

Theory of the Firm

MONTPELLIER UNIVERSITY SCHOOL
OF MANAGEMENT

Introduction

- About You
- What you want
- What do you expect to get from this course
- About Me
- House Rules
- Expectations

• **Module Summary:** The summary poses a thought-provoking question about the power dynamic between humans and businesses in the AI era. It also introduces the concept of the "theory of the firm" which is a framework used to study and understand how firms operate.

• **Prerequisite:** This course doesn't have any prerequisites. It's likely suitable for students from various backgrounds.

• **Module Aims:** The aim of the course is to equip students with the ability to discuss their own thoughts about the future of business management. Students will be able to understand the traditional theory of the firm and then apply it to a world where AI is becoming increasingly influential. They'll be able to think about the impact of AI on business-society relationships and the long-term future of businesses in a technologically advanced world.

Course Content

Sessions 1 -3

- Neoclassical Theory and Questions
- Theory of Transaction Costs
- Evolutionary theory

Sessions 4-6

- Theory of property rights
- Agency theory
- Theory of conventions/Review session
(Questions/Answers)

Neoclassical Theory and Questions

Core Principles:

- **Supply and Demand:** The cornerstone of Neoclassical theory. It argues that prices are determined by the interaction of supply and demand.
- **Utility Maximization:** Individuals seek to maximize their "utility" (satisfaction) from consuming goods and services.
- **Profit Maximization:** Firms aim to maximize profits by producing the optimal quantity of goods at the lowest possible cost.
- **Perfect Competition:** A theoretical model where many small firms compete in a market with perfect information and free entry/exit.

Key Concepts:

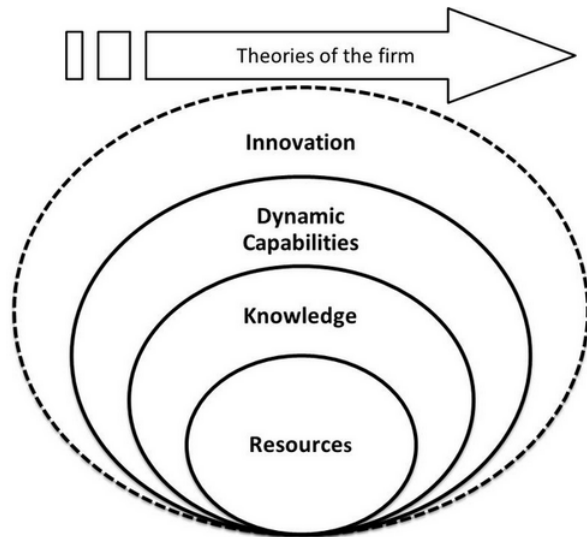
Rationality: Assumes that individuals and businesses act rationally to maximize their self-interest. This means they weigh costs and benefits carefully to make decisions.

Marginalism: Focuses on the effects of small changes (at the margin) in economic variables, such as prices or production levels, on decisions.

Equilibrium: Theories often seek to identify a state of equilibrium where supply and demand balance, leading to a stable market.

Markets: Emphasizes the importance of free markets and competition in allocating resources efficiently

Theory of the Firm



- What are your thoughts on Modern Firms
- How has modern technology affected how firms operate today
- Are individual expectations greater than that of the firm
- What role does ethics and sustainability play in firms today?

Neoclassical Theory and Questioning

- Existence. Why do firms emerge? Why are not all transactions in the economy mediated over the market?
- Organization. Why are firms structured in such a specific way, for example as to hierarchy or decentralization? What is the interplay of formal and informal relationships?
- Types of firms/Organizations

How Organizations are formed and the cultural aspects of firms across different nations

Ethics

Recap of the session

Questions that Neoclassical Theory Addresses

How are prices determined?
(Through supply and demand interactions)

How do individuals make choices?
(By maximizing their utility)

How do firms make decisions?
(By maximizing profits)

What is the role of government in the economy?
(Often seen as a regulator to ensure fair competition and provide public goods)

We Have to Talk of A Firm

The term "firm" in economics is used to describe a business organization. It's a very broad term, encompassing various types of companies, but it essentially refers to any entity that:

Produces and/or sells goods or services: Whether it's a small bakery, a large manufacturing company, or a tech startup, a firm exists to create and offer something to the market.

