

Business Economics: **Microeconomics** for **A2**

2nd Edition

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 **informe**

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Unit 1: **The role of the entrepreneur and the profit motive**

Firms

Firms are defined as business organisations where decisions are made. They are of particular interest to economists because, as business organisations, they are typically engaged in the production of goods and services. In other words, firms combine scarce resources (factors of production) in order to produce a valuable output which satisfies human needs or wants. Factors of production are classified under the headings of land (covering all natural resources), labour (human resources), capital (man made goods for use in producing further output) and enterprise (the entrepreneur who organises the other three resources). These resources are finite in quantity and hence scarce relative to infinite human needs and wants.

Profit

This is the excess of a firm's revenue over its costs. From an economic point of view, cost means the opportunity cost of the factors of production used (i.e. the value of each factor when employed in its next best use).

A money payment for a factor of production will generally be a fairly accurate reflection of its opportunity cost, because this is the minimum payment required to ensure the factor is not lost to another use (often called transfer earnings), and one would not expect a firm to pay more than necessary for a factor's services. Consider, for example, a machine available for hire. Suppose, for the sake of simplicity, that only two firms would like to hire the machine and that it will generate £400 revenue per week for firm A and £300 for firm B. If the rent rises above £300 per week, firm B will drop out of the bidding. We therefore expect firm A to hire the machine, at a rent of marginally above £300 per week. This £300 per week represents the opportunity cost of the machine, as it would generate this sum in its next best use (with firm B).

To find the full economic cost of production we must also include a sum to represent the opportunity cost of factors of production for which no money payment is made. These may be termed **imputed costs**. Consider, for example, the person who gives up a job paying £40,000 per annum in order to set up his/her own business. This £40,000 given up is a real cost of the new business, although no money changes hands to cover this cost.

Accordingly: Economic cost = money cost + imputed cost

The accountant's measure of profit takes into account only money costs such as wages, raw materials and power. Thus, his measure of profit exceeds that of the economist, i.e. when the economic profit is zero, the accounting profit is positive. This is described as a situation in which **normal profit** is made. If revenue were to fall further, it would not be sufficient to cover the opportunity costs of all factors of production. These factors would then, in the long run, move to their next best use. Normal profit, therefore, is the minimum accounting profit required to keep factors of production in their current use. Any profit over and above this level is termed abnormal profit, supernormal or economic profit. For the entrepreneur normal profit represents his/her transfer earnings and abnormal profit represents economic rent.

To summarise:

Accounting Profit = Sales Revenue – Accounting Cost (money cost)

Economic Cost = Accounting Cost (money cost) + Opportunity Cost of the factors of production (imputed cost)

Economic Profit (abnormal profit) = Sales Revenue – Economic Cost

Resources will be attracted to those activities where abnormal profits can be earned.



Question 1.1

A recruitment consultant resigns from his £50,000 per annum position in order to set up his own business. In the process of setting up the new business, he invests £60,000 of his own capital. During the first year, premises are rented for £30,000 while the only other costs are administration (£15,000) and the salaries of two junior consultants (each £25,000). Assume that in a typical year the owner of the new firm would have received £10,000 worth of bonuses in his old salaried job. The annual interest rate is 5%. The revenue of the new business in the first year is £150,000.

- On the basis of these figures, identify the accounting costs and economist's imputed costs of the business.
- Calculate and describe the profit made last year.
- Repeat part (b), using an interest rate of 3%.
- In general, what market conditions must hold for supernormal profit to be made?
(The final part of the question should only be attempted if you have studied the theory of the firm – see Section C.)

The entrepreneur

The entrepreneur is an economic agent who perceives market opportunities and assembles factors of production to exploit them in a firm. In the static, neo-classical economics of perfect competition there is no place for the entrepreneur since it is assumed that there is perfect information and freedom of entry. Following the work of Frank Knight it can be argued that the pure function of an entrepreneur is to deal with uncertainty in the dynamic, imperfect, real world in which profit is a return to uncertainty and entrepreneurship is inseparable from control of the firm in which he operates. The essence of the entrepreneur, therefore, is that he/she is alert to gaps in the market, which others do not see, and is able to raise the finance and resources required by a firm in order to exploit the market that he/she initiates. If successful he/she will make a **supernormal/abnormal** profit that will later reduce to a normal profit, as new competitors are attracted into the market. In this conception, the pure function of an entrepreneur is as a fourth factor of production. Economists have attributed other functions than risk-taking to the entrepreneur: invention; the provision of risk capital and management, for example. Though not part of the pure entrepreneurial function, which is remunerated by profit, all these functions may be embodied in the owner of a small business. His/her remuneration may be made up of rent as an owner of land, interest as a return on capital, a wage or salary for his/her management function, and therefore as a return for his/her labour, and profit as a return for his/her entrepreneurship.

