UNIT-3

Laws of Production

→ The law of production describes the way which are technically possible to increase the level of production.

Laws of production

- Law of Variable Proportions
  or
  Returns to a factor
  or
  Law of Diminishing returns
  or
  Short Run Production
  (A single factor is variable)
- Law of Returns to scale.
  or
  Long run Production Function
  (All factors are Variable)

Law of Diminishing Returns scale

→ In short run, the output can be increased by increasing the amount of the variable factor. The response of output to changes in the amount of a variable factor, when other factors of production remain constant, is referred to as Returns to a factor or law of variable proportions.

→ The total output may initially increases at an increasing rate, but beyond a certain level of output, the rate of increase in the total output decreases.

For eg → one variable factor of production (labour) and Land is a fixed factor.

Law of Returns to scale

→ In the long period, all the factors of production are variable and an increase in output is possible by increasing all the inputs. The firm can hire large quantities of inputs and change the scale of production. Therefore in the long run, the firm can change the scale of operations and in the process get governed by the 'Law of Return' to scale.

In other words - The terms returns to scale refers to the change in output as all factors change by the same proportion.

Types of Returns to Scale

Increasing Returns to Scale

→ In it output increases more than in proportion to change in all inputs

Constant Returns to scale

→ In it output increases by the same proportion as all input increase

Diminishing Returns to scale

In it output increases less than in proportion to the increase in all inputs.

	Point of Difference	Returns to a Variable Factor	Returns to scale
(1)	Period	It is studied with reference to short period	It is studied with reference to long period.
(2)	Change of factors	There is change in variable factor only	There is change in all factors
(3)	Factor Ratio	The ratio between fixed and variable factor changes	The ratio between fixed and variable factor remain same.
(4)	Scale of Production	Scale of production remains the same	Scale of production changes.

Overview of Cost

Cost: The total money, time, and resources associated with a purchase or activity

The cost concepts which are relevant to business operations and decisions can be studied on the basis of their purpose, under two overlapping categories:

(i) Concepts used for accounting purposes, and

(ii) Concepts used in economic analysis of the business activities. Let us discuss here some important concepts of the two categories.

A. Some Accounting Cost Concepts:

1. Opportunity Cost and Actual Cost:

Opportunity cost refers to the loss of earnings due to opportunities foregone due to scarcity of resources. If resources were unlimited, there would be no need to forego any income-yielding opportunity and, therefore, there would be no opportunity cost. Resources are scarce but have alternative uses with different returns. Incomes maximizing resource owners put their scarce resources to their most productive use and forego the income expected from the second best use of the resources.

Therefore, the opportunity cost may be defined as the expected returns from the second best use of the resources foregone due to the scarcity of resources. The opportunity cost it is also called Alternative cost. For example, suppose that a person has a sum of Rs. 1, 00,000 for which he has only two alternative uses. He can buy either a printing machine or, alternatively, a lathe machine. From printing machine, he expects an annual income of Rs. 20,000 and from the lathe, Rs. 15,000.

If he is a profit maximizing investor, he would invest his money in printing machine and forego the expected income from the lathe. The opportunity cost of his income from printing machine is the expected income from the lathe, i.e., Rs. 15,000.

The opportunity cost arises because of the foregone opportunities. Thus, the opportunity cost of using resources in printing business, the best alternative is the expected return from the lathe, the second best alternative. In assessing the alternative cost, both explicit and implicit costs are taken into account.

Associated with the concept of opportunity cost is the concept of economic rent or economic profit. For example, economic rent of the printing machine is the excess of its earning over the income expected from the lathe (i.e., Rs. 20,000 – Rs. 15,000 = Rs. 5,000).

The implication of this concept for business man is that investing in printing machine is preferable so long as its economic rent is greater than zero. Also, if firms know the economic rent of the various alternative uses of their resources, it will be helpful in the choice of the best investment avenue.

On the other hand, actual costs are those which are actually incurred by the firm in payment for labour, material, plant, building, machinery, equipment, travelling and transport, advertisement, etc. The total money expenses, recorded in the books of accounts are, for all practical purposes, the actual costs. Actual cost comes under the accounting concept.

2. Business Costs and Full Costs:

Business costs include all the expenses which are incurred to carry our business. The concept of business costs is similar to the actual or real costs. Business costs "include all the payments and contractual obligations made by the firm together with the book cost of depreciation on plant and equipment".

