What do Economists Mean by Earning a Normal Rate of Return: A Look at What Principles Textbooks Teach.

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Abstract

The pure competitive market structure teaches that free entry and exit of firms is determined by the rate of return earned by firms at the margin. The number of firms reaches as equilibrium when the last firm earns a normal rate of return. Principles of Microeconomics textbooks are somewhat fuzzy over exactly what is a normal rate of return and how is it calculated. Some textbooks calculate a normal rate of return as the return on investor capital as the return to the entrepreneur. However, suppose an entrepreneur rents all of the capital along with all other inputs. The opportunity cost of the rental rate will be counted as a fixed payment toward the cost of production, similar to labor and other inputs. Where is the return to the entrepreneur to induce him to enter the marketplace? Some textbooks do not even include an entrepreneurial return. The goal of our paper is two-fold: 1 – review Principles of Microeconomics textbooks and see what they say about entrepreneurial ability, 2 – attempt to sort out how these textbooks calculate a normal rate of return consistent with their definition of entrepreneurial ability.

**Introduction**

The pure competitive market structure teaches that free entry and exit of firms is determined by the rate of return earned by firms at the margin. The number of firms reaches as equilibrium when the last firm earns a normal rate of return[[1]](#footnote-1). Lester Thurow in his discussion of Profits in David Henderson’s (2008) Encyclopedia of Economics provides a typical statement of how most principles textbooks view the notion of profit and a normal rate of return.

*“When profits are above the normal level, they attract additional investment, either by new firms or by existing firms. New investment enters until profits are competed down to the same level the investment could earn elsewhere.”*

However, Principles textbooks are somewhat fuzzy over exactly what is a normal rate of return and how is it calculated. Some textbooks calculate a normal rate of return as the return on investor capital as the return to the entrepreneur. Entry or exit of the firm into an industry reaches equilibrium when the entrepreneur earns a normal rate of return on capital or zero economic profits. However, suppose an entrepreneur rents all of the capital along with all other inputs. The opportunity cost of the rental rate will be counted as a cost of production similar to labor and other rented inputs. Where is the return to the entrepreneur to induce him to enter the marketplace? Many textbooks appear to ignore a separate return for entrepreneurship ability though they treat entrepreneurial activity as a separate factor of production. Some view the entrepreneur as some sort of inactive or passive person who is merely responsible for paying for the inputs used in the production process. The goal of our paper is two fold: 1 – Review Principles of Microeconomics textbooks and see what they say about entrepreneurial ability, 2 – to see how these same textbooks come up with a workable definition of a normal rate of return based on their definition of entrepreneurial ability. .

**The Role of the Entrepreneur**

The use of the term entrepreneur was first coined by Richard Cantillion (2001) and later used by Say (1948) as a factor of production. Cantillion used the term to refer to the risk taking inherent in organizing the factors of production. Say emphasized that the entrepreneur was a separate factor of production from land, labor and capital. Hunt et. al. (2011) claim that classical economists viewed the entrepreneur as receiving the profit or residual value as capitalists after paying for the necessary costs of production.

Adam Smith (1976, Chapter 6) discusses and identifies three components of the price of commodities, labor, stock and land. However, he points out that there may be confusion when the same person supplies all inputs.

*“When those three different sorts of revenue belong to different persons, they are readily distinguishable; but when they belong to the same they are sometimes confounded with one another, at least in common language. … The gardener, who cultivates his own garden with his own hands, unites in his own person the three different characters, of landlord, farmer and labourer. His produce, therefore should pay him the rent of the first, the profit of the second, and the wages of the third. The whole, however, commonly considered as earnings of his labour. Both rent and profit are, in this case, confounded with wages. “(I.6.19, 23)*

Similarly, Smith addresses the issue of who manages or directs the production process in his analysis of the overseer.

