

Market Structure Part II

Monopolistic Competition

Monopolistic Competition

Major Assumptions

- Many buyers, fewer sellers.
- Limited entry barriers may exist due to product differentiation .
- Product differentiation.

Monopolistic Competition

Sidebar Discussion: Product Differentiation

- Products have attributes or key characteristics.
- For example, with sodas it could be flavors, sizes, image.
- Key customer groups may have consistent yet different tastes; example: latinos. (1st gen)

Monopolistic Competition

Importance of Assumptions/Entry Barriers

- Markets become segmented.
 - Customers are grouped or segmented according to preferences in goods & services.
 - Firms differentiate their products to appear to specific customer segments.

Monopolistic Competition

Importance of Assumptions/Entry Barriers

- Monopolistic competitive firms face a market in which product variation becomes a variable and at the same time an entry barrier.
- Consumers have limited product choice, given that entry is limited or blocked, firms may enjoy some pricing power .

Monopolistic Competition

Operational Considerations

- Demand will tend to be more inelastic than that found in competitive markets but more elastic than that in monopolistic markets.
- Firms may have competitors but customers perceive those products as imperfect substitutes.

Monopolistic Competition

Operational Considerations

- Simple demand curves are misleading as firm has influence over preferences through advertising giving it some ability to change demand.

Monopolistic Competition

Operational Considerations

- Consequently, firms have several operational decisions: pricing, output, and advertising (product differentiation may become a strategic consideration).

Monopolistic Competition

Operational Considerations/Pricing Practices

- Price Discrimination
- Block Pricing
- Two-part Tariff
- Bundling

Monopolistic Competition

Operational Considerations/Pricing Practices

- Price Discrimination

- Price discrimination is charging different prices to the same or different customers.
- There are two conditions to maintain price discrimination: one, have knowledge of the demand curve, and two, be able to segment and separate markets.

Monopolistic Competition

Operational Considerations/Pricing Practices

- Price Discrimination
 - Its purpose is to maximize profit by extracting consumer surplus.

Monopolistic Competition

Operational Considerations/Pricing Practices

- Block Pricing
 - Identical products are packaged together forcing customers to make an all or none purchase decision.
 - The advantage of block pricing is that it does not rely on market segmentation as does price discrimination.

Monopolistic Competition

Operational Considerations/Pricing Practices

- Two-part Tariff
 - Customers are charged a fixed fee plus a per unit fee.
 - Often the fixed fee is an initiation fee.
 - Common in golf clubs, health clubs, etc.

Monopolistic Competition

Operational Considerations/Pricing Practices

- Bundling
 - Bundling several products together to sell at a single price.
 - By offering package deals, firms can enhance their profits.

Monopolistic Competition

Pricing Practices/Bundling

Customer Main Entree Salad

1	\$25	\$5
2	20	2
3	8	9

Monopolistic Competition

Pricing Practices/Bundling

- If the manager knew each customer's preferences then TR would be $\$25 + 5 + 20 + 2 + 8 + 9 = \69 .

Monopolistic Competition

Pricing Practices/Bundling

- Since the firm cannot price discriminate based on each customer's preferences, the menu price set at \$20 for the main entree and \$7 for the salad would generate a profit of $\$20 * 2$ and $\$7 * 1 = \47 .

Monopolistic Competition

Pricing Practices/Bundling

- But if the manager offers a combo deal for \$22, then sales become $\$22 * 2$ plus one salad for \$7 for a total of \$51.
- The combo pricing would increase sales by \$4.

Monopolistic Competition

Pricing Practices/Bundling

- Bundling several products together to sell at a single price.
- By offering package deals, firms can enhance their profits.

Monopolistic Competition

Operational Considerations/Advertising

- Provides information about prices, products, quality, and location.
- Advertising is used to increase sales, however, a cost is incurred.
- The marginal benefit of advertising tends to decline as advertising increases.

Monopolistic Competition

Operational Considerations/Advertising

- Types of advertising
 - Informative: details basic characteristics and target experienced customers.
 - Persuasive: attempts to influence tastes and targets inexperienced customers.

Monopolistic Competition

Operational Considerations/Advertising

- Effect of Advertising on Competition
 - Usually advertising intensifies competition, often promoting price competition.
 - However, in some cases advertising can be used to promote business practices restricting competition.

Monopolistic Competition

Strategic Considerations

- Since product variation may require long term commitments using capital outlays, it becomes a major strategic consideration.