These cost concepts are used for calculating business profits and losses and for filling returns for income-tax and also for other legal purposes.

Full costs, on the contrary, include business costs, opportunity cost and normal profit. The opportunity cost includes the expected earnings from the second best use of the resources, or the market rate of interest on the total money capital, and also the value of entrepreneur's own services which are not charged for in the current business.

Normal profit is a necessary minimum earning in addition to the opportunity cost, which a firm must get to remain in its present occupation.

3. Explicit and Implicit or Imputed Costs:

Explicit costs refer to those which fall under actual or business costs entered in the books of accounts. The payments for wages and salaries, materials, license fee, insurance premium, depreciation charges are the examples of explicit costs. These costs involve cash payments and are recorded in normal accounting practices.

In contrast with these costs, there are not certain other costs which do not take the form of cash outlays, nor do they appear in the accounting system. Such costs are known as implicit or imputed costs. Implicit costs may be defined as the earning expected from the second best alternative use of resources. For instance, suppose an entrepreneur does not utilize his services in his own business and works as a manager in some other firm on a salary basis.

If he starts his own business, he foregoes his salary as manager. This loss of salary is the opportunity costs of income from his own business. This is an implicit cost of his own business; implicit, because the entrepreneur suffers the loss, but does not charge it as the explicit cost of his own business. Thus, implicit wages, rent and interest are the highest wages, rents and interest which owner's labour, building and capital can respectively earn from their second best use.

Implicit costs are not taken into account while calculating the loss or gains of the business, but they form an important consideration in whether or not a factor would remain in its present occupation. The explicit and implicit costs together make the economic cost.

4. Out-of-Pocket and Book Costs:

Out-of-pocket costs means costs that involve current cash payments to outsiders while book costs such as depreciation do not require current cash payments. In concept, this distinction is quite different from traceability and also from variability with output. Not all out-of- pocket costs are variable, e.g., salaries paid to the administrative staff.

Neither are they all direct, e.g., the electric power bill. Book costs are in some cases variable and in some cases readily traceable, and hence become a part of direct costs. The distinction primarily shows how cost affects the cash position. Book costs can be converted into out-of-pocket costs by selling the assets and having them on hire. Rent would then replace depreciation and interest.

While undertaking expansion, book costs do not come into the picture until the assets are purchased. Yet the question to be answered is: What will be the gross earnings of the investment during its life time and do they justify the outlay? Transfer of old equipment to new areas will bring book costs into the picture

B. Some Analytical Cost Concepts:

1. Fixed and Variable Costs:
Fixed costs are those costs which are fixed in volume for a certain given output. Fixed cost does not vary with variation in the output between zero and certain level of output. The costs that do not vary for a certain level of output are known as fixed cost.

The fixed costs include:
(i) Cost of managerial and administrative staff.
(ii) Depreciation of machinery, building and other Axed assets, and
(iii) Maintenance of land, etc. The concept of fixed cost is associated with short-run.

Variable costs are those which vary with the variation in the total output. They are a function of output. Variable costs include cost of raw materials, running cost on fixed capital, such as fuel, repairs, routine maintenance expenditure, direct labour charges associated with the level of output, and the costs of all other inputs that vary with output.

2. Total, Average and Marginal Costs:

Total cost represents the value of the total resource requirement for the production of goods and services. It refers to the total outlays of money expenditure, both explicit and implicit, on the resources used to produce a given level of output. It includes both fixed and variable costs. The total cost for a given output is given by the cost function.

Average cost:
Average cost (AC) is of statistical nature, it is not actual cost. It is obtained by dividing the total cost (TC) by the total output (Q), i.e.
$AC = TC / Q$ = average cost

Marginal cost:
Marginal cost is the addition to the total cost on account of producing an additional unit of the product. Or, marginal cost is the cost of marginal unit produced. Given the cost function, it may be defined as
$MC = TC/ Q$
These cost concepts are discussed in detail in the following section. Total, average and marginal cost concepts are used in economic analysis of firm's production activities.

3. Short-Run and Long-Run Costs:

Short-run and long-run cost concepts are related to variable and fixed costs respectively, are often marked in economic analysis interchangeably.

Short-run costs are the costs which vary with the variation in output, the size of the firm remaining the same. In other words, short-run costs are the same as variable costs.

Long-run costs, on the other hand, are the costs which are incurred on the fixed assets like plant, building, machinery, etc. Such costs have long-run implication in the sense that these are not used up in the single batch of production.

