DOWNLOAD PDF ECONOMICS OF THE FIRM

Chapter 1 : The Firm And Its Presence Economics Essay

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Originally Published September 20, What is a firm? This may not seem like a question in lack of an answer. In the United States, as in most other countries, it is a registered, regulated entity acting legally as a person. But economically, the legal definition is irrelevant: So could there be firms without corporate law? The answer is obvious: Indeed, one can easily argue that corporate law is primarily about government taxation and regulation of the market â€" and defines the firm only as a means toward these ends. Consequently, the economic question remains, and it necessarily includes the "where," "how," and "why" of the business firm. How can one economically define what a firm is? What, from an economic point of view, is a business firm? The questions may seem foreign, but economics has not been able to find very good answers to them, neither historically nor in contemporary theory. The economic question of the firm is old. Adam Smith discussed firms in The Wealth of Nations and established that they, in the sense of "manufactures," were more efficient in producing than individual, self-employed craftsmen and labor workers. But he quickly moved on to discuss other economic issues instead of elaborating on this analysis which, by the way, was heavily criticized by Rothbard. Generations later, Karl Marx wrote in Das Kapital about the Smithian kind of manufactures and how they establish and exploit the more intense division of labor. Of course, he finds the manufacture and the division of labor highly problematic, since the individual worker is separated from the end product and therefore is "alienated" through work performed within the manufacture. Marx was obviously not very interested in the economic analysis â€" division of labor increases productivity and increases prosperity for all individuals involved as well as society as a whole â€" and so focuses solely on the problem he identifies. A few decades later, the sociologist Emile Durkheim wrote a whole treatise on the division of labor and â€" characteristically difficult to read â€" defines its constitution and limitations. He also connects the division of labor to the structure of society and theorizes about its utilization and distinct types in towns and rural areas. The conclusion is that towns have greater density, which makes it easier to trade, because potential trading partners, as well as products to trade, are closer at hand. Durkheim focuses on the limitations of the division of labor as it was famously defined by Smith in the phrase, "the division of labor is limited by the extent of the market. About the same time as Durkheim, Marshall authored his magnum opus, Principles of Economics , which laid a foundation for neoclassical economics. Marshall also talked abstractly about how industries and market structure can be analyzed in terms of "representative firms," which are simplified representations ideal types of firms. Adopting this perspective or the common interpretation thereof allows for analytical precision, but at the same time does away with existing differences between real firms. In direct contrast to the Marshallian analysis, E. Robinson analyzed the firm in terms of the division of labor in his book The Structure of Competitive Industry Robinson continued the Smithian analysis of firms as constituting a more intense division of labor, and attempted to identify the "optimal size" of firms in the market. He recognized that small firms tend to have a single general manager, while larger firms often employ an increased division of labor even within management. In this way, he wrote, firms can grow in terms of both scope and scale through internal divisions of labor. Coase knew from economic theory that the price mechanism is efficient in resource allocation, which should mean that firms by definition must be suboptimal. So, he asked, why are so many transactions in the market organized within or between firms? By directing labor workers, who are bound in open-ended employment contracts, rather than contracting with labor providers in the market, firms can avoid the costs of using the price mechanism. The way Coase sees it, the market is efficient in its resource allocation, but it is very costly to bring about this efficient allocation due to frictions such as search and marketing costs and negotiations over contract terms. Coase quotes Robertson [] in saying that firms are "islands of conscious power. At this time, economics had already adopted the production-function view of the firm â€" it was considered a "black box" that transforms inputs into outputs. Outside of economics, however, theoretical developments in management and organization theory are based on the Robinsonian or Smithian theory rather than that of Marshall and Coase. This tradition has evolved almost exclusively within business schools and has lost much of its basis in economic theory; it therefore appears quite eclectic in terms of approach, analysis, and method. Some discoveries have been made within the Coasean framework, but research primarily focuses on applications of Coasean reasoning as well as on re defining and measuring transaction costs. But what about the Austrian School? The answer is that we sadly do not have a theory of the firm. Mises did not theorize much on firm organizing, and Rothbard finds it sufficient to briefly discuss the natural limit to firm size due to the calculation problem in Man, Economy, and State More recently, we have seen several attempts to draft an Austrian theory of the firm, but they generally remain drafts rather than developed theories. Klein has made some progress in integrating the transaction-cost approach with Austrian capital theory and Misesian entrepreneurship see his The Capitalist and the Entrepreneur [] and the forthcoming Organizing Entrepreneurial Judgment: A New Approach to the Firm []. While these approaches are predominantly Austrian in both flavor and substance, they all tend to disregard the traditional, "older" view of the firm as a different type of division of labor; instead, they focus more narrowly on several distinctly Austrian insights. Furthermore, the firm tends to be analytically separated from the overall market process due to the emphasis put on its internal organization and boundaries. Mises put great emphasis in Human Action and elsewhere on the value and effects of the division of labor, both as a productive force in and necessary condition for the market process and as a prerequisite for civilization. I choose to see the firm in light of this fundamental Misesian view of the market and society; it is not only a vehicle for profit-seeking entrepreneurs to establish novel structures of production; it also plays an indispensable role in the evolution of the market process and the unfolding of future divisions of labor and, hence, in civilization. The firm is the means through which entrepreneurs establish new and more intense divisions of labor, which, when profitable, set in motion an entrepreneur-driven competitive discovery process that is uncompromising in thrusting the market toward more efficient utilization of scarce resources. There is good reason to put the firm at center stage, rather than making it a marginally important phenomenon in the market. Indeed, I attempt in an article for the Quarterly Journal of Austrian Economics to show that the firm not only provides a function in the market place but could be an essential part of the wealth-creating market process as well as an essential part of civilized society. The firm is much more than a legal entity â€" it is a cornerstone of the market and instrumental to entrepreneurial profits.

