V

What Are Profits?

FOR GENERATIONS—certainly for well over a hundred and sixty years—economists have distinguished three types of income from the productive process. These are income from labor, income from the ownership of capital and income from the ownership of land. Income from labor—at any rate when the labor is hired by an employer—has been called "wages." To the income from capital some writers, *e.g.*, Henry George, have applied the term "interest." And the income received by way of the ownership of land has commonly been called "rent" or, sometimes, "land rent" or "economic rent."

It cannot be said that there has been any one generally followed and unquestioned terminology. Economists—and there are some—who use both the term "rent" and also the term "interest" to refer alike to income from capital and income from land, may strenuously deny that the usage referred to above is the prevailing one. But something like this use of terms has been general enough so that we may perhaps refer to it as more widely accepted than any other.

However this may be as regards "interest" and "rent," there is wide variation in the use of the term "profits." And it may be worth while to inquire (1) whether any of the meanings most frequently given to the term makes it helpful in economic analysis; and (2) whether there is an advantage in having any such term in addition to the terms "wages," "interest" and "rent."

I

JOHN STUART MILL defined "profits" as including interest on capital, wages of management and compensation for risk. The same usage was followed by Alfred Marshall.

As against this concept of "profits" the question at once arises why we want to include wages of management along with interest on capital in a single term. Wages of management, as such, are received for work done. True, the particular kind of work is not of the manual variety, but neither is the work of the accountant or the clerk or of those junior executives whom the top executive hires. Indeed, the top executive himself is pretty likely to be, in these days of wide use of the corporate form of organization, an employee of a corporation. To class together the returns on capital, received by stockholders of (investors in) the corporation, and the wages (salary) of a hired president or manager, under the heading "profits," would certainly be incongruous. Why should not the wages of the hired manager be classed rather with the wages of junior executives, accountants, clerks, artisans and other employees, since all of these incomes are received *for working?*

Probably the economists who have defined "profits" so as to include wages of management, especially the earlier writers, were thinking of individually owned businesses rather than of corporations. But, even if so, it still seems that the incomes received by business managers *by virtue of* their managerial activities, should be classed with other incomes that are received *by virtue of* work done rather than with incomes received *by virtue of* ownership of capital (or of land).[1]

If we should follow in the inclusion of some wages and some interest in the term "profits" such writers as those referred to above, why should we not include some land rent in that term, also? If the return on his capital received by a man who is managing his own business is thought of as

[1] Even though a corporation is run, in the main, by a hired president or manager, the stockholders—at any rate some of the larger stockholders—may participate in management, as through attendance at stockholders' meetings. It may be contended, therefore, that some small part of their dividends should be reckoned, in strict theory, as "wages" for work.

"profits," along with that part of his return which comes from his management (and which, presumably, he would not receive if he hired a manager to do the work), why should we not include also, as part of his "profits," the part of his income that he receives by virtue of his ownership of land?

The tradition among economists is not to include this last in "profits." But the individual business man managing his own little business generally does so. Whatever he gains from his business over outlays for his goods, wages for his employees and payments made for the use of land and capital belonging to others, he is likely to refer to as "profits." He will not usually make any separation of his own gains into income from his labor, income from his capital and income from his land. Actually, a part of his income is due to his work, managerial or otherwise, for, if he did not work, his income would, in general, be considerably less. Another part is due to his ownership of land. This part he could enjoy even though he did no work, for potential tenants would be found ready to compete with each other in offering him rent for the use of his land. Still another part is derived from his capital and this part, too, since others are ready to pay him for the use of his capital, he could enjoy regardless of whether or not he works. But instead of saying that he receives these three kinds of income—which are conveniently referred to as wages for work, rent of land and interest on capital—he is likely to call the total his "profits."

The individual who owns and operates a business is likely to think chiefly of the net income from his business and to be interested relatively little in tracing this total income to its various sources. The term "profits" may involve as much analysis as he cares to be bothered with!

But what if (say) his land and capital together could be leased to another business man who would pay for their use

$10,000 a year net (in excess of depreciation), whereas he is himself able to make only $10,050 a year from running his own business. That would indicate that his managerial labor for an entire year adds only $50 to the income he could enjoy if he did no work at all. It would presumably indicate that he was wasting his time in work for which he was not fitted and that he should either change to other work or, perhaps, devote his time to other things than earning (or trying to earn) a living. Thus, even to the individual proprietor who may imagine that he is not interested in dividing "profits" into its economically significant components, such division may be important as a guide to wise action.

II

BUT IF THE INDIVIDUAL business man, often, is not interested in an inquiry regarding the different factors from which his income is drawn and how much of his income is attributable or "imputable" to each, the student of economics ought nevertheless to be greatly interested. For such analysis is essential to an understanding of our economic order and, especially, to an appraisal of its fairness. Surely there is reason for distinguishing between an income which an individual receives from work that adds to the total output of enjoyable goods and, on the other hand, income which he receives by virtue of holding title to a part of the earth. The latter kind of income he could receive without work, merely by charging a tenant for *permission* to use that part of the earth.

