

Chapter 20 – The Firm

1. **Firm** – an institution that hires factors of production and organizes them to produce and sell goods/services
 - a. A firm's goal is to maximize profit (duh)
 - b. A firm's profit is its revenue – its expenses
2. **Opportunity cost** – the highest valued alternative forgone
3. **Explicit costs** – paying other people money
4. **Implicit costs** – use of existing capital, time investments. Use of capital is called the **Implicit Rental Rate**
5. **Economic Depreciation** – loss of value of capital over time
6. **Normal profit** – the average profit of an entrepreneur if he were in some other business
7. **Technology** – any method of producing a good or service. A firm's production is limited by its technology
8. **Information** – we don't process all the information we would like, we lack information. A firm's production is limited by the information available to it
9. **Market Constraints** – prices are constrained by what customers are willing to pay
10. **Technological efficiency** – when a firm produces a given output by using the least amount of inputs/resources
11. **Economic efficiency** – when a firm produces a given output at the least cost
 - a. Technological and economic efficiency usually do NOT occur at the same level of production. This is why energy companies sometimes buy power to meet higher demand and GM leaves assembly lines empty
12. **Command System** – a method of organizing production that uses a managerial hierarchy. Commands are passed down through the hierarchy. The military is the purest form of a command system, normal companies are usually variations.
13. **Incentive System** – a method of organizing production that uses a market like mechanism inside the firm. Instead of issuing commands, managers create compensation schemes that will induce workers to perform in ways that maximize the firm's profits
14. **Principle Agent Problem** – aka The Prisoner's Dilemma – the problem of devising compensation rules that induce an agent (someone you hire) to act in the best interest of a principal (you)
 - a. CEO's delegate power to managers and/or workers, in hope that they will act in the CEO's best interest. However, this almost never happens w/o it also being in the best interest of the manager/worker
15. Fixing the Principle Agent Problem
 - a. **Ownership** – by giving managers/workers ownership, it gives them an incentive to do what's best for the business, since the success of the business brings them prosperity as well
 - b. **Incentive Pay** – by paying managers/workers based on performance, they often work harder
 - c. **Long term contracts** – by giving them long term security, they are more willing to do what's best in the long term interest of the company and not just increasing profits in the short run to get a promotion
16. Types of Business
 - a. **Proprietorship** – a firm with a single owner who has unlimited liability, meaning he's responsible for all the debts of a firm up to an amount equal to the entire wealth of the owner
 - b. **Partnership** – a firm with two or more owners who have unlimited liability
 - c. **Corporation** – a firm owned by one or more limited liability stockholders. These owners are responsible only for the value of their initial investment. The downside to this limited liability is that corporate profits are taxed independently of the stockholders incomes, so they're basically taxed twice
 - d. Corporations generally dominate when large amounts of capital are required, ie. Technology, manufacturing, etc. Proprietorships generally dominate when critical decisions must be made often and quickly, such as in many service industries
17. **Perfect competition** – there are many firms, selling an identical product, and no restrictions on the entry of new firms into the industry. There are also many buyers who are well informed about the prices of the products of each firm and the industry
18. **Monopolistic competition** – a market structure in which a large number of firms compete by making similar but slightly different products
19. **Product differentiation** – making a product slightly different from that of a competing firm
20. **Oligopoly** – a market structure in which a small number of firms compete
21. **Monopoly** – one firm, which produces a good or service that has no close substitutes and in which the firm is protected by a barrier preventing the entry of new firms. Think AT&T in the early 80's
22. **Four firm concentration ratio** – the percentage of the value of sales accounted for by the four largest firms in an industry
23. **Why firms?**
 - a. **Lower Transaction Costs** – doing business is more efficient in a firm, with all the people in the same place, everyone doing their jobs, and easier supervision
 - b. **Economies of scale** – when the cost of producing a unit of good falls as its output rate increases
 - c. **Economies of scope** – when it uses specialized resources to produce a range of goods and services. For example, Microsoft hires programmers, designers, and marketing experts to produce a wide range of

products, and in turn coordinates these resources better than an individual who can buy all these services separately in the marketplace

- d. **Team Production** – when groups can specialize, output increases