Edexcel (A) Economics A-level

Theme 3: Business Behaviour & the Labour Market

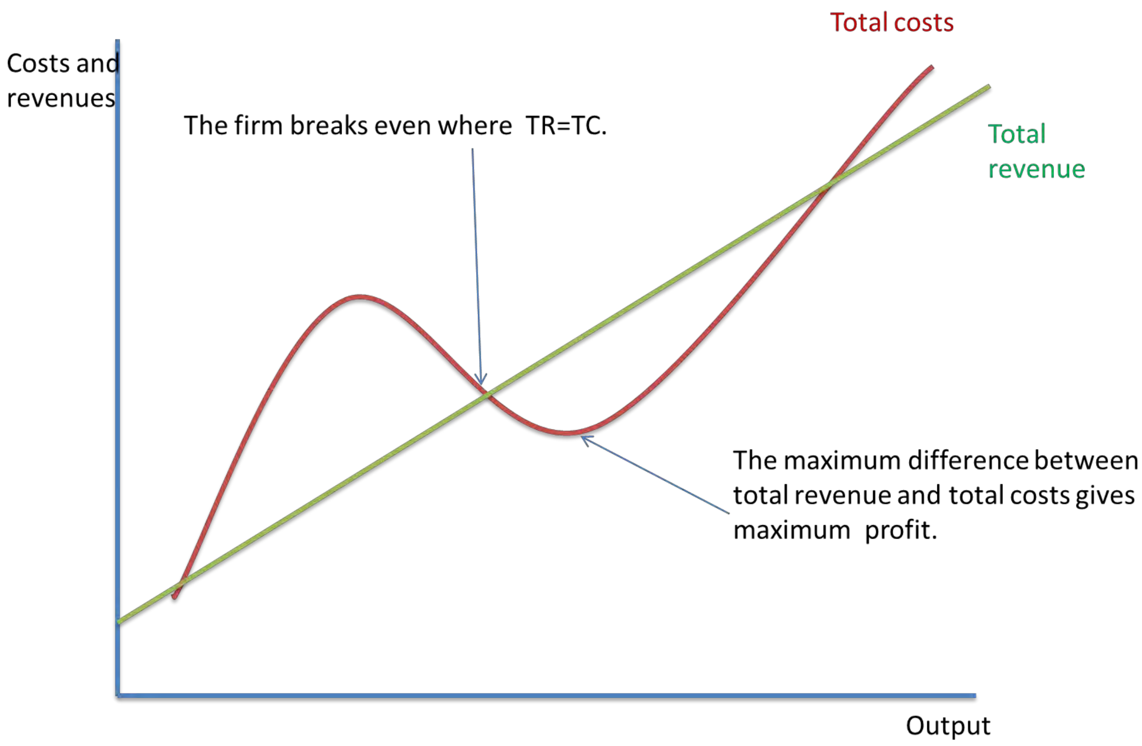
3.3 Revenue Costs and Profits

3.3.4 Normal profits, supernormal profits and losses

Notes

Condition for profit maximisation:

- Profit is the difference between total revenue and total cost. It is the reward that entrepreneurs yield when they take risks.
- **Profit maximisation** occurs when marginal cost = marginal revenue (MC = MR). This is so that each extra unit produced gives no extra loss or no extra revenue.