Chapter 2 : The Transaction Cost Approach to the Theory of the Firm

The theory of the firm consists of a number of economic theories that explain and predict the nature of the firm, company, or corporation, including its existence, behaviour, structure, and relationship to the market.

Transaction cost refers to the cost of providing for some good or service through the market rather than having it provided from within the firm. Coase describes in his article "The Problem of Social Cost" the transaction costs he is concerned with: In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. More succinctly transaction costs are: The Nature of the Firm by Ronald Coase Coase observes that market prices govern the relationships between firms but within a firm decisions are made on a basis different from maximizing profit subject market prices. Within the firm decisions are made on through entrepreneurial coordination. Robertson on there being, "Islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk. In agriculture often most of the labor force works on a day-to-day basis. In other industries the labor force may be permanent, tied to the firm with long-term contracts. Repair services in some firms may be supplied by an internal organization; in others it is provided by specialized firms from outside. A firm is a system of long-term contracts that emerge when short-term contracts are unsatisfactory. The unsuitability of short term contracts arise from the costs collecting information and the costs of negotiating contracts. This leads to long term contracts in which the remuneration is specified for the contractee in return for obeying, within limits, the direction of the entrepreneur. Coase notes that the economic theory of the production level of a plant in the short run and long run are well worked out, but the theory of the size of the firm is not well developed. This is clear in the matter of acquisition of companies by other companies. Ronald Coase gives the origin of The Nature of the Firm as a course in the organization of the business unit which he taught in He noted that there are inconveniences of market transactions, but if transactions are not governed by the price system there has to be an organization. The object of an business organization is to reproduce the conditions of a competitive market for the factors of production within the firm at a lower cost than the actual market. But if an organization exists to reduce costs then why is there any market transactions at all? Coase gave two reasons: Here is what Coase himself says: My inclination was to take a degree in history but having come to the school at age twelve rather than at the usual age of eleven, there was no question of my taking Latin at school. This lack of Latin barred me from taking an arts degree or at any rate the one that I wanted to take. I therefore started to work for a science degree, with the intention of specializing in chemistry. However, I soon found that mathematics, a requirement for a science degree, was not to my taste, and I switched to the only alternative open to me at school, working for a commerce degree. This move was undoubably made easier by the fact that I was at that time a socialist and the interest in social problems that this implies made studying economics a requirement for a commerce degree attractive In , I went, aged eighteen, to the London School of Economics to continue work for a commerce degree. In economics Coase single handedly pioneered a nonmathematical but deeply penetrating economic analysis. He examined questions that never occured to most economists. In the rare cases where others considered those questions they did not come to meaningful conclusions as did Coase. The uniqueness of his contribution was recognized with his being awarded the Nobel Prize in economics. His contribution which is most widely known in economics is what George Stigler named the Coase Theorem. Coase never referred to this proposition as a theorem and its role in his article, "A Problem of Social Cost" is subsidiary to transaction cost approach. In presenting the "Coase Theorem" Coase was arguing that in the absence of transaction costs many surprising results hold. Intervention of the government in such cases does affect the distribution of income. The economics profession has focused upon the content of the proposition rather than the fact that significance of the presence or absence of transaction costs.

