WHY SHOULD PROFITS BE PAID?

THE function of profits in the economic system is widely misunderstood.

To some people profits perform no function at all. They are simply an unnecessary and unjustified exaction from the consumer who is forced to pay more than the true cost of the article.

In this view, profit is a payment for which no corresponding service is rendered. It is easy to understand that wages are a reward for labour, and salaries for the services of management, and even that interest is a payment for the use of other people's savings (although some people have contested the idea that the mere fact of saving is entitled to any reward). But what is profit the reward for? Does it represent a payment for an essential contribution to the process of production, without which that contribution would not be forthcoming? Would production be carried on, and carried on just as well and efficiently, if there were no such thing as profit? In sum, what useful function does profit perform?

This is a question worth answering.

It can best be answered by reference to basic economic theory. Let us look, first of all, at the essential nature of the modern process of production. There are two significant features of this process:—

First, with rare exceptions, people these days do not produce the things that they themselves use or consume. They produce things for other people, usually people they have never seen, and often living in far-away countries.

The second feature is that modern production has become, in the terminology of the text-books, exceedingly roundabout Usually a large interval of time elapses between the time the production of an article or commodity or service is first planned and the time when it finally reaches the consumer. Four years went by from the day the Holden car was first mooted until the first finished product was delivered off the assembly line and sold to a customer. A modern steel mill takes years to plan and construct before the first steel is made and sold. The evolution of a new product may absorb years of research and experiment and organisation before it finally emerges for sale. Another good example is the storage of temporary gluts of commodities such as wheat or cotton against adverse seasons.

Now this roundabout character of modern production and distribution involves two things.

It means, first, that the people engaging in it must outlay very large sums of money—sometimes, as in the construction of a large industrial plant, running into many millions of £'s—before they receive so much as a £ in income from the output of the plant. Immense resources in materials and labour, both brain and hand, are used up without any immediate result in the form of satisfactions which add to the standard of living. We may have built half an oil refinery, but we don't get any petroleum until the plant is completed.

Obviously this process is only possible where there are some people who are able and prepared to forgo the use of some of their income in the present, some addition to their standard of living in the present, in order to get back, over a period of time, the equivalent of what they have sacrificed, and a little more. In other words, it requires that certain people will be prepared **to wait** to receive the full use and enjoyment of their income. The inducement for people to do this is known as **interest**—a payment for waiting (or saving), for postponing satisfactions **in the present** in order to receive somewhat greater satisfactions in the future.

Secondly, the roundabout character of modern production entails risks. Since a large interval often elapses between the use and development of certain resources and the time when they should bear fruit, there is a risk that the fruits may never be obtained or, more likely, that they may be insufficient to compensate for the resources used. **To induce people to undertake these risks is the function of profit. Profit, in its strict economic sense, is a reward for risk-taking.**

THERE are various kinds of risks.

There are, for instance, straight physical risks, such as the risk that the resources invested in, say, a manufacturing plant, will be destroyed by fire. To some extent it is possible to provide protection against such risks through insurance.

There are technical risks. These risks, it is true, can be reduced by painstaking planning and preliminary work designed to minimise the possibility of errors. But in human affairs there is always room for miscalculation. There is always the possibility of the intrusion of some "unknown", some decisive factor which no one thought about. The product when eventually made may prove to be not quite adequate for the purpose it is designed to meet, or to have some fatal flaw which renders it unsaleable.

Think of the Comet air-liner!

Or the production methods used may for some reason absorb more resources, and thus prove more costly, than was originally anticipated.

Finally, there are the uncertainties of the market—the most important and unforeseeable of all risks. The product may be technically adequate but in the meantime something better, or something just as good at a lower price, may have been produced by someone else. Fashions, for instance in cosmetics, change suddenly. Attractive substitutes may come on the market. Or there may be over-production so that producers can't dispose of their output. There is the ever-present risk of miscalculating demand. There is the risk that some vital ingredient for the manufacture of the product cannot be obtained in sufficient quantity or at the budgeted cost. There is the risk arising from the capriciousness of the general economic climate which, with little warning, may turn from fair to foul. The different sorts of risks are almost countless. **But they all mean that when money is invested in**

some form of production, or in some asset designed to provide a service such as a shop or an hotel, the people concerned always take the chance of not getting their money back, or not getting all of it back. It follows that this investment will be undertaken only if a good prospect exists of receiving back substantially more than the money put into it.

Sometimes the risks are comparatively small, for example, when a well-established industry is being extended to cater for an expanding demand. Sometimes, as in gold mining or oil prospecting, they may be considerable and in these cases the inducement must be all the greater. The risks can be reduced or minimised, but not eliminated, by initiative and imagination, by efficient management, by careful planning, so that profit from this perspective can be regarded as a reward for enterprise and efficiency. Enterprising and able management, other things being equal, will obtain, and is entitled to obtain, a larger profit than inefficient and incompetent management.

Profit is a reward for taking and for successfully overcoming the risks inseparable from modern economic processes. It should not be confused with interest. As we have shown, interest has a different function. Interest is the reward for waiting, for the postponement of satisfactions that could be enjoyed here and now. Profit is the reward for risk-taking, not a certain guaranteed reward, but a reward payable only to those who achieve success in their object.

