ECON 2106 - Microeconomics
Chapter 21 - Financial Environment

Lecture Outline

1. Introduction and Overview

2. Types of Organizations

3. Costs and Objectives

4. Introduction and Overview

In the preceding chapters, we examined the basic principles of supply and demand and the relationship between elasticity and revenue. We now move from the study of the formulation of demand and supply to an examination of the production side of the market, that is, we now will study different types of business organizations, their cost structures, and what motivates businesses in the modern economy.

Before we proceed with our analysis, we need to formally define some of the terms that we will use in this chapter:

Firms: *Firms are specialized organizations that buy resources from households (land, labor, capital, and entrepreneurship) and other firms to produce goods or services for sale to customers (which might be households and/or other firms).*

Production: *Production transforms inputs into outputs (resources into goods and services) that are more valuable in form, place, possession or time, that is, production adds value to the inputs in the process of creating outputs.*

Short-Run: *The short run is a period during which the amount of at least one resource is fixed and firms can neither enter or exist the market.*

Long-Run: *The long run is a period of sufficient duration for all feasible resource adjustments to any event to be completed, including enter into and exit from the market.*

There are a variety of business types, from sole proprietorships to multi-national corporations. Each of these types has specific advantages and disadvantages which we will examine later on in this chapter.

As we move from the smallest type of firm (sole proprietorship) to large types of firms (partnership, corporation, joint-venture, multi-national corporation), we start to observe that firms engage in different activities, that is, they tend to diversify from their core business.

Broadly speaking, we can classify firms into two types: horizontally and vertically integrated firms.

Horizontal Integration: A firm is horizontally integrated if it engages in similar activities to produce like goods and services at a number of different sites.

Vertical Integration: A firm is vertically integrated if it operates at different production levels within a specific industry.

Examples of horizontally integrated firms abound. Car manufacturers, airlines, fast food restaurants. Vertically integrated firms: Steel, Oil corporations.

We can now address the question of why firms exist, that is, why do we not make our own products, farm our own food, build our own houses?

Obviously, such subsistence activities leave little room for more productive activities, that is, if you have to do everything just to survive, it is somewhat hard to go to college.

Firms operate to produce goods and services that allow households to concentrate on other activities. Instead of having to grow your own food, you realize substantial savings in time and money if you buy food from an intermediary who purchases the food from a farmer who specializes in the production of food.

Thus, firms **reduce transactions costs** and reap the benefits of **specialization**.

Economies of Scale: *Economies of scale in production or distribution occur when average costs decline in the long run as a firm expands its production and distributive capacity.*

Economies of Scope: *Economies of scope occur when a firm realizes lower costs by producing or distributing multiple products which utilize the same technologies or marketing and distribution networks.*

When can observe that firms merge with each other in attempts to reap economies of scale, that is, to lower their costs of production so that their profit margins increase. Economies of scope are when firms engage in complementary activities, that is, milk producers also make ice cream; gasoline producers also make jet fuel; etc.

2. Types of Organizations

There are a wide variety of firms in the marketplace and to cover each type is almost impossible as new forms of businesses are created on a daily basis. We can, however, note some of the common types of forms so that you are more familiar with these forms when you encounter them in the market.

A. Sole Proprietorships
B. Partnerships
C. Corporations
D. Cooperatives

Sole Proprietorships: Simply put, a sole proprietorship is a firm owned and operated by a single individual or household. The proprietorship has sole liability for the operation of the business.

Partnership: A partnership is a legal entity, formed by two or more individuals, in which the liability for the partnership is shared among the individuals forming the partnership.

Corporation: A corporation is a legal entity that is considered separate and independent from its owners. The corporation assumes all liability for its products, thus shielding its owners from this hazard.

Cooperative: A cooperative is a legal entity that may or may not shield its owners from liability, depending on its legal form. In general, cooperatives are make up of individuals and/or firms that do not have the incentive to merge, but have the incentive to jointly market their products.

	Advantages	Disadvantages
Sole Proprietorship	Easy to start, dissolve Easy management Moderate Govt Interference	Unlimited Liability Limited Capital

Partnership	Easy to start, dissolve Moderate management Moderate Govt Interference	Unlimited Liability in most cases Limited Capital Harder to manage
Corporation	Moderate to start, dissolve Limited liability Access to Capital	Harder to manage Govt regulation Double taxation
Cooperative	Moderate to start, dissolve Potential limited liability Joint marketing efforts	Harder to manage Govt regulation access to capital

One question is how to firms finance their operations? For sole proprietorships and partnerships, the options are quite limited. They must essentially rely on their own resources or perhaps a temporary loan of financial capital from a financial institutions. Thus, the growth opportunities for these organizations are limited due to their inability to secure sufficient capital to fuel expansion.

Corporations, on the other hand, often issue common stock so as to raise capital to finance operation. If a corporation makes a net profit, it may issue a dividend to shareholders. Of course, it is incurs a lose, then no dividend is issued and the stock price is likely to fall.

Corporations may also issue their own bonds, which are secured debt instruments paying a specific interest rate for the term of the bond.

3. Business Costs and Objectives

Most of us are familiar with accounting costs, that is, revenue - expenses = profit or loss. In economics, we also look at economic costs that capture opportunity costs. Thus, in some cases while a firm might appear to make an accounting profit, it may make an economic loss.

Explicit Costs *Explicit costs require outlays of money*

Implicit Costs *Implicit costs are the opportunity costs of resources the firm's owner makes available for production without any cash outlays*

Economic Costs *Economic costs of production include both **implicit and explicit** costs*

Accounting Profit *Accounting Profit is a firm's total revenue minus its total costs, where a loss is incurred if costs exceed revenue and a profit is realized is revenue exceeds costs.*

Economic Profit *Economic Profit occurs only when a firm's revenue exceeds all costs, including explicit (monetary) and implicit (opportunity) costs.*

We can look at an example of the difference between accounting and economic perspectives:

Assume that we are looking at a partnership, two individuals whose best foregone alternative is $50,000 a year.

Total Sales Revenue:	$1,500,000
Total Finance Revenue:	**$** 200,000
Total Revenue:	**$1,700,000**
Wages and Salaries	$ 800,000 (for employees other than the owners)
Cost of Goods	$ 300,000
Other costs	$ 400,000
Taxes	$ 150,000
Total Explicit Costs	**$1,650,000**
Net Accounting Profit	**$ 50,000**
Salaries Foregone	$ 100,000
Interest Foregone	$ 7,000
Total Implicit Costs	**$ 107,000**
Net Economic Loss	**$ 57,000**

Thus, it is readily apparent that the two owners would be better off if they sold the business and went to work with their best alternative.

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Why won't sharks attack economists?
Professional courtesy.

Q: What do you get when you cross the Godfather with an economist?

A: An offer you can't understand.

They say that Christopher Columbus was the first economist. When he left to discover America, he didn't know where he was going. When he got there he didn't know where he was. And it was all done on a government grant.

Santa Claus, the tooth fairy, a practical economist, and an old drunk are walking down the street together when they simultaneously spot a hundred dollar bill. Who gets it? The old drunk, of course, the other three are mythological creatures.