Chapter 3 : Theory Of The Firm

The main input factors of a firm are capital, labour and technologies. Firms sell their products in the product markets to the consumers. This course will give the student knowledge about the operation of the firm in this setting from an empirical perspective.

Economics Business is considered as going to become more and more technical day by day with the advancement of new monetary reforms and globalization. On each and every stage of business effective research, strategic thinking and management is essential to get succeeded. Economics is recognized as the study of behavior of people in creating, distributing and consuming goods and services within the whole world having the limited resources. Managerial economics is recognized as the utilization of such economic analysis to help make the business decisions so as to effectively utilize all the limited resources of the organization and the global business environment which leads to reduced cost and high profitability. Managerial economics also helps in implication of monetary evaluation in formulating and planning business regulations. Managerial economics really helps to execute the theoretical types of economical in the useful business decisions in order to design the plans and laws in the simplest way which leads to effective profitability and finally the competitive advantage for the business Ideas of Managerial Economics. The project aspires to analyze different facets of managerial economics through analyzing the company and its goals to use business within the business and monetary environment. The job analyzes the firm and its own goals through analyzing the reason why for the lifetime of the businesses, its monetary goals and optimal decisions making. The task also throws light on the goals of the company which are apart from profit and also analyses the financial gains of the Company. The task also assess two main goal of the organization i. The Firm and its existence: Traditionally firm is recognized as the integration of resources that are being changed into the products according to the demand of the customers. The cost incurred by the Company in converting the resources in to product is determined by the technology used and the quantity of the products produced. The prices fixed for such products are affected by the causes of market. The difference between your revenue and the cost of the company is referred to as the earnings for the organization. However the modern theory is convinced in the life of firm. The main focus of the modern theory is on the questions such as why the company performs certain functions internally and other function with the aid of the market. How big is company are also put on question mark by such theories as the scale is not being made the decision by the scientific factors. Within its interacting with the marketplace, the company incurs deal cost, which is incurred when the firm enters in contract with other entities. The business deal cost is high when the opportunistic behavior is shown by either get together meaning one party efforts to have the advantage of the other party. Thus it could be said that firm efforts to reduce its cost that are incurred within its trades with the market through minimizing the internal cost Paul G. The businessmen operate any business with a particular or various goals. Most of the people believe that businesses are being controlled to earn income. The monetary theory of the company on which the building blocks of managerial economics is based also supposes that main aim of the company to increase its income and earnings. Thus the financial goal of the organization is to earn earnings and maximize it success through various options Paul G. In general conditions profit is defined as the amount kept after deduction of cost from the earnings. These costs also entail the opportunity cost and so response to this question leads to analysis that whether the firm has used optimal decision or not. The perfect decision refers to the purchase price and quantity chosen by the firm, the combination that results to the development of success for the firm. The role of opportunity cost in deciding that if the decision is optimal or not is very significant as it not only will depend on the price and number but also on the other factors of awareness. Thus economic profit can be explained as net accounting cash flow minus the opportunity cost of the administrative centre and other resources supplied by the owner of the firm William J. But the perfect decisions not only will depend on the economic income, price and number but also on various other factors such as total, average and marginal earnings and total, average and marginal cost. Total, Average and Marginal Revenue: In order to investigate that how the total profit is determined by total revenue, the concept of total income, total cost and the full total profit must be made clear and there tendencies with the change in productivity must be examined. The total cost and the total revenue both depends on the combo of price and output combo as considered for the perfect decisions. Baumol, As in the purchase price is denoted as the earnings per unit and thus the demand curve in these figure is referred to as the Average revenue curve. Marginal revenue can be defined as the addition to the total revenue with the addition of one device of total output. The marginal revenue is denoted as the slope of the full total income curve. Thus the price output combination determines the total, average and marginal earnings which ultimately results to analyze the optimal alternatives and decisions William J. Total, Average and Marginal Cost: The total cost, average cost and marginal cost are shown with the help of following results Source: Baumol, Profit Maximization: However the lack of financial success of the company cannot be considered as the region of controversy on the later basic principle. The attainment of such goals leads to various decisions such as earnings increase more than cost increase or income decrease significantly less than cost lower or maintaining regular revenue with decrease in cost results to the profit maximization of the company Paul G. Goals other than Profit: The typically ultimate goal of the company is "profit Maximization" i. So, if managers pursue profit maximization they can maintain their position as well as financial benefits in the firm. It also features voluntary social responsibilities and plays vital role in reaching fair distribution of income and in boosting efficiency Chapter: The income maximization can be measured at the end of the fiscal yr that includes performance of executives and department, their contribution towards the profits which is determined and rewarded by the benefit or incentives plan Paul G. Profit maximization includes maximization of revenue from each division of the company with achieving respective targets of the team. The different targets lead for taking different decision or may be same decision with the framework of same resources. To be able to identify the efficiency of the target, professionals have to breakdown the total goal of the revenue maximization into intermediate goals in respect to various department or section of the organization and thus, known as Economic Goals. The economic goals of the organizations are the following Maximizing Market Share Maximizing talk about holder value Advanced Technology The financial goals help in revenue maximization either directly or indirectly. At the same time, companies also adopt some goals which are from the inexpensive thinking but immediately and indirectly good for the company. Some of the non economical goals are Corporate Citizenship.

