THE NATURE OF PROFIT

INTRODUCTION

I believe that there is no greater confusion in economics than that which surrounds the concept of 'Profit'! Some of us believe that Profit is **bad** because it is the result of greedy self-interest and that if I make a Profit then I am reducing the economic well-being of others. Others of us believe that Profit is **good**, and see it as the engine of economic growth, which adds to the economic well-being of everyone.

After reading this short article, I hope you will come away a better understanding for forming your opinion. I believe we have diverged from the original meaning of Profit, and by so doing, have lost sight of what Profit can delivers to us. I hope to demonstrate that either view of Profit **can be** valid**. It depends** on how the profit is **created** and how **it is allocated.**

ANALYSIS

In other parts of my website, I introduced you to Condor, my caveman friend who lived 6,000 years ago. He is able to explain all kinds of economic things in very simple, clear terms. I asked Condor could he explain **'**Profit**'** to us. He said: "Sure Don. I will use myself and two members of my community to explain it."

"First, you folks need to understand what **the source** of Profit is. The source of Profit comes from using some of our 'time' to benefit our 'future' instead of for our benefit 'now'. In other words, in order to have Profit we need to sacrifice either some of the time we spend for current **consumption** or current **leisure** in order to have the time to produce 'something' for future use. 'Profit' is the **higher productivity per hour in the future** that occurs from that 'something' which was created from a current **sacrifice**.

Before I invented the hafted [with a handle] Axe, my two neighbors worked 4,000 hours a year to survive ---1,000 hours hunting and fishing, 1,000 hours obtaining firewood, 1,000 hours gathering grain, berries, and 1,000 hours for their shelter, clothing and water.

I was able to work 500 hours less just to survive because I live in a cave and only have to spend 500 hours for shelter, clothing and water. So I have some choices the others do not. **I might have spent** my additional 500 hours gathering some more berries that I really like, or have 500 additional hours of leisure, or use the 500 hours to invent something. Based on what I said above, you already know what I decided**. I spent the 500 hours to invent my Axe**.

My Axe functioned for 2,250 hours before it was no longer usable. Economists in your world call this the 'economic' or 'revenue producing life' of my Axe. **What is most important** is that when the axe was used for those 2,250 hours, my neighbors and I obtained the same amount of firewood that used to take us 3,000 hours, so the axe provided **a labor savings of 750 hours.**

I gave up 500 hour of 'consumption production' and invented the axe, which saved 750 hours. The 'Profit' on **from** my axe is 50% [(750 minus 500)/500]. Of course the reason that you subtract the 500 is that I needed to get back the labor that I invested and what was left was the return to my investment".

Thanks Condor! That was a great explanation.

But wait. I'll bet some of you are saying: "I thought Profit was associated with a business and that Profit was equal to Revenue minus Cost? Doesn't the IRS define Profit that way?**" Well ---yes they do ---and so do economic textbooks –and therein lies the confusion.**

To clear the air, let's start with a basic economic 'fact' to which all of the economists agree: 'Total National Income = Total National Production = Total Wages = Total Revenue'. 'Wages' include (1) hourly or salaried payments to employees [workers], interest payments on loans [debt], and 'return' to the owners of a company [either stockholders or to private company owners]. In other words, the 'intrinsic cost' of Production is the same as the Value of Production in monetary terms, which turns out to be what we 'pay' for production. That is why the Cost/Value of Production is equal to the "Price paid for Production", or equal to Total Revenue.

Think for just a moment why these are **all** equal. The Total Revenue 'available' to buy what is produced must equal Total Wages. By definition Total Wages equals Total Income, whether the 'wages' are in the form of a paycheck, or a dividend check, or an interest payment to a bank, or an increase in stock value due to retained earnings, or the 'allocation' of money to a private company owner.

The 'division' of revenues between the so-called 'costs' versus the portion going to so-called 'profits' is nothing more than a reflection of the 'allocation of ownership over what has been produced'. **In other words,** what the IRS and the economic textbooks call 'Profit' is **that portion** of the profit that was created which is allocated to those who invested in whatever **generated** the profit. Economists talk about 'normal' versus 'economic' profit, but that distinction is not relevant to understanding the fundamentals which Condor explained.

Here is the key to removing the confusion: When Profit **is created** as explained by Condor, under normal market operations, those who have invested in production will **not receive** all of **'profit'** they have created. It is when market operations are 'not normal' that profit, or the allocation of profit **can be bad**. Otherwise, Profit is a very good thing.

Condor shouts: "Don, let me explain what you mean". Sure Condor ---go ahead.

