

Eco Final Exam Notes

PURE COMPETITION

Perfectly elastic demand: the firm is a price taker- firm cannot obtain a higher price by restricting output, nor need it lower its price in order to increase its volume of sales.

Market demand curve is downward sloping (for the *industry* the only way to get lots of sales is accepting a lower price)>> 'demand schedule' faced by the *individual* firm is perfectly elastic

Profit Maximisation in the Short Run

Total Revenue- Total Cost Approach: whether to produce? The firm should produce in the short run if it can realise a profit, or a loss that is less than its fixed costs. How much should be produced? Gap between TR & TC is greatest (profit maximising) or whenever TR exceeds TVC, and some contribution is being made to TFC (loss minimising).

MR-MC Approach: Any unit whose MR is greater than MC should be produced>> the firm will maximise its profits/ minimise losses at MR=MC (P=MC)

Profit Measurement

$$(Q \times P) - (Q \times ATC) = \text{Economic Profit}$$

The perfect competition firm wants to maximise *total* profits, not *per-unit* profits.

Short Run Supply Curve: portion of the firm's MC curve that lies above its AVC curve (from 'close down point' upwards)

Changes in the price of variable resources & technology will shift MC in a firm>> i.e. there is a shift in the *supply curve* of the pure competition firm.

Market price results from the simultaneous supply decisions of all competitive firms in the market.

Profit Maximisation in the Long-Run

The number of firms may increase or decrease in the long-run.

Zero Economic Profit (Break-Even) Equilibrium

Where price & minimum ATC are equal eco profits are zero (normal profit)- no tendency for exit or entry

Entry Eliminates Economic Profits

The presence of eco profits ($P > ATC$) will lure new firms into the industry. As firms enter, the market supply of the product will increase, causing price to go down (to minimum ATC) depleting eco profits.

Exit eliminates Economic Losses

Consumer demand falls, forcing price down, making production unprofitable, forcing firms to leave the industry, industry supply will decrease, price will begin to rise until long-run equilibrium is restored.

The long-run supply curve of a constant-cost industry is perfectly elastic, up-sloping for an increasing-cost industry & down-sloping for a decreasing cost industry.

Pure Competition & Efficiency

A competitive market will allocate resources in such a way to maximise satisfaction>> overall efficient use of limited resources requires allocative efficiency & productive efficiency.

Productive Efficiency: the firm is using the most efficient technology & producing output at the lowest average cost>> evident in $P = \text{minimum ATC}$

Allocative Efficiency: mix of products that is most wanted by society>> resources are being allocated in accordance with consumer preferences>> this is evident in $P = MC$

Underallocation ($P > MC$): producing short of $p = MC$ means less than maximum profits to the individual firm, underallocating resources>> the fact that price exceeds MC indicates that society valued additional units of X more highly than alternative products.

Overallocation ($P < MC$): less than maximum profits for producers>> resources are being used in the production of X when they could be used for other G&S that society value more than units of X

Adjustments to change: the competitive price system will reallocate resources in a response to a change in consumer tastes, technology or resource supplied so as to maintain allocative efficiency.

PURE MONOPOLY

Barriers to Entry

Economies of Scale: reduce average cost of producing a product as the firm expands the size of its output in the long-run

Natural Monopoly: industries whose technological & economic realities rule out the possibility of competitive markets. E.g. railways

Ownership of Raw Materials: preventing competitors from acquiring the necessary inputs to compete

Legal Barriers: provide the owner with exclusive rights to use an idea, process etc

Barriers to entry may be surmountable in the long-run due to technological & regulatory changes

Monopoly Demand

Crucial difference between monopolist & competitive seller lies on the demand side of the market. The monopolist's demand curve is *down-sloping* [$MR < AR (P)$] due to three factors

Price Exceeds MR: the monopolist must lower price to boost sales; MR is less than price (AR) for every level of output except the first. (Price cuts apply to all units of output)>> when MR is positive, TR is increasing, when MR is zero, TR has reached its maximum.

'Price Maker': faced with a down-sloping curve, each output is associated with some unique price, the monopolist determines price in deciding what volume of output to produce>> the monopolist's demand curve means that the monopolist cannot raise price without losing sales (or gain sales without charging a lower price)

Price Elasticity: MR curve is below demand>> TR increases at a decreasing rate, reaches a maximum then declines. A monopolist will never operate in the inelastic section; MC must intersect MR in MR's positive range.

Price- Output Determination

MR= MC rule (it will produce additional units as long as it adds more TR than TC)

Monopolist will price in the elastic range (as demand is down-sloping)>> as there is only one optimum price-output combination, the monopoly seller has a supply point, but not curve. At equilibrium, $P > MC$.

Barriers to entry provide profits in the long-run.

Misconceptions about Monopoly: monopolist does not charge highest price it can get; monopolist seeks maximum *total* profits, not *per-unit* profits (same as competitive firms); and monopoly does not guarantee eco profits- high costs & weak demand eg.

Economic Effects of Monopoly

Price, Output & Efficiency: Monopolist's profit-maximising output results in an underallocation of resources ($P > \min MC$) & thus there is no productive efficiency. The monopolist will find it profitable to sell a smaller Q & higher P than a competitive industry.

Income Distribution: Monopoly increases inequality of income & they can levy a 'private tax' (higher price than competitive industry, with same costs) on consumers increasing profits which are distributed to upper income groups

Cost Complications

X- inefficiency: the failure to produce any given output at the lowest AC possible> a firm's actual costs of producing any output are greater than minimum possible costs>> this is because manager's have goals- firm growth, easier work place- that conflict with cost minimisation>> prevents economies of scale

Technological Advance: Dynamic Efficiency- ability to develop the most efficient production techniques over time. Economists argue whether monopoly is conducive to technological advance. For: ability to realise eco profits provides financing. Against: absence of rival firms & monopolist's desire to exploit fully existing capital facilities weaken incentive to innovate.

Price Discrimination

Price discrimination is when a given product is sold at more than one price & the price differences are not justified by cost differences. E.g. Tim (higher rates when demand is strong) and age (ability to pay)