CHAPTER 10 LECTURE –ORGANIZING PRODUCTION

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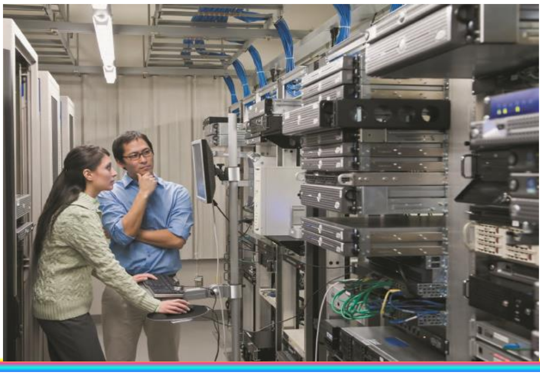

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The Firm and Its Economic Problem

A **firm** is an institution that hires factors of production and organizes them to produce and sell goods and services.

The Firm's Goal

A firm's goal is to maximize profit.

If the firm fails to maximize its profit, the firm is either eliminated or taken over by another firm that seeks to maximize profit.

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The Firm and Its Economic Problem

Accounting Profit

Accountants measure a firm's profit to ensure that the firm pays the correct amount of tax and to show it investors how their funds are being used.

Profit equals total revenue minus total cost.

Accountants use Internal Revenue Service rules based on standards established by the Financial Accounting Standards Board to calculate a firm's depreciation cost.

Economic Accounting

Economists measure a firm's profit to enable them to predict the firm's decisions, and the goal of these decisions is to maximize economic profit.

Economic profit is equal to total revenue minus total cost, with total cost measured as the opportunity cost of production.

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The Firm and Its Economic Problem

A Firm's Opportunity Cost of Production

A firm's opportunity cost of production is the value of the best alternative use of the resources that a firm uses in production.

A firm's opportunity cost of production is the sum of the cost of using resources

- Bought in the market
- Owned by the firm
- Supplied by the firm's owner

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The Firm and Its Economic Problem

Resources Supplied by the Firm's Owner

The owner might supply both entrepreneurship and labor.

The return to entrepreneurship is profit.

The profit that an entrepreneur can expect to receive *on average* is called **normal profit**.

Normal profit is the cost of entrepreneurship and is an opportunity cost of production.

In addition to supplying entrepreneurship, the owner might supply labor but not take a wage.

The opportunity cost of the owner's labor is the wage income forgone by not taking the best alternative job.

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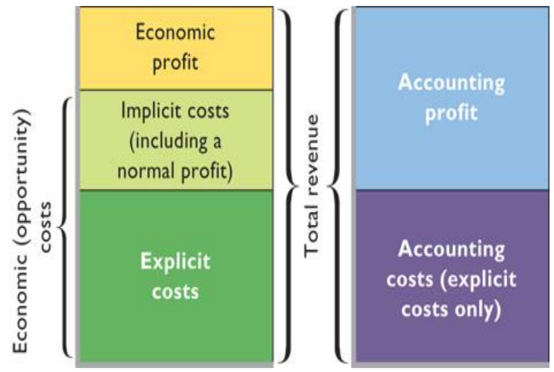

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The Firm and Its Economic Problem

The Firm's Decisions

To maximize profit, a firm must make five basic decisions:

1. What to produce and in what quantities
2. How to produce
3. How to organize and compensate its managers and workers
4. How to market and price its products
5. What to produce itself and what to buy from other firms

The Firm's Constraints

The firm's profit is limited by three features of the environment:

- Technology constraints
- Information constraints
- Market constraints

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Information and Organization

The Principal–Agent Problem

The **principal–agent problem** is the problem of devising compensation rules that induce an agent to act in the best interests of a principal.

For example, the stockholders of a firm are the principals and the managers of the firm are their agents.

Coping with the Principal–Agent Problem

Three ways of coping with the principal–agent problem are

- Ownership
- Incentive pay
- Long-term contracts

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Information and Organization

Ownership, often offered to managers, gives the managers an incentive to maximize the firm's profits, which is the goal of the owners, the principals.

Incentive pay links managers' or workers' pay to the firm's performance and helps align the managers' and workers' interests with those of the owners, the principals.

Long-term contracts can tie managers' or workers' long-term rewards to the long-term performance of the firm. This arrangement encourages the agents work in the best long-term interests of the firm owners, the principals.

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Types of Business Organization

Proprietorship

A *proprietorship* is a firm with a single owner who has *unlimited liability*, or legal responsibility for all debts incurred by the firm—up to an amount equal to the entire wealth of the owner.