“Let me clarify all of this for you folks. Don gets all caught in his “economic talk”. When I use my Axe, I save 250 hours in the production of my firewood. After I subtract the 500 hours that I invested in inventing it, **my net return** *from my personal use* is **negative** 250 hours, or -50% [(250-500)/500]. In other words, I saved less labor than I incurred in the invention of the axe. **But** the axe has an additional 1,200 hours of use remaining. Now I could ‘store’ the axe and use the next year and the next, in order to use up all of its remaining useful hours. Let’s see, if I did that over the next three years I would save 750 hours. Now my net return is a plus 50% [(750-500)/500].

“But that doesn’t make a lot of sense. If they ‘pay’ me [Don says the economists in your day call this ‘rent’] for using its remaining hours of functionality, then **maybe** it will make sense for me to spend time making an Axe each year. Of course, the ‘rent’ that my neighbors pay **can’t be so high** that is doesn’t **‘pay <u>them</u>**’ to rent. In other words, they need to experience a ‘return on their use’ before they are <u>willing</u> to rent the Axe from me. That is how the ‘profit’ gets shared. If I don’t share it, I can’t get others to use it. In other words, if I don’t allow some of the increase in hourly productivity from the Axe to <u>accrue</u> to my neighbors, they have no reason to use the Axe. In like manner, if they don’t pay me <u>something</u> for the use of the Axe, I have no reason to let them use it.”

Don helped me to prepare the following table. Since the overall Profit is 50% **what if** both the ‘user of the axe’ and the ‘inventor of the axe’ all made 50% on the deal. Think about for a minute: I **can’t** get the potential profit from the Axe unless it is completely used up ---that is how we get to a 50% return. However as I just explained, my neighbors need to get a return from using the axe. If they have no ‘return’ incentive they won’t use it. <u>So –the following table **is the deal** that I cut with my two neighbors</u>:

Log Production [Labor Hours]	Community Total	Condor the Caveman	Condor's neighbors	
		Per Person		
Without Axe	3,000	1,000	1,000	1,000
With Axe	2,250	750	750	750
Savings	750	250	250	250
Condor Initial Investment	500	500	0	0
Transfers To		334		
Transfers From			167	167
Net Investment	500	166	167	167
Return	250	84	83	83
Return on Investment	50%	51%	50%	50%

Notice that under this deal **we all obtained a 50% return from the invention of the Axe**. My two neighbors each ‘contributed’ 167 hours of their time by hunting, fishing and gathering grain for me as their ‘rent payment’ for using the Axe. That in essence replaces 334 of the 500 hours that I spent inventing the axe. Now my ‘net investment’ is 166 hours [500 minus 334]; and my net return is 51% [(250 minus 166)/166]. In like manner, my neighbors have also ‘invested’ 167 hours each in the investment in the form of ‘rent payments’, and the result is that they also get a 50% return on ‘their use’ of the Axe [(250 minus 167)/167].”

Thanks again Condor! I believe you have made it all quite clear. What we **now** call ‘profit’ is the payment to the investor that represents **their share** of the ‘profit’ that was created. In other words, we now call ’profit’ is **only a portion** of it ---the portion that goes to the investor. Profit seeking has indeed improved the economic well-being **of both** the investor and the user of the investment ---the worker. This is what happens under **normal** competitive market operations. In a moment I will explain how profit can turn into a bad thing when market operations are **not** normal. But what is most important is that ‘profit’ is **usually** a very good thing. In our world of today, this translates into a higher wage for workers. In our world of today, increases in productivity per hour are usually defined by the price we are willing to pay per unit produced. [Exceptions to this is another whole discussion]. In other words, the price we are willing to pay defines the value of the productivity.

I should note in passing another important example where the ‘nature of profit’ was not initially understood. It was in the early days of Labor Unions. When they were formed, Labor Unions were a very good thing, because they did a lot to address what I call later “monopolistic control over labor’, which can turn profits into a bad thing. At first, Labor Unions resisted technological innovation because they thought that workers would lose their jobs. They discovered, however, that not only did the workers, in the long run, **keep** their jobs, but they also earned **more** because the **value** of their labor increased. The unions did not **explicitly** understand that this was because the workers were sharing in the profits created by the innovations, but that is exactly what happens. Some companies who offer ‘profit sharing’ **instead of** wage increases are starting to more explicitly recognize the basic nature of profit and the need to share it between the investor and the user, that is to say, with the worker that is using the innovation in the production process.

Now let’s talk about how the **sharing of** Profits **can be bad**. I have referred to Condor’s explanation as ‘normal market operations’. What are **abnormal** market operations and how does that affect things?