Monopolistic Competition

Strategic Considerations

- To the extent that the firm can produce a unique product that other firms have trouble duplicating then an entry barrier is created.
- Some economic profit may be possible under this circumstance.

Monopolistic Competition

Strategic Considerations

- Investment in Research & Development (R&D), particularly that which results in new products becomes important.

Monopolistic Competition

Economic Efficiency

- Monopolistically Competitive firms lack productional and allocational efficiency.
- BUT, developing and producing new products that have high utility to customers increases economic efficiency.

Oligopolistic Competition

Oligopolistic Markets

Major Assumptions

- Many buyers, very few sellers.
- Entry barriers may or may not be effective .
- Products may be homogeneous or heterogeneous.

Oligopolistic Markets

Importance of Assumptions

- Typically, this market structure has 2 to 4 large firms.
- The competitors know one another.
- Firms must consider reactions of other firms to its actions.

Oligopolistic Markets

Importance of Assumptions

- Even operational decisions contain an element of strategy.

Oligopolistic Markets

Operational Considerations

- Because firms must consider what competitors are going to do, the demand curve no longer is a smooth line. It is shaped very differently.

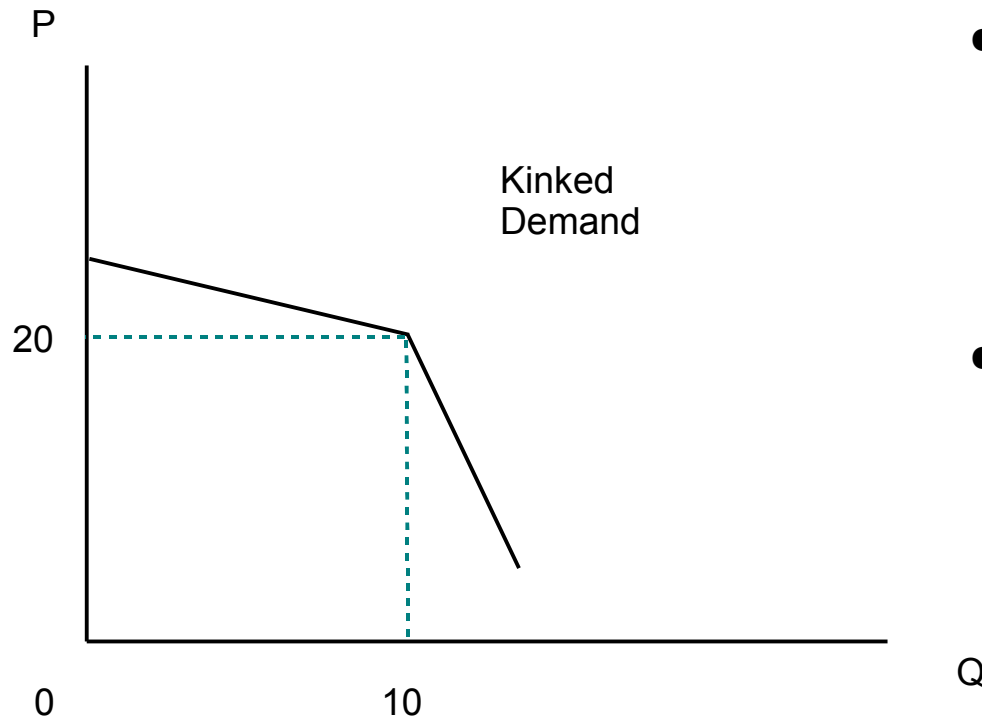
Oligopolistic Markets

Operational Considerations

- Kinked Demand Curve
 - One oligopolistic model of behavior that attempts to show interdependence of pricing decisions is the Kinked Demand Curve Theory.

