1.5 Big Ideas..

Key concepts

9 Bits to look our for…

- DMR/Returns to scale
- Economies of scale
- Efficient resource allocation (AC curve)
- 3 goals of a Firm
- Price discrimination
- Goals of firms: Profit maximisation vs sales growth vs sales revenue maximisation (see slide 21for other goals)
- Kinked demand curve (oligopoly)
- Collusion (oligopoly)
- Compare + contrast (evaluate) the 4 models models: evaluate 1 or 2 of the 4 models

See Webnote 1591

Accurate Diagrams....

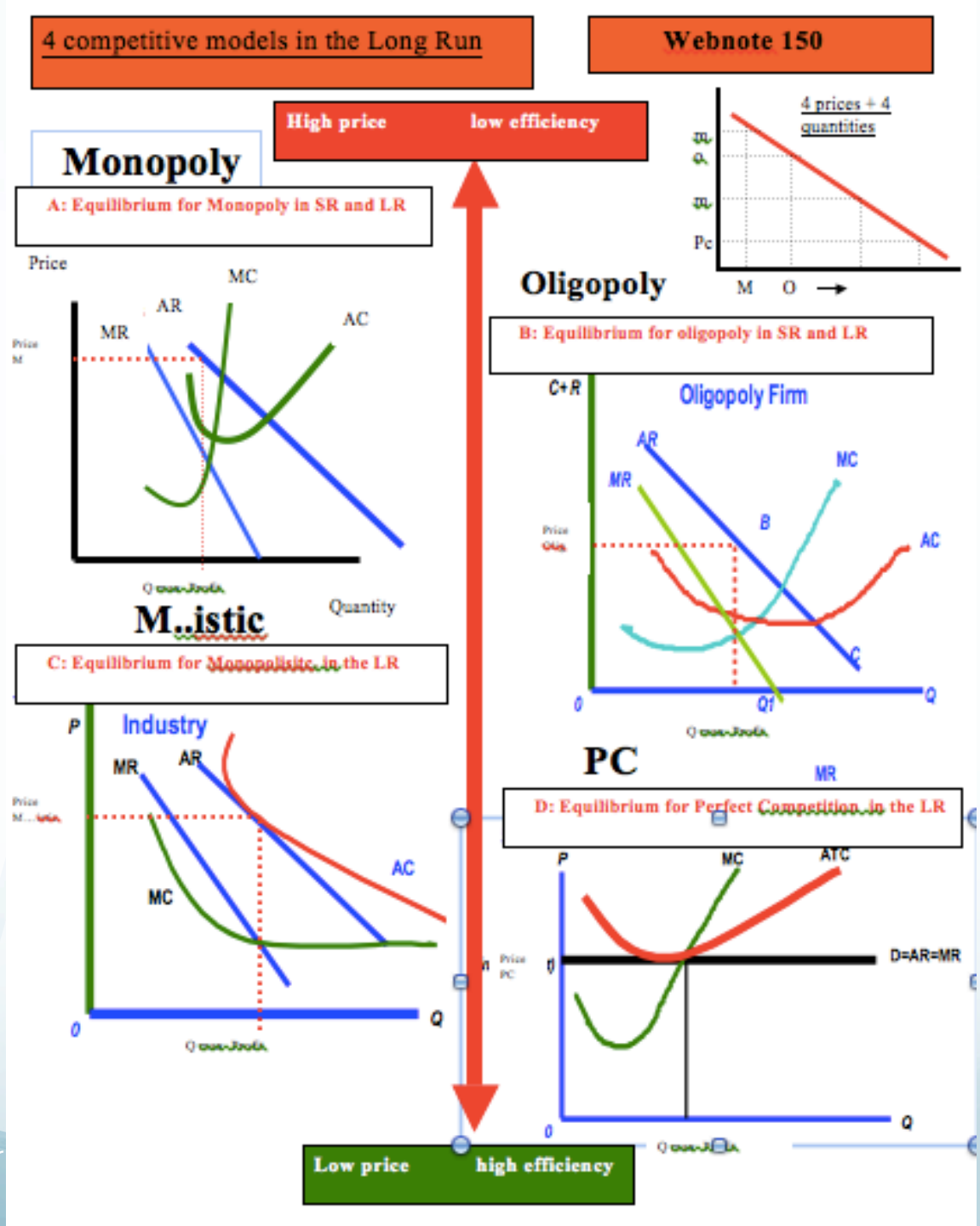
5 Tips...