*“Common farmers seldom employ any overseer to direct the general operations of the far. They generally too work a good deal with their own hands, as ploughman, harrowers, and C. What remains of the crop after paying the rent, …., but pay them the wages due to them as labourers and overseers. Whatever remains, however, after paying the rent and keeping up the stock, is called profit. … The farmer, by saving these wages, must necessarily gain them. Wages therefore, are in this case confounded profit.” (I.6.21)*

Smith acknowledges that a component to production is the effort to oversee the production process and should be rewarded as a component of labor. Payments can be made to a sole proprietor as income, which accounts for labor and entrepreneurial input.

Neoclassical thought viewed entrepreneurs as buying inputs to sell products and earn zero profits. Hunt, et al., uses the term “accidental entrepreneur” to refer to the person who sells the goods. He could be a capitalist supplying his own capital or a laborer who receives wages or a landowner who receives rent. In any case, the product price covers all of the factor payments and the entrepreneur earns zero profits. Later economists would appear to attribute the return on capital as the return to the entrepreneur. John Bates Clark (1965) acknowledges that that the entrepreneur is compensated for “superintending the mill, managing the finances, keeping the accounts, doing all the work of directing the policy of business”. Edgeworth (1967) also refers to the entrepreneurs’ act of supervision. Menger (2007) provides a more detailed role of the entrepreneur as obtaining information about the economic situation, economic calculation, an act of will, and supervision. However, Menger appears to discount the role of risk bearing. Kirzner (1973) sees the entrepreneur as an arbitrager to move markets toward equilibrium. Finally, Shumpeter (1950) refers to the obsolescence of the entrepreneur (they become managers) seeing them more as innovators creating new markets or improving markets through reducing costs or increasing revenues.

While the above description is brief, it covers the essential components of the role of the entrepreneur. We will focus on the basic role of the entrepreneur as the individual who organizes the inputs to produce a product. The entrepreneur spends time hiring and managing the inputs, bears the risk of receiving payment for his efforts, and does all this for some type of return for his efforts. In this sense, the entrepreneur should be seen as a separate factor of production from labor and paid the opportunity cost for bearing the risk of receiving payments and his efforts to manage the production process.

**How is the Entrepreneur compensated?**

Compensation of the entrepreneur is based on his perceived role. For those economists who see the role of the entrepreneur as a passive agent supplying one or more factors of production, the entrepreneur receives a payment for supplying his own input and earns a zero profit. If he supplies his own capital then the interest received is his return and represents a normal rate of return based on the opportunity cost of renting the capital elsewhere. For those economists who see an active role of the entrepreneur, some see no rewards while others view the rewards in terms of supplying labor as the owner of the firm, which includes his labor to produce the good along with his labor to manage the firm.

Perhaps it is easier to see the reward to the entrepreneur by looking at how the firm is organized. Most textbooks spend some time discussing this topic and generally define the three major categories of firm ownership: sole proprietor, a partnership and a corporation. The sole proprietor can be viewed as the entrepreneur, who buys, organizes, directs, and manages the inputs. He also bears the risk of receiving payment for supplying his own factors of production along with his entrepreneurial input. The opportunity cost of supplying his own labor can be broken down into two components; the foregone income of working for another firm as an employee and the income required to compensate him for his entrepreneurial efforts. Suppose the sole proprietor supplies only his own labor to the firm. In this case a normal rate of return will be the amount of payment required to make the entrepreneur indifferent between working for someone else or working for himself. If the sole proprietor also supplies other inputs besides labor, the normal rate of return would have to incorporate the additional income from supplying his own factors such as capital or land rather than renting them to another firm plus the additional risk associated with receiving payment for each input. The same approach would also be applied to a partnership if all partners were active in running the business. In some cases, a partner may not supply labor and supply other inputs. In this case his entrepreneurial return would be the additional income from supplying land and/or capital plus the additional risk that accrues to receiving payment. A corporation, consisting of shareholders, would normally hire a manager to run the firm. The owners would provide incentives to the manager, like stock options and incentive bonuses, to induce the manager to operate in an efficient manner. The manager, is therefore, compensated with income to run the firm plus some incentives to compensate for risk, and the silent owners are compensated supplying capital and accepting risk by stock appreciation.