Oligopolistic Markets

Kinked Demand Curve

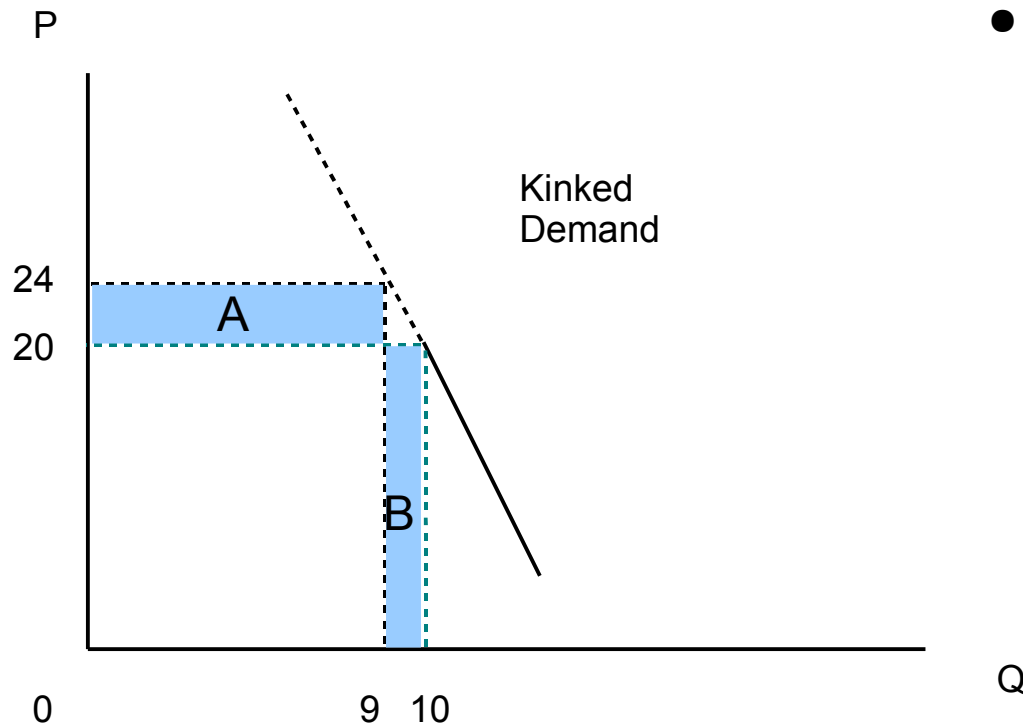


- The point where $P=20$ is called the sticky point.
- It is in the firm's best interest not to change

Oligopolistic Markets

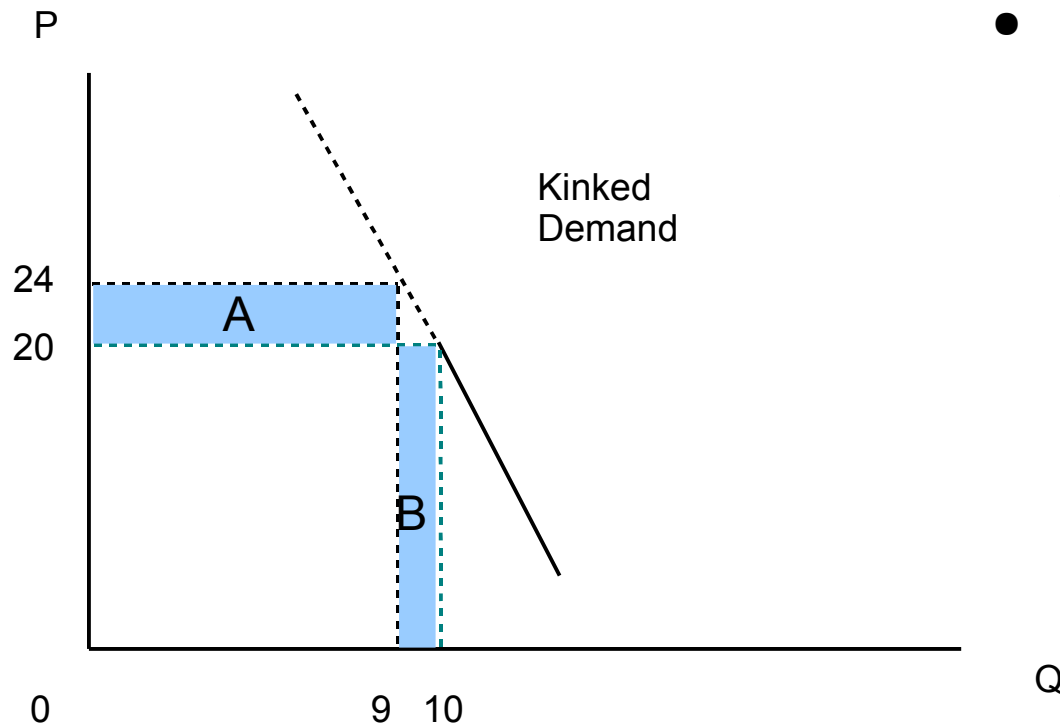
Kinked Demand Curve

- The firm believes demand is inelastic so it increased price to \$24.



