

## ECONOMIC, ACCOUNTING, AND NORMAL PROFIT

The basic definition of total profit is the difference between total revenue and total cost:

$$\text{Total Profit} = \text{Total Revenue} - \text{Total Cost} \quad \text{TPI} = \text{TR} - \text{TC}$$

Although economists and accountants agree on the meaning of total revenue, the two disciplines have different views about the meaning of total cost. Thus, their calculations of the value of total profit will not be the same.

Accountants consider a firm's costs to be its **explicit costs**. These costs represent outlays or expenditures by the firm for such items as labor, raw material, interest payments, and advertising. Economists consider a firm's costs to be the sum of its explicit costs and its implicit costs, where **implicit costs** represent the opportunity cost to an entrepreneur of using her/his own resources in the firm. Examples of implicit costs include the foregone salary of a job given up to run one's own company, rent that is passed up by the entrepreneur using her/his own building or equipment rather than renting it to some other firm, and foregone interest that results from using one's own money in the running of the firm rather than leaving that money in an interest-generating instrument such as a money market account.

**Accounting Total Profit** = Total Revenue - Explicit Costs

**Economic Total Profit** = Total Revenue - (Explicit Costs + Implicit Costs)

Another type of profit is **normal profit**. A normal profit is a fair return that an entrepreneur can reasonably demand for the use of her/his own resources in the company. Since those resources have alternative uses, the entrepreneur should consider their value if she/he uses them in her/his firm. To not do so would lead the entrepreneur to underestimate the true costs of running the business. The value of normal profit will be equal to the value of implicit costs.

Consider the following examples of a firm's total revenue, total costs, and total profit.

	<u>Total Revenue</u>	<u>Total Explicit Costs</u>	<u>Total Implicit Costs</u>	<u>Total Accounting Profit</u>	<u>Total Economic Profit</u>	<u>Total Normal Profit</u>
1.	\$80,000	\$50,000	\$25,000	\$30,000	\$ 5,000	\$25,000
2.	\$75,000	\$50,000	\$25,000	\$25,000	\$ 0	\$25,000
3.	\$70,000	\$50,000	\$25,000	\$20,000	-\$5,000	\$25,000

A key point is that in the second case where firm's total economic profit equals \$0, the entrepreneur is doing as well as she/he could be doing in her/his best alternative. The entrepreneur in this instance will have \$25,000 (the total accounting profit) left after paying all explicit costs. Because this is exactly equal to the value of the entrepreneur's best alternative use of her/his resources (the implicit costs), the entrepreneur in her/his current occupation is earning zero economic profit. The point is that zero economic profit is not necessarily a sad situation since the entrepreneur does have \$25,000 with which to live. She/he just does not earn more than what she/he could have earned with the resources in their best alternative uses.