Combines factors of production: This means a firm gathers resources like labor, capital (machines and tools), land, and raw materials to create its products or services.

Seeks to make a profit: The ultimate goal for most firms is to generate more revenue than its costs, resulting in a profit.

Types of Firms

- Sole Proprietorship: Owned and operated by a single individual who has unlimited liability for its debts.
- Partnership: Two or more individuals own and operate the business, sharing profits and losses.
- Corporation: A legal entity separate from its owners, with limited liability. Shares of stock are typically owned by many individuals.
- Non-profit Organizations: Do not seek profits and focus on providing public benefits.

The Theory of the Firm:

- This is a branch of economics that tries to explain how firms make decisions, such as:
 - How much to produce?
 - What prices to charge?
 - How to organize and manage resources?
 - How to respond to competition?

Neoclassical economic theory often focuses on the concept of profit maximization as the driving force behind firm decisions. However, other theories, like behavioral economics, suggest that firms may also be motivated by factors like social responsibility or managerial preferences.

In short: When we talk about "firms" in economics, we're talking about the basic building blocks of our economic system – the businesses that produce and sell the goods and services that we consume.

A Firm

A firm is an organization which sells or produces something, or which provides a service which people pay for.

Within a firm there are several dynamics and intricate relationships that come into play, one of which is culture, culture is a vague term that is most easily described as being an organization's "DNA". It is a short-cut to talk about the way an individual employer functions and the principles it lives by. A healthy internal culture has long been seen as a building block of performance, belonging and success.

When we say we re studying theory of the firm we are going to be looking at a number of economic theories that explain and predict the nature of the firm, company, or corporation, including its existence, behavior, structure, and relationship to the market. Firms are key drivers in economics, providing goods and services in return for monetary payments and rewards. Organizational structure, incentives, employee productivity, and information all influence the successful operation of a firm in the economy and within itself. As such major economic theories such as Transaction cost theory, Managerial economics and Behavioral theory of the firm will allow for an in-depth analysis on various firm and management types.

[What do we mean when we talk about workplace culture? | Financial Times \(ft.com\)](#)

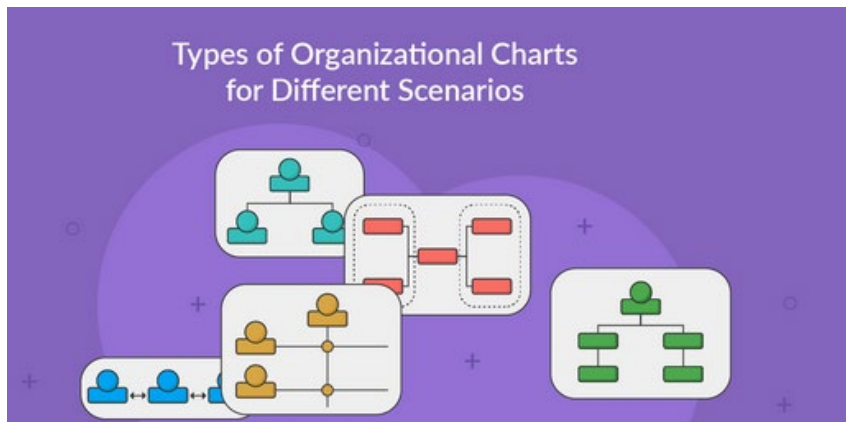
[Theory of the firm - Wikipedia](#)

A Firm



- What do we understand is a Firm? What is a Firm?
 - perception the firm
 - the main function
 - the firm is considered as the “black box”
- Why do they exist?
 - firms came into being to make it easier and less costly to get work done. ... A well managed company strives to achieve an optimal balance between what work gets done within and outside its boundaries. As The Economist article points out, market frictions and transaction costs are not the only reason why firms exist.
- What kind of transactions occur in a firm? Do all transaction in the Economy take place in the marketplace?

