Competitive Diversity

- How can cost functions differ?

Different Cost Functions

- We have looked at two cases:
  - Firms with identical cost functions
  - Firms with different cost functions.

- To most, it seems obvious that firms have different cost functions.
Different Cost Functions

• We have looked at two cases:
• To most, it seems obvious that firms have different cost functions.
  – Not to economists
  – How can one firm have special knowledge?

Sources of Differences

• Different Endowments

Sources of Differences

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Sources of Differences

• Different Endowments
  – Suppose farmer Jones has rich flat bottomland, while Smith has hilly rocky land.
  – Then different production functions and hence different AC and MC functions.

Sources of Differences

• Different Endowments
  • Learning Curve
    – Suppose Smith is just starting out, while Jones is an old hand at this business.

Sources of Differences

• Different Endowments
  • Learning Curve
  • Aging Plants
  • Patents and other know how.

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Economic and Accounting Profits

• We are told that firms are in business to make a profit.
  – When firms are identical and industry is in equilibrium $P = AC$, meaning zero profit.
  – Accountants and the IRS take a different view.

Economic and Accounting Profits

• Joe Smith Widget Works sold $1,000,000 last year.
  – Paid workers $700,000
  – Accountants and the IRS would record profits of $300,000

• The difference is opportunity cost
Economic and Accounting Profits

- The difference is opportunity cost
  - Joe could have earned $150,000 working for Baker Widgets
  - Joe had $1,500,000 in business, could have earned 10% elsewhere.

Economic and Accounting Profits

- The difference is opportunity cost
- Then economic profits are zero; the $300,000 represents opportunity cost.

End

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