

Ch 15: Entry, Exit, + Long Run Profitability

accounting profits := total revenue - explicit costs

economic profits := total revenue - explicit costs - implicit costs ^{→ opportunity costs}

(what we use as economists)

economic profit
≠ accounting profit

↳ can be 0 or even negative

includes opportunity costs (foregone income) in order to construct a relative measure of profit, relative to other choices

average revenue := $\frac{\text{total revenue}}{\text{quantity}}$ = price

average cost := $\frac{\text{total cost}}{\text{quantity}} = \frac{\text{fixed cost}}{\text{quantity}} + \frac{\text{variable cost}}{\text{quantity}}$

$$\text{Profit} = TR - TC = (AR)(Q) - (AC)(Q) = Q(AR - AC) = Q(P - AC)$$

fixed cost = sunk cost when deciding how much to produce in short run: $TR > VC$

↳ fixed costs avoidable in long run where rule of production becomes $TR > TC$ → entry & exit available

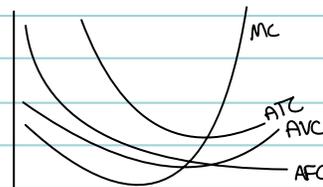
Trends: AFC decreases as q increases

MC decreases immediately but soon increases as q increases

As $MC < ATC$, ATC decreases but once $MC > ATC$, ATC increases

As $MC < AVC$, AVC decreases but once $MC > AVC$, AVC increases

$$ATC - AVC = AFC$$



Profit Margin := $P - AC$

$$\hookrightarrow \frac{\text{Profit}}{Q} = \frac{(P - AC)Q}{Q} = P - AC$$

Entry & Exit:

Rational Rule for Entry & Exit: Enter (exit) a market if there are positive (negative) economic profits

↳ entry lowers profits & exit increases profits so all industries move toward 0 economic profits in the long run

market price ↓ → P ↓, q ↓

market price ↑ → P ↑, q ↑

$$\Pi = TR - TC = Q(P - AC) = 0$$

→ $\Pi > 0$ iff $P > AC$

barriers to entry := obstacles that prevent new firms from entering & ∴ allow for positive long run economic profit

↳ ex: gov franchising, licensing, regulation, patents, economies of scale, cost advantages, ownership of scarce factor of production, network effect

Ch 16: Sophisticated Pricing Strategies

price discrimination := selling the same product at different prices to set prices as close as possible to consumers' reservation price

perfect price discrimination := price = reservation price

↳ max WTP

"first degree"

→ allows firms to make max profit on each sale AND sell more ... sell until $P = MC$

→ removes all CS

→ results in socially optimal quantity produced

What conditions allow for Price Discrimination?

→ firm w/ market power, preventable resale, accurate targeting

group pricing := price discrimination by charging different prices to different groups.

the hurdle method := offer lower prices to buyers who are willing to jump over a hurdle you set high enough so that high MB consumers find it

"second degree"

too costly

· quantity discount

· bundling