7.1: Explicit and Implicit Costs, and Accounting and Economic Profit

Skills to Develop

- Explain the difference between explicit costs and implicit costs
- Understand the relationship between cost and revenue

Private enterprise, the ownership of businesses by private individuals, is a hallmark of the U.S. economy. When people think of businesses, often giants like Wal-Mart, Microsoft, or General Motors come to mind. But firms come in all sizes, as shown in Table 7.1. The vast majority of American firms have fewer than 20 employees. As of 2010, the U.S. Census Bureau counted 5.7 million firms with employees in the U.S. economy. Slightly less than half of all the workers in private firms are at the 17,000 large firms, meaning they employ more than 500 workers. Another 35% of workers in the U.S. economy are at firms with fewer than 100 workers. These small-scale businesses include everything from dentists and lawyers to businesses that mow lawns or clean houses. Indeed, Table 7.1 does not include a separate category for the millions of small "non-employer" businesses where a single owner or a few partners are not officially paid wages or a salary, but simply receive whatever they can earn.

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>Firms (% of total firms)</th>
<th>Number of Paid Employees (% of total employment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>5,734,538</td>
<td>112.0 million</td>
</tr>
<tr>
<td>0–9</td>
<td>4,543,315 (79.2%)</td>
<td>12.3 million (11.0%)</td>
</tr>
<tr>
<td>10–19</td>
<td>617,089 (10.8%)</td>
<td>8.3 million (7.4%)</td>
</tr>
<tr>
<td>20–99</td>
<td>475,125 (8.3%)</td>
<td>18.6 million (16.6%)</td>
</tr>
</tbody>
</table>

Table 7.1: Range in Size of U.S. Firms (Source: U.S. Census, 2010 www.census.gov)

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<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>Firms (% of total firms)</th>
<th>Number of Paid Employees (% of total employment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>100–499</td>
<td>81,773 (1.4%)</td>
<td>15.9 million (14.2%)</td>
</tr>
<tr>
<td>500 or more</td>
<td>17,236 (0.30%)</td>
<td>50.9 million (49.8%)</td>
</tr>
</tbody>
</table>

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

\[ \text{Profit} = \text{Total Revenue} - \text{Total Cost} \]

Total revenue is the income brought into the firm from selling its products. It is calculated by multiplying the price of the product times the quantity of output sold:

\[ \text{Total Revenue} = \text{Price} \times \text{Quantity} \]

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

We can distinguish between two types of cost: explicit and implicit. Explicit costs are out-of-pocket costs, that is, payments that are actually made. 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 already owned by the firm. Often for small businesses, they are resources contributed by the owners; for example, working in the business while not getting a formal salary, or using the ground floor of a home as a retail store. Implicit costs also allow for depreciation of goods, materials, and equipment that are necessary for a company to operate. (See the Work it Out feature for an extended example.)

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 \( \PageIndex{1} \): Calculating Implicit Costs

Consider the following example. Fred currently works for a corporate law firm. He is considering opening his own legal practice, where he expects to earn \( \$(200,000) \) per year once he gets established. 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. A law clerk could be hired for \( \$(35,000) \) per year. If these figures are accurate, would Fred's legal practice be profitable?

**Step 1:** First you have to calculate the costs. You can take what you know about explicit costs and total them:

\[
\begin{array}{c c c}
\text{Office rental:} & \$50,000 \\
\text{Law clerk's salary:} & \$35,000 \\
\hline
\text{Total explicit costs:} & \$85,000
\end{array}
\]

**Step 2:** Subtracting the explicit costs from the revenue gives you the accounting profit.

\[
\begin{array}{c c c}
\text{Revenues:} & \$200,000 \\
\text{Explicit costs:} & \$85,000 \\
\hline
\text{Accounting profit:} & \$115,000
\end{array}
\]
But these calculations consider only the explicit costs. To open his own practice, Fred would have to quit his current job, where he is earning an annual salary of $125,000. This would be an implicit cost of opening his own firm.

**Step 3:** You need to subtract both the explicit and implicit costs to determine the true economic profit:

\[
\begin{align*}
\text{Economic profit} &= \text{total revenues} - \text{explicit costs} - \text{implicit costs} \\
&= \$200,000 - \$85,000 - \$125,000 \\
&= -\$10,000 \text{ per year}
\end{align*}
\]

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 firm.

Implicit costs can include other things as well. Maybe Fred values his leisure time, and starting his own firm would require him to put in more hours than at the corporate firm. In this case, the lost leisure would also be an implicit cost that would subtract from economic profits.

Now that we have an idea about the different types of costs, let’s look at cost structures. A firm’s cost structure in the long run may be different from that in the short run. We turn to that distinction in the next section.

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### Key Concepts and Summary

Privately owned firms are motivated to earn profits. Profit is the difference between revenues and costs. While accounting profit considers only explicit costs, economic profit considers both explicit and implicit costs.

### References


### Glossary

- **accounting profit**: total revenues minus explicit costs, including depreciation
- **economic profit**: total revenues minus total costs (explicit plus implicit costs)
- **explicit costs**: out-of-pocket costs for a firm, for example, payments for wages and salaries, rent, or materials
- **firm**: an organization that combines inputs of labor, capital, land, and raw or finished component materials to produce outputs.
**implicit costs**

opportunity cost of resources already owned by the firm and used in business, for example, expanding a factory onto land already owned

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**private enterprise**

the ownership of businesses by private individuals

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**production**

the process of combining inputs to produce outputs, ideally of a value greater than the value of the inputs

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**revenue**

income from selling a firm’s product; defined as price times quantity sold

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**Contributor**

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