Quadrant II - Notes

Course Code: ECC101

Module Name: Cost concepts and Costs in the short run

Module No: 44

EXPLICIT AND IMPLICIT COSTS, AND ACCOUNTING AND ECONOMIC PROFITS

From: Openstax Principles of Microeconomics (Chapter 7.1)

Each business, regardless of size or complexity, tries to earn a profit:

Profit = Total Revenue – Total Cost

Total revenue is the income the firm generates from selling its products. We calculate it by multiplying the price of the product times the quantity of output sold:

Total Revenue = Price × Quantity

We will see in the following chapters that revenue is a function of the demand for the firm's products.

Total cost is what the firm pays for producing and selling its products. Recall that production involves the firm converting inputs to outputs. Each of those inputs has a cost to the firm. The sum of all those costs is total cost. We will learn in this chapter that short run costs are different from long run costs.

We can distinguish between two types of cost: explicit and implicit. Explicit costs are out-of-pocket costs, that is, actual payments. Wages that a firm pays its employees or rent that a firm pays for its office are explicit costs. Implicit costs are more subtle, but just as important. They represent the opportunity cost of using resources that the firm already owns. Often for small businesses, they are resources that the owners contribute. For example, working in the business while not earning a formal salary, or using the ground floor of a home as a retail store are both implicit costs. Implicit costs also include the depreciation of goods, materials, and equipment that are necessary for a company to operate. We will cover an example shortly.

These two definitions of cost are important for distinguishing between two conceptions of profit, accounting profit, and economic profit. Accounting profit is a cash concept. It means total revenue minus explicit costs—the difference between dollars brought in and dollars paid out. Economic profit is total revenue minus total cost, including both explicit and implicit costs. The difference is important because even though a business pays income taxes based on its accounting profit, whether or not it is economically successful depends on its economic profit.

Example

Consider the following example. Fred currently works for a corporate law firm where he earns $125,000 per year. He is considering opening his own legal practice, where he expects to earn $200,000 per year once he establishes himself. To run his own firm, he would need an office and a law clerk. He has found the perfect office, which rents for $50,000 per year. He could hire a law clerk for $35,000 per year. If these figures are accurate, would Fred's legal practice be profitable?

First, let us calculate revenue. This is simple as it is given to us. Fred will earn $200,000 worth of revenue (as stated in the problem.)

Next, let us calculate the explicit costs. These are the actual outlays of money. In this example, Frank is spending $50,000 per year on rent and $35,000 on a law clerk. This means that the total explicit cost is $85,000.

Therefore, his accounting profit, which is revenue minus explicit cost, is

$$\text{Accounting Profit} = \$200{,}000 - \$85{,}000 = \$115{,}000.$$

However, we are ignoring the fact that Fred has to leave his job to start his own firm. This is where implicit costs come in to play. Fred does not have to pay to leave. Instead, he is giving up the ability to earn his salary. In this example, the implicit cost is $125,000, which is the salary he is giving up to start the firm.

Therefore, his economic profit, which is revenue minus explicit cost minus implicit cost, is

$$\text{Economic Profit} = \$200{,}000 - \$85{,}000 - \$125{,}000 = -\$10{,}000.$$

Fred would be losing $10,000 per year. That does not mean he would not want to open his own business, but it does mean he would be earning $10,000 less than if he worked for the corporate