1. Draw AR and AC
2. Select a max profit quantity
3. from this point highlight S/N profit where AR >AC (or normal profit)
4. Add in MC cutting AC (at lowest point or not?)
5. Add in MR. It must be where you have marked the profit maximising level of output

Note: remember for PC: AC=AR (ar is drawn horizontal)

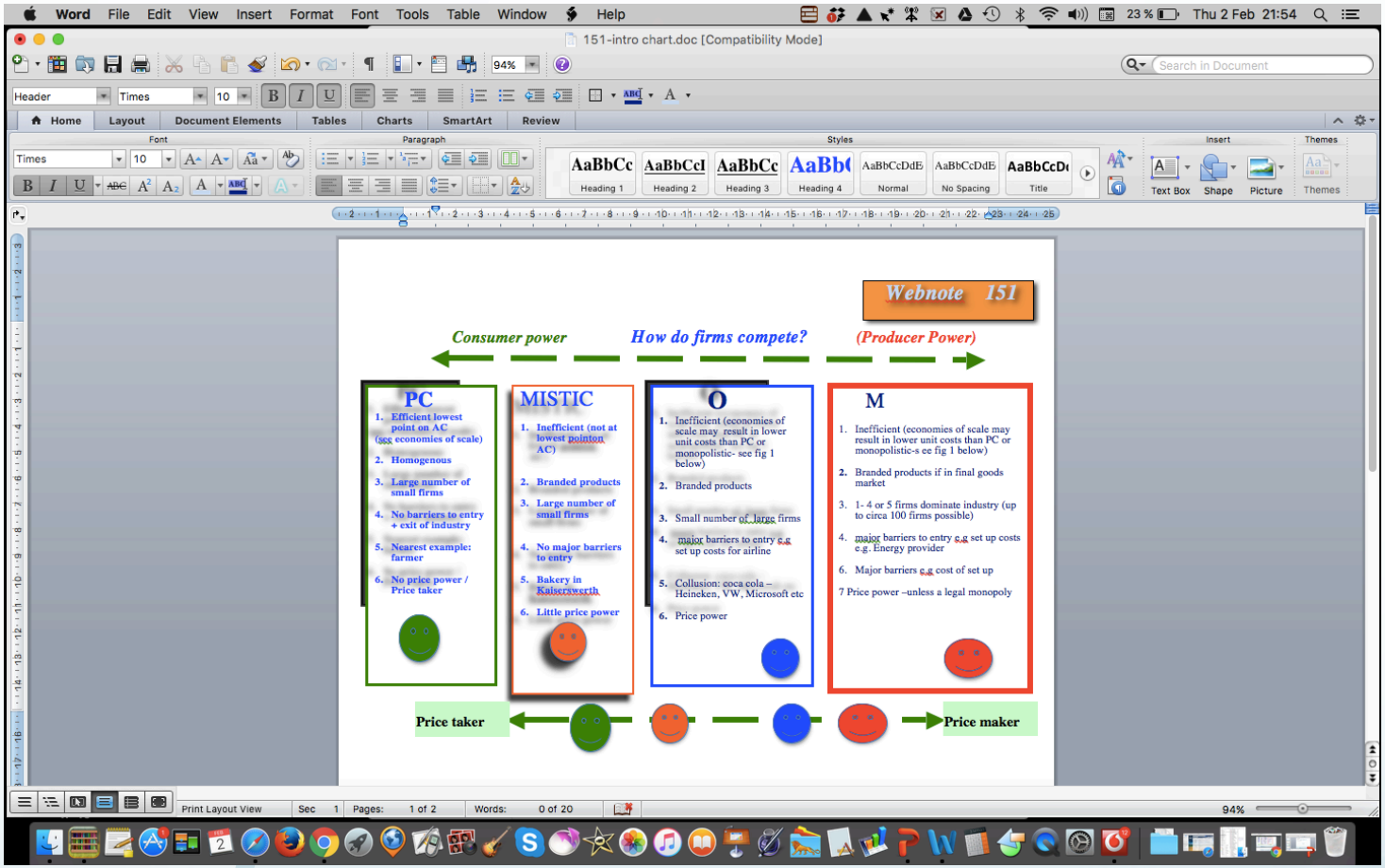
Page 2 of 2 2

models costs+revenue webnote 150



See webnote 151

4 Models- see webnote 151



Theory of the Firm

- **4** Targets for **each** of the **4** models

1. Price and output of 4 models in the SR + LR
2. Profit Maximisation: 'profit finder' where MR=MC Supernormal/abnormal profits?
3. Efficiency (AC)
4. Barriers to Entry

Others include: economies of scale, non profit maximisation goals + price discrimination

