The Journal of Private Enterprise 34(3), 2019, 35–42

How Do Principles Textbooks Treat the Return to Entrepreneurship? The Missing Factor

John Estill
San Jose State University

Tom Means
San Jose State University

Abstract
Principles textbooks have improved in incorporating entrepreneurship in theory. However, they still generally lack simple demonstrations of the entrepreneurial input, particularly when teaching the theory of a normal rate of return. Many texts are unclear over the definition of a normal return and its constituent parts. Our paper (1) reviews the theory of the entrepreneurial input; (2) sorts how popular textbooks calculate a normal rate of return consistent with their definition of the entrepreneurial input; and (3) provides a simple numerical example that incorporates the entrepreneurial input, which can be more fully developed in intermediate texts.

JEL Codes: A22, D20
Keywords: entrepreneur, normal rate of return, zero economic profit, principles textbooks

I. Introduction

Going back to the 1980s, economists have commented on how traditional microeconomic principles textbooks have said little about entrepreneurship (Kent 1989; Kent and Rushing 1999). Since then, most textbook authors have added information on entrepreneurs. However, the actual contribution of the entrepreneur in the calculation of profits and a normal rate of return has not generally made this transition.[1] A significant disconnect exists between how textbook authors define the entrepreneur's role and how they explain the actual return to entrepreneurial activity.

Too often, economic principles students exit the course with a complete misunderstanding of the entrepreneur's actual contribution

[1] "Normal rate of return" and "normal profit" are used interchangeably in these texts and represent the same concept. We follow this convention in our paper.

and how one determines the costs necessary for an entrepreneur to make good decisions. Yet entrepreneurship, economic profits, and a normal rate of return are essential topics to understanding a market economy. The failure to address these topics consistently makes it appear that economists are merely waving their hands in presenting these topics in the classroom. Finally, if these topics are not presented adequately at the principles level, one might assume that they are not presented adequately at the intermediate or graduate level, either.

II. The Role of the Entrepreneur and His Compensation

Adam Smith identifies and discusses three components of a commodity's price: 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, is commonly considered as the earnings of his labour. Both rent and profit are, in this case, confounded with wages. (Smith [1776] 1981, I.vi.19, 23, pp. 70–71)

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 farm. They generally too work a good deal with their own hands, as ploughman, harrowers, etc. 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. (Smith [1776] 1981, I.vi.21, p. 70)

Smith acknowledges that a component of production is the effort to oversee the production process and that it 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.

A more contemporary view of the entrepreneur's contribution is "a decision-maker whose *entire* role arises out of his alertness to hitherto unnoticed opportunities" (Kirzner 1973, p. 39, emphasis original). The entrepreneur clearly brings more to the production process than the elements that could be supplied by others, including managers, resource holders, and those who provide capital. These missing elements of risk-bearing and profit recognition must be compensated as well.

We focus on the entrepreneur's basic role as the individual who organizes the inputs to produce a product through risk-bearing and profit recognition. The entrepreneur bears the risk of receiving payment for his efforts as well as a return for his entrepreneurial insight.[2] In this sense, the entrepreneur should be seen as a factor of production separate from land, labor, capital, and management. He requires additional compensation for these entrepreneurial elements.

Assume a sole proprietor who supplies only labor to the production process and rents all other inputs. He receives a return to his labor for managing the firm and accepts the risk of being a residual claimant to the firm's profits. This return must be high enough to induce him to own the firm rather than work for someone else in the same line of business. An entrepreneur earns zero economic profit if he covers the opportunity cost of the resources he rents and if the cost of his entrepreneurial efforts represents a normal rate of return. If he also supplies other factors of production, there must be an additional payment for both the opportunity cost of supplying each factor and the risk of receiving payment, as well as his recognition of this profit opportunity. In other words, using his own factors of production internally carries a return and an entrepreneurial payment compared to renting them from another source. The entrepreneur will only do this if he believes (correctly or incorrectly) that each owned asset provides a profit opportunity in

[2] We concede there are other roles attributed to an entrepreneur. However, seventeen of the textbooks we surveyed used the basic definition we just described.

excess of rented resources. Similar arguments would cover entrepreneurial activity in a partnership or corporation.[3]

III. The Entrepreneur and a Normal Rate of Return

The purely competitive market structure teaches that the rate of return earned by firms at the margin determines their free entry and exit. The number of firms reaches equilibrium when the last firm earns a normal rate of return or profit.[4] Lester Thurow states, "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" (2008, p. 419).

However, principles textbooks are often unclear in the treatment of a normal rate of return and how is it calculated. Some textbooks calculate it as the return on investor capital and conflate this with 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 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 ignore a separate return for entrepreneurial activity, though they treat it as a separate factor of production. Some view the entrepreneur as an inactive or passive person who is merely responsible for paying for the inputs used in the production process. However, a normal rate of return must include the opportunity cost of *all* inputs into the production process, including the entrepreneurial factor—even if that is not easily measured.

