2.2. The Role of Profits

"We expect our dinner not out of the goodwill of the butcher, the brewer, or the baker, but out of their care for their own benefit," says Adam Smith in The Wealth of Nations.

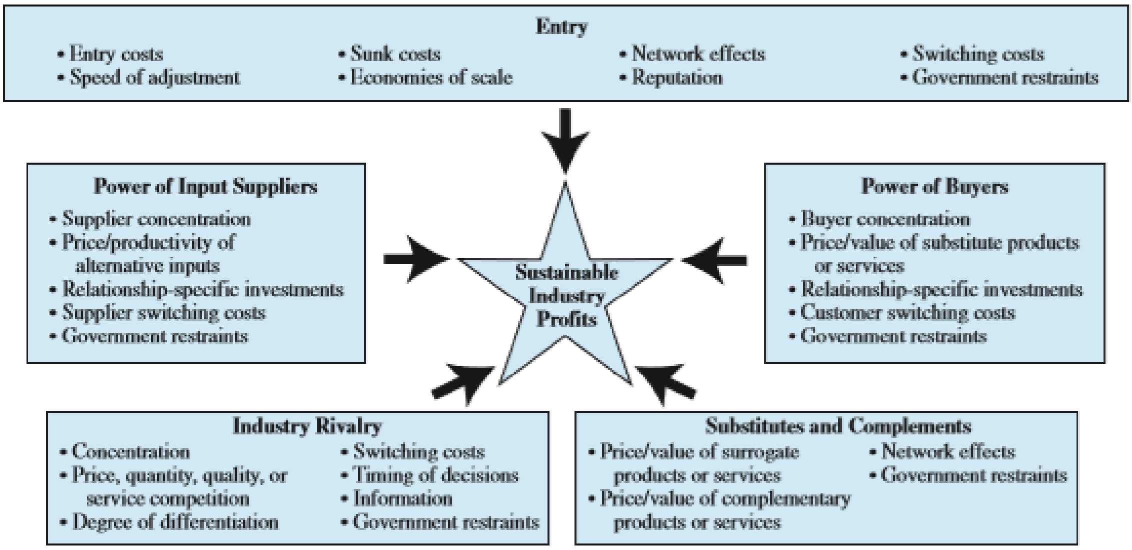
Smith is arguing that a firm's self-interest—the goal of increasing profits—meets society's needs in the end. If you can't make a career as a rock singer, it's probably because society doesn't respect singing; society would regard your talents more highly in another field. If you break five dishes every time you clean up after dinner, you might be better off filing papers or mowing the grass. Similarly, company profits indicate where society's limited resources are best distributed.

When businesses in a given industry profit, the opportunity cost to resource holders outside the industry rises. Other resource owners rapidly understand that continuing to run their old operations will result in a loss of revenue. This encourages new companies to enter markets where they can make money. The industry will grow more competitive as more enterprises enter it, the market price plummets, and economic profits plummet as well. Profits thus indicate to resource owners where their resources are most highly valued by society. By moving scarce resources toward the production of goods most valued by society, the total welfare of society is improved. As Adam Smith first noted, this phenomenon is due not to benevolence on the part of the firms 'managers but to the self-interested goal of maximizing the firms 'profits.

Principle: Profits Are a Signal
Profits signal to resource holders where resources are most highly valued by society.

2.3. The Five Forces Framework and Industry Profitability

Factors that impact industry profitability. “Five Forces” Framework pioneered by Michael Porter



Five categories or "forces" that impact the sustainability of industry profits also known as Porter's f Forces
(1) entry,
(2) power of input suppliers,
(3) power of buyers,
(4) industry rivalry, and
(5) substitutes and complements

Entry

In a wide range of industries, entry increases competition and diminishes existing firms' margins. As a result, current businesses' capacity to make a profit is determined by how entry barriers affect the ease with which new businesses can enter the industry. Entry can occur in a variety of ways, including the development of new businesses.

BARRIERS TO ENTRY

• Entry costs – The more cash required to enter the business, the more difficult it is for a new entrant to succeed.

• Sunk costs - Sunk cost is a cost that cannot be withdrawn or used after it has been paid; it is irrelevant in decision-making; for example, an advance rental payment that cannot be withdrawn or used, or the cost of processing a business permit or government documents when the business will not continue; the higher the sunk cost, the more difficult it is to break into the industry.

• Network effects -Network effects provide incumbents first-mover advantages that are difficult for new entrants to overcome in many industries (including aircraft, electric power, and Internet auction marketplaces).
A network is made up of linkages that connect different sites in geographic or economic space (called nodes).