Perfect Competition

1. **Efficient lowest point on AC or ATC**
2. **Homogenous**
3. **Large number of small firms ('000's)**
4. **No barriers to entry + exit of industry**
5. **Nearest example: farmer**
6. **No price power / Price taker**
7. **Perfect information re profits and losses**

monopolisitc

- **“MISTIC”**

1. **Inefficient (not at lowest point on AC)**
2. **Branding is common “ local pizza”. (Advertising wasteful)**
3. **Large number of small firms (’00’s)**
4. **No major barriers to entry**
5. **bakery in Kaiserswerth. Small goods retailer or service provider**
6. **Little price power but this often depends on ‘location’**

oligopoly

1. Inefficient (economies of scale may result in lower unit costs than PC or monopolistic
2. Branded products. Large scale advertising.
3. 4 or 5 firms (up to 100 possible but 'concentration' of market share is between a small number of firms)possible e.g. Microsoft, apple,linux..
4. major barriers to entry e.g. set up costs
5. Collusion/anti competitive behaviour: coca cola –see webnote 151, Ford, Bosch, Heineken, Sothebys etc
6. Price power

monopoly

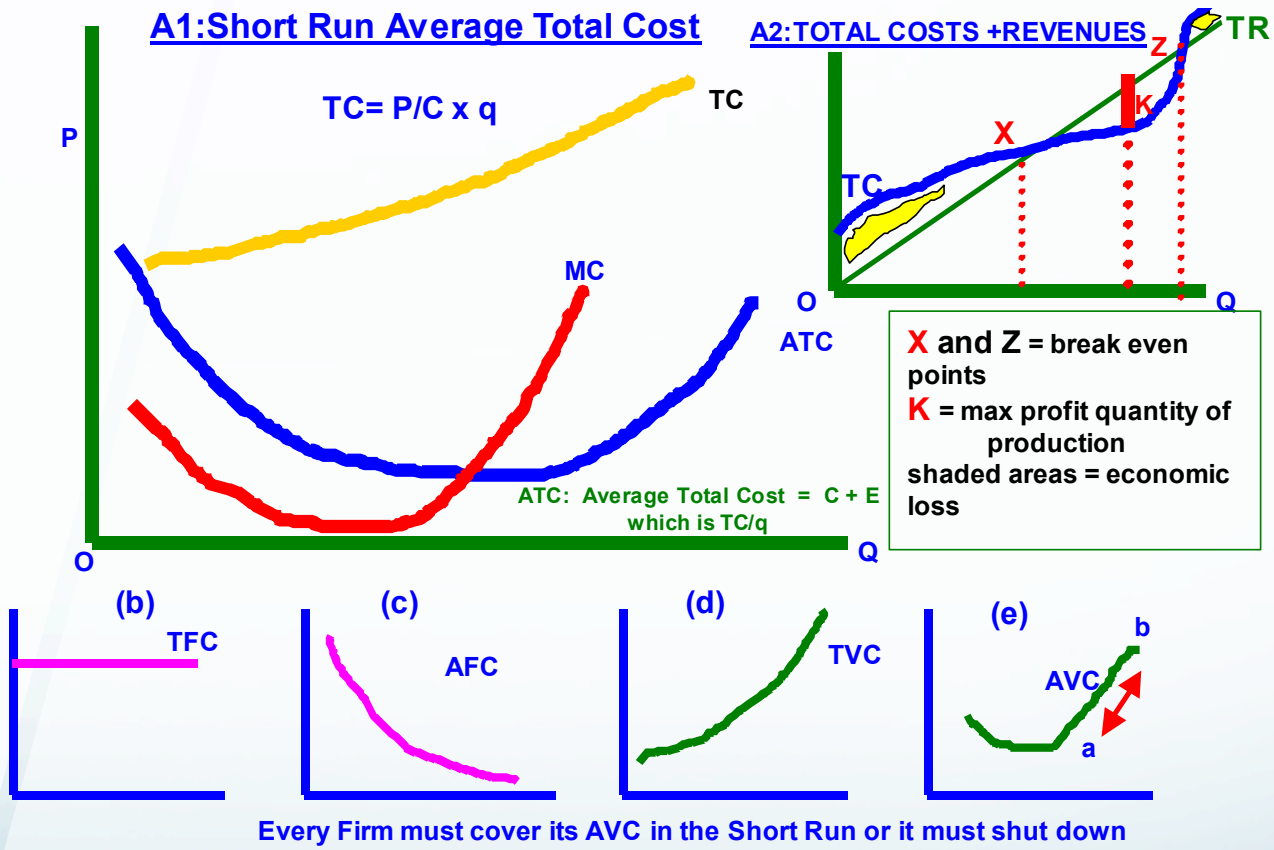
1. Inefficient but (economies of scale may result in lower unit costs than PC or monopolistic)
2. Branded products if in final goods market
3. 1- 4 or 5 firms dominate market share e.g. microsoft and apple, others??
4. major barriers to entry e.g. set up costs
5. Price power –unless a legal monopoly

The Big Ideas…

- **Costs** of firms: tell us about profit and efficiency (ac,mc,avc,afc,atc (ac),srac,lrac)
- **Revenues** of firms (ar (=demand=price),mr,) and Price is key here i.e.level of price power (maker or taker).
- **Profit:** TR-TC, ar>ac (supernormal profit).
- **4 Models:** price + output in LR + SR, profit levels, efficiency (unit cost/ac), price power, R+D, Economies of Scale + barriers to entry and price discrimination.

