

Economic Profit¹

Instructional Primer²

Economic Profit

In all of business profit equals total revenue less total expenses, and we know that the greater the profit the greater the level of utility, or happiness, for the owners of the firm. But in economics we think of profit maximizing points in competitive markets where profit is equal to zero³, and this seems like a contradiction at the very least. Why would anyone want to be own and run a business, with all of its attending risks and headaches if the best we can hope for is nothing? Well, obviously economists don't really mean zero profit as in no profit at all. What we mean is zero profit as in no "economic profit" and this brings into question how we calculate profits in respect to economics.

Accountants think of profit as the difference between total revenues and total expenses, which is the same way an economist thinks. Accountants and economists agree on what total revenue is: price x quantity. So the difference lies in what expenses are. Both economists and accountants separate expenses into two categories: explicit costs and implicit costs. Explicit costs are easy to define: we actually pay them. Rent, wages, raw materials, cost of goods sold, utilities, printing, and advertising, etc. are all explicit costs. Implicit costs are a little harder to think about and might be very different depending on the type of business: depreciation is an explicit cost to a business with high capital investment in equipment, technology, etc. A business that expects some spoilage or inventory shrinkage might calculate this as an implicit cost. And some reserve for bad debt might even be included as an implicit cost. Accountants recognize all of these, as do economists, but the economist also want to think about the opportunity cost the business owners, capitalists, investors or entrepreneurs incur when they run the business and this is where accountants and economist start to diverge. If you own a business are you putting time into it beyond that which is recognized by the paycheck you take home, if you even take a paycheck? As an investor/entrepreneur did you put hard earned capital into the business? The answer to both of these questions is almost certainly "yes". So there are resources being used by the business for which there is no explicit cost being paid, but there is certainly an opportunity cost being born. That time on the part of the firm owner and capital on the part of the investors could easily be put to use elsewhere for some sort of financial benefit – if we can credibly identify these opportunity costs, then as economists we want to include them in the implicit costs. They will obviously have an impact on profit when we do so.

Here's an example:

Let assume that Marv's Gym in Tremonton, Utah has total revenues of \$1,600,000 in a given year. Marv put \$1,000,000 into this business and also spends 60 hours a week at the business, but doesn't take a regular paycheck. Like most small business owners, his income is the business's net income for the year, so Marv adds up all the gym's costs and finds the following:

¹ This primer is intended to present an abbreviated discussion of the included economic concepts and is not intended to be a full or complete representation of them or the underlying economic foundations from which they are built.

² This primer was developed by Rick Haskell (rick.haskell@utah.edu), Ph.D. Student, Department of Economics, College of Social and Behavioral Sciences, The University of Utah, Salt Lake City, Utah (2014).

³ A profit maximizing condition in business is where marginal revenue is equal to marginal cost, which yields a zero profit in a competitive goods market. This primer doesn't specifically address this topic; see the Instructional Primer and In-Class Problem titled "Profit Maximization in Competitive Markets: $MR = MC$ "

Revenues		\$1,600,000
Expenses		
Rent	\$120,000	
Salaries	\$700,000	
Utilities	\$24,000	
Phone	\$1,000	
Printing	\$2,000	
Postage	\$2,000	
Equipment purchases	\$260,000	
Supplies	\$50,000	
Advertising	\$300,000	
Depreciation	<u>\$40,000</u>	
Total Expenses		<u>\$1,499,000</u>
Accounting Profit		<u>\$101,000</u>

As economists concerned about the efficient use of scarce resources, we're not satisfied with this figure. Sure, it shows Marv is earning over \$100,000 per year in this business, which is significant, but what resources were used to earn that? In this case, Marv used \$1,000,000 in investment capital and 60 hours a week. We know his investment capital could easily earn the same rate as a treasury bond, let's say 2% annually or \$20,000, and since Marv is a good businessman he could reasonably earn \$100,000 a year were he to put in the same 60 hours a week in someone else's business. So even though Marv may have done what he needs to satisfy the needs of the IRS, he's come up with his accounting profit, he now needs to think about the economic profits from his business.

To do this Marv needs to include the opportunity costs of his time and capital, assuming they were put to use elsewhere in a safe and reliable manner, which in this case is \$120,000, as follows:

Accounting Profit		\$101,000
Opportunity Costs		
Capital	\$20,000	
Time	\$100,000	
Total Opportunity Costs		\$120,000
Economic Profit		(\$19,000)

So Marv realizes that he isn't making quite as much as his accountant had supposed, but he also isn't making nothing. He's earning \$101,000 towards the opportunity costs of his time and capital. Since it's his business he can decide to continue to manage the business as he is and know that he's leaving \$19,000 of potential earnings on the table; maybe he gets enough personal utility by owning the gym and being his own boss that he's satisfied with this, but let's not fool ourselves, the business of business is making money, and in this case he might be choosing personal satisfaction over optimal earnings.

How does this all fit into the zero profit condition? In this case we would say that Marv has a zero economic profit if he's satisfied with only earning \$101,000 toward his time and capital. But as business owners subject to profit maximization in an effort to satisfy our own best self-interests, we'd expect Marv to work to increase his revenues or decrease his expenses such that he would end up with at least a zero economic profit. Were he to manage his business such that he earned a positive economic profit, sometimes referred to as a "super profit", we've have to consider whether or not his firm is truly in a competitive goods market.

If economic profits are positive we must assume that at least one of the assumptions of perfect competition has either been violated or at the very least relaxed such that he's able to continue to charge his customers a price greater than his costs ($MR > MC$).