Profit in a Free Economy

By John J. Seater

Profit, like politics and religion, is a subject that evokes strong feelings and hot arguments. At one extreme, profit is said to be the fruit of shameless exploitation that cheats the consumers, pollutes the environment, and oppresses the workers. At the other extreme, profit is said to be the reward for hard work, risky investment, and clever innovation—enterprises that have no undesirable consequences and that in fact are indispensable for social welfare and progress.

Neither of these extreme views is accurate, but each does contain elements of truth. Fundamentally, profit is simply a tool for achieving social goals. However, like a pistol or a scientific discovery, the profit tool can be misused. Thus society's task is to construct safeguards that prevent, or at least discourage, the objectionable uses of the profit mechanism but that still allow society to gain from the beneficial uses.

PROFIT: WHAT IS IT AND HOW MUCH IS THERE?

Profit is simply the difference between revenue and cost.[1] In economic terms, it is the return to the owners of capital—the capitalists. Capital is any product used to produce another product, such as a printing press or an oil refinery. The owners of capital are those having legal claim to the capital equipment; for the most part, they are the stockholders of the nation's companies. Stockholders receive their profit in two forms. Some is received as annual dividends. The rest is reinvested in the company, thus building the value of the company's stock; this profit is eventually captured when the stock is sold.

How much profit do capitalists make? One way to answer this is to look at the profit

[1]Actually, profit is not a simple concept. Throughout this article, profit will be the difference between *explicit* revenue and cost; this is often called the accounting definition of profit. Explicit costs, for example, are employees' wages, raw materials costs, machine rentals, taxes, and so on. Economists use a more subtle definition of profit—the difference between revenue and costs, both explicit and *implicit*. An implicit cost is, for example, the salary that the owner of a business could have made in his highest paying alternative occupation.

rate—that is, profits relative to production costs. People generally estimate the profit rate to be quite large. For example, in a recent survey, the average person guessed the *after-tax* profit rate of manufacturing corporations in 1974 to be 33 percent.[2] In fact, however, the after-tax profit rate in manufacturing was 5 percent. A second way to look at the size of profits is to examine the share of the national income earned as profit. In the United States, after-tax corporate profits have averaged about 6 percent of national income over the last 45 years; even the *before*-tax rate has been only 11.5 percent (see Table). Moreover, a recent study argues that profits as a share of national income have been falling since World War II.[3] In short, corporate profit rates, on average, are smaller than many people believe and may not even be growing as fast as national income.

PROFIT: A VALUABLE SOCIAL TOOL

Profit has been defined as the monetary

[2]Estimates of particular profit rates are even more strikingly incorrect. For example, the average person felt the after-tax profit rate of petroleum companies was 61 percent in 1974; in fact, it was 7.2 percent. The survey was conducted by the Opinion Research Corporation of Princeton, New Jersey. It is reprinted in *New Jersey Business*, August 1975, pp. 25-27.

[3]See William D. Nordhaus, "The Falling Share of Profits," *Brookings Papers on Economic Activity*, No. 1 (1974): 169-217. Nordhaus has adjusted the profit data somewhat, so they are not perfectly comparable to those presented in the table.

AFTER-TAX PROFITS HAVE AVERAGED ABOUT SIX PERCENT AS A SHARE OF NATIONAL INCOME

	(A) Net National Product (Billions of Dollars)	(B) Net Corporate Profits Before Taxes (Billions of Dollars)	(C) Net Corporate Profits After Taxes (Billions of Dollars)	(D) Before-Tax Corporate Profit Rate (Column B Divided by Column A x 100%)	(E) After-Tax Corporate Profit Rate (Column C Divided by Column A x 100%)
1929	$ 95.2	$ 10.0	$ 8.6	11%	9%
1933	48.6	1.0	0.4	2%	1%
1939	83.2	7.0	5.6	8%	7%
1940	92.2	10.0	7.2	11%	8%
1945	200.7	19.7	9.0	10%	4%
1950	266.4	42.6	24.9	16%	9%
1955	366.5	48.6	27.0	13%	7%
1960	460.3	49.7	26.7	11%	6%
1965	625.1	77.8	46.5	12%	7%
1970	889.8	74.0	39.3	8%	4%
1971	961.2	83.6	46.1	9%	5%
1972	1055.1	99.2	57.7	9%	5%
1973	1184.1	122.7	72.9	10%	6%
1974	1277.2	141.0	85.2	11%	7%

