Funding the Future

Profit rewards work, not ownership. Economics got this ...

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What is profit, and who actually deserves to receive it?

In this episode of *Understanding Economics*, I explain why profit should be understood as the reward for enterprise, and that it is not a return for the ownership of money, property or shares.

Enterprise involves bringing together people, skills and resources to produce goods and services that meet human needs. Profit is the uncertain reward for undertaking that work, which is that of the entrepreneur - who is always a person.

The problem is that both modern economics and almost all conventional accounting confuse profit with other forms of income, including interest and economic rent.

I explain how this happened, suggesting that the use of limited companies has allowed shareholders to claim profits generated by the work and enterprise of employees, even when those shareholders contribute nothing beyond financial capital. This might have resulted in the biggest misallocation of economic returns in history.

To illustrate this, I use an example based on a café to demonstrate the difference between wages, profit, interest, and economic rent.

Drawing on the ideas of Adam Smith, I argue that shareholders should receive a fair return for providing finance, while the rewards of enterprise should belong to those who actually create them.

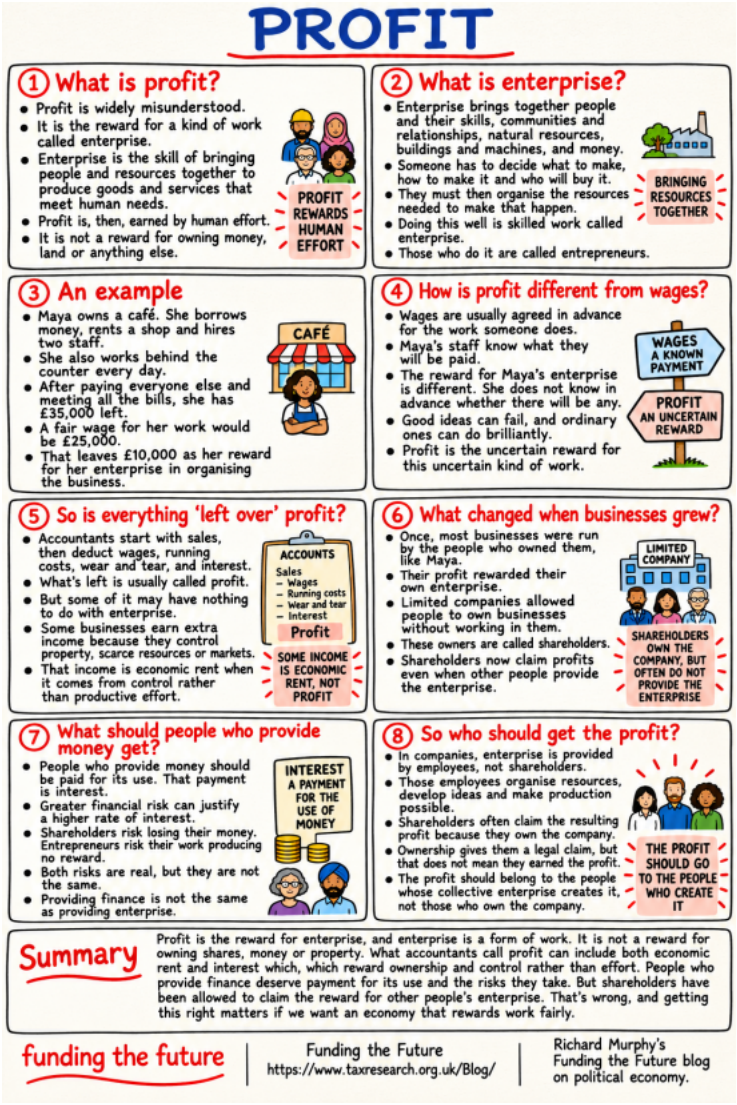
If we want an economy that rewards work fairly, we need to fundamentally rethink who receives business profits, and it is not shareholders.

https://www.youtube.com/watch?v=iVMha8N_nxo?si=epPcaRo5bbi0JU30

This is the audio version:

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This infographic supports this video:



This is the transcript:

Hello, I'm Richard Murphy, and this is Understanding Economics. That's the series of videos that I am making, which explains how I see economics in the real world. And in this video, I want to talk about one of the most difficult concepts in economics, which I think is also one of the most misunderstood, and that is profit.

Profit, if it is properly understood, is a reward for a particular and rather special kind of work called enterprise. Enterprise is the skill of bringing together people and resources to produce goods and services that meet human need. Profit is then earned by human effort. It is not a reward for owning money. It is not a reward for owning land. It's not a reward for anything else. It is earned income, but of a very particular type.

An enterprise brings together people and their skills, communities and relationships, all forms of capital, including natural resources, buildings , machines, and money, and combines them in a way that meets human need.

Someone has to decide what to make, how to make it, and who will buy it. The skill of doing that is called enterprise. And that person must then organise the resources needed to make that all happen. And this, again, is part of this skill base. Those who have this skill are called entrepreneurs. The activity they undertake is called enterprise. And the return they make for their efforts is profit.

So, let's use an example because in this case I think it will help. Maya wants to create a cafe. She borrows money, rents a shop, and hires two staff, and she herself works behind the counter every single day. And after paying all the bills and totting up all the receipts, at the end of her first year, she's got £35,000 left.

