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How Profit Creates Abundance

HOW PROFIT CREATES ABUNDANCE

Profit is under constant attack: “It’s not fair,” “Profit is greed,” “Profit exploits workers,” “Profit rips-off consumers,” and so on and on and on. Many of the attacks are the result of jealousy and resentment, but not all. Lots of fair minded people fall into the profit-is-bad trap because they don’t understand that profit is the source of abundance. I don't blame them. It is not at all intuitive or clear how profit benefits all parties to a transaction and creates abundance, which I define as the availability of more and more for less and less effort.

It seems that if someone gains — “profits” — from a transaction, someone else must lose. “How can both parties benefit from exchange?” That is a great question, and I'll answer it below.

WHAT IS PROFIT?

Profit is a uniquely human phenomenon that results from free exchange between willing parties who, consciously or not, have bought into the ideas of division of labor and specialization. As Adam Smith said: “No dog willingly exchanged a bone with another dog.” But people do. Well, not bones, but other goods and services. The result of exchange is the undeniable abundance we see everywhere around us: The increases in life expectancy, food, medicine, innovation, leisure time, transportation, electronics, information, labor saving machines, and on and on. There are no resources on earth that weren't here a thousand or even a million years ago, so what happened? Where did all this abundance come from? The answer is “from Profit” which arises from division of labor and specialization.

So how does it work? How can we produce more and more with less and less without stealing time and resources from other people? How can free exchange benefit both parties? David Ricardo, a 19th century British economist, first showed us how it works. I'll borrow from Dr. Matt Ridley of Oxford University and use the simple example of a couple of cavemen entrepreneurs to show how:

If Grog takes 4 days to make a stone axe, and 3 days to make a spear, he will invest 7 days to equip himself with an axe and a spear.

Grog:	
Spear	4 days
Axe	3 days
Grog's total	7 days

If OZ takes 1 day to make an axe and 2 days to make a spear, he will invest 3 days to equip himself with an axe and spear.

Oz:	
Spear	1 day
Axe	2 days
Oz's total	3 days

Grog and Oz together require 10 days to bring 2 axes and 2 spears into the world.

Clearly, OZ is better at making both axes and spears, so maybe he should make both?* No. This is where the benefits of specialization and exchange are not obvious, or at least they weren't to me.

If instead of Oz making both, each man does what he does best, with Oz making 2 axes and Grog making 2 spears, the time required would look like this:

Grog	
1st Spear	3 Days
2nd Spear	3 Days
Grog's Total	6 days (down from 7 days)

Oz	
1st Axe	1 Day
2nd Axe	1 Day
Oz's Total	2 days (down from 3 days)

By specializing, Grog and Oz together require only 8 days to bring 2 spears and 2 axes into the world, which is a savings of 2 days. If they then exchanged products, each would have an axe and a spear and 1 day of saved time. The saved days are both profit to Grog and Oz and an increase in general abundance. Each man has an extra day to work on making more spears and axes, and each would become more efficient at his specialization. The world would benefit** from more and better tools made with reduced labor cost.

The same principles apply to businesses, institutions, countries*** and the global economy. More stuff for less effort is abundance, and the reason we have it is profit arising from exchange, division of labor and specialization. That is how both parties benefit from free exchange and that is why profit is the source of abundance. The world would be better off if we all understood that.

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com

* You may still be thinking that Oz should make everything, after all, if he made two axes and two spears the total time required would be 6 days, a savings of four days. That's true, but Grog would be idle and would have no means to acquire an axe or spear.

**There are other benefits of profit. Abnormally high profits direct time and resources to produce what the market most values. Profit is also the reward that incentivizes the entrepreneurs to accept the inherent risks of business and exchange.

*** A classic Ricardo example involves France and Britain in the 1800s. Although both countries made wine and wool, England was good at wool and bad at wine, France was good at wine and bad at wool. That's why, to this day, nobody talks about "a fine British wine" or "a classic French Tweed."

Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.