

## 3.3.4 Normal profits, supernormal profits and losses

- Condition for profit maximisation
- Normal profit, supernormal profit and losses
- o Short-run and long-run shut-down points: diagrammatic analysis
- Profit: 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. This is where the gap between TR and TC is the biggest and where their gradient is the same.
  - At a lower output there is more profit to be made from increasing output therefore the marginal profit is greater than zero
  - At a higher output there is a loss from increasing output any more
- 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 average revenue = average costs. Normal profit is considered to be a cost, so it is included in the costs of production. It depends on the level of risk involved and the other investment opportunities available. It doesn't act as a signal for new firms
- 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. A firm doesn't necessarily shutdown when it makes a loss.
- 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.



- There are costs to a firm of closing down equal to the fixed costs which can't be redeemed. Total fixed costs represent the maximum loss a company can face before shutting down.
- In the long-term all factors are variable so AFC+AVC must exceed AC (shutdown point)
- In the short-term the shutdown point is where AVC>AR
- Short-run profit maximisation implies a firm will continue producing even if it is not fully covering its total costs
- 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.