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**Lecture 01: Theory of the Firm**

1. Wealth of Nations
   1. One of the oldest ideas in economics is the division of labor, famously outlined by Adam Smith in his seminal work, *The Wealth of Nations*.
   2. The story of the pin factory
2. Why division of labor works
   1. Adam Smith outlined three key reasons why people are more productive if they specialize.
      1. Less time is wasted shifting between tasks.
      2. Productivity increases (learned dexterity, learning by doing).
      3. Time-saving devices are more likely to be developed.
   2. Smith’s explanations can more or less be summed up as learned specialization; anyone can theoretically swap for anyone else and similar productivity will eventually emerge.
   3. Economist David Ricardo noted the importance of a different explanation, what we can call natural specialization.
      1. These benefits stem from a person’s endowment: height, intelligence, aptitude, drive, attractiveness, etc.
      2. Specialization allows people (or regions) with the right attributes to make the most out of their endowment.
3. Limits
   1. The division of labor is limited by the extent of the market.
      1. The extent of the market is the number of people one can exchange with.
      2. All things being equal, large cities have more specialization.
   2. This is intuitively a function of demand: a carpenter in a small town will work on many different types of jobs; in a large town, he is more likely to focus (say, as a roofer or in remodeling).
   3. It’s also a function of supply: a carpenter may wish to hire an accountant but in a small town, one might not be available.
      1. Untangling these two is not easy, though. Perhaps if the town was larger, the carpenter could earn more money to pay an accountant a sizable wage, thus attracting people to learn how to be an accountant.
   4. The extent of the market is limited in two ways
      1. Natural barriers, such as distance, information, or simply population size, cannot be corrected easily, if at all.
      2. Artificial barriers, such as tariffs, laws regarding movement, racism, etc can, theoretically, be corrected overnight.
4. Why do we have firms?
   1. *Transaction costs*—costs of engaging in the price system
      1. Ex: Writing contracts, risk of nonrenewal, difficulty of conveying information, search, negotiating
   2. *Organizational costs*—costs of operating in a hierarchy
      1. Ex: Combating shirking, managing disputes, managing promotions, inflexibility
   3. Coase (1937) argued that firms exist as a balance between these two costs: between millions of self-employed and one single conglomerate
   4. Changes in these costs change firm size (sales tax, information technology, etc)