IV. A Sample of Textbooks and What They Teach

We compiled a list of twenty-seven currently available and widely used texts.[5] We used six criteria to differentiate the treatment of

---

[3] We focus on the sole proprietorship type of firm since most textbooks assume this type of firm organization in presenting numerical examples of accounting and economic profit.

[4] Most principles textbooks prefer to use the competitive model to show how a firm decides to enter or exit an industry based on its expected return. Similarly, most do not use the term "at the margin." This imprecision may be used to avoid explaining whether it is the marginal or average firm or the average of all firms with some turnover.

[5] This list appears at the end of this article, below the references. To determine what textbooks to include, we researched several sources. We canvassed our own faculty and included all eight texts currently being used. We also asked several

entrepreneurship and the calculation of a normal return (including entrepreneurial profit). From these categories, we built a matrix of outcomes and summarized the results.[6] Our results show that most textbooks introduce the concept of the entrepreneur, with some notable exceptions. Most (eighteen out of twenty-seven) include a definition of an entrepreneur,[7] and a slight majority (sixteen out of twenty-seven) listed entrepreneurial effort as a separate factor of production. The entrepreneurial duties listed included bearing risk and organizing, managing, and/or directing the other factors of production.

However, there appears to be a severe disconnect when determining the opportunity cost of the entrepreneurial factor of production while calculating the economic costs for a firm. Of the twenty-seven textbooks sampled, twenty-two provide numerical examples of how the entrepreneur's profit is determined,[8] and twenty define the normal rate of return as zero economic profit. In most cases (nineteen out of twenty-seven), these examples define the normal rate of return based on the input contribution of the firm's owner.[9] While most state that the owner of the firm is a residual claimant, they provide no adjustment from using his own capital rather than renting it out to another firm and receiving a fixed payment. Similarly, most treat the labor supplied by the entrepreneur as an economic cost and only include the opportunity cost of working somewhere else. They do not include a payment for taking risk or identifying profit opportunities.

Most textbooks do not accurately describe or assign a cost to entrepreneurial activity. Less than a majority (twelve out of twenty-seven) acknowledge entrepreneurial effort by including the cost of working for someone else and including an additional labor cost of

---

major publishers, including Macmillan, Wiley, and McGraw-Hill, for lists of their most popular texts, both locally and nationally. Finally, we reviewed the CourseSmart (now called VitalSource) website for all microeconomics principles texts available for electronic access to instructors.

[6] A summary table of our textbook analysis is available on request.

[7] One identified entrepreneurship as an element of labor.

[8] However, fourteen of the twenty-two texts that have numerical examples do not include any entrepreneurial factor, while one views the payment of this factor as outside of the calculation of a normal return.

[9] Seven of these include all opportunity costs but fail to mention the owner, or they refer only to payment for the owner's capital. Just one text mentions that it is possible to rent capital, like other inputs, from other owners and still be an entrepreneur.

managing or organizing another firm. Only six texts define the entrepreneurial costs as subjective or difficult to measure. Overall, the majority fail to acknowledge the risk-bearing or profit recognition of the entrepreneur. Most fail in providing a consistent connection between how they define the entrepreneur's role and how a normal rate of return is calculated in order to make decisions. This obscures, rather than clarifies, principles students' understanding of dynamic markets.

VII. What Textbooks Should Teach: An Example

One text, the twentieth edition of *Microeconomics: Principles, Problems, and Policies* by McConnell, Brue, and Flynn (2015), provides a better distinction of the entrepreneur's contribution. It offers a numerical example that clarifies a normal return, the various roles an entrepreneur might assume, and an improved demonstration of entrepreneurial and economic profit. In chapter 9, "Economic Costs" (pp. 197–99), the authors describe an entrepreneur who starts his own T-shirt company. In the section "Accounting Profit and Normal Profit," they first explain and subtract explicit costs from total revenue to determine accounting profit. Their example also states that the entrepreneur provides some funds, a location, and labor for the venture. In addition, they estimate a normal return to the entrepreneur for entrepreneurial skills (previously described) that might earn a fixed amount in another endeavor (summarized in table 1).

Table 1. Numerical example of the entrepreneur's contribution

Accounting profit	**$57,000**
Foregone interest	1,000
Foregone rent	5,000
Foregone wages	22,000
Foregone entrepreneurial income	5,000
Total implicit costs	$33,000
Economic profit	**$24,000**

This example uses a fixed value for the foregone entrepreneurial income that, in reality, is hard to quantify. It does, however, demonstrate that the entrepreneurial element requires compensation. This example thus provides a stepping stone to further discussions on the entrepreneurial element either in those principles classes that wish to pursue it or to further development in intermediate microeconomics.

