Theory of the firm IB Cheat Sheet

by egomezc via cheatography.com/146282/cs/31611/

Main equations

Profit maximization → MR = MC

Normal profit → AR = AC

Supernormal profit → AR > AC

Economic losses → AR < AC

Revenue maximization → MR = 0

Productive efficiency → MC = AC

Allocative efficiency → MC = AR

Perfect competition

Perfect competition markets are those in which each firm has a small market share, They are powerless to determine price and they charge prices that are set by the market

CHARACTERISTICS

many buyers and sellers

Freedom of entry and exit

Perfect knowledge

Homogeneous products

Profit maximization

Firms are price takers

MAIN TERMS

Marginal cost: cost added by producing 1 extra unit of a product

Average cost: the average cost of each unit

Average revenue: the revenue gained per unit sold

Marginal revenue: increase in revenue from the sale of one extra unit

short run

long run

Profit maximization: earn maximum profit with low costs

normal profit: difference between total revenue and costs are equal to zero

Supernormal profits: excess profit a firm makes above the minimum return necessary

Economic loss: circumstances when individual or firm loses money

Revenue max: firm attempts to sell at a price that achieves the highest sales revenue

Productive efficiency: economy cant produce more of a good without sacrificing another good

Allocative efficiency: all goods and services are optimally distributed among buyers

Monopolistic competition

Structure with many small firms selling similar products

ASSUMPTIONS

Large amount of small firms

No barriers

Large number of buyers and sellers

Product differentiation

Each firm has the same ability to set prices

Monopoly

Monopolies are an extreme consequence of free-market economics and are often used to identify an individual that has complete or near-complete dominance of a market

CHARACTERISTICS

unfair edge over their competitors

High barriers to entry

Price makers

Economies of scale

ASSUMPTIONS

One dominant firm

Unique products with no close substitutes

High barriers

Price makers

Economies of scale

CAUSES OF HIGH BARRIERS

Economies of scale

Legal barriers (patents, copyright, licenses)

Control of resources

Aggressive tactics

Risks of one or few dominant firms

lack of competition

Rigid prices

Higher prices

Reduced output

Reduced options for consumers

Oligopolies

Market structure with small amount of firms and where each firm is interdependent, creating uncertainty

ASSUMPTIONS

Few dominant firms

Interdependent firms

Homogeneous or differentiated products

High barriers

Firms set prices

PRICE COMPETITION

Firms in oligopolistic competition participate in various price competitiveness strategies

price wars

Predatory pricing

Limit pricing

NON PRICE COMPETITION

Increase consumer appetite and develop brand loyalty

COLLUSIVE VS NON COLLUSIVE

collusive: agreement between firms to limit competition by restrictive trade practices;

Non collusive: These do not collude and act independently but are aware of other firms prices but not others decisions

FORMS OF COLLUSION

Cartels: An agreement between oligopolistic firms in the same industry to collude in fixing prices or to restrict the level of output in the market, thereby effectively acting as a monopolist.

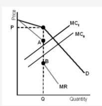
Informal collusion: Smaller firms could collude by following prices of larger firms. This limits competition and sets high prices

Game theory

		Firm A			
Firm B		($1) high price		($0.5) low price	
	($1) high price	$3m	$3m	$0.5m	$4m
	($0.5) low price	$4m	$0.5m	$1m	$1m

What a firm does if the other firm changes the price

Kinked demand curve (non collusive)



This model assumes that there will be intervals of relative price stabilization under inflation. Firms will not follow if prices rise

Government intervention to market power abuse

Legislation: used to prohibit things such as takeovers or mergers that can occur among firms which would end up giving one firm more than a certain percentage of the market share.

Regulation: markets setting up anti-monopoly commissions with the purpose of investigating markets and ensure that monopoly power is not being used against public interests

Nationalization. when a government takes control of a private sector industry in order to run it as part of the public sector for the best interests of the public

Rational producer behaviour - profit max

Profit maximization refers to the level at which a firm will produce the greatest amount of profit this is the output level at which marginal costs equal marginal revenue.

EQUATIONS

TR - TC → Profit is maximum at the level of output where TR - TC is greatest

MR = MC → Profit is maximum at the level of output where MR = MC.

Abnormal profit → AR > AC

Normal profit → AR = AC

Losses → AR < AC

Degrees of market power

Market power refers to the ability a firm has to increase its profits by setting a price that is higher than the marginal cost.

Degree of market power: The degree to which an individual firm is able to set prices will determine how competitive the market is

**ADVANTAGES OF LARGE MARKET POWER

Economies of scale and investment

Research and development and innovation

The natural monopoly justification

Monopolistic corporations as agents of common good