Chapter 4 : The Economics of the Firm | NHH

Economic analysis of the business firm, particularly with respect to price, output and technological choice; the effect of diversity on domestic and international policy on business firm behavior. The overall learning objectives for the EMBA are a broad set of knowledge and skills we wish students.

To economists, rationality means an individual possesses stable preferences that are both complete and transitive. The technical assumption that preference relations are continuous is needed to ensure the existence of a utility function. Although microeconomic theory can continue without this assumption, it would make comparative statics impossible since there is no guarantee that the resulting utility function would be differentiable. Microeconomic theory progresses by defining a competitive budget set which is a subset of the consumption set. It is at this point that economists make The technical assumption that preferences are locally non-satiated. Without the assumption of LNS local non-satiation there is no guarantee that a rational individual would maximize utility. With the necessary tools and assumptions in place the utility maximization problem UMP is developed. The utility maximization problem is the heart of consumer theory. The utility maximization problem attempts to explain the action axiom by imposing rationality axioms on consumer preferences and then mathematically modeling and analyzing the consequences. The utility maximization problem serves not only as the mathematical foundation of consumer theory but as a metaphysical explanation of it as well. That is, the utility maximization problem is used by economists to not only explain what or how individuals make choices but why individuals make choices as well. The utility maximization problem is a constrained optimization problem in which an individual seeks to maximize utility subject to a budget constraint. Economists use the extreme value theorem to guarantee that a solution to the utility maximization problem exists. That is, since the budget constraint is both bounded and closed, a solution to the utility maximization problem exists. Economists call the solution to the utility maximization problem a Walrasian demand function or correspondence. The utility maximization problem has so far been developed by taking consumer tastes i. However, an alternative way to develop microeconomic theory is by taking consumer choice as the primitive. This model of microeconomic theory is referred to as revealed preference theory. The supply and demand model describes how prices vary as a result of a balance between product availability at each price supply and the desires of those with purchasing power at each price demand. The graph depicts a right-shift in demand from D1 to D2 along with the consequent increase in price and quantity required to reach a new market-clearing equilibrium point on the supply curve S. The theory of supply and demand usually assumes that markets are perfectly competitive. This implies that there are many buyers and sellers in the market and none of them have the capacity to significantly influence prices of goods and services. In many real-life transactions, the assumption fails because some individual buyers or sellers have the ability to influence prices. Quite often, a sophisticated analysis is required to understand the demand-supply equation of a good model. However, the theory works well in situations meeting these assumptions. Mainstream economics does not assume a priori that markets are preferable to other forms of social organization. In fact, much analysis is devoted to cases where market failures lead to resource allocation that is suboptimal and creates deadweight loss. A classic example of suboptimal resource allocation is that of a public good. In such cases, economists may attempt to find policies that avoid waste, either directly by government control, indirectly by regulation that induces market participants to act in a manner consistent with optimal welfare, or by creating " missing markets " to enable efficient trading where