Oligopolistic Markets

Kinked Demand Curve

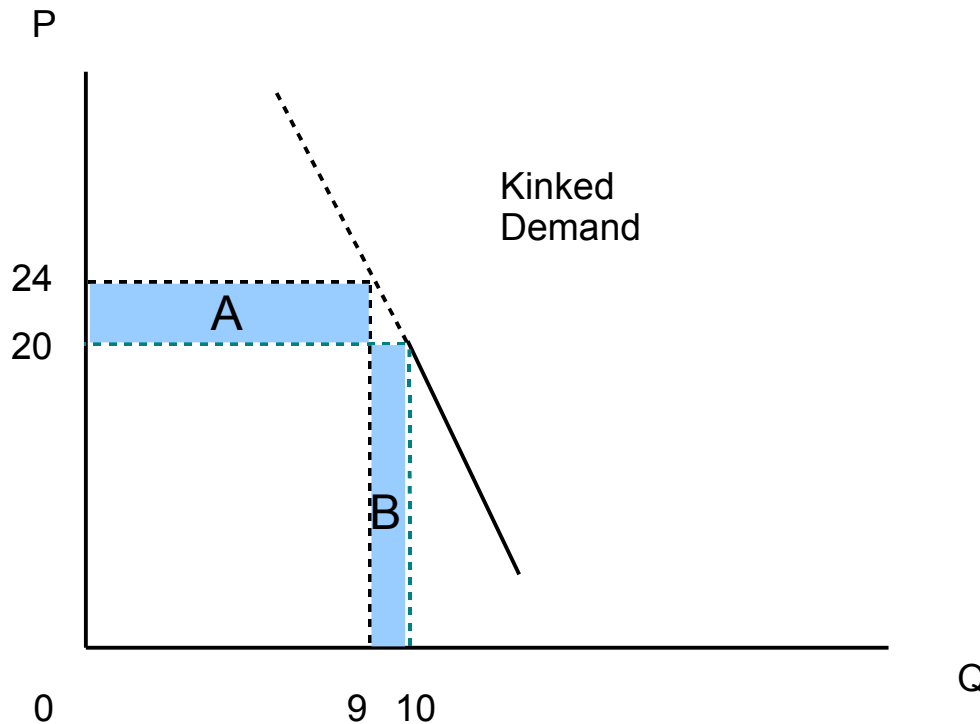


- If demand were inelastic, then TR would increase from \$200 ($\20×10) to 216 ($\$24 \times 9$)

Oligopolistic Markets

Kinked Demand Curve

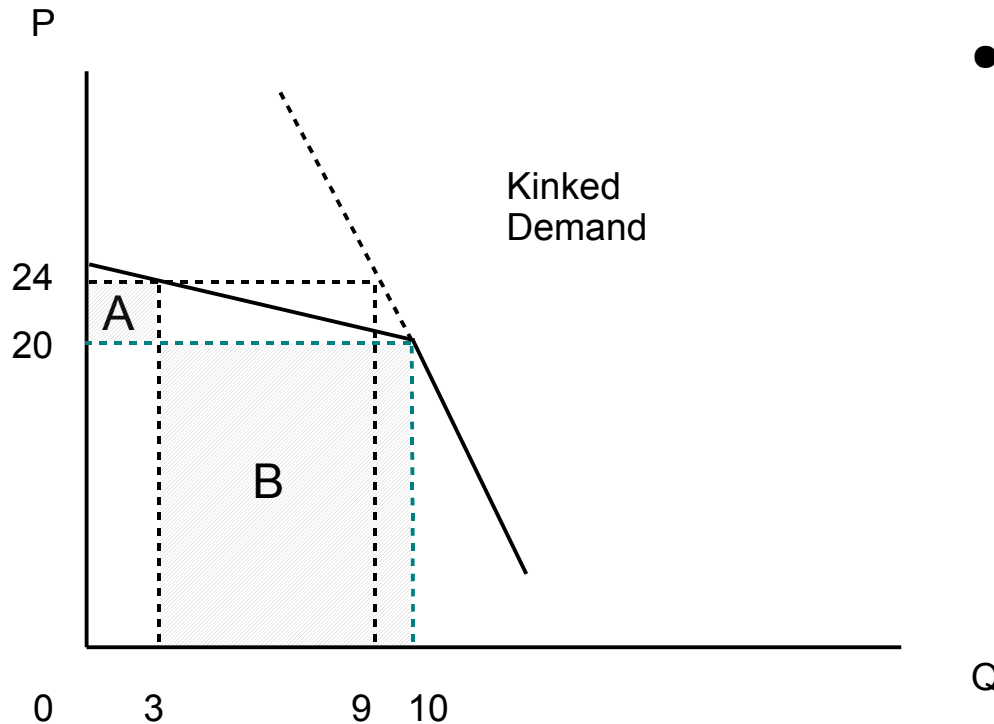
- Note the revenue lost in B, \$20, is less than the revenue gained in A, \$36.