Know your cost diagrams- webnote 153

Short Run AC Curve (SRATC or AC)



Every Firm must cover its AVC in the Short Run or it must shut down

costs

IBQ:

2. (a) Explain why a firm in monopolistic competition will make normal profit in the long run. [10]

(b) Evaluate the view that monopolistic competition is a more efficient market structure than monopoly. [15]

M14/3/ECONO/HP1/ENG/TZ2/XX

2. (a) Using a diagram, explain why firms in monopolistic competition are neither allocatively nor productively efficient. *[10 marks]*

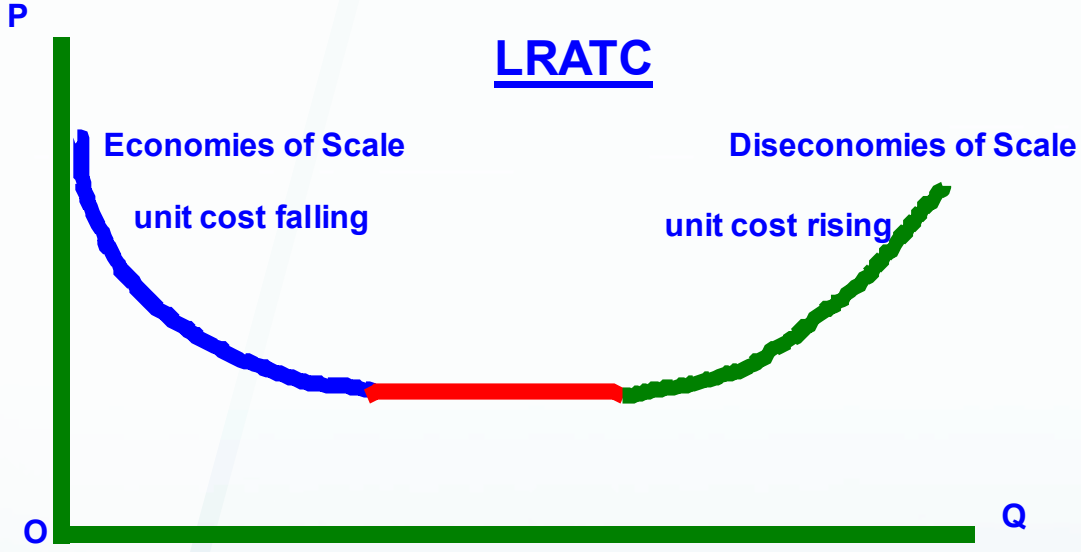
(b) Examine the view that the market for food is more beneficial to consumers if dominated by a monopoly retailer (supermarket) rather than by a large number of small shops operating under monopolistic competition. *[15 marks]*

N15/3/ECONO/HP1/ENG/TZ0/XX

Know your cost diagrams- webnote 153

Long Run AC Curve (LRATC)

F: Long Run ATC Depends on Internal + External (DIS) Economies of Scale



IBQ:

revenue

– 2 – M13/3/ECONO/HP1/ENG/TZ2/XX

SECTION A

*Answer **one** question from this section.*

Microeconomics

1. (a) Distinguish between decreasing returns to scale and the law of diminishing returns. *[10 marks]*

(b) Using diagrams, compare and contrast the market structure of monopoly with that of perfect competition. *[15 marks]*

– 2 – M13/3/ECONO/HP1/ENG/TZ1/XX

SECTION A

*Answer **one** question from this section.*

Microeconomics

1. (a) Explain how welfare loss may result from monopoly power. *[10 marks]*

(b) Discuss the effectiveness of government policies (legislation and regulation) to reduce monopoly power. *[15 marks]*

M14/3/ECON/HP1/ENG/TZ2/XX

2. (a) Using a diagram, explain why firms in monopolistic competition are neither allocatively nor productively efficient. *[10 marks]*

(b) Examine the view that the market for food is more beneficial to consumers if dominated by a monopoly retailer (supermarket) rather than by a large number of small shops operating under monopolistic competition. *[15 marks]*

