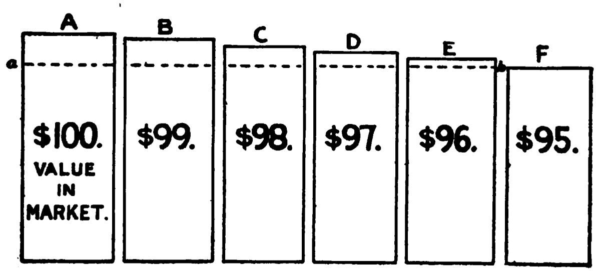
CHAPTER VIII

PROFITS—A GRATUITY

PROFITS may be defined as the remainder of the proceeds of any business operation after all expenses including compensation for management have been paid. That profits thus defined are an unearned gratuity will appear when three questions have been answered, namely, What are the sources of profits? How are they separated from the rest of gross proceeds? And in what form are they received by those who get them?

Profits may be illustrated by a series of parallelograms. In the first use of the illustration a state of competition will be assumed, in the second a condition of monopoly. In any line of production which is open to competition, where enough and only enough is being produced to supply the market demand, there will be some concern just paying expenses and receiving a fair compensation for conducting the business, but will not be securing profits. If more concerns are producing than are required to supply the market at a normal price, somebody is operating at a loss. Suppose six concerns are producing the same commodity and are just filling the demand for it. Let the accompanying parallelograms represent the values produced by these six concerns respectively from the same outlay of capital and labor, which outlay we will call a unit of productive power.

ILLUSTRATING PROFITS



The values produced by the one operating at greatest advantage will then be represented by the parallelogram marked A, and those of one operating under greatest disadvantages by the one marked F. This last we have assumed is just paying all expenses, including compensation for a competent business manager.

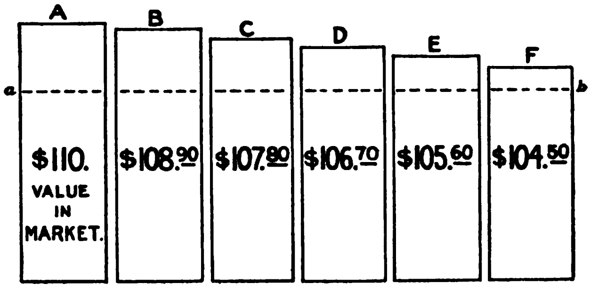
The larger producing power of some of these six establishments in comparison with the others may be explained by fortunate circumstances of location, equipment, and management. Location may be fortunate relative to raw material and to market for finished product, thus reducing freight expenses; fortunate also relative to power and kind of labor needed, thus reducing their cost to its minimum. The concern whose location is favorable may be operating on a large scale, thus securing economy in capital, advantage of purchasing raw material in large quantities, the most effective division of labor, and the advantage of carrying on in connection with a large plant or combination of plants subsidiary and allied processes, making by-products out of what would otherwise be waste, and articles required in the main process which must otherwise be bought from some other concern. This same large establishment may combine with all the other advantages that of being equipped with the best machinery, controlling the latest inventions, etc. Some one of the six concerns may combine all these advantages of location and equipment and produce through use of the same unit of productive power one hundred dollars of value, while another possessing fewer advantages will produce ninety-nine or less, while the one which possesses fewest advantages may produce only ninety-five. If as we have assumed this ninety-five dollars is sufficient to pay due reward for the use of the land, for the use of the capital, and for all the services embraced in our unit of productive power, all value above ninety-five dollars produced by any concern will be profit. While the concern which produces ninety-five dollars of value is just paying all legitimate expenses, the concern which produces one hundred dollars of value makes a profit of five dollars, the portion of parallelogram A above the dotted line, while the one producing ninety-nine secures a profit of four dollars, the profit of each concern being smaller as the value produced by the same unit of productive power decreases.

