

Where Do Profits Come From?

A ship in harbor is safe, but that is not what ships are for. —John A. Shedd

As we all know, there are three factors of production in any economy and each factor earns its own type of income.

- Land (natural resource) generates income through rent
- Labor (human resource) generates income through salaries and wages
- Capital (capital resource) generates income through interest, dividends and capital gains

But where do profits come from? Your answers might range from entrepreneurs and value, to revenue and customers, and everything in between. But none of those are the true source of profits. The real answer is that profits come from risk.

All business ventures are based on risk. When a business engages in innovation, it's taking a risk; when they test new marketing initiatives, they're taking a risk; when they hire a recent grad for a new position, they're taking a risk. In Italian, the word risk derives from *risicare*, which means "to dare." It implies a choice, not a fate, as Peter L. Bernstein points out in his iconic study, *Against the Odds: The Remarkable Story of Risk*.

In other words, risk is an economic positive. There are five possible responses when confronted with risk: avoid it, reduce it, transfer it, accept it or increase it. And the choice for every entrepreneur should be to accept risks and exploit them.

No Risk, No Profits

A business cannot eliminate risk, because that would eliminate profits. The goal for any business should be to take calculated risks and choose them prudently. However, the dilemma in many companies is that they are allocating a disproportionate share of their resources in perpetuating yesterday and today rather than creating tomorrow. In other words, they're focused on maintaining procedures and the status quo, not on innovating their operations or their offerings.

Consider labor unions, a perfect example of an institution attempting to avoid risk. Talk with union members, and you'll quickly discover that they credit the union for their standard of living. Certainly, they are paid an above-market wage (Milton Friedman has proved this point), receive good benefits, a healthy pension and generous time-off. But have you ever met a wealthy rank-and-file union member? The tradeoff they made for their union compensation package is an artificial ceiling they can never rise above, at least not while employed in a union job, since seniority and other restrictions limit their potential.

Risk avoidance is the antithesis of a successful enterprise. It condemns ventures to mediocrity, perhaps even extinction. Instead, risks need to be weighed against one another; there should be no zero risk or concepts of "acceptable" and "unacceptable" risks. The goal should be to maximize wealth-creating opportunities, not to minimize risk.

Businesses have very sophisticated means of measuring the costs and benefits of risks, but these measures only take place after those risks have already been taken. But the risk occurs only before the event, and it cannot be accurately measured until after it has occurred. If movie studios knew which movies were going to fail beforehand, they wouldn't make them.

The Cost of Not Taking Risks

There's no theory in economics or finance that measures the cost of not taking a risk. Yet it's precisely these losses that cost the most. For a company to be truly innovative, it must not only do new things; it must also stop doing old things. It's impossible to create tomorrow unless one first disposes of yesterday.

Maintaining yesterday is always expensive. The human body has an automatic mechanism to discharge waste, but it appears the corporate body does not; that requires strong leadership and vision, something that's missing from many organizations. Peter Drucker was fond of saying, "Results are achieved by exploiting opportunities, not solving problems. Solving problems only returns the company to the status quo."

The word "profit" comes from the Latin noun *profectus*, meaning "progress," and the verb *proficere*, meaning "to advance." We must always remember that profits, ultimately, are derived from risk taking. And no equation, no matter how complex and intricate, will ever be able to capture the essence of an entrepreneur, an effective executive or a profit-making enterprise with a distinguished purpose that advances progress for society.

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