Organisations and How they are Structured



- Why are firms structured in different ways
 - Rules, roles and responsibilities are directed
 - Aim: achieve the objectives of the organization
 - Information flows between different levels
- Hierarchy in firms
- What is the interplay of formal and informal relationships in firms

Organisations and How they are Structured

Why do companies have a structure?

- Internationalization → organization of activities
Adaptation of structure to different factors: size, strategy

What if they do not have a formal structure?

- Difficulty in knowing who to report to
- Uncertainty who is responsible for what

Advantages of formal structure:

- Improve efficiency and clarity for everyone at every level
- Departments → more productive and focused on energy and time

Organisations and How they are Structured

- Organizations → living organism. Dynamic environment → organizational chart/ structured frequently adapted
- Proper organizational structure: NOT sufficient. Will face internal barriers:
- Organizational structure:
 - Communication and reporting lines → effectively
 - Organizational culture → need for change
 - People at work have resistance.

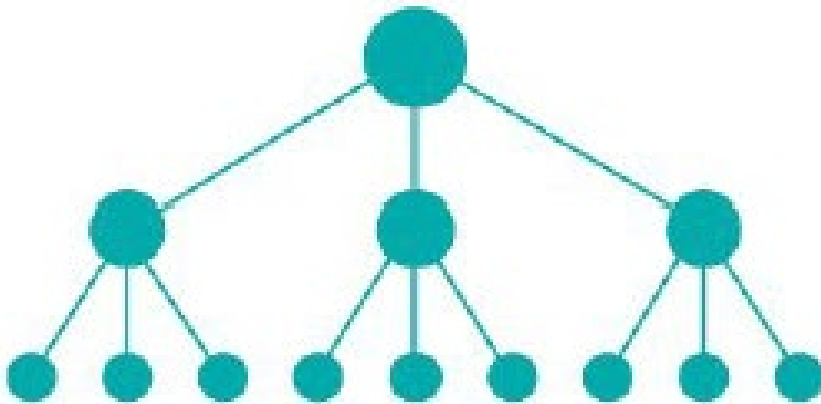
How to overcome internal barriers:

- Involvement → feel part of it → invest, adapt and learn
- Create competencies → complex situations with trade-offs
- A proper structure and people working the way you want them to is the key to success.