Oligopolistic Markets

Kinked Demand Curve

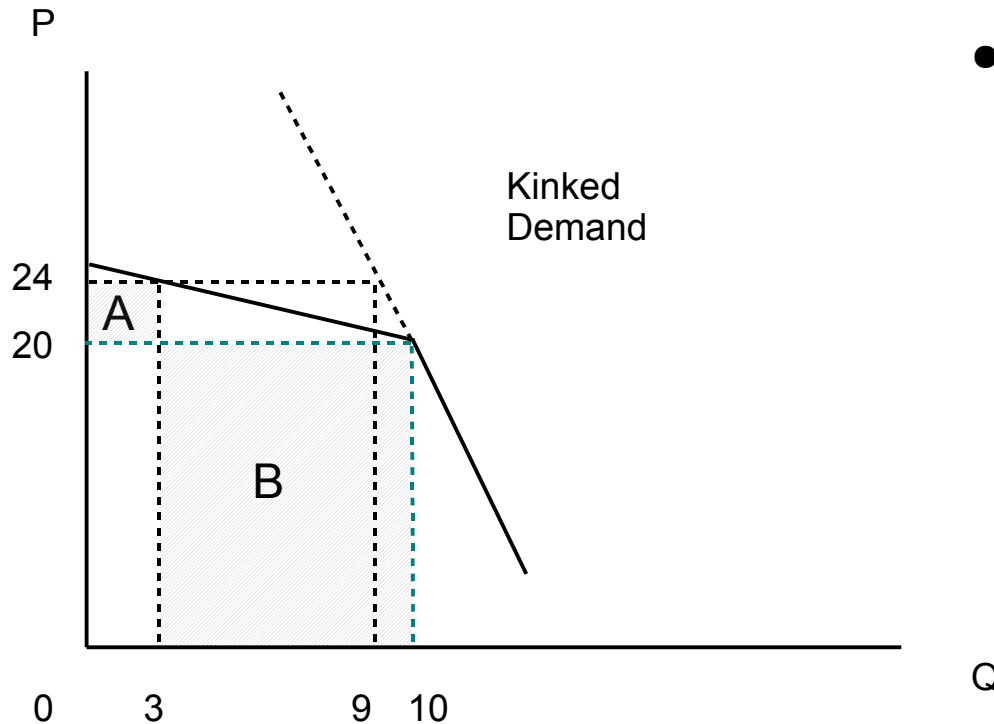
- But the other firms fail to increase their price, thus taking customers away from this firm.