Long-run costs are, by implication, the same as fixed costs. In the long-run, however, even the fixed costs become variable costs as the size of the firm or scale of production increases. Broadly speaking, 'the short-run costs are those associated with variables in the utilization of fixed plant or other facilities whereas long-run costs are associated with the changes in the size and kind of plant.'

4. Incremental Costs and Sunk Costs:

Incremental costs are closely related to the concept of marginal cost but with a relatively wider connotation. While marginal cost refers to the cost of the marginal unit of output, incremental cost refers to the total additional cost associated with the marginal batch of output.

The concept of incremental cost is based on the fact that in the real world, it is not practicable for lack of perfect divisibility of inputs to employ factors for each unit of output separately. Besides, in the long run, firms expand their production; hire more men, materials, machinery and equipments.

The expenditures of this nature are incremental costs and not the marginal cost (as defined earlier). **Incremental costs** arise also owing to the change in product lines, addition or introduction of a new product, replacement of worn out plant and machinery, replacement of old technique of production with a new one, etc.

The Sunk costs are those which cannot be altered, increased or decreased, by varying the rate of output. For example, once it is decided to make incremental investment expenditure and the funds are allocated and spent, all the preceding costs are considered to be the sunk costs since they accord to the prior commitment and cannot be revised or reversed or recovered when there is change in market conditions or change in business decisions.

5. Historical and Replacement Costs:

Historical costs are those costs of an asset acquired in the past whereas replacement cost refers to the outlay which has to be made for replacing an old asset. These concepts own their significance to unstable nature of price behaviour.

Stable prices over time, other things given, keep historical and replacement costs on par with each other. Instability in asset prices makes the two costs differ from each other.

Historical cost of assets is used for accounting purposes, in the assessment of net worth of the firm. The replacement cost figures in the business decision regarding the renovation of the firm.

6. Private and Social Costs:

There are not certain other costs which arise due to functioning of the firm but are not normally marked in the business decisions nor does are such cost explicitly borne by the firms. The costs of this category are borne by the society.

An Overview of Short and Long Run cost Curves

Short Run Average Cost Curve:

In the short run, the shape of the average total cost curve (ATC) is U-shaped. The, ***short run average cost curve*** falls in the beginning, reaches a minimum and then begins to rise. The reasons for the average cost to fall in the beginning of production are that the fixed factors of a firm remain the same. The change only takes place in the variable factors such as raw material, labor, etc.

As the fixed cost gets distributed over the output as production is expanded, the average cost, therefore, begins to fall. When a firm fully utilizes its scale of operation (plant size), the average cost is then at its minimum. The firm is then operating to its optimum capacity. If a firm in the short-run increases its level of output with the same fixed plant; the economies of that scale of production change into diseconomies and the average cost then begins to rise sharply.

Long Run Average Cost Curve:

In the long run, all costs of a firm are variable. The factors of production can be used in varying proportions to deal with an increased output. The firm having time-period long enough can build larger scale or type of plant to produce the anticipated output. The shape of the ***long run average cost curve*** is also U-shaped but is flatter that the short run curve as is illustrated in the following diagram