Organisations and How they are Structured

Hierarchy in firms

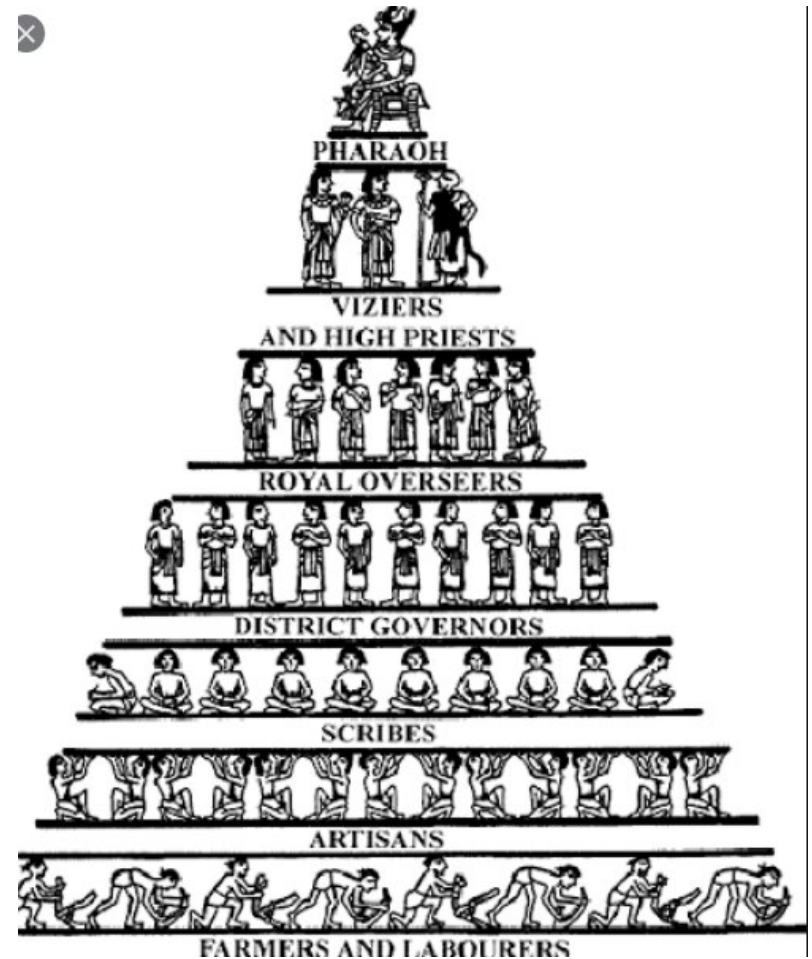
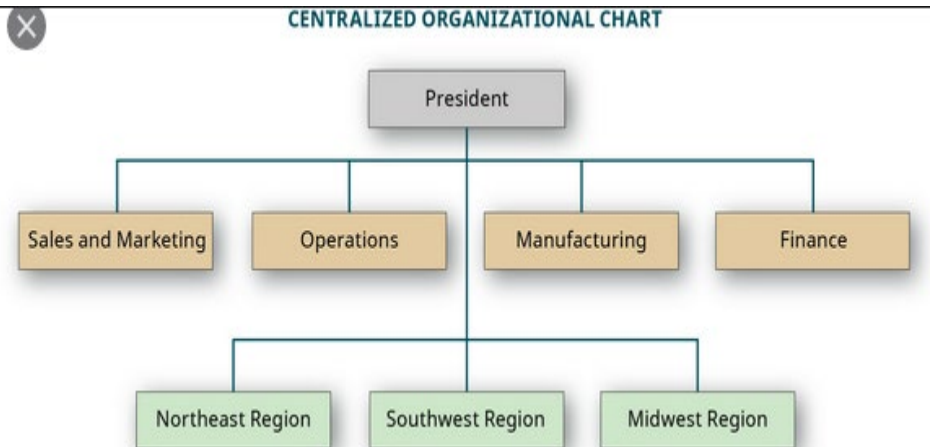
- Centralized
 - Decisions → concentrated to specific leader/ location Other offices receive commands
 - Flow: Top-down Defined chain of command