Data from Economic Report of the President, 1975.

return to the owners of capital. Why should capitalists be rewarded at all? The answer is simple. If a society decides that forcibly coercing individuals to produce certain goods and services is undesirable, then there must be some other incentive to encourage people to commit resources, such as time and money, to production. Presumably, the probability of earning a money return that exceeds the costs of production (that is, of earning a positive profit) will make production attractive. Thus profit can act as the desired incentive. Furthermore, profit fulfills a broader social function than simply encouraging production. It also serves as a signal of the kinds of goods and services that society deems most valuable.

The Individual's View. From an individual capitalist's point of view, profit has three functions. First, some of the profit is a payment for investing his money in capital equipment instead of spending it elsewhere. The capitalist's money is like the laborer's time. A laborer can spend his time either relaxing or working. He will work only if he is paid enough to be compensated for not relaxing. Similarly, a capitalist will buy a factory or a machine only if he earns more that way than by doing something else with his money, such as depositing it in a bank. So, much of what is called profit is merely interest on the capitalist's money.

Second, some of the profit is compensation for the risk a capitalist assumes in investing in uncertain enterprises. Everyone knows that buying stocks is riskier than putting money in a bank account. The firm whose stock you buy may suffer a decline in sales or, worse, go out of business. Either way, the value of the stock falls, possibly to nothing. No such thing happens with a bank account. The money value of a bank deposit cannot decline (except possibly in the case of bankruptcy), and it is possible to earn a guaranteed interest rate. Moreover, deposits in amounts up to $40,000 are insured against default at almost all banks. Obviously, under these conditions, no rational person will buy stock rather than open a bank account unless the expected return on the stock exceeds the expected return on the bank account by enough to make the extra risk worth taking. This extra compensation for risk is another element of what is called profit.

Third, part of profit is a reward for enterprise and invention. Invention usually occurs because the inventor sees it as a means of earning money. So, part of profit is a compensation for the inventor's effort and insight. Profits of this kind usually are temporary, being ultimately competed out of existence as rivals and imitators adopt the technique. But as one source of innovational profit disappears, another arises somewhere else in the economy so that there is always some innovational profit in existence.

Society's View. The pursuit of profits by individuals also produces gains for society. Profits provide the incentive for capital formation and hence for economic growth. By providing interest on the capitalist's investment, compensation for risk, and reward for inventiveness, profits create incentives to invest money in the machines and factories needed for economic progress. In more general terms, profits signal to producers which goods are most desirable to society. (As we shall see shortly, the signal sometimes may be imperfect.)

A timely illustration of this is the development of the energy industry. Before industrialization, fuel production was minimal. Some coal and wood was used for heating purposes and for forging tools, but most other energy demands were met with wind and water power and with the labor of men and their beasts of burden. Petroleum was merely an object of curiosity. With the emergence of industrialization, however, energy demands multiplied enormously. It quickly became *profitable* to extract coal and petroleum in huge quantities and refine them for various uses. People wanted the products offered by industrialization. In response to the profit that those new desires made possible, resources were diverted from other uses to the production of the energy needed to fuel the industrial machine. Thus, it was the lure of profit that organized resources so as to satisfy the desires of society. Now petroleum is becoming scarcer, and petroleum prices are rising. The result? Predictably, new profit opportunities have developed. Oil companies now find it profitable to pump out of the ground petroleum that was formerly too expensive to recover. Research is being devoted to producing petroleum products from nonpetroleum sources, such as coal, and also to finding alternative sources of energy. So profit once again is leading businessmen and entrepreneurs, through their own self-interest, to satisfy some of the desires of society.[4]

PROFIT: A LESS-THAN-PERFECT MECHANISM

Thus it is clear that profit seeking can produce desirable ends. However, the profit mechanism can yield some undesirable outcomes as well. Social ills such as fraud and pollution often are attributed to profit-seeking, and the charge that profits are excessive and result in the exploitation of workers is a familiar and long-lived assertion.

Are Profits Excessive? The term "excess profits" is used frequently and is a cornerstone of some political ideologies. In a broad sense, we can say that profits are excessive when they are larger than is required to carry out the functions of profit—to encourage production and signal scarcities.

Excess profits arise whenever industries are not effectively competitive.[5] A lack of competition means that firms can restrict output and create artificial scarcities to increase the price of their product and thereby earn excess profits.[6]

If we can gauge the extent of noncompetitive enterprise in the U. S., we can get a rough idea of the magnitude of excess profits in our economy. The task is difficult, but some attempts have been made. A study in 1951, covering the years 1899 to 1939, found that private noncompetitive industries produced about 15 percent of the Gross National Product in the U. S.[7] A more recent study found that the extent of noncompetitive enterprise in manufacturing industries showed no marked tendency to increase or decrease between 1947 and 1966.[8] If nonmanufacturing industries also experienced little change during this period and if there were no sharp changes in the degree of competition in the economy during World War II, then we can estimate that noncompetitive enterprise continues to account for about 15 percent of the national product.

There is also some recent evidence that even when businesses operate in a noncompetitive environment, they are not very effective in raising prices above the competitive level. One study estimates that noncompeti-

[4]A different way to see the importance of profit in governing production is to examine the meat shortage of 1973. The price controls then in effect made it impossible for producers to satisfy demand and still earn a profit. Beef producers left their cattle to graze rather than bring them to market at the controlled prices. Chicken raisers even killed many of their young chickens rather than bear the expense of raising them only to have to sell at a loss at the artificially low prices. The moral is simple and clear: no profit, no production.

[5]An industry may not be perfectly competitive but may be "perfectly competitive enough for all intents and purposes," in which case it is said to be effectively or workably competitive. See F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally and Company, 1970), pp. 36-38, for a discussion of the criteria for workable competition.

[6]See Paul A. Samuelson, *Economics*, 9th ed. (New York: McGraw-Hill Book Company, 1973), Chaps. 25 and 26, for a good discussion of the economics of noncompetitive industries.

[7]G. Warren Nutter, *The Extent of Enterprise Monopoly in the United States, 1899-1939* (Chicago: University of Chicago Press, 1951).

[8]*Studies by the Staff of the Cabinet Committee on Price Stability* (Washington, D. C.: U. S. Government Printing Office, 1969). Note that the findings deal with manufacturing only. Though not indisputably true, it seems reasonable to assume that there was no marked change in noncompetitiveness in nonmanufacturing sectors as well.

tive industries sell at prices that are on average about two percent higher than they would be if the industries were competitive. Such a small effect on prices suggests that the effect on the total size of profits is small, too.[9]

If these various studies are valid, it seems fair to conclude that, though there are some excess profits in the U. S. economy, they probably are not large and by no means dominate the corporate profit picture (see Box). However, an absence of excess profits does not let the profit system off the hook in the minds of many. What about fraud, pollution, and exploitation of labor?

Information Costs Allow the Profit System to be Misused. Information about almost anything is costly to obtain, usually requiring expenditure of time as well as money. In instances where the costs of gathering information are high, some firms may try to make a profit by cheating, that is, by misinforming consumers. A supplier may figure that if he provides incorrect or incomplete information, customers will buy his product, believing it better than it really is. Thus, the supplier could charge more than the product is "worth" and thereby earn an excess profit. However, excess profits from cheating typically will disappear over time. There are two reasons why. First, the supplier may lose business as people eventually learn he cannot be trusted. Second, even if cheating pays in the sense that people do not recognize the deception, other fraudulent suppliers will appear and drive the excess profit down to zero.[10] Eventually, then, business will settle down to a state in which some suppliers are frauds but in which there is *no* excess profit.

In the long run, then, excess profit stemming from deception is not likely to be a problem, but deception itself may be a burden. Here is an instance where it seems reasonable to attack an undesirable use of the profit mechanism rather than the mechanism itself. One way to do so is to make the objectionable means of profit seeking unprofitable. For example, society makes fraud costly by making it illegal and by imposing heavy penalties.[11]

Pollution: An Uncounted Cost. Another problem often associated with profit seeking is pollution. Pollution is an example of what economists call an external cost, which is a cost not borne by those responsible for it. For example, paper mills are notorious for emitting foul odors, which are a cost to the local residents.

If there is no compensation for the emission of odors, the paper mill evades one of its costs, which is borne instead by the local residents. This reduction in the mill's costs tends to produce excess profits. However, as with fraud, these excess profits are not likely to last because they will induce other firms to enter the paper mill business and force the

[9]See Richard A. Posner, "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* 83 (1974): 807-27. A small total (or absolute) change in excess profits could be accompanied by a large percentage change. For example, suppose initially that excess profit is zero when a firm manages to exploit its monopoly power to raise prices by two percent and thereby create an excess profit of one dollar. Then the percentage rise in excess profit is infinite, even though the absolute rise of one dollar is miniscule. This is why the percentage change in profit can be a misleading indicator of the change in the size of profit relative to national income.

[10]The obvious exception is noncompetitive enterprise. A monopolist, for example, does not have to worry about other suppliers competing excess profit away from him. Thus, he may be able to earn excess profits from fraud.

[11]However, even when providing incomplete or incorrect information is legal, it is still undesirable. This is why many economists agree that one social responsibility businessmen have is to provide the best information they have on their product, whether legally required to do so or not. Information can be quite costly to provide, though. If it is of little value, it probably is better not to bother providing it. Thus either the businessman or the government must decide whether to provide certain information. In either case, the decision is a difficult one, for the costs and benefits involved often are difficult to determine. See Kenneth J. Arrow, "Social Responsibility and Economic Efficiency," *Public Policy*, Summer 1973, pp. 303-317; and Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), p. 133.

BOX

WHY NONCOMPETITIVE INDUSTRIES GET SO MUCH ATTENTION

There are several reasons why the man in the street might overrate the extent of noncompetitive industries and their profits. First, noncompetitive industries—especially monopolies—are newsworthy. Many people would be interested to learn that the Justice Department is scrutinizing IBM for monopolistic behavior, but almost no one would care to hear that this year, once again, saw and planing mills operated in a competitive environment. It is something like traffic accidents—if someone is hit crossing the street, it's news; if he crosses safely, no one cares.

Second, bigness is often confused with monopoly. In fact, however, a firm does not have to be big to be a monopoly, and a big firm may belong to a competitive industry. For example, the Besser Manufacturing Company was found guilty in 1951 of illegally monopolizing the concrete-block machinery industry, even though it employed only 465 people at the time and had sales of less than \$15 million. In contrast, Cities Service Oil Company had sales of \$1.2 billion in 1965 but accounted for less than 3 percent of U. S. crude petroleum refining.[A]

Third, most people seem to have manufacturing in mind when discussing the extent of noncompetitive behavior. Indeed, noncompetitive behavior apparently is more important in manufacturing and mining than in any other sector of the private economy, but manufacturing and mining are not the whole story. Two-thirds of national output is produced in other sectors, many of which are highly competitive.[B]

People also may underestimate the natural economic forces tending to limit noncompetitive behavior. The most important force is profit itself. If a noncompetitive industry has excess profits, entrepreneurs enter that industry to capture some of the excess profits for themselves. Incoming firms make the industry more competitive, however, and the excess profit is driven down toward zero.[C] Other forces also limit noncompetitive behavior—technological advances in transportation and communication, for example. Cheap transportation enables consumers to visit distant stores where prices may be lower. It also enables distant suppliers to ship their goods to new markets. Foreign cars in the American automobile market are an example. In both cases, competition is increased.

There are situations, however, where these competitive forces are absent. One case is "natural monopoly," in which technical considerations make it much cheaper for one

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[A] These examples are taken from F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally and Company, 1970), p. 11.

[B] Even in manufacturing and mining, noncompetitiveness may not be as extensive as popularly believed. Only about a fifth of the output of this sector comes from industries in which four firms account for 60 percent or more of sales. See Richard A. Posner, "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* 83 (1974): 819.

[C] The railroads, for example, are no longer a monopoly; airplanes, buses, and automobiles have provided new modes of transportation for people and airplanes and trucks have provided new modes of transportation for goods.

firm to produce the industry's entire output. The telephone system is an example.[D] Natural competitive forces also are restrained sometimes by the government, either directly (for example, through legal entry restrictions) or indirectly (for example, by protective tariffs). Some people argue that such government support is the major cause of noncompetitive behavior in the United States.[E]

[D] It may be desirable to regulate such monopolies. However, Posner, "The Social Costs of Monopoly and Regulation," presents evidence suggesting that the costs of regulation exceed the benefits.

[E] See Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), pp. 125-132.

excess profits down to zero. These new firms, of course, will use the same polluting techniques as the original firm, for otherwise their costs would be higher and they would not be able to compete. Thus, the paper mill business will settle down to a state in which all mills pollute but in which there is no excess profit.

Again, the resulting situation is undesirable—not because there is excess profit, but because there is too much pollution. The appropriate social response is to institute tax or regulatory policies to reduce pollution by making it costly for firms to pollute. For example, society could require the paper mill to compensate the local residents, perhaps through an emission tax on the mill's malodorous output. Such a tax forces the mill to "internalize" the cost associated with bad odors by making the mill either pay a tax for continuing its emissions or install equipment to reduce the odors. In either case the mill will face higher costs of production and will respond by reducing output and raising the price of the paper, just as it would if any other production cost were to rise. This response is economically efficient; the buyers of the mill's paper ultimately pay *all* the costs of paper production, including the cost associated with the by-product odor.

Many external costs of firms are more consequential than the foul odors of a paper mill. Some kinds of air pollution are injurious to health, for example.[12] But all cases of external costs are essentially like the paper mill example and can be treated by similar policies. As with fraud, the existence of external costs usually does not lead to excess profits (with the possible exception of noncompetitive enterprise). Again, the appropriate policies to combat these kinds of social problems do not involve attacking *profit itself* but only certain *means* of acquiring profit.

Exploitation and Income Distribution. It is sometimes said that businessmen earn much of their profit by exploiting their employees. The most extreme version of this position is that of Karl Marx and Friedrich Engels, who asserted that *all* profit resulted from exploitation of the workers. How well does this view fit the American economy?

If the buyers of labor services—the employers—are competitive with one another, there will be virtually no exploitation of labor. Rather, workers will be paid what they are economically worth, which means they will be paid according to their ability to produce. If an employer tried to exploit his workers by paying them less, other employers would bid the workers away by offering them higher wages. The original employer would be forced to match the higher wages or go out of business for lack of labor. Thus, in such a labor market, there can be no exploitation and therefore no excess profit from exploitation. The crucial question, then, is whether buyers of labor services in the American labor market

[12] For an attempt at measuring the mortal consequences, see Lester B. Lave and Eugene P. Seskin, "An Analysis of the Association between U. S. Mortality and Air Pollution," *Journal of the American Statistical Association* 68 (1973): 284-90.

are competitive with each other. Apparently they are, to a very high degree.

In determining whether an industry is noncompetitive, economists often use a measure called the four-firm concentration ratio. This is simply the percentage of the industry's output sold by the four largest firms in the industry. The usual rule of thumb is that when four or fewer firms control 50 percent or more of the industry's output, the industry is considered noncompetitive.[13] It seems reasonable to apply a similar test to the American labor market. A fairly recent study has done just that by examining a large number of local labor markets and determining how many employers accounted for 50 percent or more of the employment within those markets. It was found that in only about five percent of the local labor markets surveyed were four or fewer firms hiring 50 percent or more of the labor. In addition, only about two percent of the labor force covered by the survey was in these noncompetitive areas.[14] These are strikingly small percentages. If they are representative of the entire American labor market, they strongly suggest that exploitation of labor is an insignificant problem in the United States.

Despite this evidence, many people still feel some antipathy toward profit. Why? Perhaps Paul Samuelson has said it best: "Much of the hostility toward profit is really hostility toward the extremes of inequality in the distribution of money income . . ." The problem, then, is the equity issue of unequal incomes, or more fundamentally, that certain people are unable to earn incomes society deems adequate. The undeniable fact is that some people are born with mental, physical, or social handicaps and, through no fault of their own, do not have the same chance in life as most people. And while these people live in poverty, others live in luxury.

What is to be done? This is a difficult question, but in seeking the answer, it is important to remember that in most cases economic exploitation in contemporary labor markets is not the cause of the unequal income distribution. In a competitive labor market, those who earn low wages do so because they do not work in fields society values most. Some lack the skills to do so, and others may prefer not to work in such fields. It is economically efficient that employers be allowed to pay them a competitive wage, even if it is low. If firms are forced to pay higher than competitive wages, economic logic dictates that they will hire fewer workers and produce less.[15]

A preferable solution, when labor markets are as competitive as in the United States, is to let the market determine wage rates and employment patterns and then for government to *supplement* the incomes of those earning too little on their own. The debate over the best way to carry out such public assistance has not been settled. Many programs have been tried, and there is now interest in reforming the welfare system.

However, whatever redistribution scheme is adopted, it is important that profit not be viewed as inherently different from other forms of income. To make profit a scapegoat for the unequal distribution of income and to tax it especially heavily would be an ironic mistake indeed. Such treatment of profit undoubtedly would hinder one of the most important forces for alleviating poverty and reducing income inequality—economic growth.[16]

[13]The four-firm concentration ratio is by no means infallible and is often supplemented by other considerations. See Nutter, *Extent of Enterprise Monopoly*, pp. 1-10, and Scherer, *Industrial Market Structure*, Chap. 2.

[14]See Robert L. Bunting, *Employer Concentration in Local Labor Markets* (Chapel Hill: University of North Carolina Press, 1962).

[15]The minimum wage, for example, gives some people a higher wage but leads to fewer people being hired in the first place. Thus, the goods that the unemployed would have produced are lost. The precise magnitude of the employment reduction is difficult to measure, but the existence of the effect has been confirmed by several studies. See Robert S. Goldfarb, "Quantitative Research on the Minimum Wage," *Monthly Labor Review* 98, No. 4 (April 1975): 44-46, and the articles discussed there.

[16]See Samuelson, *Economics*, Chap. 6, and also Morton

THE BOTTOM LINE

There are three important instances when profit seeking produces an undesirable outcome for society—when business is noncompetitive, when the cost of acquiring information about products and producers is high, and when business does not bear the full costs of production. The first allows some firms to earn excess profits, the second opens the door to cheating and fraud, and the third produces such social ills as pollution. All of these problems can be combatted by making undesirable behavior costly through antitrust laws, fraud legislation, emission taxes, and the like. Such policies help reduce the occurrence of undesirable outcomes while retaining profit as a useful tool for organizing economic activity.

Profit is not only the concern of those in executive suites, for it affects all of society. It is an inducement to the business world to innovate, bear risk, and perform efficiently. It also is a means of allowing consumers to signal which goods they want and in what amounts while simultaneously rewarding producers for complying with their demands. Certainly the profit tool has some defects, but it seems far more desirable to repair the defects than to discard the tool.

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