VIII. Concluding Remarks

Our survey results show that even though current textbooks provide a much-improved explanation of the entrepreneur, there remains a disconnect in identifying the entrepreneurial reward for participating in the market process. Some texts acknowledge the costs of various roles an entrepreneur might fulfill, but most do not recognize the opportunity cost of the entrepreneurial element. The entrepreneur's reward for assuming risk and profit recognition is missing when determining the normal rate of return to induce the entrepreneur to participate in the marketplace. However, at least one text, McConnell, Brue, and Flynn, has made strides to correct this deficiency. We hope that others will follow suit.

References

Kent, Calvin A. 1989. "Entrepreneurship as a Concept in Collegiate Principles of Economics Texts." *Journal of Economic Education*, 20 (Spring): 153–64.

Kent, Calvin A., and F. W. Rushing. 1999. "Coverage of Entrepreneurship in Principles of Economics Textbooks: An Update." *Journal of Economic Education*, 30(2): 184–88.

Kirzner, Israel. 1973. *Competition and Entrepreneurship*. Chicago: University of Chicago Press.

Smith, Adam. (1776) 1981. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Vol. 1. Indianapolis: Liberty Fund. Reprint, Oxford University Press.

Thurow, Lester C. 2008. "Profits." *The Concise Encyclopedia of Economics*, ed. David Henderson, 419–21. Indianapolis: Liberty Fund.

Reviewed Principles of Microeconomics Texts

Arnold, Roger A. 2014. *Microeconomics*. 11th ed. Boston: Cengage Learning.

Bade, Robin, and Michael Parkin. 2013. *Foundations of Microeconomics*. 6th ed. New York: Pearson Education.

Baumol, William J., and Alan S. Blinder. 2012. *Microeconomics: Principles and Policy*. 12th ed. Boston: Cengage Learning.

Besanko, David, and Ronald R. Braeutigam. 2014. *Microeconomics*. 5th ed. Hoboken, NJ: John Wiley & Sons.

Case, Karl E., Ray C. Fair, and Sharon M. Oster. 2014. *Principles of Microeconomics*. 11th ed. Boston: Pearson Prentice Hall.

Chiang, Eric P. 2014. *Core Microeconomics*. 3rd ed. New York: Worth.

Cowen, Tyler, and Alex Tabarrok. 2013. *Modern Principles of Microeconomics*. 2nd ed. New York: Worth.

Dolan, Edwin G. 2013. *Introduction to Microeconomics*. 5th ed. Redding, CA: BVT.

Frank, Robert H., and Ben S. Bernanke. 2013. *Principles of Microeconomics*. 5th ed. New York: McGraw-Hill.

Gwartney, James D., Richard L. Stroup, Russell S. Sobel, and David A. Macpherson. 2012. *Microeconomics: Private and Public Choice*. 14th ed. Boston: Cengage Learning.

Gottheil, Fred M. 2014. *Principles of Microeconomics*. 7th ed. Boston: Cengage Learning.

Hall, Robert E., and Marc Lieberman. 2008. *Microeconomics: Principles and Applications*. 4th ed. Boston: Cengage Learning.

Hubbard, R. Glenn, and Anthony Patrick O'Brien. 2013. *Microeconomics*. 4th ed. Boston: Pearson Prentice Hall.

Krugman, Paul, and Robin Wells. 2013. *Microeconomics*. 3rd ed. New York: Worth.

Mankiw, N. Gregory. 2015. *Principles of Microeconomics*. 7th ed. Boston: Cengage Learning.

Mateer, Dirk, and Lee Coppock. 2013. *Principles of Microeconomics*. New York: W. W. Norton.

McConnell, Campbell, Stanley Brue, and Sean Flynn. 2015. *Microeconomics: Principles, Problems, and Policies*. 20th ed. New York: McGraw-Hill.

Miller, Roger Leroy. 2014. *Economics Today: The Micro View*. 17th ed. Boston: Pearson Prentice Hall.

Nicholson, Walter, and Christopher Snyder. 2012. *Microeconomic Theory: Basic Principles and Extensions*. 11th ed. Boston: Cengage Learning.

O'Sullivan, Arthur, Steven M. Shefrin, and Stephen J. Perez. 2014. *Microeconomics: Principles, Applications, and Tools*. 8th ed. Boston: Pearson Prentice Hall.

Parkin, Michael. 2014. *Microeconomics*. 11th ed. Boston: Pearson Prentice Hall.

Ragan, Christopher T. S., and Richard G. Lipsey. 2011. *Microeconomics*. 13th ed. Boston: Pearson Prentice Hall.

Rittenberg, Libby, and Timothy Tregarthen. 2009. *Principles of Microeconomics*. V1.0. Boston: FlatWorld Education.

Schiller, Bradley, Cynthia Hill, and Sherri Wall. 2012. *The Economy Today*. 13th ed. New York: McGraw-Hill.

Skousen, Mark. 2009. *Economic Logic*. 3rd ed. Washington, DC: Capital.

Slavin, Stephen. 2011. *Microeconomics*. 10th ed. New York: McGraw-Hill.

Taylor, Timothy. 2014. *Principles of Economics*. 3rd ed. St. Paul: Textbook Media.