Organisations and How they are Structured

Hierarchy in firms

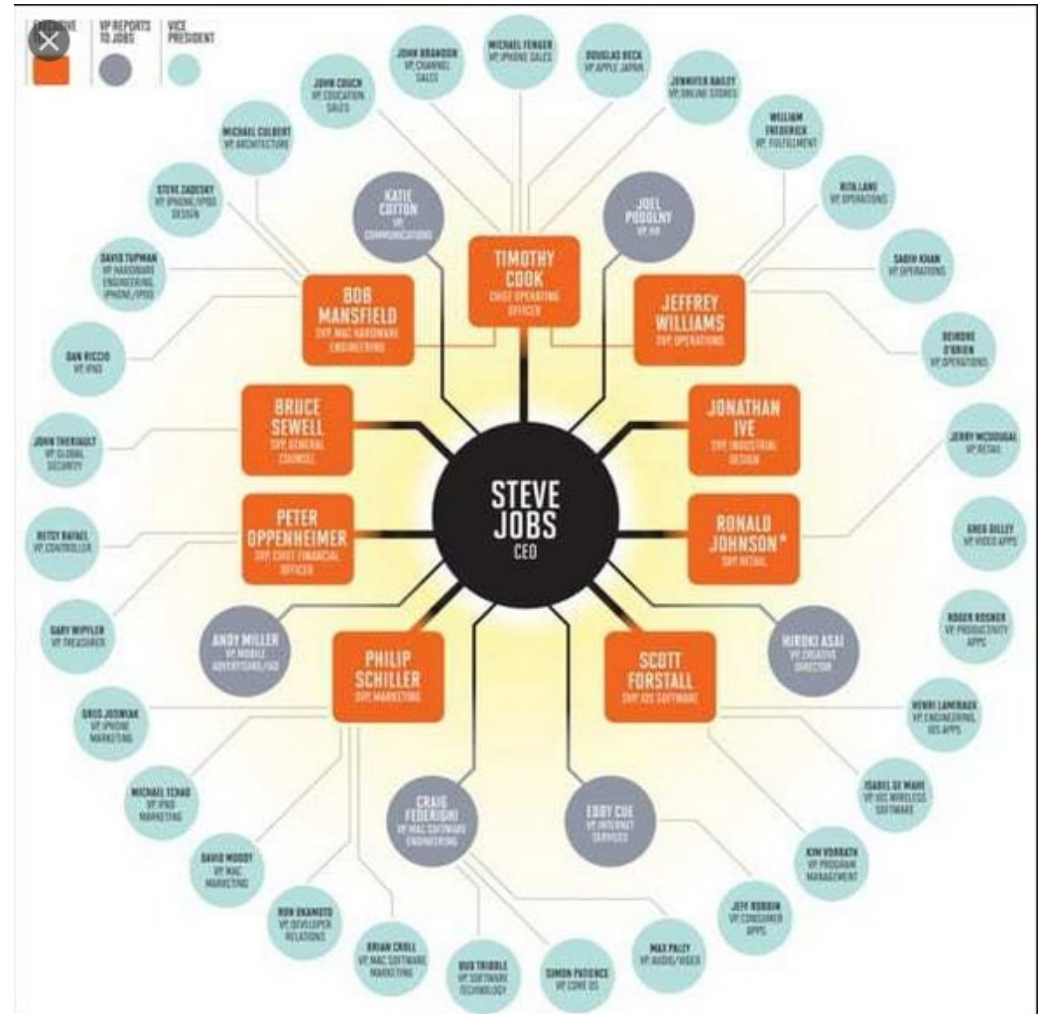
- Centralized: Like Military



Organisations and How they are Structured

Hierarchy in firms

- Centralized:



Centralized Structure

Advantages

- Clear chain of command → everyone knows who to report to
- Focused vision → clear lines of communication
- Quick implementation of decisions → small group takes decisions BUT if lower-level managers get involved → longer and conflicts arise

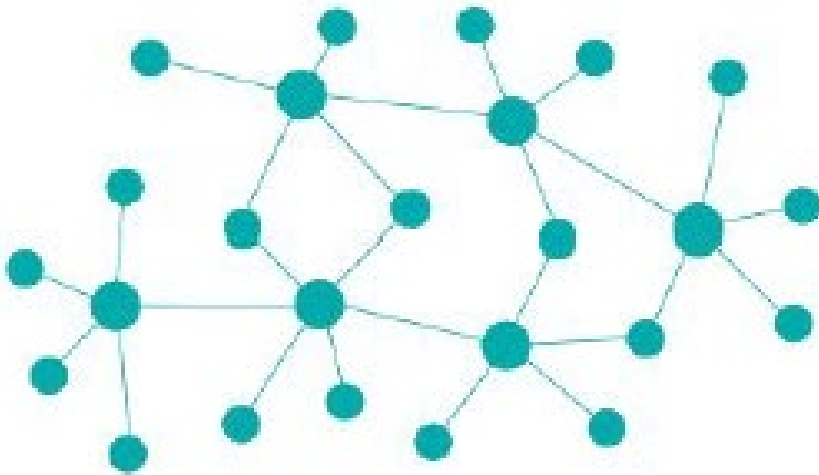
Disadvantages

- Bureaucratic leadership → deliver only asked results → lack of motivation
- Delays in work → records are sent to and from the head office
- Lack of employee loyalty → lack of opportunity to be creative