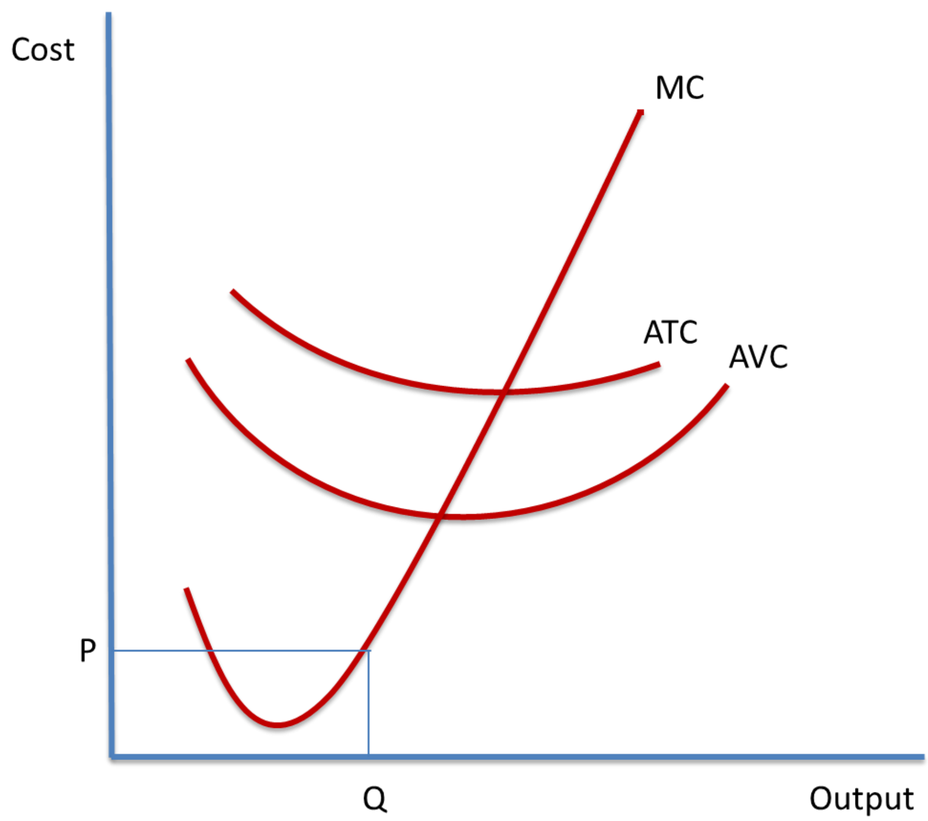


Normal profit, supernormal profit and losses:

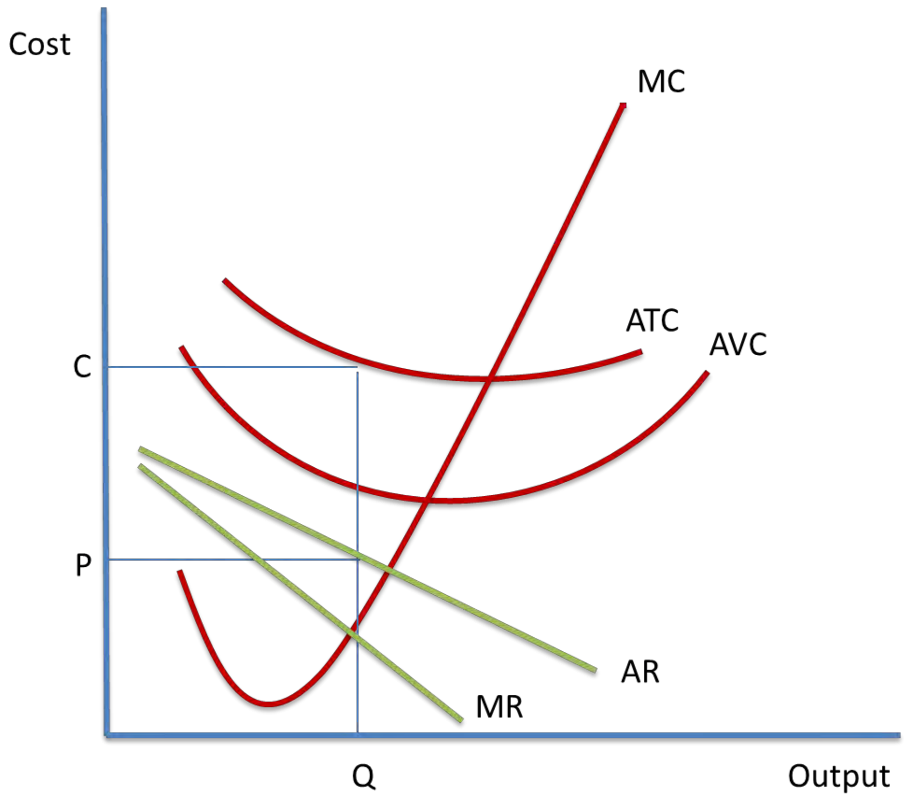
- **Normal profit:** Normal profit is the minimum reward required to keep entrepreneurs supply their enterprise. It covers the opportunity cost of investing funds into the firm and not elsewhere. This is when total revenue = total costs (TR = TC). Normal profit is considered to be a cost, so it is included 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.
- **Losses:** A firm makes a loss when they fail to cover their total costs.

Short-run and long-run shut down points:

- A firm which profit maximises continues to operate in the short run if P > AVC. This means firms continue to produce in the short run as long as variable costs are covered.
- When shutting down, no variable costs are incurred by the firm. However, fixed costs have to be paid whether the firm shuts down or continues to produce. This means that fixed costs are not considered when a decision to shut down is being made.
- The shut-down point is P < AVC, when variable costs cannot be covered. This is at the lowest point on the AVC curve.
- When a firm shuts down, it is a short run decision. This means production is only temporarily stopped. However, in the long run, the firm can leave the industry. This will happen when TR < TC.



- In the diagram, price is below AVC. Therefore, producing Q costs (AVC) more than the revenue they earn (P), so in the short run, the firm shuts down.



- This diagram shows how the revenue curves lie below the cost curves. Therefore, P < C. The rectangle formed shows the area of loss. At a price of P and an output of Q, the firm would shut down in the short run.