Dr. Barry Haworth
University of Louisville
Department of Economics
Economics 201

Theory of the Firm

What kind of firms are there?

Firms organize in one of three (general) ways:
1) *Sole proprietorship*
2) *Partnership*
3) *Corporation*

How do these different means of organizing differ?

Ownership & Operation: these forms differ in terms of whether owners are operators

- Sole proprietorships owners who are also operators
- Corporations have separation between owners and operators

Liability: these forms differ in terms of their liability to potential creditors

- Sole proprietorships have unlimited liability
- Corporations have limited liability

Firms and costs

1. Transactions costs occur as goods and services are provided

- Definition: cost of "doing business" (costs other than production and distribution costs)

2. Firms minimize costs

- Cost minimization => Profit maximization

Transaction costs:
Suppose Ford wants to design and sell a new automobile.
There are various stages that Ford follows, in order to produce a commercially viable product.

- Design stage
- Testing stage
- Prototype stage
- Marketing stage
- Commercialization stage

What type of transaction costs do firms encounter?

1. Organizing a project: firms may have to choose between developing a project internally vs externally
    - internal commitment of specialized resources => *switching costs*

2. Securing/appropriating a return on an investment into a project
    - safeguarding against opportunistic behavior => *monitoring costs*

3. Adapting to future problems - developing contingencies
    - the gathering of information can be costly => *information/search costs*