Entry and Economic Profit

1. Free entry
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3. MLT principle
4. What is exogenous and endogenous?
5. Normal and economic profit

Free Entry

A market has free entry if:

(1) New firms are legally free to enter the market.

(2) Every firm in the market has the same long run costs.

(3) A new entrant's opportunities to sell its product would be similar to what existing firms already have.

Barriers to Entry

A barrier to entry is anything that prevents new firms from entering a market and competing (within a reasonable amount of time) on equal footing with existing firms.

Examples of barriers:

- Patents or licensing requirements.
- Technology or inputs that other firms cannot access.
- Consumer loyalty to existing firms.

Implications of Free Entry (I)

Assume that we are considering a competitive market, with free entry.

In this market, positive profits attract new entrants.
=> supply increases
=> price falls

Assume that the long run is long enough for an unlimited number of new firms to enter. Then…

In the long run:
(1) economic profits are zero.

Money Leaves the Table

MLT Principle: In a world of selfish and rational people, easy money gets picked up quickly.

If it looks too good to be true, it usually is.

Implications of Free Entry (II)

If economic profits are zero, then it is impossible to enter and earn positive profit. Therefore…

In the long run (in a competitive free entry market):

(2) price falls to the lowest possible long run average cost of production, given current technology.

In other words, the long run market supply curve (long enough to include supply from entrants) is horizontal at the lowest possible average cost.

What is Exogenous in the Long Run / Free Entry Model?

Exogenous:

Demand function

Minimum long run average cost (new)

Endogenous:

Price and Quantity

Supply function (formerly exogenous)

Economic Profits

Economic profits can differ from accounting profits mainly because the economic profit calculation should:

- Ignore sunk costs
- Include opportunity costs

Accounting profits are *backward*-looking. Economic profits are *forward*-looking.

Sunk Cost

Sunk costs are, broadly: costs that are already spent and cannot be recovered.

Sunk costs should not affect decision-making, but they can lead to two opposite errors:

- Irrational desire to stay on course, to avoid acknowledging errors or wasted investments.
- Irrational desire to reverse course, to erase the memory of errors or wasted investments.

Opportunity Cost

Opportunity cost is, broadly:
the opportunity one sacrifices by investing resources somewhere else.

Much of economics concerns tradeoffs.

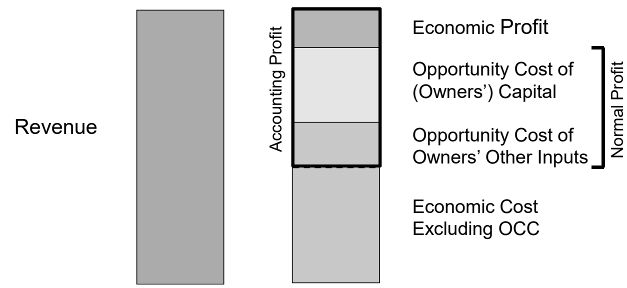
Normal Profit

The money that an investor could earn by investing elsewhere is the opportunity cost of capital (OCC).

Normal profit is what a firm must earn to compensate its owners for their opportunity costs, including the OCC. Normal profit is not economic profit.

A firm's economic profit is its profit in *excess* of normal profit.

Accounting Profit Often Exceeds Economic Profit



Accounting profit may differ in other ways, not shown, from both SR and LR economic profit.

Connecting Entry to Normal Profit

Economic profit attracts new investors and entry. Therefore, in the long run, in a perfectly competitive market:

- Firms earn only “normal profit.”
- Economic profit is zero.