds of risk. They are replacement, obsolescence, risk proper and uncertainty. The first two are calculated and insured. But the other two are unknown and unforeseen risks. No entrepreneur will be willing 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. If the entrepreneur does not receive the reward, he will not be prepared to undertake the risk. Thus higher the risk greater is the possibility of profit.

According to Hawley the entrepreneur can avoid certain risks for a fixed payment to the insurance company. But he cannot get rid of all risks by means of insurance. If he does so he is not an entrepreneur and would earn only wages of management and not profit.

Criticism:

1. Risk-taking is not the only entrepreneurial function which leads to emergence of profits. Profits are also due to the organizational and coordinating ability of the entrepreneur. It is also reward for innovation.

2. According to Carver profit is paid to an entrepreneur not for beaming the risk but for minimizing and avoiding risk.

3. This theory assumes that profit is proportional to risk undertaken by entrepreneurs. But this is not true in practical life because even entrepreneurs who do not take any risk are paid profit.

4. Knight says that it is not every risk that gives profit. It is unforeseen and non-insured risks that account for profit. According to Knight risks are of two types viz., foreseeable risk and unforeseeable risk. The risk of fire in a factory is a foreseeable risk and can be covered through insurance. The premium paid for the fire insurance can be included in the cost of production. The entrepreneur can foresee such a risk and insures it. An insurable risk in reality is no risk and profit cannot arise due to insurable risk.

5. There is little empirical evidence to prove that entrepreneurs earn more in risky enterprises. In a way all enterprises are risky, for an element of uncertainty is present in them and every entrepreneur aims at making large profits.