What Is Profit?

Fred Foldvary
San Jose State University, ffoldvary@gmail.com

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Basically, profit is revenue minus costs. It sounds simple, but the concepts of "revenue" and "cost" are complex when we examine them closely.

In economics "cost" is not the money one pays for a purchase. If you buy a lunch for $10, the money is not an economic cost, because the exchange of money for food is a gain. You would rather have the food than the money, so the payment generates a benefit not a cost. But the purchase does have a cost—namely, the next best thing you could have bought for the $10.

In economics the forgone item—what you could have done or gotten instead—is called the "opportunity cost." All costs are opportunity costs: what you give up when you do or get something.

Costs come in two categories: explicit and implicit. What accountants and bookkeepers record are explicit costs—that is, payments to others, such as payments for labor, real estate, or supplies. Subtracting those from revenues produces what, in economics, is called an "accounting profit."

But the implicit costs are also real costs, so for economics the accounting profit does not provide the real profit.

Suppose you are self-employed and want to calculate the real gain from your business. Your annual revenue is $500,000, and your explicit costs are $400,000, so you have an accounting profit of $100,000. But your real gain is the economic profit, which is revenue minus all costs, both explicit and implicit.

One implicit cost is the wage you could have earned if you worked for another firm instead of being self-employed. Suppose the highest wage you could earn as an employee is $80,000. That amount is the opportunity cost of self-employment. You give up the $80,000 you could have earned, so it is a cost of business. In effect, you as owner are paying yourself as a worker the $80,000.

Suppose also that you own assets such as machines worth $400,000 in your business. If you sold the business, you could buy bonds that safely pay 5 percent. The $20,000 interest income you could earn is another opportunity cost of your business. The implicit costs are therefore $80,000 plus $20,000, or $100,000. To get the economic profit, subtract the $100,000 implicit cost from the $100,000 accounting profit, leaving an economic profit of zero.

You don't have any real gain from your business that year, because costs equal revenue. That does not imply you should sell the business, because the accounting profit provides you with an implicit wage of $80,000 and an implicit return on assets of $20,000, the same you would get if you sold the business.

We also need to distinguish economic revenue from accounting revenue. Suppose a thief enters a house and steals $1,000 of loot. To break into that house he bought a tool for $100. Ignoring the opportunity cost of his time, the thief's accounting revenue is $1,000, and his cost is $100. Is the $900 net gain a profit in the economic sense?

Stolen loot is not real profit because it is a forced transfer of goods or money from the victim to the thief. True profit is a net gain from production and exchange. If someone gives you a gift of $100, it too is just a transfer.

If instead of directly stealing wealth someone uses the government to forcibly take money from some and give it to others, the gain is also not true profit. Corporate welfare—subsidies, protection from competition, and other forms of transfer seeking—is not an economic gain and should not be included in economic profit.

The existence of real profit implies there has been a productive benefit to society. The entrepreneur has put resources to better use than in his other opportunities. But when gains are due to subsidies and government-protected monopolies, the social opportunity costs are the gains that would have gone to more productive labor and enterprise. These costs need to be subtracted from revenue.

One reason some people have a dim view of profit is that they include gains from looting. After removing forced transfers from profit, what is left are gains that benefit society, not just the entrepreneur. We should celebrate true profit and deplore gains from forced transfers that masquerade as profit. FEE

Fred Foldvary (fred@foldvary.net) teaches economics at San Jose State University.