To inquire here on a specific question of public policy, may it not be economically desirable to tax more heavily an income which owners of land can thus enjoy merely for *permitting* others to work on or live on the earth, than an income earned by productive labor?

There is a difference, too, between an income derived from permitting men to work on the earth and to enjoy community-produced location advantages and, on the other hand, an income from capital brought into existence by means of one's own saving. As for the practical application of this distinction, it should be noted that a high tax on capital or the income from it may possibly discourage the saving necessary to produce it or may cause the capital to be invested in some other state or country where such a tax is not levied. But a land-value tax will not decrease the total amount of land or cause land to be transferred from one state or country to another!

Surely the student of economics interested in public policy cannot afford to rest satisfied with the lumping together of wages and interest and rent in a single term "profits." Rather will such a student insist—at any rate he ought to insist—on putting into one class all incomes from land, whether derived from an individual landowner's private business or paid to him by a tenant or tenants or received in the form of dividends on the stock of a corporation owning and using land. Such a student will—at any rate he should—insist on putting into one class all incomes from capital and distinguishing such incomes from land rent, even though the particular owner makes no distinction and calls them both "profits."[2] And the student of economics will wish to class

[2] Because it involves something of a digression from the main theme, I am not including in the text above any analysis of the excess gains of monopoly. Such excess gains may accrue to labor, if one or more persons are protected by labor union or governmental or other restriction against the competition of other workers in the particular occupation. They may accrue to the owners of capital, if the capital of rivals is in a similar manner excluded from the particular industry, *e.g.*, by the threat or actuality of unfair competition on the part of the would-be monopolist. And they may accrue to the owners of land, if other land is forcibly kept out of the particular line of production, as by the quota restrictions in the Agricultural Adjustment Act or by the threat of unfair competition, or if, through complete monopoly by one company or monopolistic collusion among several companies, the number of coal or copper mines or oil wells in use is restricted so as to hold down output and thus hold up price. The excess gains of monopoly may be, therefore, excess wages or excess interest or excess rent or any two or all three of these. If this fact is kept clearly in mind, there is perhaps no objection to referring to the excess gains of monopoly as monopoly "profits." But then we should logically, it would seem, use the expression "monopoly profits" for the excess *wages* paid to workers

together also, for a large part of his analysis, all incomes from labor, whether the labor be managerial, "junior" managerial, clerical, statistical, professional or manual.

But how about the view that "profits" include a "compensation for risk"? Or the view that "profits" are nothing but the excess gains from fortunate enterprises or in fortunate years which compensate, more or less, for the losses from unlucky ventures or in unlucky years?

If we are consistent in this use of the term, must we not say that "profits" are so offset by "losses" that in the long run and on the average there are really no—or almost no—*net* "profits"? In other words, may it not be that, on the average, the returns from a business will just about equal the ordinary or normal rate of pay for the capital, land and labor devoted to it?

If we are to make a special point of income received as "compensation for risk" in the case of a corporation or other business concern, should we not do likewise in the case of the salesman who works on a commission basis? For he, too, is "compensated" for his "risk" of having inadequate income at certain times, by his chance of having appreciably larger income at other times. The fluctuations of his income, in other words, are not entirely or, perhaps, at all, the result of fluctuations in his effort, concentration and skill. Shall we then call the excess income of his lucky weeks or months his "profits"?

Indeed, even the employee who is paid by the day, week or month, may be said to assume some risk, for example, the

---

in a trade where, by limiting the number of their competitors, *e.g.*, through limitation of apprentices, the workers in control of the trade are able to command higher wages for their labor than would otherwise be possible to them; or else we should distinguish between (say) *corporate* "monopoly profits" and *labor* "monopoly profits." And in thus referring to the "monopoly profits" of labor, we are including in "profits" incomes that are almost invariably thought of, spoken of and written of as "wages"!

But it is certainly important to distinguish between incomes earned in fair competition and the excess (and *unearned*) gains of monopoly, whether these excess gains accrue to capitalists, to landowners or to workers.

risk of periodical unemployment, the risk that failure of the employing concern will leave him minus some of his accrued wages, or the risk that his employer or some hired executive will abscond with the payroll, leaving the company without means to meet its wage obligations. Shall we then say that a small part of every worker's wages ought to be regarded as "compensation" for the "risk" that he will not continuously receive his full regular wage, and that this part should be separated in thought from the rest and be considered not as wages at all but as "profits"?

And how about the income received by the owner of a bond? May we not regard a certain part of this income as "compensation" for the "risk" that the full return promised, or possibly, even any return at all will not be realized? If so, just how much of the income received shall be thus reckoned separately from the rest and be classed with "profits"?