In order to appreciate the part profits play as a distributing agency it must be borne in mind that the ninety-five dollars, it is assumed, will pay for managing ability as well as every other expense. If a competent manager is fairly compensated out of the ninety-five dollars, whatever he receives above the fair compensation is a bonus, or gratuity which the situation puts into his hands. To show still more clearly that this is a gratuity, let us suppose that the business manager of the establishment where the five dollars profits are secured from every one hundred dollars of value produced dies, and the interests of the business fall to his wife. She now employs a competent man to conduct the business and pays him a specified salary which is considered adequate compensation for his services. He conducts the business along the same lines as it has been conducted on and with equal success, producing $100 of value still, as often as the concern operating under greatest disadvantages produces only ninety-five. The profits are still secured and are handed over to the wife of the former manager. We are not now discussing the right or the wrong of the fact that she receives the profits, instead of somebody else, but are simply saying that profits are a gratuity, and are not earned or produced by the party who receives them. If they were, in this case they could not be received by the woman, who does absolutely nothing towards the production of the values. Before her husband's death he received them. The net proceeds of the business he took to himself, but did not distinguish between profits and compensation for his own services. Now, however, compensation for the same services is distinguished from profits, and the profits go to the lucky woman.

However true it may be that profits result from advantages of location and equipment, it is just as true that the profits of any establishment may be increased by unusual skill in management over and above what they would be in the absence of such management. Managing ability, however, is only one of the many possible sources of profits, and, although it is a very important factor, yet it can not counterbalance every disadvantage. It may not even equal some other factor in importance. Co-operation between the management and the other factors is just as essential to the most capable management as it is to the other factors. The tendency is to attribute success in any business enterprise, especially any noted success, entirely to the skill and sagacity of the business manager. In exceptional cases this is undoubtedly true, but it is just as true that marked successes sometimes result from fortuitous circumstances which the business manager did not produce, or possibly could not even prevent. This seems to be true in a measure, for example in the steel industry, which is making Pittsburg a city of palaces. The situation of Pittsburg relative to deposits of coking coal, of iron ore and natural gas, also to river transportation, together with the forty per cent. ad valorem bonus given by the public in the name of tariff to assist the business manager, produces a combination of circumstances which certainly reduces the difficulty of the manager's job. Again, a manager's job is not so difficult if the people help him by holding their armies ready to prevent anybody else from making the thing he wants to make. This they do when they give him a patent. Neither is the task so difficult if the thing to be produced is some fad, which a fad-crazy public holds itself ready to buy simply because it is a fad and not because it is a thing of beauty or value,—a Teddy bear for example. The business manager deserves reward, often great reward, but the public's tendency is to over-estimate his importance relative to the other factors which contribute to success.

Profits can be increased over and above the amount secured through advantages of location, equipment, and management, by monopolistic power in a field where competition has been fettered or destroyed. Suppose the six concerns represented in our illustration are manufacturing clocks. They form a trust for the sake of controlling the supply. They accomplish their end and raise prices ten per cent. Through this arbitrary increase of price they now receive, in return for the expenditure of the same given amount of capital and labor which they used when competing with each other, the amounts indicated in the several accompanying parallelograms, the portion above the dotted line in each case representing profits, as in our former use of the illustration. Operation under monopoly may use the same land and hence pay the same rent as under a condition of competition; may use the same capital and hence pay the same interest; may employ the same labor and

ILLUSTRATING INFLUENCE OF MONOPOLY ON PROFITS



management, hence pay the same compensation for services. The expenses of operation may be exactly the same as under a state of competition, so that the portion of the accompanying parallelograms below the dotted line will represent the ninety-five dollars of value produced, which in our use of the illustration under competition paid all expenses. The arbitrary increase of prices of ten per cent. must then be so much addition to profits. It has not changed the character of profits, which are still a gratuity to the party who receives them. The public has been mulcted this increase of price in return for the protection it guarantees to the clockmakers. The profits secured are a gratuity to those who get them. Certainly they have not been produced or earned. They have simply been taken.

Still another source of profits on the part of some favored concern is through "rebates" from the railroads, cut-rate prices for the transportation of goods. Suppose for example the railroads charge the Sugar Trust forty cents a barrel for shipping sugar a certain distance while for the same distance they charge the Trust's competitors seventy cents. This means thirty cents a barrel profits for the Trust, since the Trust sells sugar at the same price at which its competitors sell it. The forerunner of the Standard Oil Company, known as the South Improvement Company, had an advantage of this sort of forty cents a barrel on the shipment of oil from the oil-fields to Cleveland. The contract made by the railroads with the directors of this first form of the Oil Trust embraced the following six points: to double freight rates, not to charge them the increase, to give them the increase collected from all their competitors, to make any other charges of rates necessary to guarantee their success in business, to destroy their competitors by high freight rates, and to spy out the details of their competitors' business.