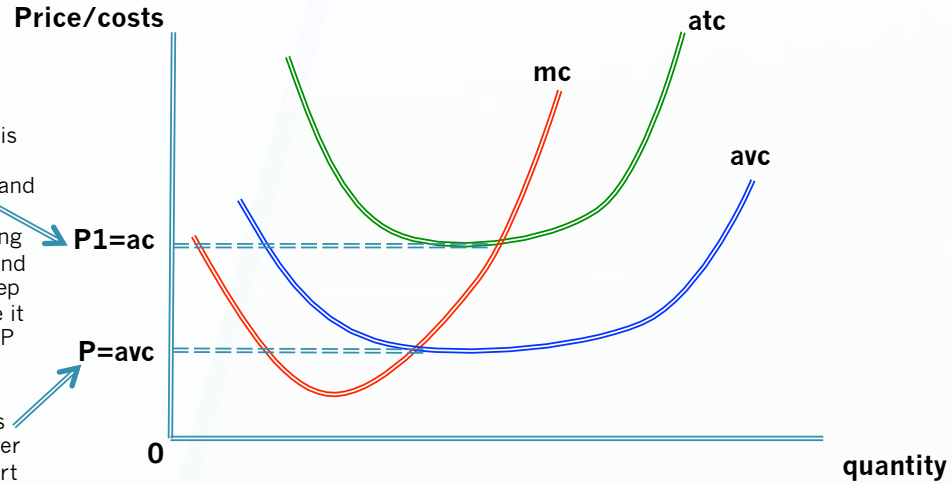
Opportunities to refer to "revenue' in answering a 1.5 Essay Question

2 key points for revenue

- Break even vs shut down point

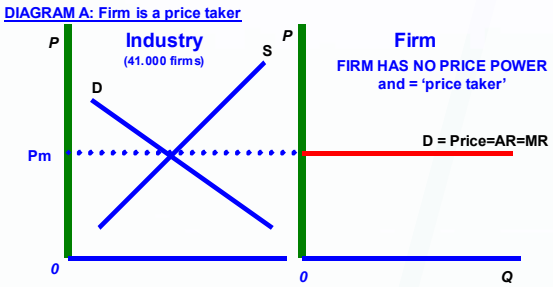
Break even price = P1. Firm is paying all costs (including implicit/opportunity costs)) and earning Normal profits including. This includes paying for all Land, labour, capital and enough profit (normal) to keep the firm in the industry. Note it is a long run idea. See Blink P 97

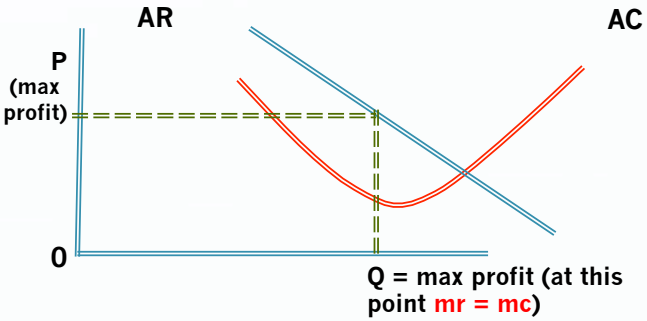
Shut down price is P. At this price the firm is able to cover its variable costs in the short run because P =avc and so it is not able to pay its fixed costs at this price. Any price below P then becomes a "shut down" price. See Blink P97.



Revenues + Profits
is the firm a price taker or a price maker? Webnote 151

Price Taker OR **Price Maker**

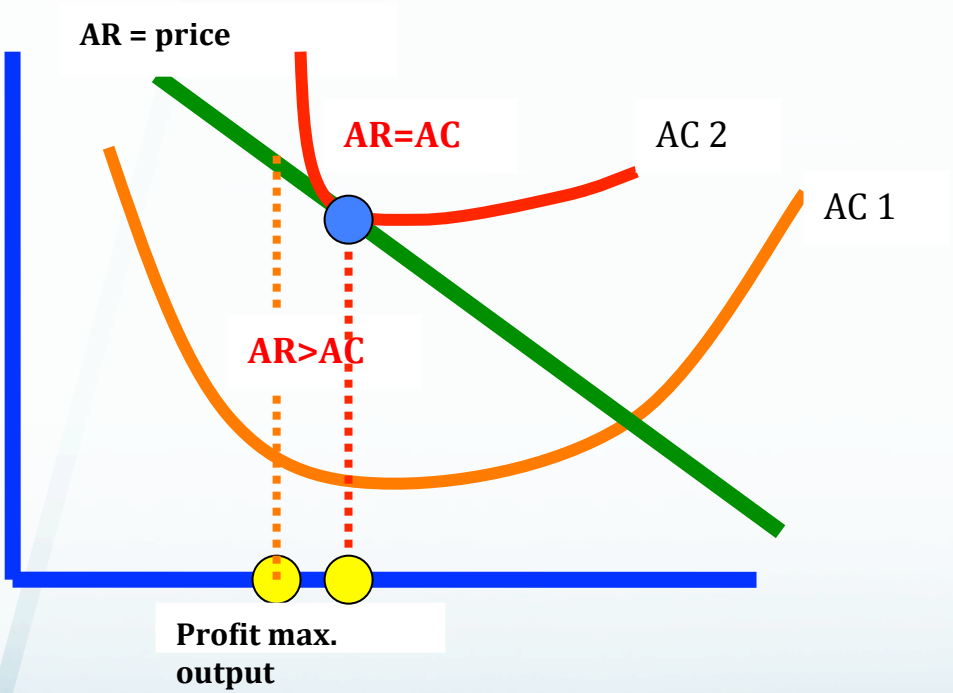




Revenues + Profits

Webnote 1592

- Normal or supernormal?