Organisations and How they are Structured

Hierarchy in firms

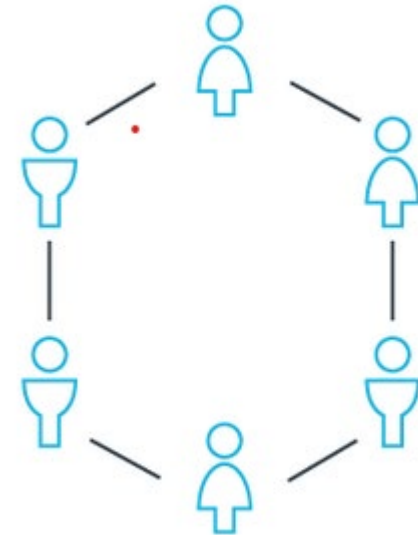
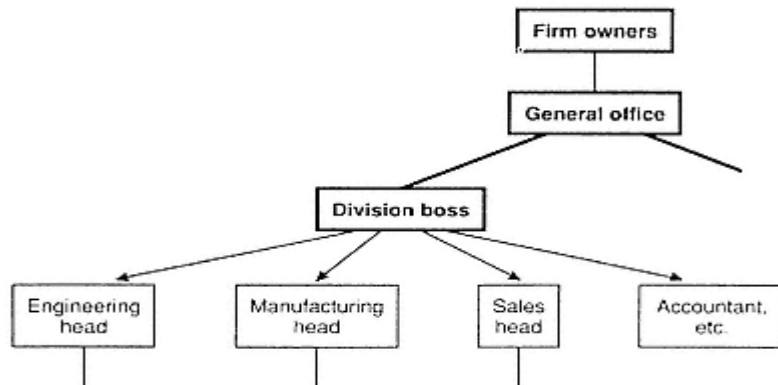
- Decentralized
 - Decisions/ responsibilities are distributed
 - Top management can concentrate on major



Organisations and How they are Structured

Hierarchy in firms

- Decentralized organizations also tend to implement less traditional workplace environments like hot desking, office hoteling, and use of coworking spaces. This creates a greater sense of freedom and flexibility and shared, or mobile office structures often incorporate informal spaces for meeting and collaborating that can take some of the pressure off the use of meeting rooms and event spaces.



Organisations and How they are Structured

Hierarchy in firms

- Decentralized:
- Over 200 units that function autonomously.



Johnson & Johnson

Decentralized Structure

Advantages

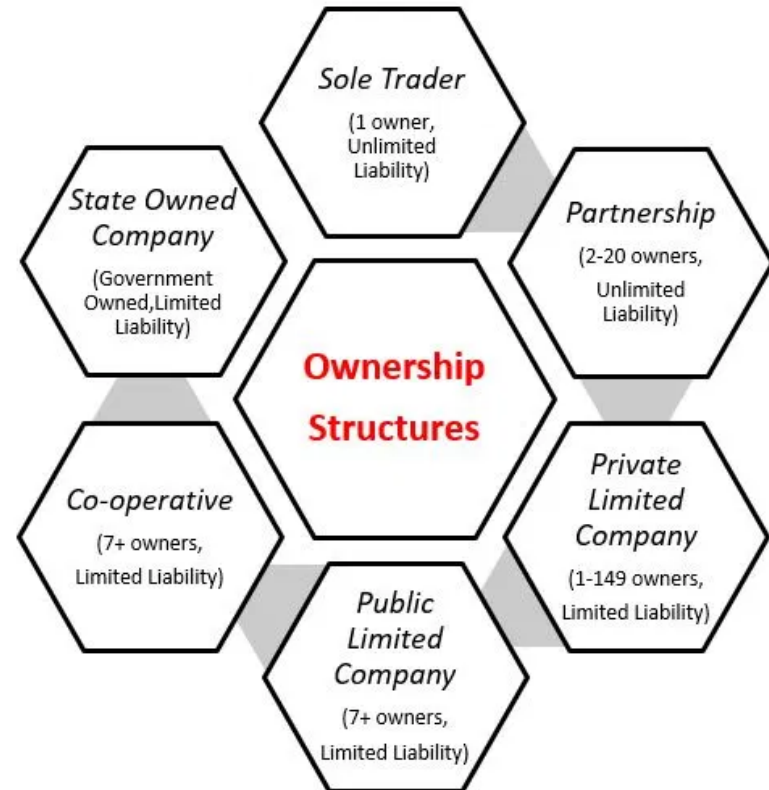
- Motivation of subordinates → more responsibility → job satisfaction
- Quick decision making → authorized personnel → faster and accurate results
- Efficient communication → less hierarchical levels → more intimate relationships develop