**How does Zero Economic Profits Equal a Normal Rate of Return?**

For the sole proprietor of a firm, who supplies only labor to the production process and rents all other inputs, there is a return to his labor for working at managing the firm including risk. This return must be high enough to induce him to own the firm rather than work for someone else doing the same type of business. In this sense he earns zero economic profit if he covers the cost of his entrepreneurial efforts. If he also supply’s other factors of production, there must be both an additional payment for the opportunity cost of supplying the factor plus an additional risk of receiving payment associated with their use. This would also be incorporated into his normal rate of return. In other words, using his own factors of production internally carries a return and a risk payment compared to renting them out to another firm. The entrepreneur will only do this if he believes (correctly or incorrectly) that his costs, including the associated risks, are less that that for which he can rent his resources. Similar arguments would cover a partnership or corporation.

**What do Micro Principles textbooks teach?**

We reviewed 25 Principles of Microeconomics textbook (see appendix) to see what they teach about entrepreneurs and entrepreneurial compensation. Our results show that most textbooks introduce the concept of the entrepreneur, though there were some notable exceptions. Most of those texts include a definition of an entrepreneur (16/25), and most listed entrepreneurial efforts as a factor of production (14/25). The entrepreneurial duties were listed as organizing, managing, and directing the other factors of production. Perhaps the best discussion of the role of the entrepreneur is in Skousen (2009) who devotes and entire chapter on the role of entrepreneurship.

However, there appears to be a disconnect when determining the opportunity cost of the entrepreneurial factor of production when calculating the economics costs for a firm. Most textbooks provide numerical examples of how the entrepreneur’s profits are determined (20/25) and define the normal rate of return as zero economic profits (18/25). In most cases these examples define the normal rate of return based on the input contribution of the owner of the firm (19/25). No mention is made of the fact that it is possible to rent capital from other owners like other inputs and still be an entrepreneur. While most textbooks state that the owner of the firm is a residual claimant, there is no risk adjustment to the entrepreneur from using his own capital rather than renting it out to another firm and receiving a fixed payment. Similarly most textbooks that treat the labor supplied by the entrepreneur as an economic cost, only attach the opportunity cost of working somewhere else. There is a clear disconnect between how textbooks define the activities of the entrepreneur and how they assign a cost to the entrepreneurial activity. We found a few textbooks (11/25) that acknowledge the entrepreneurial effort by assigning a labor cost as the opportunity cost of managing another firm. Some separate out this component from the opportunity cost of working somewhere else. One textbook even provided an example of viewing the opportunity cost of the entrepreneur as a fixed cost in the determining short-run cost schedules. Fewer textbooks (5/25) define the entrepreneurial costs as subjective or immeasurable. Overall, the majority of textbooks treat the entrepreneur as supplying capital to the production process and receiving compensation at the opportunity cost, which translates in to a normal rate of return. Zero economic profits are then equal to zero when the entrepreneur covers the opportunity cost of the capital he provided to the firm.

**Concluding Remarks**

Our survey results show that even though the term entrepreneur is introduced in most Principles of Microeconomic textbooks, there is a clear disconnect in identifying his reward for participating in the market process. The entrepreneur’s role of directing/managing inputs and accepting the risk of payment appears to be disconnected when determining the normal rate of return to induce the entrepreneur to participate in the marketplace. A few texts appear to acknowledge a role for managerial efforts but most fail to account for the role of risk in receiving payments for supplying inputs in the production process and being a residual claimant.

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1. Most principles textbooks do not use the term at the margin. This imprecision may be to avoid explaining whether it is the marginal or average firm or the average of all firms with some turnover. [↑](#footnote-ref-1)