Goals of the Firm

Goals of firms = **5**

1. Revenue maximisation,
2. sales growth maximisation,
3. profit maximisation,
4. satisficing and
5. corporate social responsibility.

Goals of firms

IBQ:

M16/3/ECON/HP1/ENG/TZ1/XX

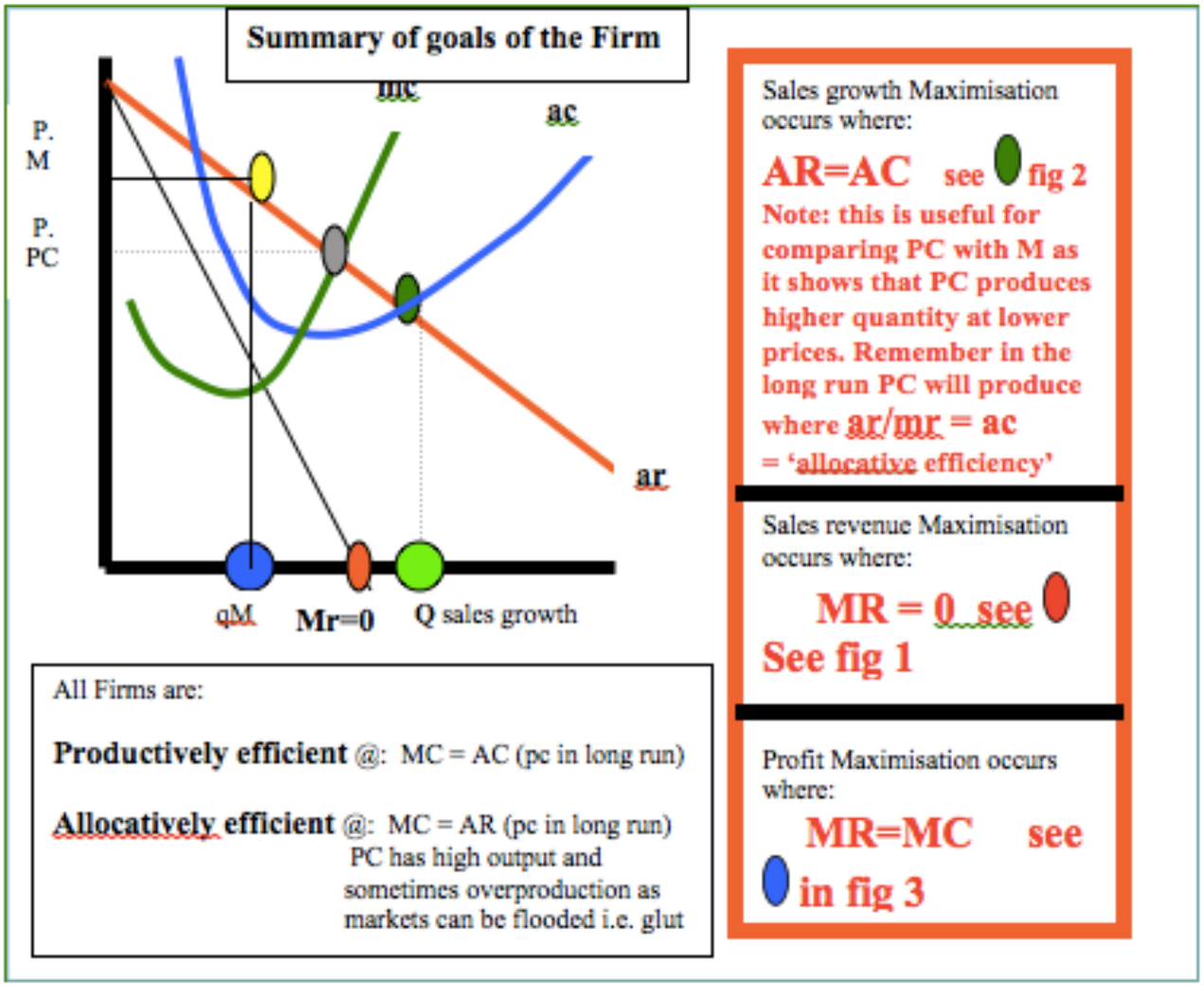
2. (a) Explain why firms may not always pursue the goal of profit maximization. [10]

(b) In monopoly, economic (abnormal) profit can be earned in both the short run and the long run. Examine the role of barriers to entry in earning economic profit. [15]

M08/3/ECON/HP1/ENG/TZ2/XX

Explain how a firm operating in an oligopolistic market might attempt to increase its market share.