Disadvantages

- Expensive → responsibility for organization → work hard → paid more
- External factors → market uncertainties, government interventions

Types of Firms/Organizations

- Sole Trader
- Partnership
- Limited Partnership
- Limited Liability (LLC)
- Corporation



Types of firms/Organizations

- The entrepreneurial organization.
- The machine organization (bureaucracy).
- The professional organization.
- The divisional (diversified) organization.
- The innovative organization ("adhocracy").

Types of Firms/Organizations

- The entrepreneurial organization :
- Simple organizational form that typically includes one large operational unit, with one or a few individuals in top management.
 - This has made it a more flexible organization.
(a small business startup under an owner manager)
- Particularities:
 - innovative, keep doing transactions and adapting, bringing new technologies.
 - the owner-manager generally maintains strict control over business operations.



Types of Firms/Organizations

- The machine organization
- is defined by its standardization.
- Work is very formalized, there are many routines and procedures
- Decision-making is centralized
- Jobs will be clearly defined
- Procedures will regularly be analyzed for efficiency.

(The machine organization has a tight vertical structure. Examples: Large manufacturers are often machine organizations, as are government agencies and service firms that perform routine tasks.)

- Advantages:
 - Maintain centralized control.
 - Efficiency
 - rely heavily on economies of scale for their success.
- Disadvantages:
 - The formalization leads to specialization and, pretty soon, functional units can have conflicting goals that can be inconsistent with overall corporate objectives.

Types of Firms/Organizations

- The professional organization
 - very bureaucratic
 - rely on highly trained professionals who demand control of their own work
 - high degree of specialization and decision making is decentralizedCorporation

(This structure is typical when the organization contains a large number of knowledge workers common in places like schools and universities, and in accounting and law firms)

- Advantages:
 - Efficiency
 - the output is generated by highly trained professionals who have autonomy and considerable power
 - Supporting staff within these organizations typically follows a machine structure.
- Disadvantages:
 - Complex
 - lots of rules and procedures.
 - lack of control of senior executives

Types of Firms/Organizations

- The divisional organization
 - has many different product lines and business units
 - central headquarters supports a number of autonomous divisions
 - make their own decisions, create budgets and have their own unique structures
- (This structure is in large and mature organizations that have a variety of brands produce a wide range of products, or operate in different geographical regions.)
- Advantages:
 - allows line managers to maintain more control and accountability than in a machine structure
 - day-to-day decision-making decentralized, the central team can focus on "big picture" strategic plans
 - Goal: ensure that the necessary support structures are in place for success.
- Disadvantages:
 - duplication of resources and activities.
 - divisions can tend to be in conflict because limited resources from headquarters
 - inflexible

Types of Firms/Organizations

- The innovative organization
 - best suited to traditional organizations
 - organizations, bureaucracy, complexity, and centralization are far too limiting
 - creative, functional team
 - Decisions are decentralized, and power is delegated to wherever it's needed.

