Microeconomics Revision Essay (1) Profits and Resource Allocation

Profit can be seen as a return to risk-taking and entrepreneurship. Simple accounting profit measures the excess of total revenue over total cost. Economic profit takes into account the opportunity cost of funds used to finance the production of an output that might have generated an alternative rate of return had it been saved.

Profit per unit (or the profit margin) = price - average total cost - the extent to which firms can mark-up on cost depends on many factors including the price elasticity of demand and the strength of demand in the market. Profits are maximised when marginal revenue = marginal cost. We can make a distinction between different types of profit (normal, supernormal and subnormal etc)

The neo-classical assumption that dominates orthodox textbook economics is that corporations seek to maximise profits and that potential profits drives the allocation of scarce resources.

**Explain how profits can influence resource allocation:**

Any relevant market(s) can be used in the answer - examiners are looking for clear theoretical explanations and supporting examples drawn from the real world

In the example below, a firm is operating in an imperfectly competitive market. There is an **increase in market demand** (caused by a rise in real incomes or a fall in interest rates).

Higher demand leads to an **increase in market price** and acts as an **incentive** for firms in the market to expand output and employ more factors of production. Factor

![Graph showing the effects of increased demand on profit maximising output and total profit](image-url)
resources flow where the expected rate of return is highest. In markets where demand is growing strongly, the potential rate of return increases and land, labour and capital are committed to that sector. Profits therefore act as a signalling mechanism in the free market mechanism.

If the market is offering supernormal profits, there is an incentive for new suppliers to enter the market in the long run - providing that barriers to entry are not prohibitive. This leads to an increase in market supply.

When market demand falls (for example in a recession) or where factor costs have risen, profitability declines and, in the absence of offsetting factors, lower profits will signal that output needs to fall. Those firms that are making sub-normal profits may decide to leave the market if they cannot make normal profits in the long run. Take some examples from the real world (Psion, ITV Digital etc)

Profits also influence planned capital investment in an industry. Retained profits are the most important source of internal finance for companies wanting to go ahead with major capital projects. If business conditions improve and the expected post-tax rate of return on an investment rises, then the marginal efficiency of capital increases leading to a higher capital investment at each rate of interest.

![Graph showing Investment demand curve](image)

The Investment demand curve shifts when there is a change in:

(a) Business Confidence
(b) The expected growth of demand
(c) A change in the costs of purchasing capital inputs
(d) A change in the taxation on company profits

The apparent volatility of investment demand comes from the unpredictable nature of demand and costs when businesses are assessing potential returns from capital investment projects.

Not all firms seek to maximise profits and decisions about resource allocation taken by the government are rarely driven by the profit motive - public sector capital projects may be undertaken on the basis of a cost-benefit analysis of the social costs and social benefits of a particular project.

The neo-classical assumption of profit maximisation as a basis for resource allocation in the market also assumes that businesses have sufficient information about their costs of production and revenue conditions in their market.
Economies of scale - a fall in long run average costs as a result of the expansion of output in the long run. Scale economies come from the exploitation of increasing returns to scale.

A distinction can be made between internal and external economies of scale - don't spend too long on outlining what these economies of scale are - more important to discuss the welfare consequences / economic efficiency (allocative and productive etc.)

Impact of economies of scale on economic welfare

Clear analysis is required - do not rely on simple supply and demand curves

In the diagram above a business is able to exploit economies of scale by moving onto AC2 from AC1. With a given set of revenue curves, the profit maximising output rises from Q1 to Q2 leading to a rise in output, a fall in market price and an increase in total profits.

Consumer welfare: Might be measured by the level of consumer surplus (clear increase) because of a lower price and higher equilibrium output - an improvement in allocative efficiency

Producer welfare: Producer surplus or profit is a relevant concept to use - higher total profits signify an increase in producer surplus

With internal economies of scale, both producer and consumer welfare can increase at the same time. If businesses move towards the low point of their long run average cost curve, then a market is moving towards productive efficiency. The higher profits created from lower costs might also be reinvested in activities that yield additional
social benefits - for example, higher spending on research and development - leading to potential improvements in dynamic efficiency

Scale economies are likely to be greatest in industries where the ratio of fixed to marginal costs is very high - i.e. where there is great potential for increasing returns to scale (relevant examples to draw on might include pharmaceuticals, software, the major utilities) - indeed a natural monopoly may exist in some industries

**Evaluation**

Will economies of scale always improve consumer welfare?

(1) Mass production might lead to a standardisation of products - limiting effective consumer choice in the market

(2) There are obvious limits to economies of scale - market demand may be insufficient for economies of scale to be fully exploited. Some businesses may be left with a substantial amount of excess capacity if they over-invest in new capital

(3) Businesses may use economies of scale to build up monopoly power in their own market/industry. A growing concentration of market share might lead to a reduction in consumer welfare and higher prices in the long run - leading to a deadweight loss of economic welfare / allocative inefficiency

(4) Economies of scale might be used as a form of barrier to entry - whereby existing firms have sufficient spare capacity to force prices down in the short run if there is a threat of the entry of new suppliers. These economies of scale might therefore make a market less contestable leading to a decline in overall economic efficiency and welfare

The monopoly-competition comparison diagram might be used in this part of the evaluation