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THOERY OF FIRM
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THEORY OF THE FIRM

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The theory of the firm is the microeconomic concept founded in neoclassical economics that states that a firm exists and make decisions to maximize profits. The theory holds that the overall nature of companies is to maximize profits meaning to create as much of a gap between revenue and costs. The firm's goal is to determine pricing and demand within the market and allocate resources to maximize net profits.

KEY TAKEAWAYS

- The theory of the firm is the microeconomic concept that states the overall nature of companies is to maximize profits meaning to create as much of a gap between revenue and costs.

- The theory has been debated as to whether a company's goal is to maximize profits in the short-term or long-term.

- Solely focusing on profit maximization comes with a level of risk in regards to public perception and a loss of goodwill between the company, consumers, investors, and the public.

UNDERSTANDING THE THEORY OF THE FIRM

In the theory of the firm, the behavior of any company is said to be driven by profit maximization. The theory governs decision making in a variety of areas including resource allocation, production techniques, pricing adjustments, and the volume of production.

Early economic analysis focused on broad industries, but as the 19th century progressed, more economists began to ask basic questions about why companies produce what they produce and what motivates their choices when allocating capital and labor.

Under the theory of the firm, the company's sole purpose or goal is to maximize profit. However, the theory has been debated and expanded to consider whether a company's goal is to maximize profits in the short-term or long-term.

EXPANSION ON THE THEORY OF THE FIRM

Modern takes on the theory of the firm sometimes distinguish between long-run motivations, such as sustainability, and short-run motivations, such as profit maximization. The theory has been debated by supporters and critics.

If a company's goal is to maximize short-term profits, it might find ways to boost revenue and reduce costs. However, companies that utilize fixed assets like equipment would ultimately need to make capital investments to ensure the company is profitable in the long-term. The use of cash to invest in assets would undoubtedly hurt short-term profits but would help with the long-term viability of the company.

Competition can also impact the decision making of company executives. If competition is strong, the company will need to not only maximize profits but also stay one step ahead of its competitors by reinventing itself and adapting its offerings. Therefore, long-term profits could only be maximized if there's a balance between short-term profits and investing in the future.

The theory of the firm supports the notion that profit maximization is the nature of a company's existence, but today companies must consider shareholder wealth through dividends, public perception, social responsibility, and long-term investments in the company's viability.