The proprietor also makes management decisions and receives the firm's profit.

Profits are taxed the same as the owner's other income.

Partnership

A *partnership* is a firm with two or more owners who have unlimited liability.

Partners must agree on a management structure and how to divide up the profits.

Profits from partnerships are taxed as the personal income of the owners.

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Types of Business Organization

Corporation

A *corporation* is owned by one or more stockholders with *limited liability*, which means the owners who have legal liability only for the initial value of their investment.

The personal wealth of the stockholders is not at risk if the firm goes bankrupt.

The profit of corporations is taxed twice—once as a corporate tax on firm profits, and then again as income taxes paid by stockholders receiving their after-tax profits distributed as dividends.

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TABLE 10.4 The Pros and Cons of Different Types of Firms

Type of Firm	Pros	Cons
Proprietorship	▪ Easy to set up ▪ Simple decision making ▪ Profits taxed only once as owner's income	▪ Bad decisions not checked; no need for consensus ▪ Owner's entire wealth at risk ▪ Firm dies with owner ▪ Cost of capital and labor is high relative to that of a corporation
Partnership	▪ Easy to set up ▪ Diversified decision making ▪ Can survive withdrawal of partner ▪ Profits taxed only once as owners' incomes	▪ Achieving consensus may be slow and expensive ▪ Owners' entire wealth at risk ▪ Withdrawal of partner may create capital shortage ▪ Cost of capital and labor is high relative to that of a corporation
Corporation	▪ Owners have limited liability ▪ Large-scale, low-cost capital available ▪ Professional management not restricted by ability of owners ▪ Perpetual life ▪ Long-term labor contracts cut labor costs	▪ Complex management structure can make decisions slow and expensive ▪ Retained profits taxed twice: as company profit and as stockholders' capital gains

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Markets and the Competitive Environment

TABLE 10.6 Market Structure

Characteristics	Perfect competition	Monopolistic competition	Oligopoly	Monopoly
Number of firms in industry	Many	Many	Few	One
Product	Identical	Differentiated	Either identical or differentiated	No close substitutes
Barriers to entry	None	None	Moderate	High
Firm's control over price	None	Some	Considerable	Considerable or regulated
Concentration ratio	0	Low	High	100
HHI (approx. ranges)	Less than 100	101 to 999	More than 1,000	10,000
Examples	Wheat, corn	Food, clothing	Computer chips	Local water supply

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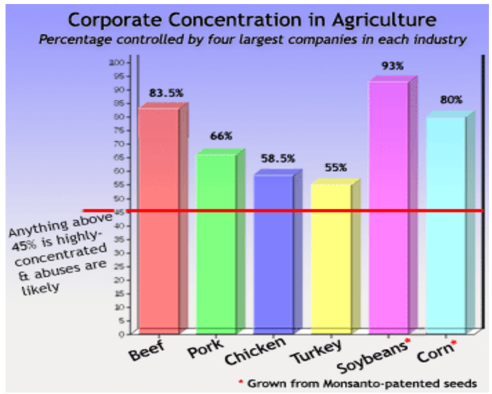

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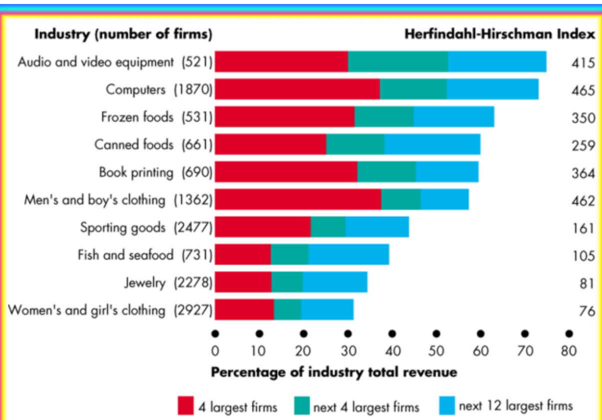

Measures of Concentration

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Produce or Outsource? Firms and Markets

Firm Coordination

Firms hire labor, capital, and land, and by using a mixture of command systems and incentive systems organize and coordinate their activities to produce goods and services.

Market Coordination

Markets coordinate production by adjusting prices and making the decisions of buyers and sellers of factors of production and components consistent.

Outsourcing—buying parts or products from other firms—is an example of market coordination of production.

But firms coordinate more production than do markets.

Why?

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