The truth is that there is risk in all the relations of life, including all the relations of business. Every type of income is subject to some possibility of fluctuation or irregularity, whether it be income from labor or from capital or from land. But to pick out a part of the income from each such source and put all these selected parts together under the heading "profits," tends to divert attention from the problem of the source or sources of the income. It tends to confusion in any attempt to attribute incomes to their respective sources, whether in productive contribution or in exploitation.

The choice of terms and of the meanings to be attached to them should be made in the light of the problem or problems we are seeking to solve. We should select and define our words with a view to emphasizing—not to blurring—the distinctions which need to be clear to us if we are to discover the cause and effect relations we seek and thereby further the adoption of wise and just policy.

III

If we consider "profits" as excess gains the possibility of which compensates for the risk of suffering losses, then we are directing our attention primarily to the *fluctuations* in incomes. If, indeed, it is the up and down fluctuations and, in general, the variations from the norm or average, rather than the average and normally-to-be-expected income in each industry and from each source, in which we are interested, this use of the term "profits" is relevant. But it is hardly relevant to an inquiry which would trace incomes to their sources in the so-called "factors of production," *viz.*, labor, land and capital.

Suppose we wish to examine critically the socialistic view that all incomes from property are unearned. We shall get no help in this venture from a demonstration that, in proportion as demand for a particular commodity is inconstant or unpredictable, the income from the capital used in its production is likely also to be inconstant or unpredictable, with the chance for gains above the average per cent offsetting the chances of lower than average gains and of positive loss.

Or suppose we are interested in a study of the rent of land. Suppose we are considering the fact that land rent is received from geologically-produced and community-produced advantages for which some men are allowed to charge other men. Suppose we are inquiring, then, whether land rent thus going to particular individuals is not really unearned. Suppose the question is raised whether the rent of land differs from both interest on capital and wages of labor, because it is not paid for any equivalent service rendered. Suppose, in short, that we are seeking to test incomes received by their relation to functions performed. Surely, in that case, we shall get no light from the fact that what a tenant agrees to pay for the use of a piece of land is sometimes a fixed amount and sometimes a proportion of the output. In the latter case, a few writers might regard the above-average income of the landowner from his land, which he receives in good years, as "profits." But both the above-average income of good years and the below-average income of poor years he receives *by virtue of* his ownership of land and *not* by virtue of his *doing* productive work or of his owning capital brought into existence by work and saving.

In the voluntary agreements of business, it is customary for some persons to assume the major fluctuations in income and thereby guarantee, to some extent, more constant income to others. Thus, if the owner of land and capital hires a manager to operate the business in which they are used, he will probably agree to pay this manager a definite or constant wage ("salary") during some agreed period. He then accepts for himself a somewhat fluctuating and unpredictable rent from his land and interest from his capital. But if, on the other hand, the manager hires from the owner the land and capital to be used in the business, the conditions are reversed. The rent paid to the owner for his land and the interest on his capital are agreed upon in advance. They are constant or definite (barring business failure by the manager, or some kind of fraud) while the wages (though he may call them "profits") of the manager take the unpredictable fluctuations resulting from the changing circumstances of demand, "cost," etc.[3]

Or, again, the owner of a piece of land may be promised a definite or constant rent by a person (or a corporation) undertaking to construct buildings and other improvements to be used with the land in some kind of production. The owner of the improvements may hire workers for definite or constant wages. His own income—interest on his capital

[3] The continously larger than average returns to the superior manager are, of course, to be regarded as wages and mirror such a manager's superior productiveness.

—is then subject to fluctuation and may be more than the usual per cent return on capital, or less, or he may lose some of his original investment. And if, instead of hiring a manager to operate the business to which his capital is thus devoted, he manages the business himself, then he receives unpredictable or fluctuating wages as well as unpredictable or fluctuating interest on his capital.

Still again, such a tenant may borrow part of the needed funds to construct the capital, providing the remainder from his own savings. If he does so, then the interest from his own capital used in the business is unpredictable and subject to fluctuation while the lender's interest and the landowner's rent are, both of them, relatively constant and predictable.

By means of these various agreements, freely entered into in the operation of the system of free private enterprise, some accept relatively fluctuating and uncertain rent or interest or wages while others arrange for rent or interest or wages that are relatively constant and certain. But the fact that some accept more risk than others does not change or in any essential respect weaken the argument for distinguishing among the various incomes on the basis of whether they are due, respectively, to the recipients' labor, to their ownership of capital that has been brought into existence through work and saving, or to their ownership of part of the earth.

If the use of the term "profits" diverts attention from such a functional analysis—and often, I think, it does—it may seriously interfere with the development of a general understanding of what is most fundamentally awry in the division of the product of industry among the various contracting parties concerned with it.