

The Normal Profit Vs. An Economic Profit

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Introduction

Normal profit and economic profit are related concepts used to evaluate whether a firm is covering the full opportunity cost of the resources it employs. They should not be confused with accounting profit or with the everyday meaning of “no profit.” Accounting statements normally subtract explicit expenses such as wages, rent, materials, interest, and depreciation from revenue. Economic analysis also subtracts implicit costs: the income or return that owners give up when they use their own time, money, land, or equipment in the business instead of the best available alternative. A firm earns normal profit when revenue covers both explicit and implicit costs, producing zero economic profit. The owners may still receive wages, interest, rent, or an entrepreneurial return embedded within those costs. Economic profit is positive when revenue exceeds the full opportunity cost and negative when it falls short. This distinction helps explain entry and exit, resource allocation, plant size, and long-run competition. The original essay correctly states part of the formula but incorrectly describes implicit costs as out-of-pocket expenses and treats depreciation as a clear example of an implicit cost. Depreciation recorded in accounts is generally an explicit accounting expense, while the implicit cost of owner-supplied capital is the return that capital could have earned elsewhere.

Explicit and Implicit Costs

Explicit costs involve actual payments or contractual obligations. A bakery pays employees, purchases flour, rents space, pays electricity, advertises, and services loans. These costs are recorded in financial accounts and affect accounting profit. Implicit costs do not require a cash payment to another party, but they remain real economic sacrifices. If the owner works full time without paying herself a formal salary, the wage she could earn in her best alternative job is an implicit cost. If she uses a building she owns, the market rent she could receive from another tenant is an implicit cost. If she invests \$200,000 of personal savings, the risk-adjusted return available from the next-best investment is part of the opportunity cost. Implicit cost is not “imputed with no basis.” It is estimated from credible alternatives, though estimation may be uncertain. Economic analysis requires identifying the relevant opportunity and avoiding double counting. A cost already included as an explicit payment should not also be added as an implicit cost.

Accounting Profit, Economic Profit, and Normal

Profit

Accounting profit equals total revenue minus explicit costs. Economic profit equals total revenue minus both explicit and implicit costs. (OpenStax) Suppose a small firm receives \$300,000 in annual revenue and pays \$230,000 in explicit expenses. Its accounting profit is \$70,000. If the owner's labor could earn \$50,000 elsewhere and the owner's invested capital could earn \$20,000 in its next-best use at comparable risk, implicit costs total \$70,000. Economic profit is zero, meaning the business earns normal profit. The owner is not working for nothing: the \$70,000 accounting profit compensates for labor and capital that could have been used elsewhere. If economic profit were \$25,000, the firm would earn more than the opportunity cost of its resources. If it were negative \$25,000, the owner would be economically better off in the identified alternative, assuming the estimates and nonfinancial benefits are accurate. Normal profit is therefore the minimum long-run return needed to keep resources in their present use. It is part of economic cost, not an extra reward added after costs have been covered.

Profit Maximization and the Optimal Quantity

The profit-maximizing output is not generally found by selecting the quantity with the lowest total cost. Producing nothing may have the lowest variable cost, but it may not maximize profit. A firm should compare marginal revenue—the additional revenue from one more unit—with marginal cost—the additional cost of producing that unit. Profit increases while marginal revenue exceeds marginal cost and decreases when marginal cost exceeds marginal revenue, so the standard decision rule is to produce where the two are equal, subject to market structure and shutdown conditions. In perfect competition, marginal revenue equals market price. A firm may continue operating in the short run even while making an economic loss if price covers average variable cost and contributes toward fixed cost. (OpenStax) In the long run, persistent negative economic profit encourages exit because all inputs can be changed. The “optimal plant size” is a long-run capacity decision. Management compares expected demand with long-run average cost, financing, technology, and risk. The plant that minimizes average cost at one output may be too large or too small for actual demand. Profit maximization requires both a production decision and a market forecast.