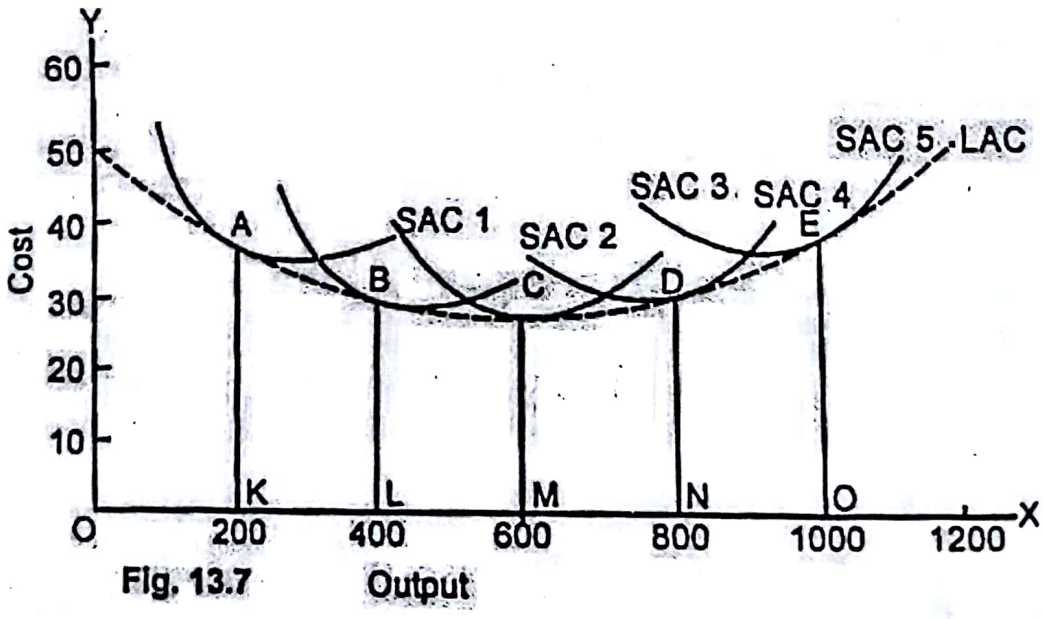

Fig. 13.7

In the diagram 13.7 given above, there are five alternative scales of plant SAC^1 SAC^2, SAC^3, SAC^4 and, SAC^5. In the long run, the firm will operate the scale of plant which is most profitable to it.

For example, if the anticipated rate of output is 200 units per unit of time, the firm will choose the smallest plant It will build the scale of plant given by SAC^1 and operate it at point A. This is because of the fact that at the output of 200 units, the cost per unit is lowest with the plant size 1 which is the smallest of all the four plants. In case, the volume of sales expands to 400, units, the size of the plant will be increased and the desired output will be attained by the scale of plant represented by SAC^2 at point B. If the anticipated output rate is 600 units, the firm will build the size of plant given by SAC^3 and operate it at point C where the average cost is $26 and also the lowest The optimum output of the firm is obtained at point C on the medium size plant SAC^3.

If the anticipated output rate is 1000 per unit of time the firm would build the scale of plant given by SAC^5 and operate it at point E. If we draw a tangent to each of the short run cost curves, we get the long average cost (LAC) curve. The LAC is U-shaped but is flatter than tile short run cost curves. Mathematically expressed, the long-run average cost curve is the envelope of the SAC curves.

In this figure 13.7, the long-run average cost curve of the firm is lowest at point C. CM is the minimum cost at which optimum output OM can be, obtained.

Profit Analysis and Concept of profit

In managerial economics, **profit analysis** is a form of cost accounting used for elementary instruction and short run decisions. A profit analysis widens the use of info provided by breakeven analysis. An important part of profit analysis is the point where total revenues and total costs are equal. At this breakeven point, the company does not experience any income or any loss.

Components of Profit Analysis

The key components involved in profit analysis include:

- Selling price per unit
- Level or volume of activity
- Total fixed costs
- Per unit variable cost
- Sales mix

Assumptions in Profit Analysis

The profit analysis incorporates the following assumptions:

- Unvarying sales price,
- Unvarying variable cost per unit,
- Unvarying total fixed cost,
- Unvarying sales mix,
- Units sold equal units produced.

These are largely linearizing and simplifying assumptions, which are frequently presumed in elementary discussions of costs and profits. In more advanced accounting treatments, costs and revenue are non linear thus making the analysis more complicated.

Applications of Profit Analysis

The profit analysis is helpful in simplifying the calculation of breakeven in breakeven analysis. Besides, it is generally helpful in simple calculation of Target Income Sales. Moreover, it also simplifies the process of analyzing short run trade-offs in operational decisions.

Method adopted for Profit Analysis

The main method adopted to carry out profit analysis is the profit volume ratio which is calculated by dividing the shareholders contribution by the sales and then multiplying it by 100 as follows:

*Profit Volume Ratio = (Shareholders contribution / Sales) * 100*

Limitations of Profit Analysis

The profit analysis is a short run and marginal analysis which presumes the unit variable costs and the unit revenues to be constant. This is, however, appropriate for small deviations from current production and sales. Besides, the profit analysis also presumes a neat division between variable costs and fixed costs, though in the long run, all costs are variable. Therefore, for longer term profit analysis considering the complete life-cycle of a product it is preferable to carry out activity-based costing or throughout accounting.

Concept of Profit: Types, Theories and Functions of Profit

The term profit has distinct meaning for different people, such as businessmen, accountants, policymakers, workers and economists.

Profit simply means a positive gain generated from business operations or investment after subtracting all expenses or costs.