Good recent examples of successful entrepreneurs include Charles Dunstone who founded Carphone Warehouse, Anita Roddick (Body Shop), Richard Branson (Virgin), Stelios Haji-Ioannou (easyJet), Martha Lane Fox (Last Minute.com), Michael O'Leary (Ryanair) and James Dyson the vacuum and washing machine inventor. Most entrepreneurs have found the going tough at times. Trevor Bayliss the inventor of the clockwork radio originally found it difficult to get financial backers for his idea, Freddie Laker's airline collapsed in the early 1980's as did Sophie Mirman's Sock Shop chain in the early 1990's. However, the most successful entrepreneurs of recent years must surely be Sergey Brin and Larry Page who founded the internet search engine 'Google'. In the ten years up to 2008 Google turned itself into the world's biggest media business acquiring YouTube in the process.

Other notable entrepreneurs in recent years are also internet related. In 1995 Pierre Omidyar and Phil Fischner founded e-Bay, and in 2004 Mark Zuckerberg founded the social networking site Facebook which was recently floated on the NASDAQ at \$38 per share.

A recent entrepreneurial success has been Will King with his company King of Shaves. King was made



Fair trade in coffee is an example of social entrepreneurship.

redundant in the early 1990s and started work on a shaving oil product which eased the pain of shaving—something he suffered from. The company grew from strength to strength producing a range of men's toiletries. The King of Shaves brand in 2009 was stocked in approximately 30,000 stores worldwide including the United States, Japan, Australia, New Zealand, Brazil and South Africa. The company's turnover almost doubled between 2007 and 2008.

In the £400m-a-year UK wet razors and blades market, Gillette has an estimated 80% to 85% share. King's company, which sold its first bottle of shaving gel in 1993, now has 10% of the UK market for wet shaving products and has made a small start in what was thought to be an impregnable competitive arena for razors dominated by Gillette and Wilkinson Sword.

One of Britain's most famous entrepreneurs of recent years, James Dyson wants a new generation of entrepreneurs who are inventors. He has warned that Britain is lagging behind its competitors in the field of invention and technology. According to Dyson "the US files 19 times more patents than us, South Korea seven times more, China nine times more – we have stopped inventing things. Pharmaceutical companies are almost the only ones left."

The government introduced the StartUp loans programme in 2012 which is targetted at 18-24 year olds who find difficulties when applying for loans from banks. Typical loans will be about £2,500 with interest charged at inflation plus 3 per cent. The loan will have to be repaid in five years. It is hoped that the scheme will launch 30,000 start-ups.

The government has also lent its financial support to 'peer to peer' lending where small businesses link directly to individuals and organisations with the latter lending money to the former. This enables small high risk ventures to have access to loan finance that would not be provided by the banks.

Social entrepreneurship has been more prominent since the start of the twenty-first century. The social entrepreneur runs firms that tackle social or environmental issues while also attempting to make a profit.

A social enterprise is a business that trades for a social and/or environmental purpose. It will have a clear sense of its 'social mission': which means it will know what difference it is trying to make, who it aims to



help, and how it plans to do it. It will bring in most or all of its income through selling goods or services. And it will also have clear rules about what it does with its profits, reinvesting these to further the 'social mission'.

Social enterprises come in many shapes and sizes from large national and international businesses to small community based enterprises. But they all:

(i) Are businesses that aim to generate their income by selling goods and services, rather than through grants and donations; (ii) Are set up to specifically make a difference; (iii) Reinvest the profits they make in their social mission.

The Big Issue, the Eden Project and Jamie Oliver's restaurant Fifteen which helps socially excluded young people are examples of social enterprises. The Annual Survey of Small Businesses UK estimated in 2010 that there are approximately 68,000 social enterprises in the UK contributing at least £24bn to the economy. Social enterprises are estimated to employ about 800,000 people.

Britain is one of the most attractive countries in which to set up a new business. Researchers at the Legatum Institute, have recently looked at the best countries to become an entrepreneur and these are:

- | | |
|-------------------|--------------|
| 1. Denmark | 6. Norway |
| 2. Sweden | 7. Ireland |
| 3. United States | 8. Singapore |
| 4. Finland | 9. Iceland |
| 5. United Kingdom | 10. Canada |

According to Legatum, to be a good entrepreneurial base a country needs "a strong entrepreneurial climate in which citizens can pursue new ideas and opportunities for improving their lives, leading to higher levels of income and wellbeing." The Legatum researchers looked at entrepreneurial environments, innovative activities and access to opportunity.

Question 1.2

Read the passages on the previous pages before responding to the following:

- Explain the claim that the function of an entrepreneur is risk-taking.
- How is it that there is only a role for an entrepreneur if the market is imperfect?
- "Entrepreneurship is the fourth factor of production". What is meant by this statement?
- There has been much talk in recent years about the development of an 'enterprise culture'. Why might this be considered important?
- Research a well known entrepreneur. In what sense is he or she so?

Why is profit important in a free market economy?

From the preceding analysis it is clear that profit fulfils some important functions:

- It rewards risk takers such as shareholders and entrepreneurs.
- It provides a stimulus to innovation to introduce new products and new production techniques.
- It provides a source of funds for investment and research and development (retained profit).
- It sends signals to potential investors and entrepreneurs because resources are drawn towards the production of goods where profits can be earned. This helps to allocate resources efficiently.