Under this contract the railroads raised the rate from the oil-fields to Cleveland from forty to eighty cents a barrel. When the eighty cents was paid by the Oil Trust, forty of it was paid back to the Trust. When the eighty cents was paid by any of its competitors forty of it was paid over, not to the shipping competitor, but to the Trust. This meant that every time a competitor of the Trust paid the freight on one of its own barrels of oil it also paid the freight on a barrel of the Trust's oil. This was a profit of eighty cents for the Trust over a competitor as often as each shipped a barrel, since they sold in the same market. For shipping oil a certain distance under another contract the railroads charged the Standard Company ten cents a barrel and its competitors thirty-five cents, and then gave the difference of twenty-five cents to the Standard Company as often as any competitor shipped a barrel. Profits secured in this manner are most assuredly a gratuity, for they are not only not produced or earned by those who receive them, but they are the spoils of a species of robbery.

From what has already been said as well as from common knowledge it is evident that the main sources of profits are in advantages of location and equipment, unusual skill in management, monopolistic power, tariff and patent laws, and advantages in transportation. It is also evident that profits are a gratuity, and are a part of total proceeds which must be separated from the rest. This separation is such a common matter-of-course transaction that the manner of doing it is lost sight of, and it is looked upon as perfectly legitimate.

There is nothing which enters or is in any way connected with any business enterprise, which is essential to it, which can not be classified as a natural resource, as capital, or as a service. Land, tools, work—these three produce all results, hence are the only factors that can claim any share of the results. This suggests a division of all results of this co-operation into three parts. In every enterprise the use of natural resources is an absolute necessity and must be paid for. Even if the business demands only an office in the top of a skyscraper, when the user of the office pays the owner of the building for its use, he is at the same time paying his share for the use of the ground under the building which makes the office possible. If for any reason any business enterprise makes use of natural resources for which compensation is not paid, as is often the case with street railroads and other public utilities, that portion of the proceeds which ought to be paid for use of the ground occupied, but is not, is reckoned as profits. Because it is called profits or dividends does not change the fact that it is rent, and ought to be paid as rent. Again, it does not matter whether the user of the natural resource is also its owner or not, a certain portion of the proceeds of the business is compensation for the use of it, and strictly must be considered rent. The important point to be noted here is that in any business enterprise the portion of the proceeds to be given for the use of natural resources is necessary and constant, a definite fixed amount. This fixedness true of rent is also true of interest. Every business enterprise must have capital, and interest on the capital must be secured if the business continues. In case it is borrowed capital the rate is agreed upon between the lender and the borrower, so the user knows at the beginning of the period for which it is borrowed the exact amount which must be paid as interest. If the user happens at the same time to be the owner of the capital, he will count interest on his own capital as a fixed charge exactly as he would if it were borrowed. So it appears that the amount to be taken out of the proceeds for interest will be a necessary fixed sum. This will be true so long as the amount of capital and the rate remain the same. Since the shares of land and capital are fixed, and since gross proceeds are variable, the portion left for labor will be variable, increasing as more is produced and decreasing as less is produced. This will do for theory, but in practice it is not true. Men divide proceeds into four parts instead of three. The fourth share, called profits, being taken from actual values produced, must be drawn from rent, or interest, or compensation due to services, or from all. If all that can be justly claimed as rent and interest has been paid to landlord and capitalist, all that goes as profits must be drawn from compensation due to services. In practical business life landlords and capitalists do get their shares. They would not allow their land and capital to be used if they did not receive a fixed compensation agreed upon and secured by bond and mortgage whenever practicable, or in some other way. Then profits must always be taken out of the portion due to those who do the work, and would always go to them if it were not for the power over division of the proceeds which is secured by control of the land and tools. This control, as has been elsewhere shown, enables the owner or manager through the wage system to make the portion paid for services also a fixed amount, as are rent and interest. When this has been accomplished, any portion of the proceeds left after paying these three fixed amounts and incidental expenses is the unearned gratuity called profits.