In economic terms profit is defined as a reward received by an entrepreneur by combining all the factors of production to serve the need of individuals in the economy faced with uncertainties. In a layman language, profit refers to an income that flow to investor. In accountancy, profit implies excess of revenue over all paid-out costs. Profit in economics is termed as a pure profit or economic profit or just profit.

Profit differs from the return in three respects namely:

a. Profit is a residual income, while return is a total revenue
b. Profits may be negative, whereas returns, such as wages and interest are always positive
c. Profits have greater fluctuations than returns

According to modern economists, profits are the rewards of purely entrepreneurial functions. According to Thomas S.E., "pure profit is a payment made exclusively for bearing risk. The essential function of the entrepreneur is considered to be something which only he can perform. This something cannot be the task of management, for managers can be hired, nor can it be any other function which the entrepreneur can delegate. Hence, it is contended that the entrepreneur receives a profit as a reward for assuming final responsibility, a responsibility that cannot be shifted on the shoulders of anyone else."
For understanding the profit as a business objective, you need to learn two most important concepts, such as economic profit and accounting profit.

Types of Profit:

Different people have described profit differently. Individuals have associated profit with additional income revenue, and reward. However, none of the description of profit is said to be right or wrong; it only depends on the field which the word profit is described.

On the basis of fields, profit can be classified into two types, which are explained as follows:

i. Accounting Profit:

Refers to the total earnings of an organization. It is a return that is calculated as a difference between revenue and costs, including both manufacturing and overhead expenses. The costs are generally explicit costs, which refer to cash payments made by the organization to outsiders for its goods and services. In other words, explicit costs can be defined as payments incurred by an organization in return for labor, material, plant, advertisements, and machinery.

The accounting profit is calculated as:

Accounting Profit= TR-(W + R + I + M) = TR- Explicit Costs

TR = Total Revenue

W = Wages and Salaries

R = Rent

I = Interest

M = Cost of Materials

The accounting profit is used for determining the taxable income of an organization and assessing its financial stability. Let us take an example of accounting profit. Suppose that the total revenue earned by an organization is Rs. 2, 50,000. Its explicit costs are equal to Rs. 10, 000. The accounting profit equals = Rs. 2, 50,000 – Rs. 10,000 = Rs. 2, 40,000. It is to be noted that the accounting profit is also called gross profit. When depreciation and government taxes are deducted from the gross profit, we get the net profit.

ii. Economic Profit:
Takes into account both explicit costs and implicit costs or imputed costs. Implicit that is foregone which an entrepreneur can gain from the next best alternative use of resources. Thus, implicit costs are also known as opportunity cost. The examples of implicit costs are rents on own land, salary of proprietor, and interest on entrepreneur's own investment.

Let us understand the concept of economic profit. Suppose an individual A is undertaking his own business manager in an organization. In such a case, he sacrifices his salary as a manager because of his business. This loss of salary will opportunity cost for him from his own business.

The economic profit is calculated as:
Economic profit = Total revenue-(Explicit costs + implicit costs)

Alternatively, economic profit can be defined as follows:
Pure profit = Accounting profit-(opportunity cost + unauthorized payments, such as bribes)

Economic profit is not always positive; it can also be negative, which is called economic loss. Economic profit indicates that resources of a business are efficiently utilized, whereas economic loss indicates that business resources can be better employed elsewhere.

The difference between the accounting profit and economic profit is shown in Table-1:

Accounting Profit	Economic Profit
Refers to the profit that is determined as per Generally Accepted Accounting Principles (GAAP)	Refers to the profit that is determined by economic principles
Includes explicit costs only	Includes explicit and implicit costs
Helps in assisting taxes and financial performance of a business	Helps in determining the entry, stay, or exit of an organization

Theories of Profit

Profits of businesses depend on the successful management of risks and uncertainties by entrepreneurs. These risks can be cost risks due to change in wage rates, prices, or technology, and other market risks. Different economists have presented different views on profit. Some of the most popular theories of profit are shown in Figure-1:

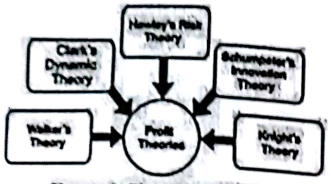

Figure-1: Theories of Profit

The different theories of profit (as shown in Figure-1).

1. **Walker's Theory:**

An American economist, Prof F. A. Walker propounded the theory of profit, known as rent theory of profit. According to him "as rent is the difference between least and most fertile land similarly, profit is the difference between earnings of the least and most efficient entrepreneurs." He advocated that profit is the rent of exceptional abilities that an entrepreneur possesses over others.

