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Introduction to Theory of the Firm

Notes

WHAT IS THEORY OF THE FIRM?

- A theory or collection of theories which attempt to explain how firms behave under different market conditions.
- The theory suggests that firms behave differently in different markets.
- Theory of the firm includes:
    - Cost theory
    - Revenue and Profit Theory
    - Profit Maximization in different types of markets
    - An evaluation of market structures against efficiency and welfare criteria

GOALS OF FIRMS: PROFIT MAXIMIZATION

- Neoclassical theory of the firm assumes that firms behave "rationally" by always attempting to maximize the profits they can make.
- This is referred to as "Profit maximization" behaviour.
- Profit = revenue - costs

OTHER OBJECTIVES OF FIRMS

1. Corporate social responsibility

- Where businesses include the "public interest" in decision making.
- Firms adopt an ethical code and accept responsibility for the impact of their activities on areas such as workforce, consumers, local community and environment.
- Example: firms reducing their impact on the environment, funding local community education projects or buy "fair trade" products.

2. Satisficing
    - New economic theory
    - Firms (or other economic agents) try to perform "satisfactorily" in many different goals rather than maximize their success in one goal
    - Example: Firm owned by shareholders are managed by non-owners. In this case, managers do not have a great deal to gain if the firm makes maximum profits. The manager will make enough profit to keep the owners of the firm happy, but not more.

3. Growth maximization - ↑ market share
    - Strategy where companies set their target to achieve growth of their business in the short run, rather than profits, in order to gain market share and dominate the market in the long run.
    - Growth can be measured by: quantity of sales, sales revenue, employment or % of market share.

4. Revenue Maximization

- Entrepeneurs measure success by the amount of revenue they make.

- "Look at how much we have sold."

- Firms with no market power are called price takers.

- Firms with some market power are called price makers (or price setters).

THE CONCEPT OF MARKET POWER

- **Market power:** the ability of a firm raise the price of a g/s above its marginal costs: above equilibrium or competitive price.

Characteristics	Perfect Competition 	Monopolistic Competition	Oligopoly	Monopoly 
1.Number and size of firms in the market	Large number of firms; small size	Many firms but not large in size	Few firms but large in size	One large firm
2.Differentiated or Homogeneous Product	homogeneous	Differentiation (in quality, packaging, marketing, etc)	Some product differentiation	unique
3. Firms Control over price	No control – a 'price taker'	Some control – a 'price influencer'	Significant control; informal collective pricing	Total control; a 'price maker'
4. Ease with which firms can enter or leave the market	No barriers	Some barriers	Many barriers	Almost total exclusion
5. Amount of non-price competition	Little (local sometimes)	Some (product quality)	Considerable (packaging, advertising)	Not much (public relations, advertising when needed – but only when close substitutes exist)
6. Examples	Doesn't really exist; agriculture close	Fast food, retail stores, cosmetics	Cars, steel, soft drinks, cereals, computers	Small-town newspaper, rural gas station