Oligopolistic Markets

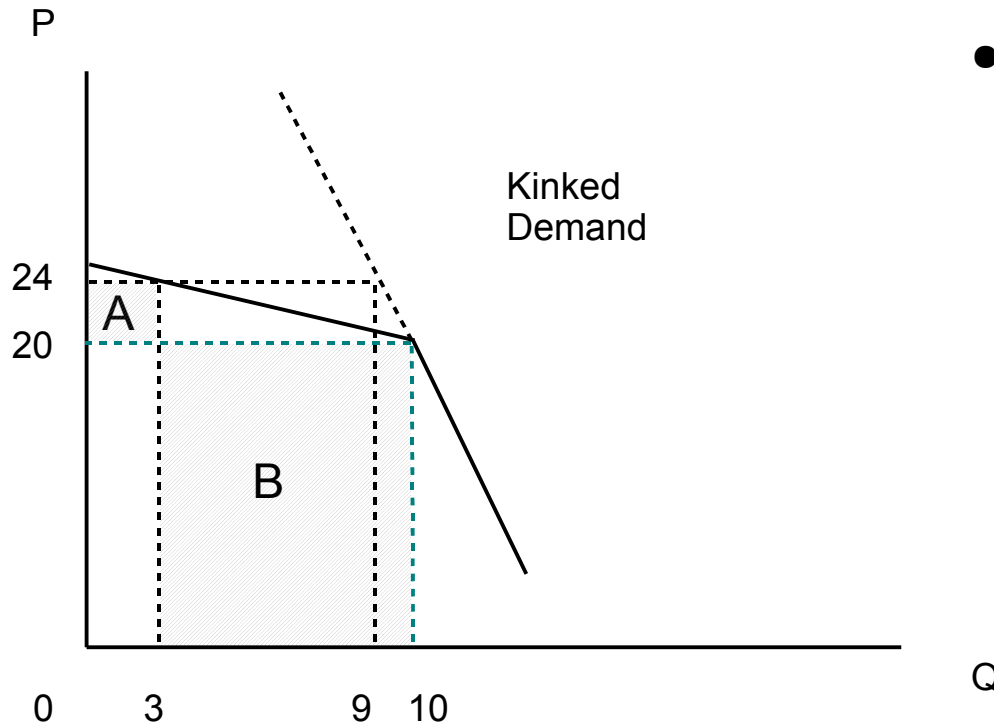
Kinked Demand Curve

- Consequently, TR drops from \$200 to \$72 ($\$24 \times 3$).



Oligopolistic Markets

Kinked Demand Curve

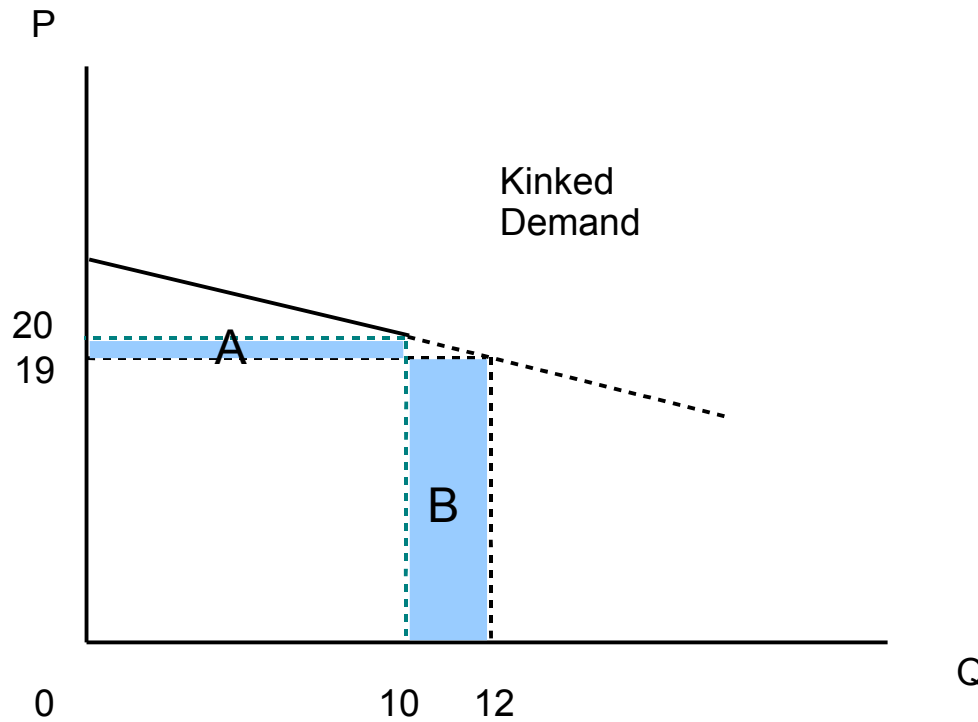


- Also note that the revenue gained $\$12$ $(\$24-20)*3$ is for less than the revenue lost.