Goals of firms – webnote 1593

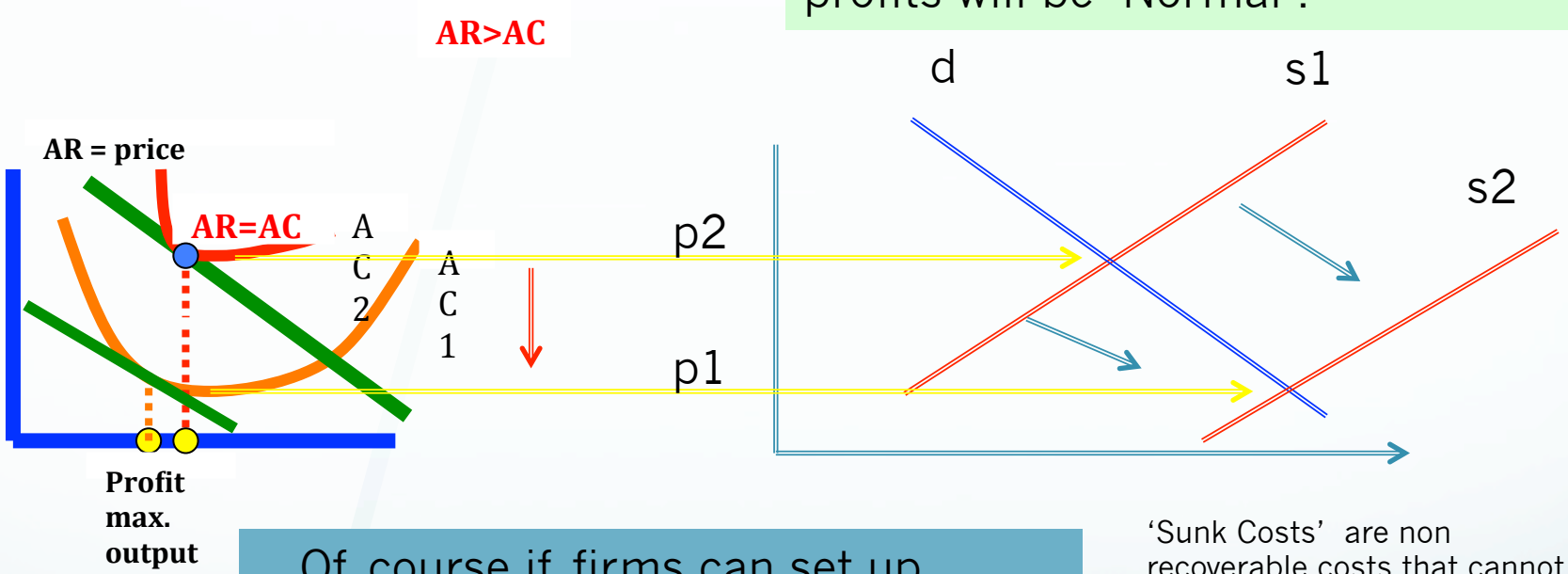


Barriers to Entry…resources follow profits!

See Webnote 1592

- Normal or supernormal?

High S/N profits cause entry and if barriers are absent then price will fall from P2 to P1. Ar=AC and profits will be 'Normal'.

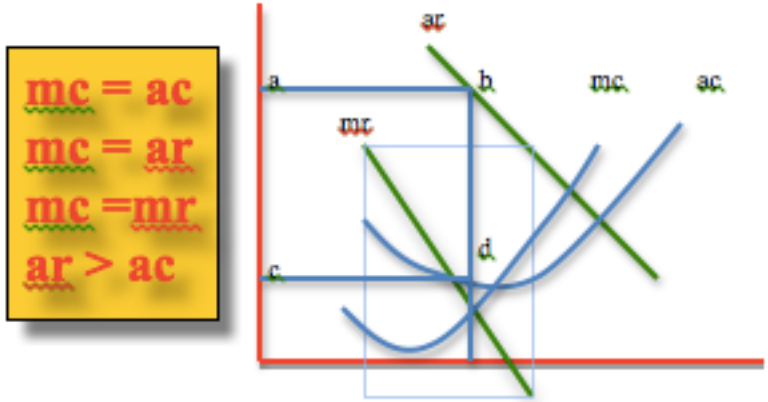


…Of course if firms can set up barriers then the S.N profits can be protected into the long run and this is typical in oligopoly and monopoly.

'Sunk Costs' are non recoverable costs that cannot be recovered if a firm leaves an industry e.g. payments made for advertising and promotions over time
High sunk costs act as a barrier to entry.

