1.5 THEORY OF FIRM (HL)
TERMS & OBJECTIVES

Part I: THE FIRM
I. Production and Cost, II. Revenues, III. Profit, IV. Goals of Firms

I. PRODUCTION AND COSTS

‡ TERMS

- Short Run
- Long Run
- Total Product (TP)
- Marginal Product (MP)
- Average Product (AP)
- Law of Diminishing Returns
- Costs of Production
- Explicit Costs
- Total Costs
- Average Costs
- Marginal Cost
- Constant Returns to Scale
- Increasing Returns to Scale
- Decreasing Returns to Scale
- Long Run Average Total Costs
- Long-Run Average Total Cost Curve
- Implicit Cost
- Economic Costs
- Fixed Costs
- Variable Costs
- Economies of Scale
- Specialization
- Diseconomies of Scale

‡ OBJECTIVES

∅ Production in the Short-Run: The Law of Diminishing Returns

- Distinguish between the short run and long run in the context of production.
- Define total product, average product and marginal product, and construct diagrams to show their relationship.
- Explain the law of diminishing returns.
- Calculate total, average and marginal product from a set of data and/or diagrams.

∅ Costs of Production: Economic Costs

- Explain the meaning of economic costs as the opportunity cost of all resources employed by the firm (including entrepreneurship).
- Distinguish between explicit costs and implicit costs as the two components of economic costs.

∅ Costs of production in the Short-Run

- Explain the distinction between the short run and the long run, with reference to fixed factors and variable factors.
- Distinguish between total costs, marginal costs and average costs.
- Draw diagrams illustrating the relationship between marginal costs and average costs, and explain the connection with production in the short run.

- Explain the relationship between the product curves (average product and marginal product) and the cost curves (average variable cost and marginal cost), with reference to the law of diminishing returns.
- Calculate total fixed costs, total variable costs, total costs, average fixed costs, average variable costs, average total costs and marginal costs from a set of data and/or diagrams.

Production in the Long-Run: Returns to Scale

- Distinguish between increasing returns to scale, decreasing returns to scale and constant returns to scale.

Costs of Production in the Long-Run

- Explain the relationship between short-run average costs and long-run average costs.
- Explain, using a diagram, the reason for the shape of the long-run average total cost curve.
- Explain factors giving rise to economies of scale, including specialization, efficiency, marketing and indivisibilities.
- Explain factors giving rise to diseconomies of scale, including problems of coordination and communication.

II. REVENUES

TERMS

- Total Revenue (TR)
- Marginal Revenue (MR)
- Average Revenue (AR)

OBJECTIVES

Total Revenue, Average Revenue and Marginal Revenue

- Distinguish between total revenue, average revenue and marginal revenue.
- Draw diagrams illustrating the relationship between total revenue, average revenue and marginal revenue.
- Calculate total revenue, average revenue and marginal revenue from a set of data and/or diagrams.

III. PROFIT

TERMS

- Economic Profit
- Normal Profit

- Break-Even Point
- Supernormal/Abnormal Profit
- Loss

‡ OBJECTIVES

∅ Economic Profit

- Describe economic profit (abnormal profit) as the case where total revenue exceeds economic cost.
- Explain the concept of normal profit (zero economic profit) as the amount of revenue needed to cover the costs of employing self-owned resources (implicit costs, including entrepreneurship) or the amount of revenue needed to just keep the firm in business.
- Explain that economic profit (abnormal profit) is profit over and above normal profit (zero economic profit), and that the firm earns normal profit when economic profit (abnormal profit) is zero.
- Explain why a firm will continue to operate even when it earns zero economic profit (abnormal profit).
- Explain the meaning of loss as negative economic profit arising when total revenue is less than total cost.
- Calculate different profit levels from a set of data and/or diagrams.

IV. GOALS OF FIRMS

‡ TERMS

- Profit Maximization
- Revenue Maximisation
- Growth Maximisation
- Satisficing
- Corporate Social Responsibility

‡ OBJECTIVES

∅ Profit Maximization

- Explain the goal of profit maximization where the difference between total revenue and total cost is maximized or where marginal revenue equals marginal cost.

∅ Alternative Goals of Firms

- Explain alternative goals of firms, including revenue maximization, growth maximization, satisficing and corporate social responsibility.