

## Understanding Profits

A recent correspondent to the *New Zealand Herald*, arguing against operating water and wastewater services on commercial lines, wrote that business has “little concern for society’s needs. Profit is all ... Water services are, in themselves, expensive. To add profit to charges is unforgivable.”

Wow! Where does one start in dealing with common misconceptions about the roles of business and profits?

Contrary to our correspondent, the whole purpose of business is to meet the needs of society. If it did not fulfill a useful role it would disappear. Businesses supply goods and services that consumers want to buy. Consumers dictate what businesses produce; businesses don’t dictate what consumers spend their money on.

In the process, businesses employ people and pay wages. They are also the source of income to savers, such as those who invest through KiwiSaver schemes.

What drives businesses to meet consumers’ needs is the prospect of profits. Profits tell us that a firm’s products are valued by consumers. They signal, in competitive markets with sound regulation, that society’s resources (of land, capital and labour) are being put to good use.

By contrast, losses tell us that a business is wasting resources. Either it is producing things that consumers don’t value sufficiently, or it is producing them inefficiently.

Ongoing losses are no use to anyone – consumers, employees or investors – because the firm won’t stay in business for long,

But what exactly are profits?

The word comes from the Latin meaning “to make progress”. Economists define profit as the difference between the total revenue of a firm and its total costs. All the relevant costs are opportunity costs. Labour and capital used by the firm can’t be used for other purposes at the same time. It’s their value in the best alternative use that establishes their opportunity cost.

People save in various ways, such as investing in government bonds, a bank deposit, a private business or a share in a public company. Returns reflect the riskiness of the investment. With a business, normal profits – the profits needed to attract capital from alternative uses – are the cost of capital.

In competitive markets firms won’t make more than normal profits over time (because rivals will drive them down) and they won’t make less than normal profits or they would go out of business. Alert entrepreneurs may make higher profits for a period – an important incentive for entrepreneurship – but open entry eliminates persistent excess returns.

Profits are not a large fraction of sales in most industries – some 7% net of tax on average. In agriculture net profit is 6.2% of every farm gate dollar. Complaints about ‘profit gouging’ are usually exaggerated.

Water services should meet the cost of the capital they employ (that is to say, make normal profits), just like other utilities such as electricity and gas. If they don’t, capital will be misallocated because it could produce more social value in other uses.

Moreover, if the cost of capital is not reflected in water prices (most councils still use rates to fund water services) water will be under-priced and too much will be consumed or wasted. Excessive investment will be made in water infrastructure, and alternative sources of water, such as harvesting rainwater, will be discouraged. Of course, water should not be over-priced either, so regulatory oversight of prices may be justified.

Our *Herald* correspondent is therefore right to say that water services are expensive – they require much capital investment – but wrong to say that “to add profit to charges is unforgiveable.” Not aiming for normal profits is

economically and environmentally wasteful. The same can be said of not taking wages or other inputs into account in pricing water.

Whether a council-controlled organisation like Watercare in Auckland should pay a dividend to its owners from its profits is a separate decision. Just as the requirement to make a profit has no implications for prices in a competitive market, nor should the issue of whether or not a dividend is paid.

That issue merely concerns what proportion of profits should be retained within the business and what proportion paid out to shareholder-owners. The government rightly insists on a dividend policy for its SOEs in order to strengthen incentives for performance. As a general rule, allowing any business to retain all profits risks creating a fat and lazy balance sheet.

The Local Government Forum, which includes Business NZ, the Business Roundtable, the New Zealand Chambers of Commerce and Federated Farmers, has recommended that a dividend policy for Watercare should be a matter for its board and the Auckland Council.

Profits (and losses) are essential features of a market economy. Attempts have been made to organise productive societies without the profit motive. Communism, a spectacular failure, is the best recent example.

But anti-profit attitudes persist, and can be the source of bad public policies.

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