Profit
Loss

PROFITS, LOSSES, SUBSIDIES, AND GUARANTEES

Brennan Sorge,
Featured High School Contributer

There are two essential signals in a market economy: profits and losses. Both help the producer better meet the demands of the consumer. Both play an important role, and when they are active, they allow a market to function. Without one or the other, a market would no longer work. When government intervenes and changes these signals, it has the capacity to do great damage.

Without profits or losses, a market would no longer work.

Profits provide signals, or act as a kind of incentive. This is usually an incentive to create something new, or to improve something already in existence. More than that, it is an incentive to make things people want to buy. After all, no matter how motivated the business, companies will find it impossible to make money if no one wants to buy what they're selling. The profit incentive also plays a vital role in stimulating innovation. Unsurprisingly, there are few who will risk their time and effort to innovate out of mere altruism or a career driven passion. Instead, innovators work out of a desire to improve their own financial well-being. These profit seekers will build the latest and best technology in order to "one up" their competitors. By improving the product they offer, or by making their product cheaper, they can sell more, and make a higher profit. When this happens, everyone benefits. Consumers get better, cheaper products to buy, businesses make more money, investors prosper, and our economy grows.

Losses are the flip side of profits. They punish those who are unable or unwilling to innovate. If companies were not punished by losses, they would steadily grow more out of touch with their consumers. Without the threat of losses, innovation would stagnate. If a business (actually, any organization) is secure in its position, with no threat of competition, it will be much less likely to innovate. Government often finds itself in this position, where it has no competition, no threat of losses, and its productivity stagnates.

Profits play a vital role in stimulating innovation.

Businesses that refuse to innovate will feel the mounting costs associated with the lack of new productivity, and will likely see their enterprises shrink as a result. Therefore, we don't want to encourage businesses that refuse to adapt, yet our tax dollars are often spent propping up various failed business models.

Government often has no competition or threat of losses, and its productivity stagnates.

Governments choose to prop up businesses for a number of reasons. Sometimes, the business has an idea that reflects the will of those in power. Subsidies for green energy serve as an example: green energy fits a government agenda, and the promotion of green energy has good public relations value. However, for the sake good public relations, tax dollars will be sacrificed to prop up an entire industry that is not ready for the market place. Without these subsidies, most of that industry would not exist, as it is not yet efficient enough to survive independently. This is because the cost of producing electricity from renewable sources is so much higher than from other sources, it cannot compete without government intervention (US Energy Information Administration, 2015).

Another example has been government guarantees for banks. If a bank is “guaranteed,” it does not have to play by the normal rules of the marketplace. If money is lost in speculative lending, the taxpayer can easily be left to foot the bill. This policy can encourage reckless speculation, as there is no threat that the bank will face any major consequences for its risky behaviour. To guarantee a bank against failure is to send a gambler to the casino on your credit card. The bank can make risky loans and investments, as they are confident that they will not be the ones to pay for losses. Ultimately, when there is little threat of excessive losses, irresponsible decisions are the result. If a bank had to pay for all of its poor investments, it would be much more risk averse in its investment choices (Gropp, Gründl, and Güttler, 2010).

Ultimately, when there is little threat of excessive losses, irresponsible decisions result.

It all boils down to this: whenever the function of either profits or losses as incentives becomes corrupted, there are consequences to the marketplace. Consumers will suffer, the taxpayer will suffer, and in the end, when these distortions are corrected, those who have built businesses and made investments on that distortion will also suffer. Both government and business should look to quickly correct distortions in the system of profits and losses, and avoid government policy that might perpetuate them. If we don't, we will all face the inexorable consequences. C

References

US Energy Information Administration (2015). *2016 Levelized Cost of New Generation Resources from the Annual Energy Outlook 2010*. EIA. <http://www.eia.gov/oiaf/archive/aeo10/electricity_generation.html>, as of June 24th, 2015.

Gropp, Reint, Christian Gründl, and Andre Güttler (2010, April 20). The Impact of Public Guarantees on Bank Risk Taking: Evidence from a Natural Experiment. *VOX*. <http://www.voxeu.org/article/do-public-guarantees-influence-bank-risk-taking-evidence-natural-experiment>, as of June 24th, 2015.

Brennan Sorge is a grade 10 student at the Discovery Centre for Balanced Education in Sun Peaks. Having taken an interest in politics, and economic policy, he hopes to earn a degree in economics as well as law, and then continue into the political arena.