On companies' microeconomic behavior: profit rate versus economic profit

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Abstract.

Profit-rate maximization leads to use fewer factors —including labor— even if profits are high and it corresponds to shareholders' financial behavior, by contrast to economic-profit maximization which corresponds to shareholders' strategic behavior. This is shown in two steps.

In part 1, two types of firms are considered: those which maximize their net profit, as assumed classically in the microeconomic theory, and those which maximize their profit rate. We compare the behavior of both types of firms by respect to output and price. If the firm is producing, the output (and the input consumption) of a profit-rate-maximizing firm is lower than (or equal to) those of a pure-profit-maximizing firm; the price of output evolves in the opposite way. The demonstration is valid for monopoly (higher price, lower input) and for perfect competition (lower input); in perfect competition with fixed coefficient of capital, the output price loses any role in the equilibrium what implies no coordination. It is also applied to the case where the capital is the total capital engaged (EVA versus ROCE) or where it is the equity (EVA versus ROE) as in part 2.

Part 2 explores how shareholders' behavior may influence companies' objective. Two main cases are examined (leaving aside the questions of corporate governance or agency theory). (i) The "strategic behavior". Strategic or controlling shareholders try to maintain fixed their control rate on firms: they maximize their own net income which includes companies' distributed profit. Hence companies maximize their economic profit. (ii) The "financial behavior". Financial shareholders control the composition of their portfolio, allocating freely their equity capital between firms: they maximize the return on their equity capital. Hence companies are encouraged to maximize their profit rate: they employ less factors, as labor. (iii) The "sleeping-partner" behavior; sleeping shareholders let their equity invested in the firm for a long time, without subscribing to any new issue of shares: they maximize the return on their equity but because of their inertia, they have a small influence on the firm. The combination of these behaviors is considered. As a result, profit-sharing leads to profit-rate maximization and natural selection is in favor of profit-rate-maximizing firms.

JEL classification. L21, D21, D24, D41, D42, G11, M2.
Keywords. Profit rate, Pure profit, EVA, ROE, Shareholder.