none had previously existed. This is studied in the field of collective action and public choice theory. This can diverge from the Utilitarian goal of maximizing utility because it does not consider the distribution of goods between people. Market failure in positive economics microeconomics is limited in implications without mixing the belief of the economist and their theory. The demand for various commodities by individuals is generally thought of as the outcome of a utility-maximizing process, with each individual trying to maximize their own utility under a budget constraint and a given consumption set. Basic microeconomic concepts[edit] The study of microeconomics involves several "key" areas: Demand, supply, and equilibrium[edit] Main article: Supply and demand Supply and demand is an economic model of price determination in a perfectly competitive market. It concludes that in a perfectly competitive market with no externalities , per unit taxes , or price controls , the unit price for a particular good is the price at which the quantity demanded by consumers equals the quantity supplied by producers. This price results in a stable economic equilibrium. Measurement of elasticities[edit] Main article: Elasticity economics Elasticity is the measurement of how responsive an economic variable is to a change in another variable. Elasticity can be quantified as the ratio of the change in one variable to the change in another variable, when the later variable has a causal influence on the former. It is a tool for measuring the responsiveness of a variable, or of the function that determines it, to changes in causative variables in unitless ways. Frequently used elasticities include price elasticity of demand , price elasticity of supply , income elasticity of demand , elasticity of substitution or constant elasticity of substitution between factors of production and elasticity of intertemporal substitution. Consumer demand theory[edit] Main article: Consumer choice Consumer demand theory relates preferences for the consumption of both goods and services to the consumption expenditures; ultimately, this relationship between preferences and consumption expenditures is used to relate preferences to consumer demand curves. The link between personal preferences, consumption and the demand curve is one of the most closely studied relations in economics. It is a way of analyzing how consumers may achieve equilibrium between preferences and expenditures by maximizing utility subject to consumer budget constraints. Theory of production[edit] Main article: Production theory Production theory is the study of production, or the economic process of converting inputs into outputs. Production uses resources to create a good or service that is suitable for use, gift -giving in a gift economy , or exchange in a market economy. This can include manufacturing , storing, shipping , and packaging. Some economists define production broadly as all economic activity other than consumption. They see every commercial activity other than the final purchase as some form of production. Costs of production[edit] Main article: Cost-of-production theory of value The cost-of-production theory of value states that the price of an object or condition is determined by the sum of the cost of the resources that went into making it. The cost can comprise any of the factors of production: Technology can be viewed either as a form of fixed capital e. Opportunity cost The economic idea of opportunity cost is closely related to the idea of time constraints. The opportunity cost of any activity is the value of the next-best alternative thing you may have done instead. Opportunity cost depends only on the value of the next-best alternative. Opportunity costs can tell you when not to do something as well as when to do something. For example, you may like waffles, but you like chocolate even more. The opportunity cost of eating waffles is sacrificing the chance to eat chocolate. Because the cost of not eating the chocolate is higher than the benefits of eating the waffles, it makes no sense to choose waffles.

