The goal of “Firms and Markets” is to give you some insight into business strategy and tactics, largely from the perspective of economics. This isn’t the only source of insight into business (that’s why you’re taking other courses), but it’s a useful one. We’ll focus specifically on decisions made by individual firms. Our areas of scrutiny will include product pricing (what to charge), product positioning (what to make), entry and exit (whether to enter or leave a market), vertical integration (whether to make your inputs or buy them). Some of the key concepts we will introduce include economic incentives, marginal analysis, and opportunity cost (what costs matter), competitive forces (why it’s so hard to make money), strategic behavior (how to predict and respond to your rivals’ decisions), and asymmetric information (what happens when others know something you don’t). Our experience with students in prior years is that much of this is intuitive. But much is not, and our hope is that the combination of theoretical structure and practical examples will be useful in the years to come. It won’t make you a success on its own, but it might give you an edge a few times when it matters.

Business can be viewed from many perspectives, including those of sociology and psychology. Economists tackle the subject by adopting a formal, explicit analysis of decision-makers that is based upon a number of assumptions. First, we assume that individuals make rational decisions to maximize some objective given a range of feasible choices. For example, firms might maximize profit or consumers might maximize “utility” (a catch-all to include whatever they care about). Secondly, we generally assume that a firm is a single decision-maker with a clear objective. Third, we assume that most economic interactions take place in markets, where buyers and sellers interact through price. All of these assumptions are questionable, and perhaps outright wrong, but they bring some clarity to our analysis that we feel is useful.

Our task is therefore to determine how individuals define their goals, examine the actions they take to attain those goals, and analyze the outcomes that result from their actions. We focus on how buyers and sellers firms interact through markets, how firms adopt strategies to interact with each other, how competitive forces bring resources to their most profitable use, how these same forces can make it difficult to sustain above-average profits, and how governments set rules to limit the power and influence of individual firms. A related issue is the firm itself. We look at the factors that determine which allocations of resources are made in markets, and which allocations are made in firms (by apparently nonmarket methods). The trick in all of this analysis is to simplify (eliminate nonessential complications) without losing the flavor of the situation being examined. It’s a delicate balance, and one that makes the subject of this course as much art as
science.

Markets

Markets are incredibly numerous and varied. The New York Stock Exchange is one prominent local market, but so are the farmer’s market at Union Square and the markets for pharmaceuticals, cable TV programs, and consulting and legal services. Markets can be highly regulated, such as the US aerospace procurement market, or as informal as buyers and sellers haggling over cheap sunglasses on a street corner. Our formal definition of a market is a collection of buyers and sellers who interact in transactions for a product or a set of products.

Although we tend to focus on “a market,” in practice it’s not easy to decide where one market begins and another ends, either geographically or in the range of products. Are Balducci’s and the Union Square farmers in the same market? It depends on the issue. This is more than a theoretical nicety. The Staples/Office Depot anti-trust case, which effectively ended their proposed 1996 merger, hinged on precisely this issue. Was WalMart part of the same market (in which case the combined firm would have a small market share) or not (in which case the market share in many areas was substantial)? The courts ruled “not”, agreeing with the FTC that the merged company would have an unacceptably high market share in many locations.

Markets (once we agree on their boundaries) differ along many dimensions: the number of buyers and sellers, the degree of differentiation among products, the transparency of market transactions, and so on. On one end of the spectrum, we consider “perfectly competitive” markets, in which many buyers and sellers of a uniform product make transactions in transparent markets. In a perfectly competitive market the large numbers of buyers and sellers means that no individual firm has any meaningful control (“market power”) over the price. It’s an extreme case, but illustrates the impact of competitive forces. Managers abhor such markets, since competition makes it very difficult to make money. Such products are referred to disparagingly as “commodities,” since commodity markets are often good examples (wheat, basic steel, photocopy paper).

At another end of the spectrum, markets with one seller are referred to as “monopolies.” Monopolies are said to have market power, generally restricting output and setting prices above what we’d see under perfect competition. Famous near-monopolies over the years include Standard Oil at the turn of the century, Deutsche Telecomm, and DeBeers (a monopoly distributor).

While some markets lie at the extremes, the majority are located somewhere in between. We refer to markets with a few sellers as “oligopolies.” These markets are much more common. They’re also more interesting and challenging to study, since some oligopolies are extremely competitive, while others behave much like monopolies. Hence a central
issue for us will be to understand the features of a market that make it more or less competitive.

**Firms**

The large business firm is one of the distinguishing features of the modern world. For the last century or more, many products have been made and sold by large organizations. The MO course is devoted, in part, to how such large collections of people work. We operate at a more “macro” level, treating each firm as a single object maximizing (say) profits. More on this shortly. Like markets, firms are diverse along many dimensions, including geographical span (think of Coca-Cola versus the Campus Eatery), in span and scope of product offerings (General Electric versus a shoe store), and in degree of vertical integration. Over the course of this class, we will learn about many distinguishing characteristics that lead to differentiation and competition among firms.

In focusing on firms, we make an important assumption about firm behavior: firms and managers maximize profits or shareholder value (we think of them as the same thing). Does this make sense? On the face of it, how can the 100,000 employees of Citigroup be thought of as working together to maximize anything? Why would the managers of General Electric work for the good of shareholders? How can the shareholders know whether the managers are doing this or not? Although we own a few shares of many firms through mutual funds, we do not have the time or resources to monitor management’s actions, other than what we read in the *New York Times* or *Wall Street Journal*. And even though Boards of Directors are ostensibly looking out for our interests, they are rarely independent from the CEO and perhaps other top operatives in the company.

How, then, might we defend profit maximization? We might argue, first, that Darwinian competition will weed out the firms that don’t. Or we might argue that managers do this to maximize their own reputations, and that competition leads managers with good reputations to be paid better. Perhaps the most compelling argument is based on capital markets: firms that do not maximize value will taken over and their management replaced. None of these arguments is watertight, but they give us some hope that the assumption is, at least, a reasonable approximation.

**It Depends**

There's an old joke that people love to tell about economists. Harry Truman, the joke goes, once asked for a one-armed economist. His advisors asked: "Why one arm?"
"Because," Truman remarked, "economists always answer questions with: on the one hand it's this, on the other hand it's that. For once, I'd like to have an economist who will give me one straight answer."

We need to tell you now: If you're looking for the one-armed economist, this isn't the course for you. Economics is not a set of answers. It is, instead, a framework for
thinking about questions systematically. It won't give you the answer, but it will allow to ask the right questions.

The answer to most questions in this class is, then, "It depends." After taking the course, you'll be able to say what it is they depend on.

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