In these days of corporations, dividends on stocks are a common form in which men receive profits after these are separated from the rest of total proceeds. "Dividends" is a blanket term including rent, interest, and profits. If a man buys a tenth of the stock of some corporation, he then owns a tenth of all the property of every form which belongs to the corporation. He is a landlord to the extent that he owns a tenth of all the land owned by the company. He is a capitalist to the extent that he owns a tenth of all the company's other property not land used in producing. When he receives a dividend he is paid for the use of his tenth of the land and capital. In other words, he receives rent and interest. If he receives more than a fair or normal compensation for his actual investment he is receiving profits also. In the organization of corporations it is a very common practice to issue an amount of preferred stock which will cover all the actual values owned by the company, and a like amount of common stock which represents no values, but is what is known as "water." If a man buys a block of preferred stock at organization, he often receives a like amount of common. He is confident he will receive dividends on his preferred stock. If the earnings of the concern are sufficient, he will receive a dividend on his common also. If he does, it is pure profit since it represents no investment or sacrifice of any kind on his part.

Two or three illustrations. The total capital stock of the Sugar Trust as reorganized in 1891 is $90,000,000, half preferred, half common. The properties have been variously estimated. In a statement made by the Trust to the authorities of the State of Massachusetts, December 31, 1905, one item of their assets was $35,156,876 for the realty owned by the Trust. This represents the Trust's estimate of the values of its own plants. The other items of assets, cash, accounts receivable, investments, etc., do not represent actual properties as the various plants do, bought and paid for at some time by means provided by individual stockholders, but they represent rather the earnings of the Trust. If we assume that $35,156,876, the Trust's estimate of its realty, represents actual values which have cost that amount, then the whole of the common stock of $45,000,000 and $10,000,000 of the preferred represent "water," and have cost nothing except the paper on which the stock certificates are printed. All dividends paid on this water are a gratuity. A 7% dividend has been paid on all preferred stock since the organization of the Trust in 1887. The dividends on the common since 1891 have ranged from 4% in 1891 to 12%, which was the annual dividend for a period of six years, from 1894 to 1900.[1] The total dividends paid during these six years amounted to about $46,000,000. Of this amount, $10,000,000 were dividends on what appears to be actual investments of real values made by the stockholders, while the remaining $36,000,000 were dividends on nothing. Every time one dollar was paid in dividends for actual investments during this period of six years, more than three and a half dollars were paid in dividends on nothings. All dividends on stocks which cost nothing are called profits. Whatever they are called, they are most assuredly a gratuity.

When the Steel Trust was organized in 1901, the capital stock authorized by its charter was $550,000,000 cumulative preferred, and $550,000,000 common.[1] Nearly

[1] For capitalization and dividends, see Moody's *Truth about the Trusts*.

the whole amount of both kinds was issued at once, the small remainder being held in reserve. About a year later $200,000,000 of the preferred was converted into a like amount of bonds, leaving $350,000,000 preferred. At the time of this conversion the Trust issued $50,000,000 bonds additional to the $200,000,000 issued in payment for the stock, making $250,000,000. This added to the $304,000,000 issued at the time of organization in payment for stock and bonds of the Carnegie Company makes a total of $554,000,000, on which the Trust is paying 5 per cent. interest. They are also paying 7 per cent. dividends on preferred stock, and at present 2 per cent. on the common. On this basis, about $65,000,000 is paid annually to its stock- and bond-holders. Just how much of this is fair and square compensation for the use of real capital it is impossible to say. Various estimates of the values of the properties have been made by those in a position to know. When before the Industrial Commission at Washington, Mr. Byron W. Holt, Secretary of the Tariff Reform Committee of the Reform Club in New York, estimated the Trust's properties to be worth about $300,000,000, or the amount of its bonds, then existing, and said that "all of both kinds of stock is what is commonly called 'water.'" This estimate was given in the spring of 1901, immediately after the formation of the Trust. After this the conversion of $200,000,000 of preferred stock into bonds took place, which resulted in increasing the amount of bonds to $554,000,000. Although Mr. Holt's line of reasoning in arriving at his conclusion is logical and convincing, yet let us assume that the real values of the real properties owned by the Trust is the face value of all bonds issued up to date. This leaves us to conclude, without ground for doubt, that all the stocks both preferred and common are fictitious, that there are no real values behind either not covered by bonds, that the $46,500,000 paid annually as dividends on stocks are not paid as compensation for services, or for real investments in real values, hence are purest profits, a gratuity to some body somewhere in the issue and transfer of bonds and stocks in the history of the Steel Trust and its constituent companies. The man who now holds stock and has paid market value for it is not getting the gratuity. But some other fellow somewhere has sold this stock which cost him nothing and is getting his gratuity in some other form of income. The gratuity is paid whether the man who now owns the Steel Trust stocks gets it or not. If, as we have assumed, the face of the bonds issued by the Trust covers all the real values of all the real properties, it follows that the dividends paid on all stocks roughly measure the total amount of gratuities which are annually being paid to those who somewhere along the line of the development of the Trust and of its constituent companies have reaped the benefit of issuing stocks which represent absolutely no values, but which can be made to pay dividends. The strong probability is that quite a portion of the $27,700,000 paid annually as interest on bonds is also a gratuity. However this may be, the amount of the gratuity is not essential to our discussion. The important point is that such a gratuity is paid in the form of dividends and is commonly considered as profits.