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Chapter 5 : Economics of the Firm: Theory and Practice - Arthur A. Thompson, John P. Formby - Google B

Investopedia defines a firm as a business organization, such as a corporation or a partnership, with different levels of legal protection. However, the Ludwig Von Mises Institute states that a firm in economics plays an important role in markets regardless of its legal definition.

Overview[edit] In simplified terms, the theory of the firm aims to answer these questions: Why do firms emerge? Why are not all transactions in the economy mediated over the market? Why is the boundary between firms and the market located exactly there with relation to size and output variety? Which transactions are performed internally and which are negotiated on the market? Why are firms structured in such a specific way, for example as to hierarchy or decentralization? What is the interplay of formal and informal relationships? What drives different actions and performances of firms? What tests are there for respective theories of the firm? It might also be costly for employees to shift companies every day looking for better alternatives. Similarly, it may be costly for companies to find new suppliers daily. Thus, firms engage in a long-term contract with their employees or a long-term contract with suppliers to minimize the cost or maximize the value of property rights. Economic theory until then had focused on trying to understand markets alone and there had been little study on understanding why firms or organisations exist. Markets are guided by prices and quality as illustrated by vegetable markets where a buyer is free to switch sellers in an exchange. The need for a revised theory of the firm was emphasized by empirical studies by Adolf Berle and Gardiner Means , who made it clear that ownership of a typical American corporation is spread over a wide number of shareholders , leaving control in the hands of managers who own very little equity themselves. Hall and Charles J. Hitch found that executives made decisions by rule of thumb rather than in the marginalist way. Transaction cost The model shows institutions and market as a possible form of organization to coordinate economic transactions. When the external transaction costs are higher than the internal transaction costs, the company will grow. If the external transaction costs are lower than the internal transaction costs the company will be downsized by outsourcing, for example. According to Ronald Coase , people begin to organise their production in firms when the transaction cost of coordinating production through the market exchange, given imperfect information, is greater than within the firm. Coase begins from the standpoint that markets could in theory carry out all production, and that what needs to be explained is the existence of the firm, with its "distinguishing mark â€¦ [of] the supersession of the price mechanism. Instead, for Coase the main reason to establish a firm is to avoid some of the transaction costs of using the price mechanism. These include discovering relevant prices which can be reduced but not eliminated by purchasing this information through specialists , as well as the costs of negotiating and writing enforceable contracts for each transaction which can be large if there is uncertainty. Moreover, contracts in an uncertain world will necessarily be incomplete and have to be frequently re-negotiated. The costs of haggling about division of surplus, particularly if there is asymmetric information and asset specificity , may be considerable. If a firm operated internally under the market system, many contracts would be required for instance, even for procuring a pen or delivering a presentation. These kinds of contracts are drawn up in situations of uncertainty, in particular for relationships which last long periods of time. Such a situation runs counter to neo-classical economic theory. The neo-classical market is instantaneous, forbidding the development of extended agent-principal employee-manager relationships, of planning, and of trust. He notes that government measures relating to the market sales taxes , rationing , price controls tend to increase the size of firms, since firms internally would not be subject to such transaction costs. Thus, Coase defines the firm as "the system of relationships which comes into existence when the direction of resources is dependent on the entrepreneur. The question then arises of what determines the size of the firm; why does the entrepreneur organise the transactions he does, why no more or less? In practice, diminishing returns to management contribute most to raising the costs of organising a large firm, particularly in large firms with many different plants and differing internal transactions such as a conglomerate , or if the relevant prices change frequently. Coase concludes by saying that the size of the firm is dependent on the costs of using the price mechanism, and on the costs of organisation of other entrepreneurs. These two factors together determine how many products a firm produces and how much of each. Williamson , suggest that managers would seek to maximise their own utility and consider the implications of this for firm behavior in contrast to the profit-maximising case. This means that to an extent managers can pursue their own interests. Traditional managerial models typically assume that managers, instead of maximising profit, maximise a simple objective utility function this may include salary, perks , security, power, prestige subject to an arbitrarily given profit constraint profit satisficing. Behavioural theory of the firm The behavioural approach, as developed in particular by Richard Cyert and James G. March of the Carnegie School places emphasis on explaining how decisions are taken within the firm, and goes well beyond neoclassical economics. Thus individuals and groups tend to " satisfice "â€”that is, to attempt to attain realistic goals, rather than maximize a utility or profit function. Cyert and March argued that the firm cannot be regarded as a monolith, because different individuals and groups within it have their own aspirations and conflicting interests, and that firm behaviour is the weighted outcome of these conflicts. Organisational mechanisms such as "satisficing" and sequential decision-taking exist to maintain conflict at levels that are not unacceptably detrimental. In effect, therefore, this is a "principal-agent" theory, since it is asymmetric information within the firm which Alchian and Demsetz emphasise must be overcome. In practice this may have limited applicability small work group activities, the largest perhaps a symphony orchestra , since most outputs within a firm such as manufacturing and secretarial work are separable, so that individual inputs can be rewarded on the basis of outputs. Hence team production cannot offer the explanation of why firms in particular, large multi-plant and multi-product firms exist, etc. Asset specificity[edit] For Oliver E. If the transaction is a recurring or lengthy one, re-negotiation may be necessary as a continual power struggle takes place concerning the gains from trade, further increasing the transaction costs. Moreover, there are likely to be situations where a purchaser may require a particular, firm-specific investment of a supplier which would be profitable for both; but after the investment has been made it becomes a sunk cost and the purchaser can attempt to re-negotiate the contract such that the supplier may make a loss on the investment this is the hold-up problem , which occurs when either party asymmetrically incurs substantial costs or benefits before being paid for or paying for them. In this kind of a situation, the most efficient way to overcome the continual conflict of interest between the two agents or coalitions of agents may be the removal of one of them from the equation by takeover or merger. Asset specificity can also apply to some extent to both physical and human capital, so that the hold-up problem can also occur with labour e. Probably the best constraint on such opportunism is reputation rather than the law , because of the difficulty of negotiating , writing and enforcement of contracts. This is partly because it is in the nature of a large firm that its existence is more secure and less dependent on the actions of any one individual increasing the incentives to shirk , and because intervention rights from the centre characteristic of a firm tend to be accompanied by some form of income insurance to compensate for the lesser responsibility, thereby diluting incentives. Milgrom and Roberts explain the increased cost of management as due to the incentives of employees to provide false information beneficial to themselves, resulting in costs to managers of filtering information, and often the making of decisions without full information. Empirical analyses of transaction costs have attempted to measure and operationalize transaction costs. Firm economies[edit] The theory of the firm considers what bounds the size and output variety of firms. This includes how firms may be able to combine labour and capital so as to lower the average cost of output, either from increasing, decreasing, or constant returns to scale for one product line or from economies of scope for more than one product line. Grossman , Oliver D. Hart , and John H. In their seminal work, Grossman and Hart , Hart and Moore and Hart developed the incomplete contracting paradigm. Specifically, consider a seller of an intermediate good and a buyer. Should the seller own the physical assets that are necessary to produce the good non-integration or should the buyer be the owner integration? After relationship-specific investments have been made, the seller and the buyer bargain. When they are symmetrically informed, they will always agree to collaborate. Thus, the ownership structure has an influence on the incentives to invest. A central insight of the theory is that the party with the more important investment decision should be the owner. Another prominent conclusion is that joint asset ownership is suboptimal if investments are in human capital. The Grossman-Hart-Moore model has been successfully applied in many contexts, e.

