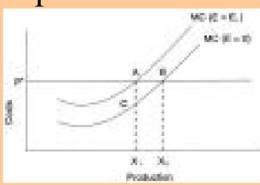
Competitive Diversity



Competitive Diversity

- How can cost functions differ?

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- Economic and Accounting Profits

Different Cost Functions

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  - Firms with identical cost functions
  - Firms with different cost functions.

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Different Cost Functions

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- 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

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  - 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
  - Smith has a new plant; Jones has a clunker.

Sources of Differences

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

Economic and Accounting Profits

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  - 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

- We are told that firms are in business to make a profit.
- The difference is Economic Profits vs. Accounting Profits.

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

Economic and Accounting Profits

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  - 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