

### The Quest for Profit and the Invisible Hand

“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard of their own interest. We address ourselves not to their humanity, but to their self-love, and never talk to them of our necessities, but of their advantage.” (Smith, *Wealth of Nations*, II)

#### Assignment, Due October 13

Find a News Analysis Article that concerns the efficiency of some Health Care proposal. Paste a copy of the article in your course journal. Write a 200 word essay in which you used course concepts associated with economic efficiency to interpret the article. Paste a copy of the essay in your journal.

#### Journals will be collected on October 13 and reviewed.

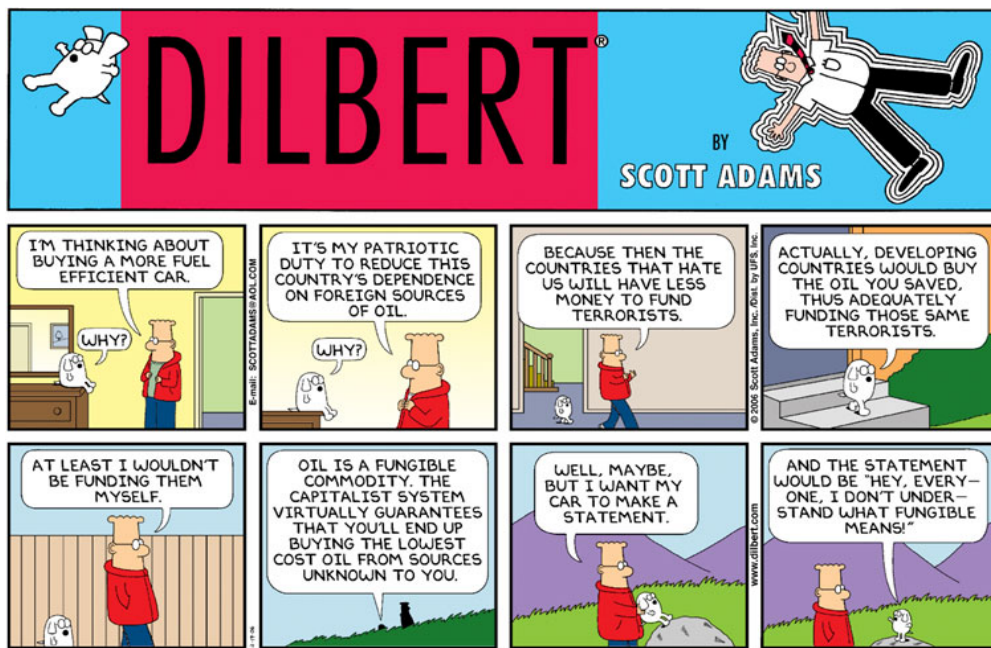
1. The economic definition of profit is different from the accounting definition of profit. The accounting definition counts only explicit costs when it calculates profit. The economic definition counts both explicit costs and the opportunity cost of the owner’s time and property when it calculates profit.
  - a. Accounting Profit = Total Revenue - Total Explicit Cost
  - b. Economic Profit = Total Revenue - Total Explicit Cost - Normal Profit
  - c. Normal Profit is the opportunity cost of resources supplied by the owners of the firm including the opportunity cost of their time.
  - d. Example

John Jones owns and manages a café in Chapel Hill whose weekly revenue is \$5,000. Weekly expenses are as follows

Item	Amount
Labor	2,000.
Food and Drink	1500.
Electricity	100.
Vehicle Lease	150.
Rent	500.
Interest on Equipment Loan	50.

- i. What is John’s accounting profit?
- ii. John could earn \$300.00 per week working as a shift manager of Foster’s Market. What is John’s economic profit per week?
- iii. John uses a gift from his Uncle to pay off the loan on his café equipment. How does John’s decision affect his economic profit?
- iv. Suppose everything remains the same except that Sarah Foster decides to open a new store and offers John \$1000 per week as store manager. Is the café still making an economic profit?
- v. Suppose now that John likes being his own boss. He would prefer running the café and receiving \$200.00 per week to working for Sarah Foster at \$1000.00 per week. Is the café making an economic profit?

2. Profit and the Invisible Hand
  - a. Profit motivates individuals to provide goods and services that members of society would like to consume and use.
  - b. Competition among individuals tends, over the long run, to reduce profits to normal economic profit levels.
    - i. Competition works best to reduce profits to normal levels (and reduce economic profit to zero) in markets where there is free entry.
    - ii. Owners of profitable firms have very strong incentives to block entry to the markets where they make profits. We will study strategies that firms use to block entry a bit later in the course.
  
3. Economic Rent is not profit. It is that part of a payment for a factor of production that exceeds the owner's reservation price for that factor.
  - a. Scott Adams loves to draw and has created a well liked cartoon series called Dilbert. When he started out, Scott earned \$3,000 per month drawing Dilbert for subscribing newspapers. Dilbert became popular and now Scott earns \$10,000.00 per month drawing Dilbert. Is Scott Adams receiving economic rent or profit?



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- b. Mario leases twenty five acres of vineyard from Gianpiero in Tuscany. With the grapes he grows, Mario makes a "single estate" Brunello wine. At first, Mario and his product were little known and Mario made just enough profit to be willing to keep making wine. Then, wine critic Robert Parker gave Mario's Brunello a very high rating. The price of Mario's Brunello went from \$25 to \$60 per bottle. Will Mario or Giampiero benefit from the price increase?