One other excellent illustration of the fact that profits are a gratuity is found in the payment of dividends on fictitious values of railroad stocks and bonds. The chief authority for the figures used here is Senator La Follette of Wisconsin, who has made an extensive study of railroad securities. In his speech made in Congress, April 19, 20, and 21, 1906, Mr. La Follette gave an array of facts and figures, with his authorities for them, which can not be successfully disputed. All the stocks and bonds issued by the various railroads, on which they were paying interest and dividends in 1904, amounted to more than $13,000,000,000. The actual cost of all the railroads was estimated at about $5,000,000,000. This latter sum represents actual values, hence payment of interest and dividends on this amount means payment for actual investments. But interest and dividends are being paid on $13,000,000,000. That is, interest and dividends are being paid on $8,000,000,000 of stocks and bonds which represent no values, hence no real investment, but are "water." If 7 per cent. is a fair compensation for invested capital, $350,000,000 will be fair compensation for all real investments representing values in the railroads of the country. However, according to the returns for 1904, the actual interest and dividends paid to those holding railroad securities for that year was $685,000,000. This means that the public pays in one year, in the form of charges for freight and travel, interest and dividends on fictitious stocks and bonds a sum amounting to the difference between $685,000,000 and $350,000,000, or $335,-000,000. If 7 per cent. is fair return for investment, the railroads are then exacting nearly as much for payment of interest and dividends on fictitious values as on real values. In that case $350,000,000 would be the annual payment on real values, while $335,000,000 would be exacted as payment on fictitious values. The gratuity is the annual payment by the public, in the form of unreasonable prices for freight and travel, of $335,000,000. Many of those who now hold railroad securities are of course not receiving this gratuity for the simple reason that they have paid actual cash for fictitious issues of stocks, but this does not change the fact that the gratuity is paid, and that somebody along the line of issue and transfer of these stocks and bonds is reaping the advantage. If somewhere along this line some man secured a piece of paper called a certificate of stock for nothing and later sold it for a thousand dollars, he "took profit" to that amount. If he invests this thousand dollars at 6 per cent. interest, he is receiving a gratuity of $60 a year, and the public is paying it. He calls it profits.

Although dividends are a very common form in which this gratuity is received, yet it is only one of many ways. Any man who receives for the conduct of an enterprise a salary which is more than an adequate compensation for his services, is receiving a gratuity. Unreasonably large salaries, such as the Steel Trust paid its first president and such as certain insurance and trust companies, banks, and railroads are paying their officials, are out of all proportion to the total earnings of the concerns, and bear no reasonable ratio to the compensation paid to employees of all classes and investors in the same concerns. Unduly large compensation for any service, or for the use of land, or for the use of capital, is such a gratuity. Any compensation for the use of capital not produced or not earned in a fair field with others by the man who receives it, is such a gratuity. Likewise in the case of any compensation for the use of natural resources.

To one who sees that the sources of profits are in advantages of location and equipment, in skill of management which is compensated, in monopolistic powers, in special privileges of patents, franchises, tariff, etc., and who sees how profits are separated from the rest of the gross proceeds, and that all profits properly defined are received in the form of unreasonably large compensation for services of some sort, or in the form of compensation for no services of any sort, to this man profits must appear as an unearned gratuity. As an unearned gratuity, it consists of values produced and earned by somebody from whom they have been taken by society-approved methods.