Q. Define profit and critically discuss the Prof. Knight’s Uncertainty theory of profit.

Profit has been defined in several ways by different economists. Some have defined it as the percentage returns on investment of capital while others have defined it as the reward of ownership of business. Some have referred it as the reward for risk taking in business while others have called it as a reward for entrepreneurship. There are still some other Economists who have defined profit as the residual income which results to a businessman after he has made payment to all the other factors of production. Though different economists have interpreted the term profit in different ways but we may safely conclude and define profit as the excess of an entrepreneur’s receipts over his total cost of production which includes both explicit as well as implicit costs.

In general, it is Gross profit which is referred to as profit. Gross profit includes Net profit and Gross profit = Total Receipts (from sales of a product) – Total Expenditure (in producing a product). Profit is the only reward of a factor of production which can be negative, where it is called ‘loss’ while rewards of other factor of production like rent, wages and interest are always positive.

Uncertainty Bearing Theory of Profit:
This theory was propounded by an American economist Prof. Frank H. Knight. This theory, starts on the foundation of Hawley’s risk bearing theory. Prof. Knight agrees with Hawley that profit is a reward for risk-taking. There are two types of risks viz. foreseeable risk and unforeseeable risk. According to Knight unforeseeable risk is called uncertainty bearing.

Prof. Knight regards profit as the reward for bearing non-insurable risks and uncertainties. He distinguishes between insurable and non-insurable risks. Certain risks are measurable, the probability of their occurrence can be statistically calculated. The risks of fire, theft, flood and death by accidents are insurable. These risks are borne by the insurance company. The premium paid for insurance is included in the cost of production. According to Knight these foreseen risks are not genuine economic risks eligible for any remuneration of profit. In other words, insurable risk does not give rise to profit.
According to Knight profit arises due to non-insurable risk or unforeseeable risk.

Some of the non-insurable risks which arise in modern business are as follows:

(a) Competitive risk:
Some new firms enter into the market unexpectedly. The existing firms may have to face serious competition from them. This will inevitably lower down the profit of the firms.

(b) Technical risk:
This risk arises from the possibility of machinery becoming obsolete or due to the discovery of a new processes. The existing firm may not be in a position to adopt these changes into its organization, and hence suffer losses.

(c) Risk of government intervention:
The government, in course of time, interferes into the affairs of the industry such as price control, tax policy, import and export restrictions, etc., which might reduce the profits of the firm.

(d) Cyclical risk:
This risk emerges from business cycles. Due to business recession or depression, consumer’s purchasing power is reduced; consequently demand for the product of the firm also falls.

(e) Risk of demand:
This is generated by a shift or change of demand in the market.

Prof. Knight calls these risks as ‘uncertainties’ and ‘it is uncertainties in this sense which explains profit in the proper use of the term’. These risks cannot be foreseen and measured, they become non-insurable and the uncertainties have to be borne by the entrepreneur. According to this theory there is a direct relationship between profit and uncertainty bearing.

Greater the uncertainty bearing the higher the level of profit. Uncertainty beaming has become so important in business enterprise in modern days, it has come to be considered as a separate factor of production. Like other factors it has a supply price and entrepreneurs undertake uncertainty bearing in the expectation of earning certain level of profit. Profit is thus the reward for assuming uncertainty.

In the modern days production has to take place in advance of consumption. The producers have to face their rival producers and the future is uncertain and unknown. These are uncertainties.
Some entrepreneurs are able to see it more clearly than others and therefore they are able to earn profit.

Criticism:
This theory has been criticised on the following grounds:
1. According to this theory, profit is the reward for uncertainty bearing. But critics point out that sometimes an entrepreneur earns no profit in spite of uncertainty bearing.

2. Uncertainty bearing is one of the determinants of profit and it is not the only determinant. Profit is also a reward for many other activities performed by entrepreneur like initiating, coordinating and bargaining, etc.

3. It is not possible to measure uncertainty in quantitative terms as depicted in this theory.

4. In modern business corporations ownership is separate from control. Decision-making is done by the salaried managers who control and organise the corporation. Ownership rests with the shareholders who ultimately bear uncertainties of business. Knight does not separate ownership and control and hence, this theory becomes unrealistic.

5. Uncertainty bearing cannot be looked upon as a separate factor of production like land, labour or capital. It is a psychological concept which forms part of the real cost of production.

6. Monopoly firms earn much larger profits than competitive firms and they are not due to the presence of uncertainty. This theory throws no light on monopoly profit.

We can conclude Prof Knight’s theory of profit by saying that like the other theories of profit, it does not furnish a comprehensive explanation of emergence of profit and hence it is inadequate. However, this is true that uncertainty bearing is an important element and determinant of profit.