J D Women's College

Course Name- MBA (PG)

(1st semester)

Subject-Managerial Economics

Topic- Theory of Profit (part-1)

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Theory of Profit

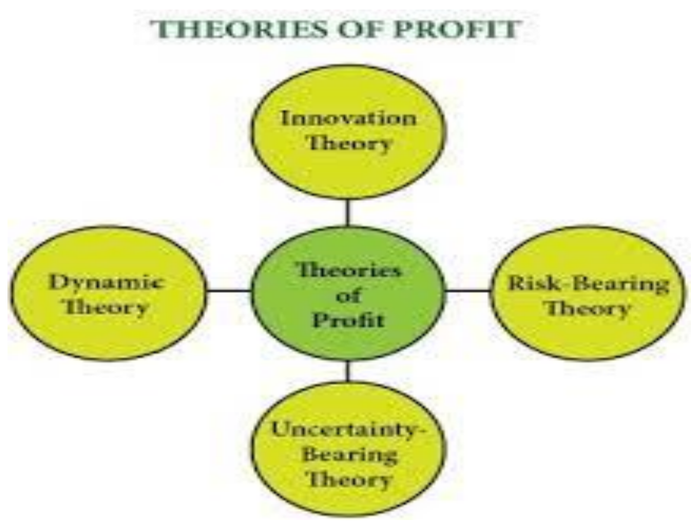
The profits of the organization depend on the successful management of business operations, i.e. how well an entrepreneur manages the risks and uncertainties of the firm. Although the profits are directly linked to the entrepreneur and his functions.Several economists have given their varied views on origin, nature and role of profit. Till date, there is no complete consensus among the economists with respect to the true nature and origin of profit. Due to this, several theories of profit came into existence. There are four major theories of profit:

1. Dynamic Theory

2. Risk-Bearing Theory

3. Uncertainty Bearing Theory

4. Innovation Theory



1. The Dynamic Theory of Profit:

Prof. J.B. Clark propounded the dynamic theory of profit in the year 1900. He states that profit is the difference between the price and the cost of production of the commodity. P rofit is the result of progressive change in an organized society. The progressive change is possible only in a dynamic state. According to Clark the whole economic society is divided into organized and unorganized society. The organized society is further divided into static and dynamic state. Only in dynamic state profit arises.

In a static state, the five generic changes such as the size of the population, technical knowledge, the amount of capital, method of production of the firms and the size of the industry and the wants of the people do not take place; everything is stagnant and there is no change at all. The element of time is non-existent and there is no uncertainty. The same economic features are repeated year after year.

Therefore there is not risk of any kind to the entrepreneur. The price of the good will be equal to the cost of production. Hence profit does not arise at all. The entrepreneur would get wages for his labour and interest on his capital. If the price of the commodity is higher than the cost of production, competition would reduce the price again to the level of the cost of production so that profit is eliminated.

The presence of perfect competition makes the price equal to the cost of production which eliminates the super normal profit. Thus Knight observes, “Since costs and selling prices are always equal, there can be no profit beyond wages for the routine work of supervision”.

It is well known that the society has always been dynamic. Several changes are taking place in a dynamic society.

According to Clark five major changes are constantly taking place in a society. They are:

(1) Changes in the size of the population,

(2) Changes in the supply of capital,

(3) Changes in production techniques,

(4) Changes in the forms of industrial organisation, and

(5) Changes in human wants.

These dynamic changes affect the demand and supply of commodities which leads to emergence of profit. Sometimes individual firms may introduce dynamic changes. For example, a firm may improve its production technique, reduce its cost and thereby increase its profit. The typical dynamic change is an invention. This enables the entrepreneur to produce more and reduce costs, leading to emergence of profit.

Criticism of dynamic theory of profit:

1. It is wrong to say that there is no profit in static state because every entrepreneur is paid profit irrespective of the state of an economy.

2. This theory does not fully appreciate the nature of the entrepreneurial function. If there are no profits in a static state, it means there is no entrepreneur. But without an entrepreneur it is not possible to imagine how different factors of production would be employed.

3. Mere change in an economy would not give rise to profits if those changes are predictable. It is only the unpredictable, provision can be made for such changes and the expenditure can be included in the cost of production.

4. This theory assumes the existence of perfect competition and static state. But they are far from reality.

5. This theory states that profit arises because of dynamic changes. But Knight says that it is only unforeseen changes that give rise to profit.

6. This theory associates profit for imitating progressive changes in the economy. But in reality profit is paid to entrepreneur for other important functions like risk taking and uncertainty bearing.

7. According to Taussig, “dynamic theory has created unnecessary and artificial distinction between “profits” and wage of management”.: