

UNIT - 4 FACTOR PRICING

Ques. What do you mean by Profit?

Ans. Meaning: Profit is the "surplus" or the "residual income" which an entrepreneur gets. after paying all the factors of production

Profit is different from other revenues in three ways:

1. Profit is a residual income and not contractual or certain income as in the case of other factors of production.
2. There are much greater fluctuations in profits than in the rewards of the other factors.
3. Profits may be negative, whereas rent wages and interest must always be positive.

Ques. State the functions of Profit.

Ans. According to Prof. Peter F. Drucker, profit serves 3 main purposes:

1. Measure of performance.
2. Premium to cover costs of staying in business.
3. Serves as a source of financing for future expansion of the firm.

According to Prof. T. A. Lee, there are five major functions of profits:

1. Profit provides the reward for the shareholders in the form of 'dividend and directors in the form of 'remuneration'.
2. Profit provides for future expansion and reserve for future contingencies.
3. Profit acts as an incentive to efficient business operations.
4. Profit measures the efficiency and effectiveness of the management.
5. Profit also acts as a vital factor in operation and control of the business.

Ques. What do you mean by "Gross Profit"?

Ans. Meaning: Gross profit is that surplus which a firm gets after deducting its total expenditure from its total receipts.

The main items included in gross profits are as follows:

1. Remuneration paid to the factors of production contributed by the entrepreneur himself, which includes:
 - a. Rent of land,
 - b. Wages of management or superintendent,
 - c. Interest on capital.
2. Depreciation and maintenance charges, this includes:
 - a. Depreciation charges,
 - b. Insurance charges,
 - c. Taxes.
3. Extra personal profits, this includes:
 - a. Monopoly profit,
 - b. Windfall gains,

c. Net.

$$\text{Gross profit} = \text{Total receipts} (-) \text{Total explicit cost}$$

Ques: What do you mean by 'Net Profit'?

Ans. The balance which remains after deducting the above items from the gross profits is known as Net Profits or Pure Profits.

$$\text{Net (or pure) profit} = \text{Gross profit} (-) \text{implicit cost}$$

The net profit is a reward accruing to the entrepreneur for performing the following functions:

1. Reward for coordination,
2. Reward for risk taking and uncertainty bearing,
3. Reward for innovation.

Ques. What do you mean by 'Normal Profit' and 'Super normal profits'?

Ans. Normal profit is also known as 'no loss no profit situation'. Normal profit is that rate of profit which an entrepreneur must earn in the long run if he wants to remain in the industry. Thus, from the point of view of an industry, normal profit is that profit which neither attracts new firms to enter the industry nor induces the existing firms to leave the industry.

When an entrepreneur enters a particular field of production he expects some minimum return for his function as an entrepreneur. So long as he gets that minimum expected return he stays in business, else he quits. The minimum return that is necessary to keep the producer in his present field of production is called his normal profit.

If his earnings exceed the normal profit, then these earnings which are in addition to normal profit are known as super normal profits. That is,

$$\text{Super Normal Profit} = \text{Actual Profit} (-) \text{Normal Profit}$$

Ques. What do you mean by 'Accounting Profit'?

Ans. Accounting profit is regarded as the excess of revenue over the costs incurred in earning this revenue, in other words, it is the revenue realized during a given period of time after deducting the actual costs and expenses incurred in earning this revenue.

Thus, accounting profits take into consideration only the actual paid-out cost or explicit cost.

Ques. What do you mean by 'Economic Profit'?

Ans. Economic profit takes into account opportunity cost or implicit cost. In other words, while arriving at economic profit, we have to consider the following:

1. Entrepreneur's earnings which he could have earned by working for someone else.
2. Income from rent on the self owned rent employed in business which the owner could have earned by letting it on hire to some other firm.

3. Interest on self owned capital invested in business which could have been earned by investing it elsewhere.

Ques. Explain the 'Rent theory of profit' given by Prof. F A Walker.

Note: This theory is not in syllabus

Ans. According to Prof. Francis A Walker, profits are regarded as rent of ability (rent is paid to the land because of its abilities). Just as there are different grades of land, there are different grades of entrepreneurs. The least efficient entrepreneur just recovers his cost of production. Above him are entrepreneurs of superior ability. Just as rent to land arises because of various advantages provided by a superior land over the unsuccessful or disabled entrepreneur, profits are thus like rent and like rent they do not enter into price. Wages of management are not profit and the no profit employer only earns the wages of management, and no more. With a slight unfavorable turn of price or costs, he may have to work as an employee rather than as an employer. Wages of management thus, must be paid, to maintain the given supply of entrepreneurs. Such wages thus, enter into price.

Criticisms of the theory of profit:

1. Rent is a known and expected surplus while profit is unknown and uncertain: It is assumed that rent and profit both are similar but it is not so because rent is a known and expected surplus while profit is unknown and uncertain. Rent can never be negative but profit can be negative. Likewise rent can arise both in the static and dynamic state but profit arises only in a dynamic state.
2. The theory does not explain the real nature of profits: It says about no profit entrepreneurs and superior entrepreneurs and also says that, there is scarcity of superior entrepreneurs like superior lands. But the rent theory of profit does not explain the cause behind the limited supply of superior entrepreneurs.
3. There may exist like no rent land but there exist nothing like no profit entrepreneur. It is because if an entrepreneur does not earn any profit he will not remain in the industry for long.
4. Again, it is not correct to say that, profits like rent do not enter in to the price of the commodity: It is because an entrepreneur may remain in the business even if he is not able to earn profit in the short run but in the long run if he does not get at least a minimum rate of profit, he would close down his business. Hence, profits enter in to the price of the commodity in the long run.
5. Moreover, not in every case, high profits accruing to the entrepreneurs are due to his superior abilities. High profits may also be of the nature of windfall incomes or the result of monopoly.
6. The theory overlooks the most important function of the entrepreneur of risk taking and uncertainty bearing.
7. We find today that in the system of joint stock companies, profits (dividends) are distributed amongst the shareholders which have little or no relation with their ability. If profits are regarded as rent of ability then why dividends are equally distributed among shareholders regardless of their abilities.

Ques. Explain the 'Risk Bearing Theory Of Profit' given by Prof. F B Hawley.

Note- This theory is not in syllabus.

Ans. The risk bearing theory of profit was developed by the American economist Prof. F B Hawley in his book 'Enterprise and Productive Process' published in 1907.

According to Prof. Hawley it is the risk taking which is the special function of an entrepreneur because he cannot hire someone else to do this function. He by himself alone has to bear the risk, and profit is the reward for this risk taking. As we know every business in modern times involves some risk or the other and the assumption of risk is necessary if production is to continue. But the bearing of risk is unpleasant and irksome. Hence, risk would not be born without the expectation of a reward. Since the entrepreneur undertakes these risks, he gets rewards in terms of profits. If the entrepreneur does not receive the reward he will not be prepared to undertake the risk.

Prof. Drucker mentioned four kinds of risk:

1. Replacement: Generally known as depreciation, is calculable and is counted as cost.
2. Risk proper: That is the risk of marketability of the product.
3. Obsolescence: It is the least calculable but is also an item in the cost, and
4. Uncertainty: These are not costs in the conventional sense but are charges against profits. They may be called the cost of staying in the business.

Physical risks like fire, accident, etc., can be provided against by insurance, hence, fire, accident, etc., are included in costs. There are however risks which cannot be foreseen and hence cannot be provided against. It is for undertaking these risks that the entrepreneur is rewarded.

Criticisms of risk bearing theory of profit:

1. The entire profit earned by an entrepreneur is not always due to risk taking. A part of profit is also due to his superior organizational or monopoly power.
2. The theory establishes a direct relationship between profits and risk taking which is not correct. It is not necessary that a high rate of risk undertaken by an enterprise will always earn a high rate of profit. Sometimes more risk taken by entrepreneurs may lead enterprises to losses.
3. As pointed out by Prof. Carver 'Profits arise not because risks are borne but because the superior entrepreneurs are able to reduce risk by their business abilities, efficiencies and skills. Hence, profits are the rewards for risk avoidance or risk minimization rather than risk taking.
4. According to Prof. Knight all kinds of risks do not give rise to profits. For example, 'known risk' or 'insurable risk' or 'foreseeable risk' is in reality no risk. Profits do not arise due to such insurable risks. It is due to 'unknown risk' or 'non insurable risk' that the profit arises.
5. The risk bearing theory of profits does not provide a satisfactory explanation as to the true nature and origin of profits.

Ques. Write a note on 'Dynamic Theory Of Profit' given by Prof. J B Clark.

Ans. This theory is associated with the name of the American economist, Prof. JB Clark. He says that, in a 'static world', where the size of the population, the amount of capital, the quantity

and quality of human wants, the methods of production, technical change, the organization of business, etc., remain the same, profits tend to disappear under a static economy.

Profits represent the difference between selling price and cost. It is surplus above cost. But as in a static economy, everything is known and knowable hence, there is nothing unknown to the entrepreneur thus, no risk no uncertainty, hence no profits.

Profits arise in a dynamic world: We know that ours is not a static world it is a dynamic (ever changing one) one. The clever entrepreneur foresees these changes. He is a pioneer. Somehow by invention or otherwise he lowers the cost and makes profit. The changing world offers limitless opportunities to the farsighted, clever and daring entrepreneurs to make profits by turning the facts of the situation in their favor. It is only because the world is dynamic that it is possible for them to keep the lead and reap the profits.

Today's world is known as dynamic due to 2 sets of factors:

1. Internal: Internal in the sense that, there are certain changes which the entrepreneur himself brings about such as innovations.
2. External: External in the sense that changes are brought about by external forces. The external changes are of two types:
 - a. Regular changes like trade fluctuations which affect all profits,
 - b. Irregular changes such as, breaking out of fire, earthquake, floods, strikes, changes in taste, changes due to govt, policies, war, etc.

Thus, profits arise out of changes. In the static world, there is no change; hence no profits. In an economy, where nothing changes, there can be no profits.

Criticisms of Dynamic theory of profit:

1. According to Prof. F H Night, profits are not due to all types of changes (that is insurable and non insurable) taking place in the society. It is only non insurable changes that are important from the point of view of occurrence of profits. It is these unforeseen changes which give rise to 'uncertainties' which give rise to profits.
2. The dynamic theory of profit does not take into account the element of risk borne by the entrepreneur. Prof. JB Clark rejects the view that profits are a reward for risk taking by the entrepreneur and that even if risk taking gives rise to profits. But this view is quite contrary to the facts and cannot be accepted as profits are not only the result of dynamic changes in the society, but they are also in part a reward for risk taking.
3. Prof. Marshall is of the opinion that, even in a static economy, profits will not be eliminated altogether. He states that although most of the risks can be eliminated in a static economy, individual risk in one form or the other do remain as a result of which profits may occur.
4. Prof. Taussig has criticized the theory on the ground that it makes an artificial distinction between 'Profits' and 'wages of management'.

Ques. Write a note on "Innovation Theory Of Profit" given by Prof. J A Schumpeter.

Ans. The innovation theory of profit has been propounded by Prof. J A Schumpeter and is in several aspects similar to that of Prof. Clark's theory. According to Schumpeter, the principal

function of the entrepreneur is to make 'innovation', and profits are the reward for performing this important function.

According to Schumpeter, innovation means discovery of a new material or a new technique of production resulting in lowering the cost of production or improving the quality of the product. Again, new measures or new policy initiated by the entrepreneur also comes under innovation.

According to Schumpeter, innovations may be of two types:

1. Product innovation: Product innovations are those innovations which change the production function and reduce the cost of production. It includes the introduction of new machinery, improved production techniques or processes, exploitation of a new source of raw material or a new and better organizational pattern for the firm.
2. Market innovation: Market innovations are those innovations which stimulate the demand for the product that is, which change the demand or utility function. It includes introduction of a new product for a new variety of an old product, new and more effective mode of advertisement, discovery of new markets, etc.

Success of any of these two types of innovations brings a handsome increase in profits. Profits increase because either the cost of production is lowered or the product fetches a higher price.

Innovational profits are temporary in nature: It may be pointed out, however, that profits owing to innovations are only temporary and tend to be competed away. The innovation made by an entrepreneur will naturally lose its novelty as the rivals imitate it. Yes, but if the innovations are patented the innovator continues to enjoy it. But in a dynamic world and progressive economy, the superior entrepreneurs continue to make innovations and enjoy the profits thereof.

We may also remember that profits are both the cause and effect of innovations. Profits serve as a necessary incentive for making innovations; hence, profits are a cause of innovations. But since innovations result in profits, the profits are the effect of innovations.

Criticisms of innovation theory of profits:

1. Prof. Schumpeter also like Prof. Clark ignores uncertainty as a source of profit.
2. He also denies that risk bearing plays any role in the determination of profit.
3. The theory considers profit as a reward for innovations only. But in modern times, an entrepreneur is equally responsible for the proper organization of the business.
4. The theory does not provide an adequate and comprehensive explanation of profits. Besides innovations, there are several other factors which give rise to profits. The theory makes no clarification of these factors.

Ques. Write a note on 'Uncertainty Bearing Theory Of Profit', given by Prof. Frank H Knight.

Ans. The uncertainty bearing theory of profit has been propounded by the American economist Prof. Frank H Knight in his illustrious book, "Risk, Uncertainty and Profit".

According to him profit is the reward for uncertainty. As he puts it, "the main task of an entrepreneur is to bear uncertainties related to production, and profit is a payment for uncertainty bearing. Prof. Knight has tried to distinguish between risk and uncertainty and said that profits are not the result of risk taking but of uncertainty bearing".

According to Knight, risks are foreseen and provided against. Risks of death and of accidents like fire, ship sinking are statistically determinable. Their incidence is measurable and is undertaken by insurance companies in return of premium paid to them. The payments of these premiums are included in the cost of production. The entrepreneur gets no profit on account of these risks. Hence, risk taking is not the function of the entrepreneur, but of the insurance companies.

But marketability of the product due to shifts in demand, other factors which affect price and cost of production are unforeseen and unpredictable. Knight calls them as uncertainty and it is due to uncertainty bearing that an entrepreneur gets remuneration in terms of profit.

Like other factors of production, uncertainty bearing has a supply price, ie, unless a certain return is expected, no entrepreneur will be induced to face uncertainty. The supply of this factor, 'uncertainty bearing', depends on the temperament of the entrepreneur, the total resources at his command and the proportion of these resources he is inclined to expose (use) to uncertainty.

According to Prof. Knight, uncertainties or non insurable risk may be of the following types:

1. Demand Risks: In a dynamic economy there are constant changes in demand due to changes in consumers' income, their tastes and preferences, changes in the price of substitutes, changes in the size and composition of population, etc. Any decisions taken with regards to the above given changes are full of uncertainty which indirectly affects the profits of a firm.
2. Competitive Risks: The entry of new firms in the industry enhances competition and affects the market share of the existing firm and consequently its profits. No one can predict when new firms will enter the market and what will be their competitive strength.
3. Technological Risks: The rapid pace of technical progress creates heavy uncertainties in many industries. The old machines and equipment get obsolete immediately on the appearance of new machines and equipment. The firm may not be in a position to adopt these technologies and may thus suffer losses.
4. Business cycle Risks: When there is a boom period in the economy, the firm earns substantial profits; but in periods of depression there is overall contraction of economic activities leading to a fall in demand and consequently fall in profits.
5. Risk of government policy: Changes in govt.'s economic policies-namely, industrial policy, trade policy, labor policy, monetary policy, fiscal policy, etc. widely affect business situations. As these policies cannot be precisely predicted, they create uncertainty in the business world.
6. Uncertainty bearing is no guarantee for profits: It is not sure that bearing uncertainty will earn profit to the entrepreneur, still however, the entrepreneurs bear uncertainties because there is the expectation of profits. Hence, so long as the entrepreneur expects profits in a particular business, they will be prepared to bear non insurable risks and uncertainties, otherwise not.

Criticisms of the uncertainty bearing theory of profits:

1. Uncertainty is not the only factor that limits the supply of entrepreneurs. Lack of funds, lack of knowledge, lack of opportunities and the presence of economic friction are some of the factors that restrict the supply of entrepreneurs.
2. Uncertainty bearing is not the only function of the entrepreneur. The profit that he gets is also the reward for other services that he renders, for example, initiating, coordinating, etc.
3. The theory does not suit well to explain the phenomenon of monopoly profit. A monopoly producer earns profits even without uncertainty bearing.
4. Uncertainty bearing cannot be elevated to the status of a factor of production. It is an element of real costs which means exertion, abstinence, sacrifice, etc., as distinguished from money cost. Cost is not generally measured in terms of real cost. We know that capital is a factor of production but not abstinence, that is, needed to have capital.
5. Prof. Knight's theory does not seem to have much relevance to the real world. Businessmen continue to estimate profits ex-ante in defiance of this theory. This theory has been criticized as heavily insulated from empirical testing and empirical relevance.

WAGES

- MEANING OF WAGES:

The share of labour in the national income is known as wages. The term wages has been defined as the price paid for the services rendered in production by labour. It includes all payments made to labour.

A wage may be defined as the sum of money paid under contract by an employer to a worker for services rendered.

Prof. Benham

- TIME WAGES AND PIECE WAGES:

Wages paid according to the period of time for which the worker is employed is known as time wages whereas if wages are paid according to the quantum of work put in by the worker, it is known as piece wages. For example, if a worker is paid monthly wages Rs. 5,000, it will be known as a time wage whereas when a mason is paid, say Rs. 2,000 for completing the plastering work of a given area it is known as piece wage.

- MONEY WAGES AND REAL WAGES

It is usual to make a distinction between money wages and real wages. Nominal wages are also known as money wages later to the amount of wages which a worker receives in terms of money.

In other words nominal wages are wages paid or received in terms of money. For example, a monthly wage of Rs. 3,000 received by a textile mill worker or a monthly salary of Rs. 10,000 received by a professor of economics is his money wage or the nominal wage.

Real wages, on the other hand, refer to the amount of goods and commodities which a worker can buy with this money wages. It refers to the net advantages of the worker's remuneration, that is the amount of necessities, comforts and luxuries which a worker can obtain in return for his services together with the non-monetary benefits connected with the employment which he gets.

It should, however, be remembered that money wages alone do not give us a correct idea of the economic position of the workers. It is possible that nominal wages may be very high but if the purchasing power of money is very low, the real wages would also be very low because in that case the worker would be able to buy less quantity of goods and commodities.

On the other hand, it is likely that the money wages may be low, but if the worker gets a number of incidental benefits connected with the employment like free residence, free medical aid, free education for his children and essential articles at subsidised rate, his real wages would be quite high. From the point of view of standard of living, real wages would be quite high. From the point of view of standard of living, real wages are more important than money wages.

In the words of Adam Smith. The labourer is rich or poor, is well or ill-rewarded in proportion to the real and not to the nominal value of his wages." Thus, while considering the real value of a worker's earnings, we should take into consideration not only the money value of his wages but also a number of other factors on which the real wages depend.

- FACTORS AFFECTING REAL WAGES:

The following are the main factors which affect real wages:

1. Purchasing Power of Money: Workers are generally paid wages in terms of money. But money by itself is not so important, what really matters is the purchasing power of money.

Purchasing power refers to the amount of goods and commodities which can be purchased by a unit of money, say Rs. 5. The purchasing power of money depends upon the general price level. Money wages of the workers may be high, for example, they may be getting Rs. 400 per month, but there is a continuous rise in the general price level, this will mean a fall in the purchasing power of money. They will then be able to buy few goods and services and consequently their real wages would be low. If, on the other hand, there is a fall in the general price level this will mean a rise in the purchasing power of money and the workers will be able to buy more goods and services with the same amount of money, consequently their real wages would rise.

Again, money wages may be equal in two regions, but real wages may differ considerably because of different purchasing power of money in both the regions. For example, the cost of living in big cities is higher than in town though they may be getting the same money wage. Similarly, in times of inflation there is a fall in real wages of the workers while in a period of depression there is a rise in their real wages.

2. Form of Payment: Real wages also depend upon the form of payment. Although workers are generally paid wages in form of money, in many occupations they receive extra benefits which increase their real earnings. For example, in certain occupations, workers

are provided free quarters, free medical aid, free uniform, free education for their children and essential articles at subsidised rates and so on. In such employment, although the money wages may be low, real wages are quite high. In considering the real wages, therefore, all these benefits and facilities should be taken into consideration.

3. Possibility of Extra Earnings: In certain occupations, workers may have plenty of opportunities to undertake other remunerative work along with their regular work or in their spare time and thus supplement their earnings. Real wages in such occupations may be thus higher than in those occupations where no such opportunities exist.

For example, a professor can supplement his income by writing books, contributing articles in periodicals, by assessing examination answer-books by giving private tuitions etc. The possibility of extra earnings may arise where opportunities for employment are available to other members of the worker's family.

4. Regularity or Irregularity of Employment: There are certain occupations which give regular employment to the workers, while in some other occupations the employment is just seasonal or only for a part of the year.

Real wages will naturally be higher in those occupations where employment is regular than in those occupations where employment is irregular, seasonal or uncertain.

5. Nature of Employment: The nature of employment is also an important factor which affects the real wages of a worker. For example, there are certain occupations which are hazardous and risky. For example, the captain of a ship or the pilot of an aircraft or the railway engine driver.

Similarly workers engaged in coal or iron or mines or those working in steel mills are more liable to become victims of diseases or accidents than say, a clerk working in the office or a teacher. In those occupations therefore, which are risky and dangerous and which reduce the duration of working life or shorten the total earning period although money wages may be high, real wages would be lower than in occupations in which workers feel greater security of life.

6. Future Prospects: A person may be prepared to accept a low wage rate in a particular occupation if he finds that there are bright future prospects for him to get a promotion. In such cases, although the initial money wages may be low, yet as there are good prospects of a rise in the future real wages are considered quite high. On the other hand, a high initial money wage may not be considered as good in the absence of any prospects for a further rise.

In short, it is the real wage and not the money wage earned by a worker which is a correct index to judge his economic conditions. Money wages do not give us a true and a reliable picture of the economic conditions of the workers.

- WAGE DIFFERENTIALS:

- ❖ Causes of wage differences in the same occupations:

Money wages of the workers are found to be different in the same occupation for the following reasons:

1. Difference in Efficiency: Marginal productivity, also known as efficiency, is different among the workers in the same occupation. Since money wages are linked with

marginal productivity, more efficient workers receive higher wages as compared to the less efficient workers.

2. Difference in Production Techniques: Efficiency of the workers depends to a large extent on the production techniques of the firm. That is, on the quantity and quality of machinery and equipment, quality of raw materials and efficiency of management.
3. Difference in cost of living: Generally, cost of living is higher in the urban areas as compared to that in the rural areas. Therefore, workers in urban areas receive higher money wages as compared to those working in rural areas.
4. Difference in Bargaining Power: Bargaining power of the workers doing the same job is different in different states and regions. Generally, it is found that the workers in urban areas are more organised, active and aware of their rights than in rural areas. Hence, there are strong trade unions in urban areas and therefore their bargaining power is quite dominant. That is why workers in urban areas receive higher money wages.
5. Imperfect Mobility: There are many barriers to the mobility of workers from one region to another. Therefore, the money wage is high in the region where there is shortage of labour and it is low in areas where labour is available in plenty.