The Concept of Profit

If you want to be clear when talking about profits, you should not just say "profit."

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The basic concept of "profit" is simple: profit equals revenue minus costs. But "cost" is a complex concept, and "revenue" too is not all that simple, so the economic analysis of "profit" ends up being complicated.

A business typically calculates the appearance of profit rather than the economic reality. Most enterprises use money for purchases and sales, so for accounting, the appearance of profit is easy to understand. The revenue equals the proceeds from sales, and the costs are what is paid for the inputs: wages, rentals, interest, and materials. In economics, this is called "accounting profit," which equals revenue minus the explicit costs, costs paid to others.

But the payments for inputs can include capital goods - inventory, buildings, machines and other tools - that last a long time. If an enterprise buys a machine that lasts for ten years, the cost is really spread out over the duration of the capital good. So in the accounting, rather than treat the purchase as a cost in the year purchased, the cost is the depreciation, the loss of value, in each year. For simplicity, the accounting can depreciate the tool in equal amounts each year, or, following tax laws, it could accelerate the depreciation, deducting more in the first years than the last years. The annual depreciation is an explicit cost, since the original purchase consists of funds paid to others.

This accounting convention ignores the effect of price inflation. Suppose a tool costs $100 and lasts for 20 years. Without inflation, the depreciation would be $5 per year. But if during that time, prices have doubled, it will cost $200 to replace the same tool. In the 20th year, the actual depreciation should be $10, but for the income tax in the USA, inflation is ignored, so the company has to record a $5 expense.

To get the real cost, we have to move from accounting profit, which only subtracts explicit nominal costs (not adjusted for inflation), to economic profit, which also subtracts the implicit costs, those which are not paid in money to others, but are nevertheless real.

The implicit costs include all the "opportunity costs," the costs of giving up next-best opportunities. Suppose you are the sole owner of a business, and your accounting profit is $200,000 per year. Your next best opportunity would be to be employed at another firm for $80,000 per year. Since you give up a $80,000 wage by being self-employed, that is a cost of your business, and in effect you are paying yourself the $80,000 out of your accounting profit.

Suppose also that you own the real estate used by your firm. If you rented, the rental would be $60,000 per year. The opportunity cost of owing your business is the $60,000 you give up if you instead rented the place to a tenant. In effect, your business is paying you as property owner the $60,000 rent from your accounting profit.

Subtract $80,000 and $60,000 from your accounting profit, and your real gain is $60,000. That is the economic profit from your self-owned business.

The same concept applies to corporate profits. Suppose a corporation has an accounting profit of $10 million per year. It owns assets worth $100 million. If the assets were sold and converted into saf the bonds would pay four percent interest, or $4 million annually. That foregone income is subtracted from the accounting profit, for an economic profit of $6 million. The firm obtains $4 million as an asset owner, and $6 million as an enterprise.

Another aspect of profit is honesty. If a thief steals $1000, this is not economic profit. True profit means that the gain came from voluntary enterprise and legitimately owned assets. Gains from force and fraud are not economic profit. From the viewpoint of the whole economy, profit also has to take into account costs imposed on others, such as from pollution. The absence of compensation for damages is really an implicit theft.

Accounting profit can include government subsidies. But since such subsidies are not from voluntary production, they are not included in economic profit, the real gain from production.

Profit can also consist of capital gains. If you buy shares of stock at $1000 and sell them later for $1500 (after paying the broker's fee), the $500 capital gain is profit. If you instead had the $1000 in safe bonds and obtained $100 in interest, that would be the opportunity cost of the capital gain, so the economic profit from the asset is $400.

We can also look at opportunity cost from the point of view of society and the whole economy. The opportunity cost of government spending is what the taxpayers would have spent on. Land has an individual opportunity cost for the owner, but for the economy, land has no opportunity cost. The land is here by nature, and no more can be built or imported. Therefore, for the whole economy, all land rent is economic profit.

Economic profit has three origins. First there is entrepreneurial profit, the economic profit of an entrepreneur, due to his skills, insights, and talents. Second is monopoly profit, the economic profit that comes from a price greater than a competitive price, such as the profit from holding a patent. Third is the gains from asset appreciation.

Profit can be negative and zero. When an enterprise has costs greater than revenues, the loss constitutes negative profit. In a highly competitive industry, economic profits tend towards zero, as firms enter to gain profits and exit to avoid losses. But zero economic profit implies just enough accounting profit to pay for all costs, including normal returns on assets values.

If you want to be clear when talking about profits, you should not just say "profit" but indicate whether you mean accounting profit or economic profit. It gets a bit confusing, because when economists say "profit," they mean economic profit, but when anyone else says "profit," they mean accounting profit. It may be difficult to calculate economic profit, but we need to do it, because economic profit keeps it real.

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Universityhelponline

5 years ago

This is so interesting . Economics is always an interesting subject but many students find difficulty in Economics. But your post might help them

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Harry Pollard

6 years ago

Excellent discussion of profits, Fred. As a Georgist, I don't consider any kind of profit. I would say that production is decided by market clearing (a term that appears to have practically disappeared from modern economics). A producer decides he can get a worthwhile return at existing prices and sends them to market. If they disappear from the shelves, he raises prices. If they stick to the shelves he lowers his prices. If they move well at an acceptable return, he continues production. In other words, production is decided by market clearing.

As you know, Georgists expect only three returns from production - Rent, Wages, and Interest. Profits are simply an accounting term. Also, you have to include inflation in your analysis, but inflation is a political malfunction. A yardstick should not change and money is a yardstick of value. The value of money shouldn't change,

None of this detracts from your first-class description of profits.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary’s commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary’s areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.