(Who use this structure?
Filmmaking, consulting, and pharmaceuticals are project-based industries that often use this structure.)
- Advantages:
 - maintain a central pool of talent to solve problems
 - work in a highly flexible way
 - Workers move from team to team as projects are completed, and as new projects develop
 - It can respond quickly to change thanks to skilled experts able to meet new challenges.
- Disadvantages:
 - there can be lots of conflict when authority and power are ambiguous.
 - dealing with rapid change is stressful for workers

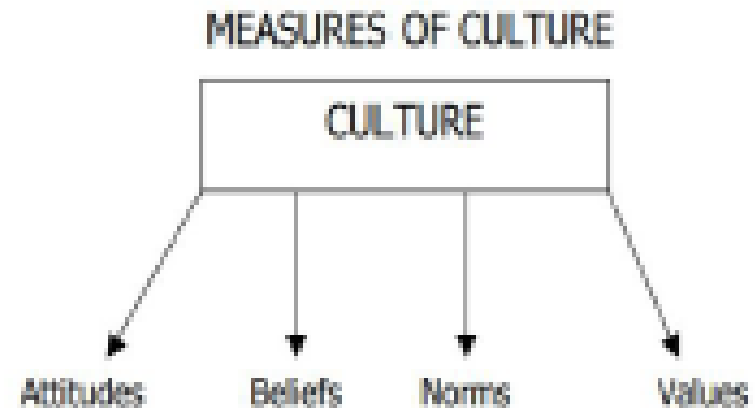
How organizations are formed and the cultural aspects of firms across different nations



- How are organizations formed?
 - setting goals
 - working on achieving
- How?
 - by creating a culture that everyone will work and behave accordingly.

The culture of the company

- Definition:
- An organization has a personality which we call its culture, and that culture influences the way employees act and interact with others.
- Why is it important ??
 - To employees:
 - A positive company culture can ensure that employees remain satisfied with their jobs and loyal to the organization. It also gives employees opportunities to grow.
 - In companies with good communication practices, employees know their opinions and ideas are welcomed.
 - if companies work in a collaborative way, employees are given opportunities to contribute, placed in roles in which they can succeed. So culture has an impact on the performance of the company.
 - To employers:
 - workers who fit in with the company culture are likely to not only be happier but also more productive
 - Engagement of employees
 - It impacts the business: managerial decision making, human resources practices, business protocol, leadership styles



How companies can improve their culture:

- Work as one team
- Understand both the current and the desired culture in order to identify what to change or improve
- Measure culture: understand employee attitudes and actions. If measurement reveals that current behaviors conflict with desired cultural values, refine the program to communicate and model culture throughout the organization.
- Adapt to other cultures
- Companies should become aware of the fact that the world is becoming a global village and the need for cross-cultural learning is increasing with the growth of business organizations beyond their national boarder. Also, cultural differences, if not understood and appreciated well, can lead to failures in business and social life.



Criticisms of Neoclassical Theory



Oversimplification: Critics argue it doesn't adequately capture the complexities of real-world economic behavior, such as imperfect information, irrationality, and social factors.



Focus on Efficiency: Critics contend that it prioritizes efficiency at the expense of equity and fairness, ignoring social problems.



Assumptions: Some of its core assumptions (like perfect rationality) are not always realistic in human behavior.

Ethics

- As with all business initiatives, the ethical operation of a company is directly related to profitability in both the short and long term.
- We shall be discussing :
 - A higher moral within your employees and the organization
 - It helps to attract new customers
 - It builds higher customer loyalty
 - It reduces the risk of negative press or backlash caused by doing “the wrong” things
 - It helps to make a positive impact on the community

In Conclusion

Neoclassical economics offers a powerful framework for understanding economic phenomena, but it's important to recognize its limitations and consider alternative perspectives. It's a starting point for exploring more complex and nuanced economic theories that seek to better explain the real world.

Questions

- ?