Fixed, Variable, and Sunk Costs

Fixed cost does not change with output within a defined short-run period. Examples may include a factory lease, insurance, and some salaried administrative positions. A cost is not fixed merely because it cannot be traced to one product; that description concerns common or indirect costs. Variable costs change with production and may include materials, piece-rate labor, packaging, and transaction fees. Many costs are mixed. Electricity can contain a fixed connection charge and a variable usage component, while labor may be fixed for a scheduled shift but variable over a longer

planning horizon. The time period matters because almost every input can change eventually. Sunk costs are historical costs that cannot be recovered and should not determine a forward-looking production decision. A company should not continue an unprofitable project solely because it has already spent heavily on it. Depreciation can represent allocation of an explicit historical asset cost in accounting, whereas the relevant economic decision may depend on the asset's current resale value and alternative use. Precise classification supports better pricing, budgeting, and shutdown decisions.

Market Entry, Competition, and Long-Run Equilibrium

Positive economic profit signals that a firm is earning more than the normal return on its resources. In a competitive market with low entry barriers, that result attracts new firms or expansion. Increased supply tends to reduce price and economic profit. Negative economic profit encourages contraction or exit, reducing supply. Long-run competitive equilibrium is commonly described as zero economic profit, but firms can still report positive accounting profit and compensate owners for time and capital. Economic profit may persist when entry is restricted by patents, regulation, scarce resources, network effects, brand loyalty, scale economies, or specialized knowledge. It can also reflect temporary innovation or unusually effective management. The concept does not imply that every positive economic profit is exploitation or that zero economic profit makes enterprise pointless. It provides a benchmark for whether resources earn more or less than their alternatives. Policy analysis must identify why profit persists before deciding whether competition is weak or the return rewards innovation and risk.

Using the Concepts in Business Decisions

Managers and entrepreneurs should use accounting and economic profit for different purposes. Accounting profit supports financial reporting, taxes, lender analysis, and cash planning. Economic profit supports decisions about whether to enter a market, continue a business, expand capacity, or use assets differently. Estimates should include risk, timing, taxes, financing, and nonfinancial benefits. A family business may accept low measured economic profit because it values independence, location, employment for relatives, or control over schedules. Those benefits are real but should be stated rather than hidden inside an inaccurate cost estimate. Similarly, an owner should not compare a risky business return with a risk-free investment without adjustment. Companies may also use economic value added, which compares operating profit after tax with a charge for capital. No single metric should replace cash flow, liquidity, customer demand, and strategic analysis. A profitable business can fail if cash arrives too late to meet obligations, while a project with early accounting losses may create value if credible future returns exceed opportunity cost.

A further complication is uncertainty. Opportunity costs are estimates of forgone alternatives, so managers should test how the conclusion changes when salary, rental value, demand, or the required

return differs from the original assumption. A business may appear to earn positive economic profit under optimistic estimates and only normal profit under conservative ones. Sensitivity analysis is therefore more informative than presenting one number as exact. The same principle applies to plant capacity: a facility that is optimal at forecast demand may be costly if demand falls. Economic-profit analysis is strongest when assumptions are explicit, alternatives are realistic, and decisions are revisited as market information changes.

Conclusion

Normal profit occurs when a firm covers all explicit and implicit costs and earns zero economic profit. It does not mean that the owners receive no income. Economic profit measures the return above or below the best alternative use of the resources, while accounting profit subtracts only explicit costs recorded by the business. Implicit costs include forgone wages, rent, or investment returns, not ordinary out-of-pocket expenses. Profit-maximizing output is found by comparing marginal revenue and marginal cost rather than simply minimizing total cost. Fixed, variable, sunk, and opportunity costs must also be separated according to the decision and time horizon. These concepts help explain why firms enter, expand, contract, or leave markets. Used carefully, they show whether a business is creating value after compensating every resource for what it could earn elsewhere.

References

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