

Profits and shut down decision critical thinking examples

[Technology](#), [Development](#)



Following the American Psychological Association's Guidelines

Why might a profitable motel shut down in the long run if the land on which it is located becomes extremely valuable due to surrounding economic development?

It is not given in the question, but I assume that the owner of the motel rents the land on which the motel built. At the beginning time, the motel started in a less valuable location. The motel owner made a comparison at the beginning between alternatives. He could open another business at this location or he would not do any business and keep the money in a bank account for interest gains. However, after thinking rationally with the given rent price, other prices and the costs, it was rational to start a motel business. However, in time, the value of the location has increased due to surrounding economic development. At the current time, he has started paying a very high monthly rent which means a higher variable cost. The question mentions that this higher cost extra creating a situation that the average variable cost in the short term and the average cost in the long run is higher than the price that the motel guests are paying to the motel. That means the motel is having loss with every new guest. As a result of this evaluation, the motel should shut down.

What kinds of costs are involved in making a decision to shut down?

There are two options here: 1) the owner of the hotel owns this location and 2) the owner of the hotel does not own this location. Option 1 gives an

alternative or hidden cost, because the owner could make more money by renting this location instead of running the motel. Option 2 gives us a higher average variable cost in short run and a higher average cost in long run. Because rent is a variable cost in short run and included in average cost in long run.

Also we should not forget that in long run, there is no discrimination between fixed and variable costs, we have just costs.

References

Nicholson, Walter, and Snyder, C. Mark. (2011). Microeconomic Theory: Basic Principles and Extensions. Cengage Learning, 11th Edition.

Bowles, Samuel. (2009). Microeconomics: Behavior, Institutions and Evolution. Princeton University Press.