Organizing Production

Firms hire factors of Production to produce and sell goods and services

The firm's goal is to maximize economic profit.

A firm that does not maximize profit is either eliminated or bought out by other firms.

Economic profit
equals total revenue
minus the firm's opportunity cost.

A firm's opportunity cost
includes
Implicit costs
Explicit costs

Explicit costs
Expenditures on utilities,
wages, raw materials.

They are paid in money

implicit costs

A firm incurs implicit costs when

1. It uses its own capital
2. It uses its owner's time or financial resources

The firm could rent the capital to another firm and receive rental income

The rental income forgone is the firm's opportunity cost of using its own capital

In the case of impliat costs, the firm does not make a payment

Economic Depreciation
The change in the market value of capital over a given period.

Example

You bought a new car last year for \$15,000. you now sell the car for \$13,500.
The amount of economic depreciation is
\$15,000 - 13,500 = \$1,500

Normal profit

The rate of profit an entrepreneur can expect to receive on the average

You have in mind a minimum return of 10 percent.

A normal rate of profit is the opportunity cost of investment

Economic profits are profits over and above normal profits.

Economic profits are excess profits.

Technological and Econo-mic Efficiency

1. Technological Efficien-cy

when a firm produces a given output by using the <u>least</u> amount of inputs

Different methods of production use different amounts of labor and capital

Example

Method B uses the same amount of capital and less labor than method C

Method B is technologically efficient

2. Economic Efficiency

when the firm produces a given output at the least cost.

Example

Method	Labor	Capital
1	5	10
2	10	7
3	15	5

Price of Labor = #10
Price of capital = #20

Which method is econono-mically efficient?

1. $5 \times 10 + 10 \times 20$ = #250
2. $10 \times 10 + 7 \times 20$ = #240
3. $15 \times 10 + 5 \times 20$ = #250

Method 2 is economically efficient

Method 2 is the cost-minimizing choice.

A firm that is not economically efficient does not maximize profit.

Economically inefficient firms go out of business or are taken over by firms with lower costs.

The optimal method of Production is the one that minimize the cost of producing a given level of output.

Information and organization

Each firm organizes production of goods and services through a

1. Command system
   A managerial hierarchy with a chief executive officer (CEO) at the top.

2. Incentive system
   Managers use compensation schemes that will induce workers to perform

in ways that maximize the firm's profit

Example: performance related bonus.

- The principal-Agent problem

Agency relationships involve agents and principals

Example

The stockholders of a company are the <u>principals</u> (owners).

The firm's managers are __agents__

The shareholders (owners) cannot monitor the managers and often the managers cannot monitor the workers.

The principals must create incentives that induce each agent to work in the principals' best interest.

incentive schemes to cope with the principal-Agent problem

1. ownership
Assign to a manager part-ownership of a business

2. Incentive pay
pay related to performance (based on profits, production, or sales targets).

3. Long-term contracts
A multi-year employment contract encourages managers and workers to work harder.

Types of Business organi-
zation

1. Sole proprietorship
A business with a single
owner (a proprietor).

It has unlimited liability.
A sole proprietorship is
responsible for all the
debts.
If the proprietor can not
pay the debts, the credi-
tors can claim the perso-
nal property of the owner.

2. partnership
A firm with two or more owners.
The owners have unlimited liability.
Each partner is liable for all the debts of the partnership.

3. Corporation
A firm owned by one or more stockholders.

stockholders have limited liability.
If the corporation becomes

bankrupt, its stockholders (owners) are not requi-red to use their perso-nal wealth to pay the corporation's debts.

Corporations' profits are taxed twice as com-pany profits and as stockholders' income (di-vidends).

Markets and the Competitive Environment

Economists identify four market types:

1. perfect Competition
2. Monopolistic Competition
3. Oligopoly
4. Monopoly

1. perfect Competition
Many firms, each selling an identical product, and no restrictions on the entry of new firms

into the industry.

Many buyers.
All participants are well informed about the prices of the products.

Example: Markets for corn, rice, and other grain crops.

2. Monopolistic Competition
A market structure in which a large number of firms compete by making similar but slightly different products.

There is product differen-
tiation
Product differentiation
gives the firm in monopo-
listic competition a de-
gree of market power.

Example: the market for
running shoes (Nike, Ree-
bok, Fila).
Consumers perceive the
products to be different.

3. Oligopolicy
A market structure in which a small number of firms compete
Airplane manufacture and international air transportation are examples of oligopolistic industries
Other examples, coke and pepsi and car companies.
Oligopoly is found mainly in manufacturing.

4. Monopoly

There is one firm and it produces a good or service that has no close substitutes and is protected by a barrier preventing the entry of new firms.

The phone, gas, electricity, and water suppliers are examples of local monopolies.

Markets and Firms

Firms coordinate economic activity
Firms are very efficient.

They can achieve
1. Lower transactions costs by reducing the number of individual transactions undertaken

There is an enormous reduction in the number of individual transactions if people get their cars fixed at the garage.

2. Economies of scale
The cost of producing a unit of a good decreases as output rate increases

3. Economies of scope
The cost of producing a unit of a good decreases when a firm uses specialized resources to produce a range of goods and services.