

AQA Economics A-level **Microeconomics**


Topic 4: Production Costs and Revenue


4.7 Profit

Notes


 Profit is the difference between total revenue and total costs.


The difference between normal and abnormal (supernormal) profit


 **Normal profit:** Normal profit is the minimum reward required to keep entrepreneurs supplying their enterprise. It covers the opportunity cost of investing funds into the firm and not elsewhere. This is when total revenue = total costs ($TR = TC$). Normal profit is considered to be a cost, so it is included in the costs of production.


 **Supernormal profit:** Supernormal profit (also called abnormal or economic profit) is the profit above normal profit. This exceeds the value of opportunity cost of investing funds into the firm. This is when $TR > TC$.


The role of profit in a market economy

 In a free market economy, profit is the reward that entrepreneurs yield when they take risks and make investments.

 An entrepreneur wants to avoid loss and gain profit, which makes them want to innovate, so they can reduce their production costs and improve the quality of their products. Entrepreneurs seek to maximise their profits.

 Profits can be retained, so they are kept within the firm and not given to shareholders as dividends. This can be a source of finance for firms if they choose to make an investment. It helps them avoid the costs of interest payments if they borrow money.

 Profits can also act as a signal to firms and consumers. For example, in markets where firms make supernormal profits, there are likely to be new firms entering the market since the market seems profitable. This increases market supply and lowers the market price. This assumes the market is contestable and there are no (or low) barriers to entry.

 Scarce economic resources generally flow where rewards to investment are higher. The factors of production are used in markets where the rate of return is higher.