“Hey Don, let me explain” says Condor. Sure Condor. Go ahead.

“Suppose in my world, all of the firewood that could be gathered was mostly gone and folks could no longer obtain enough firewood to survive. However, with my Axe, we could cut down and cut apart trees. So, the only alternative to obtain firewood now was my Axe. Suppose I was super strong and my two neighbors could not overpower me. In other words, they were physically subservient to me if I chose to impose my will. Now, they were forced to use my Axe in order to survive.

So, if I were a mean spirited human being, I could force them to work for me, and for the hours they saved in using the Axe, I made them use all of those saved hours to hunt, fish, and gather grain and water for me. The result is that all of the saved labor from the use of the Axe accrued to me, and they would get no benefit from the increased log productivity per hour. This way I could live an easy life and my neighbors would have no increase in their economic well-being."

Thanks Condor. What Condor hypothesized is what economists call 'monopolistic control over **labor**'. When this occurs, '<u>profits' are **not** properly shared.</u> When monopolistic control over labor exists, profits quite often are not shared with those doing the work. This is, in essence, slave labor or what I call 'quasi' slave labor. We all know about slave labor. <u>Quasi slave labor</u> exists when <u>the part</u> of the work force that works in support of a particular product does not have 'worker mobility'. A lack of mobility can occur from either (1) the inability to change work locations (geographic non-mobility), or (2) skill non-mobility, which means a set of workers who do not have a skill set where they can leave a company that is not paying them a wage equal to what their skills would pay in the competitive job market. In other words, they are paid a wage where none of the 'profit' from the innovations that make their productivity per hour higher is 'shared' with them like the increased productivity of the Axe is shared by Condor's neighbors.

I also **inferred** in the "Introduction" that 'profits' can be bad if they are **incorrectly** created. In order to understand this problem, I need to introduce one more concept. In our 'money based' economy, as opposed to Condor's 'barter based', it helps to view the 'the sharing of National wages' [remember 'wages' includes payments to workers and payments to investors] as an 'allocation of control over production'. In other words, wages, in whatever form they are received, represents our 'purchasing power' right?

Therefore, wages in the form of 'profits' as defined by the IRS and economic textbooks, represents how much **control** investors [either bank holdings of loans, stock and bond holders, or the 'revenue minus cost differential to private business owners] have over production. This is an important way to look at it, because it makes it easier to explain when that profit to investors is **bad**.

This can occur if there is 'monopolistic control over **production**'. Just as when there is 'monopolistic control over **labor**' when there is 'monopolistic control over production' those controlling the production **can exact** an **improper** 'allocation of control over production'**.** In other words, they can **exact** an amount of 'wages' that is **not related** to any 'profit' which was created by their investments, or even without them **making** any investments. **It is very hard** for someone to obtain 'monopolistic control over production' unless it is granted by the government. Some of you may disagree with me here. I don’t want to belabor the point in this article because it is already five pages, and I am worried about your ‘attention span’! If you can’t wait for me to talk about it, you can read an excellent book by Professor Thomas Sowell called “Basic Economics”.

Anyway let me give you an example. The Utility Industry, that is to say, the production of electricity, has a monopoly over the production of electricity [although this monopoly is being eroded by the ability of us to deploy our own sources of electricity generation]. The government has divided the country into what are called “franchised territories’, and there is only one company that can provide electricity within each territory. If you want electricity, you must buy it from that company. Since there is no competition for your business, and since most of you really need electricity, the company could charge ‘a very high price’; far beyond the increase in productivity per hour that investments have created. And by the way, the workers for the utility industry may still be able to negotiate the right wages, because they can have geographical and job skill mobility. So, you could have a situation where the workers are receiving a ‘fair share of profits’ while the owners are receiving a ‘monopolistic’ or unfair level of wages/profit relative to the value of their investments. That is why the government ‘regulates’ the return to investors to avoid the creation of **bad** profits.

CONCLUSION

You can probably tell that this discussion of ‘profits’ can have a lot of ‘arms and legs’. But I’ll close the discussion here by summarizing the three points that I have made:

- Profit is usually a very good thing. It converts our self-interests into incentives that grow our economy, and everyone benefits, both the worker and the investor.
- Profit can become a bad thing if monopolistic conditions emerge
    - Either in the form of ‘monopolistic control over workers’, which keeps them from getting their ‘fair share’ of the profits; OR
    - ‘Monopolistic control over production’, which causes people to ‘pay more’ for the product than they would if there was competition to produce the product.