Chapter 6 : The Economic Theory of the Firm | Mises Institute

The "Time Value of Money" is an important concept to understand in the understanding of finance, and its role in financial decision-making and valuation.

In the short-run, the costs of a firm are based on fixed costs and variable costs. The additional cost to make each quantity of a good is the marginal cost. The marginal cost curves intersects both the Average Variable Cost and Average Total Cost curves at the minimum points on the curves. Economies of scale is a long run concept and refers to reductions in unit cost as the size of a facility, or scale, increases. These eventually counter economies and make it disadvantagous for a company to continually increase production. The amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income. Revenue is calculated by multiplying the price at which goods or services are sold by the number of units or amount sold. Revenue is also known as "REVs". In simplist terms, total revenue is price multiplied by quantity. Normal zero profits are when a business uses resources and receives revenue in an amount that gives them a rate of return no different from the next best thing they could have done. A supernormal abnormal profit is when a business uses resources and receives revenue in an amount that gives them a rate of return higher than the next best thing. Profit maximization in terms of total revenue as well as the total costs, and in terms of marginal revenue and marginal cost. Profit maximization assumed to be the main goal of firms but other goals exist sales volume maximization, revenue maximization, environmental concerns. Efficiency Edit Productive efficiency is when the condition where the maximun output is produced with given resources and technology. That is, the lowest point on the average total cost curve. This is "efficient" because a firm is making exactly the right amount of goods so that it is spending the least amount of money to produce those goods. This is also the equilibrium level. Allocative efficiency is when a firm is producing its optimal quantity of goods. This is allocatively efficient because both producers and consumers are happy with the price and quantity demanded and there is no welfare loss due to too high or too low a price. This occurs when a perfectly competitive market is at long run equilibrium, for example. Perfect Competition These five criteria must be met in order for a market to have Perfect Competition. All firms sell an identical product. All firms are price takers. All firms have a relatively small market share. Buyers know the nature of the product being sold and the prices charged by each firm. The industry is characterized by freedom of entry and exit. Monopoly Edit Profit maximizing level of output: A monopoly has only 1 group that controls the whole market. Since the monopoly has no competition in the market, the demand will be satisfied by the firm. For example, the U. Postal Service is a monopoly because they are in charge of all mail being sent in the United States. Truly free market monopolies are very rare in reality. Most monopolies that do exist are government-created. Like in the PCM, the monopolistically competitive firm earns a normal profit in the long run. However, a firm operating in monopolistic competition with other firms experiences subpar allocative efficiency since MR is above marginal cost and is not productively efficient since they produce at an average cost above ACmin. Oligopoly Edit A theory of market structure based on three assumptions: An Oligopoly is about the same thing as a Monopoly, with the exception that at least two groups are controlling a market. The main and most obvious reason for price discrimination is that selling a good at different prices will serve to increase profits. A firm that has market power can increase profits by selling a good at the highest possible price that consumers are willing to pay. A firm can also use price discrimination to cut prices in order to force competitors out of the market or in order to penetrate a new market. To successfully price discriminate certain conditions must be met:

Chapter 7 : Theory of the firm - Wikipedia

The theory of the firm is the microeconomic concept founded in neoclassical economics that states that firms exist and make decisions to maximize profits.

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Chapter 8 : Microeconomics - Wikipedia

He is a member of the American Economic Association, the Academy of Management, and the Southern Management Association. He has also served on the editorial boards of a number of journals, including the Journal of Economics and Finance, the Journal of Management, the Journal of Management Case Studies, and the Journal of Management Issues.

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Cost of Firms and Maximization Decision To produce a good or to provide a service businesses and firms incur costs Costs are driven by the factors of production used.