

Price Setting Behavior

Note: The traditional principles of economics course asks students to spend a lot of time and effort learning the mechanics of imperfect competition and specific models of non-competitive industries such as pure monopolies, monopolistic competition, price leaders and followers. We will not follow the traditional approach. Instead, we will focus on the difference between “perfect” and “imperfect” competition and why these differences matter to consumers, producers, and policy makers.



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1. The Big Ideas

- a. In a competitive industry, there are many sellers and buyers. The price of a good that is traded in a competitive market is set by the forces of supply and demand.
 - i. No seller has the power to influence price. If any seller charges a price that is too high, buyers buy from a different seller.
 - ii. No buyer has the power to influence price. If the buyer seeks a discount, the seller refuses.
 - iii. Each buyer and seller in a competitive market is a **price taker**.
 - iv. A good example of a competitive market is the market for wheat.
- b. Most markets we trade in are not perfectly competitive. Buyers do not perceive the products offered by different sellers to be perfect substitutes.
 - i. Some buyers prefer Coke to Pepsi. Others prefer Pepsi to Coke. Still others think a cola is a cola.
 - ii. Those who prefer Coke will buy Coke even if it costs (something) more than Pepsi or a generic cola beverage.
- c. In imperfectly competitive markets, a seller has some latitude to set its own price
- d. Firms in imperfectly competitive industries face different demand schedules than firms in perfectly competitive industries.
 - i. In a perfectly competitive industry, individual firms face horizontal demand curves at the market equilibrium price.
 - ii. In an imperfectly competitive industry, individual firms face downward sloping demand schedules.
 - iii. The more inelastic the demand schedule faced by the individual firm, the more market power the firm has. It follows that a firm will have more market power if fewer substitutes exist for the good that the firm sells.

2. The Sources of Market Power

- a. Exclusive control over important inputs (DeBeers).
- b. Patents and Copyrights
 - i. A patent gives, to the patent holder, an exclusive right to sell a product.
 - ii. A copyright gives exclusive rights to sell and use intellectual properties such as books, movies, software, music, images and other published works.
- c. Government Licenses or Franchises
 - i. The government sometimes gives an exclusive contract to a firm that provides government services.
 - ii. Halliburton, Marriott and Powers Great American Midways are examples.
- d. Economies of Scale
 - i. A production process is said to have constant returns to scale if, when all inputs are doubled, output is also doubled.
 - ii. A production process is said to have increasing returns to scale if, when all inputs are doubled, output increases by more than double.
 - iii. When a production process is characterized by increasing returns to scale, the average cost of production falls as the scale of production increases.
 - iv. When there are economies of scale, equilibrium typically involves few and perhaps only one seller because that seller has low costs and new entrants to the industry face high costs.
- e. Network Economies
 - i. With some goods or services, the value of the good or service depends on how many have adopted it.
 - ii. Videotape formats, cell phone networks, and computer operating systems are examples.
 - iii. Once a particular "brand" is widely adopted, producers of complementary goods tend to make them compatible with the dominant brand further enhancing the network and further protecting the brand from would-be rivals.

3. Example

Carla supplements her income as a TA by editing term papers for undergraduates. Carla can set her price but charges the same price to all her customers. There are eight students (A-H) for whom she might edit, each with a reservation price as given by the following table.

Student	Reservation Price	Total Revenue	Marginal Revenue
A	\$40		
B	\$38		
C	\$36		
D	\$34		
E	\$32		
F	\$30		
G	\$28		
H	\$26		

If Carla's opportunity cost for editing a paper is \$29, how many will she edit (presuming that her objective is to maximize her profit)?

4. A Price Setter faces a tradeoff when they decide how much to sell.

- a. In a perfectly competitive industry, a firm will choose to supply the quantity where their marginal cost of production just equals the market price (that they take as given).
- b. In an imperfectly competitive industry, a firm understands that increasing supply has two consequences
 - i. Marginal cost
 - ii. Decreased market price
- c. The marginal revenue schedule shows how the firm's revenue changes as a function of the quantity it sells.
- d. A firm in an imperfectly competitive industry will maximize profits by choosing the quantity such that marginal cost equals marginal revenue.
- e. The marginal revenue schedule associated with the classes our Oreo Cookie demand schedule.

5. The Impact of Market Power on Efficiency

- a. In a competitive industry, market price of a good
 - i. Equals the reservation price of the "last" consumer to buy the good.
 - ii. Equals the marginal cost of the "last" producer to supply the good.
- b. In an imperfectly competitive industry,
 - i. The market price of a good is greater than the marginal cost of production.
 - ii. There are consumers willing to pay the marginal cost of producing the good who are unable to purchase it.

6. Price Discrimination—What it is and How it Works

- a. Every firm knows that in a single price market purchasers of the good receive consumer surplus.
- b. Price discrimination refers to schemes through which firms attempt to charge different prices to different consumers and thereby acquire some consumer surplus in the form of higher profits.
- c. Discounts are another form of price discrimination.

Pizza Demand, Marginal Revenue, and Marginal Cost

