

6 Factor Market

Unit 5 : Profit & Entrepreneur - the nature of firm

- I. Nature of the firm
- II. Concept of profit and role of entrepreneur

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I. Nature of The Firm

1. In 1937, Ronald H. Coase (1910 -) wrote a paper –“ The Nature of Firm “. He tried to explain the existence of firms in the presence of a product market, i.e. if the (product) market mechanism is so efficient (as what Adam Smith said), why is there the existence of firm ?

He suggested that there is a cost – a transaction cost – in using the price mechanism in a product market. Firms exists to reduce the transaction cost of this type, together with a factor market.

In a world of complicated and vast number of exchanges, the cost of using the price mechanism is very great because there are :

- Great number of transactions : The number would be even more if firms are absent. The presence of middlemen like the wholesalers has helped to reduce the number of transactions.
- Information cost : There are high costs of consumers in knowing the quality, price of products etc.
- Measurement problem : The measurement of the value of output based on the value of inputs is very difficult to determine.
- Separation problem : The contribution of each production unit/team on the output is also difficult to measure in many cases.

2. Steven N.S. Cheng further elaborated Coase’s argument. The transaction cost in using the market mechanism includes : the cost of acquiring knowledge on the products ; identifying, measuring & separating the contributions by the amount of inputs.

As a result, a firm emerges to provide a single contract to both the consumers (by the market price) and input owners (by the factor cost) to reduce the transaction costs if a product market exists.

A firm, instead of a *mere production unit* in the traditional understanding, is **an agent** in the organization of production activities based on an arrangement by the **use of contracts** with the input owners.

It is an agent making contracts with the input owners for a definite set of rights so as to direct or organize production activities, thus supplying the goods and services to the consumers.

In a product market, the market transactions involve commodities.
In a factor market, the firm transactions involve factor inputs.

Firm is able to organize the factors of production by entering contracts with the input owners for the use (rights) of the inputs (resources) to produce ; and provides a single contract – the market price – for exchanges.

A firm has a contractual **arrangement** in production to reduce transaction costs based on some well-defined property rights.

These measurement problems lead to shirking of workers and in order to *monitor* shirking, a firm emerges to give birth to a factor market, with the entrepreneur to monitor shirking.

II. Concept of Profit & The Role of Entrepreneur

Role of Entrepreneur

An entrepreneur, aiming at the monitoring of shirking, is the residual claimants to any revenue left over after paying all contractual payments. The amount, if there exists, left over from revenue after deducting all the production costs, determines the return of entrepreneur (normal profit in traditional economic textbooks).

If the entrepreneur or employer does not monitor effectively, his net wealth position is reduced. (*His profit is not maximized !*)

He exploits any unperceived opportunities for gain in wealth – with an aim of wealth maximization.

R. LeRoy Miller, Intermediate Microeconomics (Page 153) wrote :

Given positive transaction costs, it may be cheaper to organize production in such a way that some market transactions are eliminated and replaced instead by an entrepreneur who monitors and directs production.

Production by a group of individuals, who are not the “ residual claimants “ to any revenue left over after paying all contractual payments, increases the cost of monitoring, metering, directing and negotiating contracts.

Concept of Profit

1. In the accounting sense : Profit = TR- TC (Explicit Costs)
For classical economists, TC = Wage + Rent + Interest + Entrepreneur / Normal Profit.
According to Frank A. Knight, profit is an unexpected gain in wealth.
2. Steven Cheng sees profit as something or anything *outside* the total costs.
Windfall profit = Realized Outcome – Expected Outcome
Windfall profit is undeserved gain / profit because no one deserves good luck in general.
Any expected return that can be discounted or capitalized is not profit but cost, e.g. monopoly rent, scrap value of a capital good.
3. Basically, uncertainty is the source of profit. Therefore zero profit will still encourage the firm to produce so long as its opportunity costs could be covered.
Profit is a residual, i.e. what is left over out of all revenue when costs are excluded.

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