According to Walker; profit is the difference between the earnings of the least and most efficient entrepreneurs. An entrepreneur with the least efficiency generally strives to cover only the cost of production. On the other hand, an efficient entrepreneur is rewarded with profit for his differential ability.

Thus, profit is also said to be the reward for differential ability of the entrepreneur. While formulating this theory, Walker assumed the condition of perfect competition in which all organizations are supposed to have equal managerial ability. In this case, there is no pure profit and all the organizations earn only managerial wages known as normal profit.

The rent theory was mainly criticized for its inability to explain the real nature of profits.

Apart from this, the theory failed on the following aspects:

a. Provides only a measure of profit. The theory does not focus on the nature of profit, which is of utmost importance.

Assumes that profits arise because of the superior or exceptional ability of the entrepreneur, which is not always true. Profit can also be the result of the monopolistic position of the entrepreneur.

2. Clark's Dynamic Theory:

Clark's dynamic theory was introduced by an American economist, J.B. Clark. According to him, profit does not arise in a static economy, but arise in a dynamic economy. A static economy is characterized as the one where the size of population, the amount of capital, nature of human wants, the methods of production remain the same and there is no risk and uncertainty. Therefore, according to Clark, only normal profits are earned in the static economy. However, an economy is always dynamic in nature that changes from time to time.

A dynamic economy is characterized by increase in population, increase in capital, multiplication of consumer wants, advancement in production techniques, and changes in the form of business organizations. The dynamic world offers opportunities to entrepreneurs to make pure profits.

According to Clark, the role of entrepreneurs in a dynamic environment is to take advantage of changes that help in promoting businesses, expanding sales, and reducing costs. The entrepreneurs, who successfully take advantage of changing conditions in a dynamic economy, make pure profit.

There are internal and external factors that make the world dynamic. The internal changes are changes that take place within the organization, such as layoff and hiring of employees, product changes, and changes in infrastructure. The external changes are of two kinds, namely, regular changes and irregular changes.

Regular changes involve fluctuations in trades that affect profits On the other hand; irregular changes include contingencies, such fire, earthquake, floods, and war. Thus, according to Clark, profits are a result of changes and no profit is generated in case of static economy.

However Prof Knight criticized the dynamic theory on the basis that only those changes that cannot be foreseen yield profits. He further says, "It cannot, then, be change, which is the cause of profit, since if the law of change is known, as in fact is largely the case, no profits can arise. Change may cause a situation out of which profit will be made, if it brings about ignorance of the future."

3.Hawley's Risk Theory:

The risk theory of profit was given by F. B. Hawley in 1893. According to Hawley, "profit is the reward of risk taking in a business. During the conduct of any business activity, all other

factors of production i.e. land, labor, capital have guaranteed incomes from the entrepreneur. They are least concerned whether the entrepreneur makes the profit or undergoes losses."

Hawley refers profit as a reward for taking risk. According to him, the greater the risk, the higher is the expected profit. The risks arise in the business due to various reasons, such as non-availability of crucial raw materials, introduction of better substitutes by competitors, obsolescence of a technology, fall in the market prices, and natural and manmade disasters. Risks in businesses are inevitable and cannot be predicted. According to Hawley, an entrepreneur is rewarded for undertaking risks.

There is a criticism against this theory that profits arise not because risks are borne, but because the superior entrepreneurs are able to reduce them. The profits arise only because of better management and supervision by entrepreneurs. Another criticism is that profits are never in the proportion to the risk undertaken. Profits may be more in enterprises with low risks and less in enterprises with high risks.

4. Knight's Theory:

Prof Knight propounded the theory known as uncertainty-bearing theory of profits. According to the theory, profit is a reward for the uncertainty bearing and not the risk taking. Knight divided the risks into calculable and non-calculable risks. Calculable risks are those risks whose probability of occurrence can be easily estimated with the help of the given data, such as risks due to fire and theft.

The calculable risks can be insured. On the other hand, non-calculable risks are those risks that cannot be accurately calculated and insured such as shifts in demand of a product. These non-calculable risks are uncertain, while calculable risks are certain and can be anticipated.

According to Knight, "risks are foreseen in nature and can be insured". Thus, risk taking is not a function of an entrepreneur, but of insurance organizations. Therefore, an entrepreneur gets profit as a reward for bearing uncertainties and not for risks that are borne by insurance organizations.