Now a fair wage for her work behind the counter would be £25,000. And that means she's earned £10,000 in excess of her labour reward for undertaking activity in this cafe. That excess reward is her return for her enterprise in organising, setting up and running this business. This is her profit.

What's the difference between this and wages then? Wages are usually agreed in advance for the work someone does. Maya's staff, for example, know how much they will be paid. But the reward for Maya's enterprise is different. She does not know in advance whether there will be any, in fact. Good ideas can fail, and ordinary ones can do brilliantly. Profit is the uncertain reward for this uncertain kind of work where the outcome cannot be known in advance.

So is everything left over in the bottom line of a set of accounts profit? The answer is, it is not. Accountants might describe that income as profit, but it isn't. Accountants are not economists. They do not understand this distinction, and they should. And I've been an accountant for forty-two years and a professor of political economy and other things since then. And the fact is that the distinction matters, and the confusion has caused a lot of trouble in the world.

Accountants, when they start to calculate income for a business, start with its sales, and then they deduct wages, running costs, wear and tear, which they call depreciation, and interest. They call what's left over profit. But some of that income may have nothing to do with enterprise of the sort that I've just described. Some businesses earn extra income because they control property, which they rent, or they

manage scarce resources, which they can charge for at an excess price, or they can simply speculate in markets. In every one of those cases, these businesses are earning an economic rent.

They are not meeting human need. They are not engaging enterprise. They are not releasing productive effort. They are not, therefore, undertaking the activity which can give rise to profit, which is the return to enterprise. They are creating rents. And we should not confuse these two. They are fundamentally different economic concepts, and to lump them together in the term profit, which is what accountants do, is to misrepresent the truth.

To get our economic understanding right, to get our organisation of the economy right, even to get our taxation right, we have to understand that profit is not the same as every bottom line in every set of accounts. And this is particularly important when we understand the role of limited companies in all of this.

Once upon a time, all businesses were run by people like Maya, who ran the cafe in my example that I've just given. She owns that business. She runs it in her own name. She supplies the services. She gets the reward. The return to her enterprise is hers to enjoy. But then someone created the limited company.

Now, these were very largely unknown before the 1850s. And when Adam Smith was writing in the 1770s, and that is when he wrote The Wealth of Nations, the first ever economics book of substance, he condemned the idea of limited companies, which he thought were a market imperfection. He believed that people should own their own businesses, and they should trade in their own names, and they should take responsibility for their actions.

In other words, he thought that people should earn profit from their enterprise, and he could see no reason to distinguish the person and the enterprise from the profit, because as far as he was concerned, they should all be linked.

But then from the 1850s onwards, as a consequence of the rise of the railway era in the UK, Parliament allowed companies to be formed by registration rather than by Act of Parliament, and as a consequence, the number of limited companies in the economy grew enormously. There are now nearly six million of them in the UK.

And limited companies allow people to own businesses without ever working in them. In fact, that was the original idea behind limited companies. They were designed to pool people's financial capital in a way that would allow those who had entrepreneurial ability, and who could therefore undertake the activity of enterprise, to generate a profit as a result.

But these owners are called shareholders. They're not called entrepreneurs. And shareholders do, however, now claim profits when other people actually provide the

enterprise. This is where the massive confusion in our economy around profits has arisen.

So what should people who provide money get in the way of a return? They should be paid interest. That is the rate of return on financial capital that Adam Smith identified in 1776 in The Wealth of Nations, and I think he was right.

Now, I'm not saying everyone should get the same rate of interest. I am saying if there is greater risk in an enterprise, a higher rate of interest is justified. But that is the reward that people get for providing financial capital. They do not get an entitlement to share in the return from the enterprise of those who provide that skill and their human work to supply it. Shareholders might risk losing their money. Entrepreneurs might risk producing no reward. Both risks are real, but they are not the same. Providing finance is not the same as providing enterprise.

And in companies, enterprise is provided by employees and not by shareholders. Those employees organise the resources, develop the ideas, and make production possible. And this won't just be the board of directors. This enterprise will take place throughout the organisation. The person right down on the shop floor who decides how to schedule production in a way that maximises the efficiency of their team is exercising enterprise as much as the chief executive, the finance director, or anybody else might be. Shareholders often claim the resulting profit because they own the company, but ownership gives them a legal claim, but that does not mean that they actually earned the profit.

The reward for enterprise should, in my opinion, belong to those whose work created it, and that is real people. The profit in a company should belong to the people whose collective enterprise creates it, and not those who own the company. Shareholders should not be able to claim this money as their own, and the fact that they have is the result of one of the biggest distortions in economic history that has ever been created as a consequence of the use of limited companies and the claim by shareholders that they ultimately determine the reward of the company when we know that is absolutely untrue.

Profit is the reward for enterprise, and enterprise is a form of work. It is not a reward for owning shares, money, or property. What accountants call profit can include both economic rent and interest, which reward ownership and control rather than effort. The people who provide finance deserve payment for it, and they should be compensated for the risks they take. But shareholders have been allowed to claim the reward for other people's enterprise. In my opinion, that's wrong. That reward should be paid to the people who work for it inside the company that they work for, and the shareholders should get what they are owed, which is interest on the money they have provided.

Getting this right matters if we want an economy that rewards work fairly. We haven't got that at present. We need to generate it. This means we need to rethink large parts

of our private-sector economics. But this is what Adam Smith really said in 1776. Now is the time to get this right.

That’s what I think. What do you think? Please leave us your comments.

Poll

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