HERE is the essential distinction between profit and other forms of income such as wages, interest and rent. **With profit there is no certainty that it will be paid.** On the other hand an employee knows that he is assured of his wages or salary at the end of the week. The landlord or lender of money is usually assured of receiving his rent or interest; if he fails to do so he has his remedies. But there are no remedies open to the man who incurs a loss in his business or to the shareholder who receives no dividend or loses part of his capital.

Often the interpretation of profit by the accountant and businessman tends to be confusing so far as popular understanding of the economic function of profits is concerned. For instance, in the profits shown in company balance sheets there is a large element of interest or reward for waiting. Since investors in company shares could have made reasonably certain of obtaining some return on their money by putting it into bank deposits or government securities, they can only be persuaded to invest in shares if there is the prospect of a return over and above prevailing rates of interest. This marginal return is, strictly speaking, the true profit of the enterprise. In similar fashion the man who puts his savings into a street-corner garage, which he runs himself, is accustomed to describe the difference between his book receipts and his expenses as profit. Actually, to arrive at his true profit he should have deducted from his surplus something to compensate for his own labour, and something equivalent to the interest he could have obtained from his money by putting it into bonds or a bank account. His real profit is the residual left after deducting from the excess of his income over his expenses an appropriate salary for his management of the garage and an allowance for interest on his capital. This is the reward for the risks involved in his investment.

We have argued that in the modern economic system risks are inevitable and that profits are therefore a necessary and legitimate reward for those who bear the risks. This does not mean that **all** actual profits are legitimate or that there is no such thing as excess profit, any more than one could argue that every wage or salary earner was receiving no more than his due. It merely means that there must be some reasonable level of profit, varying with different types of business, to call forth the enterprise that lies behind all economic progress and higher general standards of living.

But now another question must be asked. Are these risks inevitable? Is there no way by which the risks can be reduced or eliminated so that there would be no need for profits?

Under some form of socialist planning would it not be possible to abolish the risks and thus to remove the need for profit?

The answer is that it would be possible to spread the risks more widely, or to transfer them to someone else; but it would not be possible to remove them.

AT the present time the risks of production are largely carried by a special class of people—investors in company shares, particularly ordinary shares, or proprietors of one-man farms and businesses or partnerships. It is true that there is a notable tendency for the proportion of those undertaking risks to increase and thus for risk-taking to be spread more widely. For instance the numbers of people investing in company shares is rapidly expanding. Perhaps more important is the growing institutional investment in industry by life insurance companies and superannuation and pension funds. This process is not only bringing about a wider spread of risk-taking but, as a consequence, a wider sharing in profits. **Many people today would not be nearly so ready to attack profits if they realised the extent to which their life assurance bonuses or retiring pensions were wrapped up in the dividends paid by public companies.**

But what would be the situation where the greater part of production was undertaken by the state? Would that remove the element of risk-taking from the economic process? No! There would still be risks. The difference is that instead of being concentrated in a limited class of shareholders and business entrepreneurs they would be borne partly by everyone. Everyone is a consumer and therefore everyone would gain or lose according to the errors made by the state. They would be borne partly by those who paid income taxes. The heavily taxed would carry the main burden of the risks.

Think, for instance, of the recent fiasco of the ground-nuts scheme in Africa undertaken by the British Government. Something like £40 millions of taxpayers' money was recklessly squandered and lost. If private enterprise had embarked on this project, and made the same mistakes as the Government, the loss would have fallen on a limited number of shareholders and the great mass of taxpayers would have escaped. A recent example in Australia is the closing down of the Glen Davis shale oil project with losses of **public moneys** amounting already to £6 millions.

It may be claimed that under socialism the risks involved in fluctuations of the market could be reduced, since the consumer would either have to take what the government provided or go without. At first sight this might seem to remove the risk, inherent in private enterprise, that what is produced cannot be sold. But what satisfaction would it be to have to take something that we don't really want, to have no alternative to choose from? Is it not true that, faced with this question as consumers, we would all prefer to retain our freedom of choice? And if we value that freedom then someone must be found to carry the risks of a constantly changing and discriminating demand.

Under free markets, profits are an indication of the requirements of consumers, and, therefore, assist producers to decide what and how much should be produced. Where profits in a particular line of business are unusually high, new capital is attracted, output is expanded, and prices eventually reduced and the demands of the consumer satisfied. In a highly socialised economy this function of estimating the market would be based on the necessarily arbitrary decisions of government planners.

In a socialised state it is conceivable that some, but not all, the risks inherent in private competitive enterprise could be eliminated. To that extent pure profit could be reduced. But the question we would have to decide is whether any possible gains to the public in this direction would not be far out-weighed by the loss of enterprise, the slowing down of economic growth and expansion and therefore of the trend toward higher all-round living standards. Progress means change, and change means risk, and risk means profit, or loss.

When you look at it closely, enterprise is the other side of the coin of **risk-taking.** The more risks that are undertaken the more enterprise there is. It is for this reason, if for no other, that we should preserve the idea of the necessity of good and healthy profits as an inducement to the enterprise essential to a constantly rising standard of living for all.

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