The theory of uncertainty bearing is criticized on the following grounds:

a. Assumes that profit is the result of uncertainty bearing ability of an entrepreneur, which does not always hold true. The profit can also be the reward for other aspects, such as strong co-ordination and market share.

b. Fails to show any relevance with the real world.

5. Schumpeter's Innovation Theory:

Joseph Schumpeter propounded a theory called innovation according to which profits are the reward for innovation He advocated that innovation is the introduction of a new product, new technology, new method of production, and new sources of raw materials. This helps in lowering the cost of production or improving the quality of production. Innovation also includes new policy or measure by an entrepreneur for an organization.

In general, innovation can take place in two ways, which are as follows:

a. Reducing the cost of production and earning high profit. The cost of production can be reduced by introducing new machines and improving production techniques.

b. Stimulating the demand by enhancing the existing improvement or finding new markets.

According to innovation theory, profit is the cause and effect of innovations. In other words, it acts as a necessary incentive for making innovation.

Schumpeter's innovation theory is criticized on two aspects, which are as follows:

a. Ignores uncertainty as a source of profit

b. Denies the role of risk in profit

Functions of Profit:

Profit is the primary objective of all business organizations. The expectation of earning higher profits of business organizations induces them to invest money in new ventures. This results in large employment opportunities in the economy which further raises the level of income. Consequently, there is a rise in the demand for goods and services in the economy. In this way, profit generated by business organizations play a significant role in the economy.

According to Peter Ducker, there are three main purposes of profit, which are explained as follows:

i. Tool for measuring performance:

Refers to the fact that profit generated by an organization helps in estimating the effectiveness of its business efforts. If the profits earned by an organization are high, it indicates the efficient management of its business. However, profit is not the most efficient measure of estimating the business efficiency of an organization, but is useful to measure the general efficiency of the organization.

ii. Source of covering costs:

Helps organizations to cover various costs, such as replacement costs, technical costs, and costs related to other risks and uncertainties. An organization needs to earn sufficient profit to cover its various costs and survive in the business.

UNIT-4

iii. Aid to ensure future capital:
Assures the availability of capital in future for various purposes, such as innovation and expansion. For example, if the retained profits of an organization are high, it may invest in various projects. This would help in the business expansion and success of the organization.

Apart from aforementioned functions, following are the positive results of high profits:
i. Investment in research and development:
Leads to better technology and dynamic efficiency. An organization invests in research and development activities for its further expansion, if it earns high profit. The organization would lose its competitiveness, if it does not invest in research and development activities.

ii. Reward for shareholders:
Includes dividends for shareholders. If an organization earns high profits, it would provide high dividends to shareholders. As a result, the organization would attract more investors, which are crucial for the growth of the organization.

iii. Aid for economies:
Implies that profits are helpful for economies. If organizations generate high profits, they would be able to cope with adverse economic situations, such as recession and inflation. This results in stability of economies even in adverse situations.

iv. Tool to stimulate government finances:
Implies that if the profits generated by organizations are high, they are liable for paying high taxes. This helps government to earn high revenue and spend for social welfare.

UNIT-4

MARKET STRUCTURE

Difference between Perfect Competition and Imperfect Competition

Based on competition, the market structure has been classified into two broad categories:

1) Perfectly competitive- **Perfect Competition** is not found in the real world market because it is based on many assumptions
2) Imperfectly competitive- But an **Imperfect Competition** is associated with a practical approach.

The type of market structure decides the market share of a firm in the market. If there exists a single firm, it will serve the entire market, and the demand of the customers are satisfied with that firm only. But if we increase the number of firms to two, the market will also be shared by the two. Similarly, if there are about 100 small firms in the market, the market is shared by all of them in proportion.

Therefore, it is the market structure, which affects the market. So here we are going to describe the differences between perfect competition and imperfect competition, in economics

BASIS FOR COMPARISON	PERFECT COMPETITION	IMPERFECT COMPETITION
Meaning	Perfect Competition is a type of competitive market where there are numerous sellers selling homogeneous products or services to numerous buyers.	Imperfect Competition is an economic structure, which does not fulfill the conditions of the perfect competition.
Nature of concept	Theoretical	Practical
Product Differentiation	None	Slight to Substantial
Players	Many	Few to many
Restricted entry	No	Yes
Firms are	Price Takers	Price Makers