Monopoly

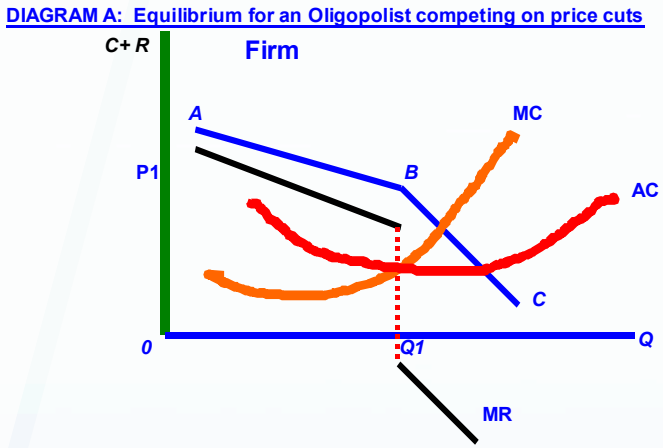
- Price power in the long run
- Due to lack of entry and therefore competition the monopolist can enjoy long run s/n profits of abcd



Long Run and Short run Equilibrium price and quantity. Note Abnormal profits exist as shown by abcd.

Watch out for: in Oligopoly

- Kinked demand curve/price rigidity/ interdependence



- Game theory

Key Terms:

1. **Collusion,**
2. **Price rigidity + kinked demand,**
3. **competitive oligoply,**
4. **price war,**
5. **price leadership**
6. **Non price competition**
7. **interdependence**

See webnote 1597

Oligopoly:

- Is the oligopoly a profit maximiser or does it have an alternative goal. Watch out for key words such as collusion, price rigidity, competitive oligoply, price war, price leadership and interdependence

- Ease of entry to an industry means low barriers to entry usually meaning low 'sunk' costs so that the firm can retrieve much of its costs on exiting the market

- Interdependence is worth special attention: focus the idea of 'contestable markets' where 1 or 2 operators can still represent a competitive market and of course 'game theory' where firms can benefit/profit more from collusion rather than competition. These examples show how firms are constantly watching what the opponent is doing!

Oligopoly

*Answer **one** question. Each question is worth [25 marks].*

1. (a) Explain how a firm operating in an oligopolistic market might attempt to increase its market share. *[10 marks]*

(b) Evaluate the view that producers, and not consumers, are the main beneficiaries of oligopolistic market structures. *[15 marks]*

*Answer **one** question. Each question is worth [25 marks].*

1. (a) Explain why, in markets dominated by a few firms, prices may remain relatively stable. *[10 marks]*

(b) "An industry with a larger number of firms will experience lower prices and greater efficiency than an industry with a smaller number of firms." Evaluate this view. *[15 marks]*

Section A

Answer **one** question from this section.

Microeconomics

1. (a) Market failure can occur when there is asymmetric information, abuse of monopoly power and positive externalities. Explain why any **two** of these represent market failure. [10]

(b) Evaluate the view that regulations are the most effective government response to the market failure of negative externalities. [15]

2. (a) Explain the conditions necessary for firms in oligopolistic markets to engage in price discrimination. [10]

(b) Discuss whether producers in oligopolistic markets should compete or collude. [15]

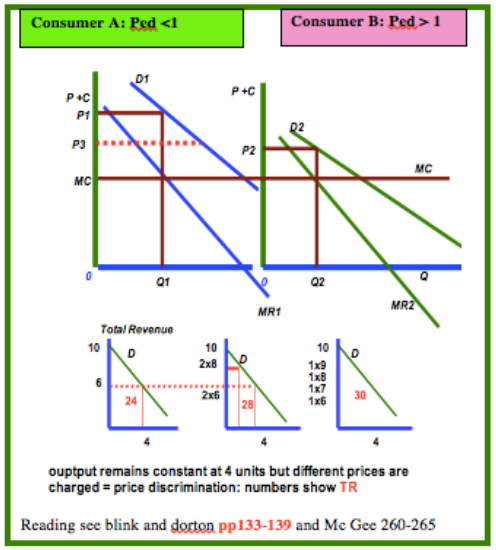
Price Discrimination:

Watch out for: 3rd degree price discrimination

- Ability of firms to charge different prices in different markets
- Note key connection with elasticity here

(B) 3 Conditions necessary for PD:

1. **Price Power:** Firm must have price power. Therefore it is possible in M, M-istic and O.
2. **Elasticity:** Household must have different elasticities of demand: Ped = - 3 (lower price will increase total revenue).
   - Hairdressing for women e.g. ped = –3 for men ped = –1
   - Flying economy class for businessmen
   - Pay TV for sport
   - 'no price shop'
   - Note for assessment: for evaluation be aware of benefits to consumers of price discrimination and the different categories of price discrimination i.e. 1st , 2nd and 3rd
3. **No Resell ability:** Household must not be able to resell. Firm must be able to identify and keep separate the groups paying different prices
   - Consumer indifference (low priced items)
   - Lack of knowledge about cheaper prices



Reading see blink and dorton pp133-139 and Mc Gee 260-265