Oligopolistic Markets

Kinked Demand Curve

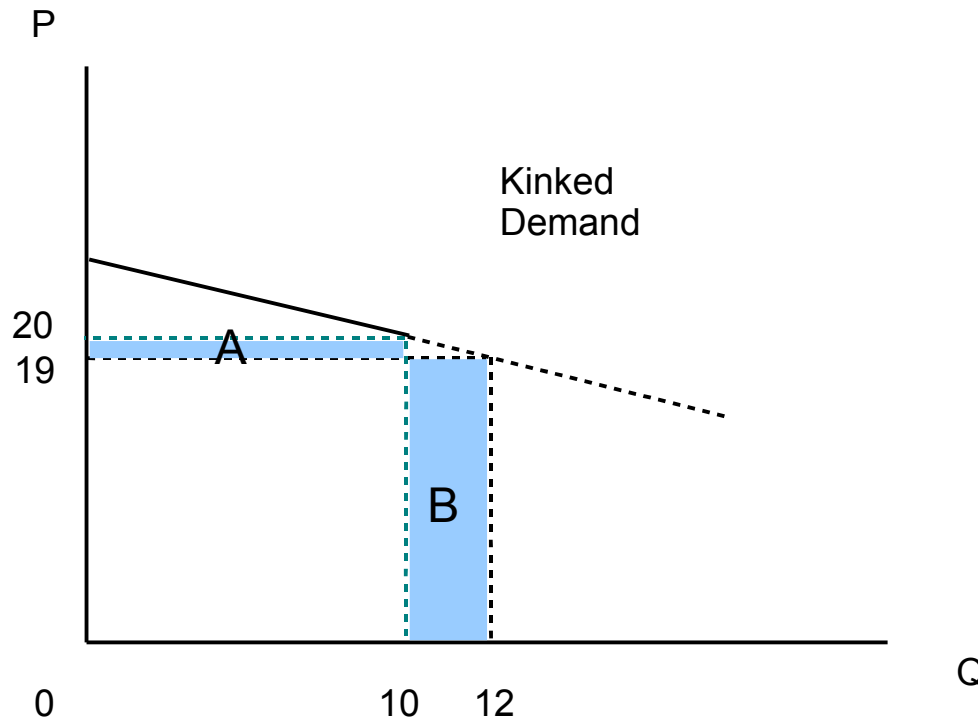
- Let's say our firm now assumes demand is elastic, so it lowers price to \$19.



Oligopolistic Markets

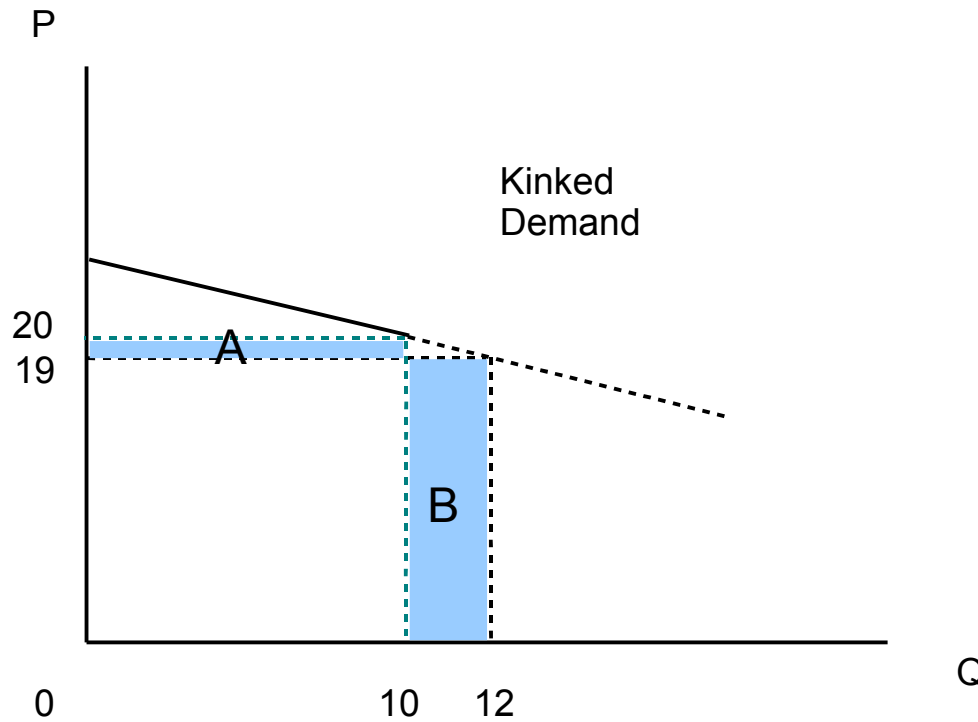
Kinked Demand Curve

- Now TR increases from \$200 to \$228 ($\$19 \times 12$).



Oligopolistic Markets

Kinked Demand Curve

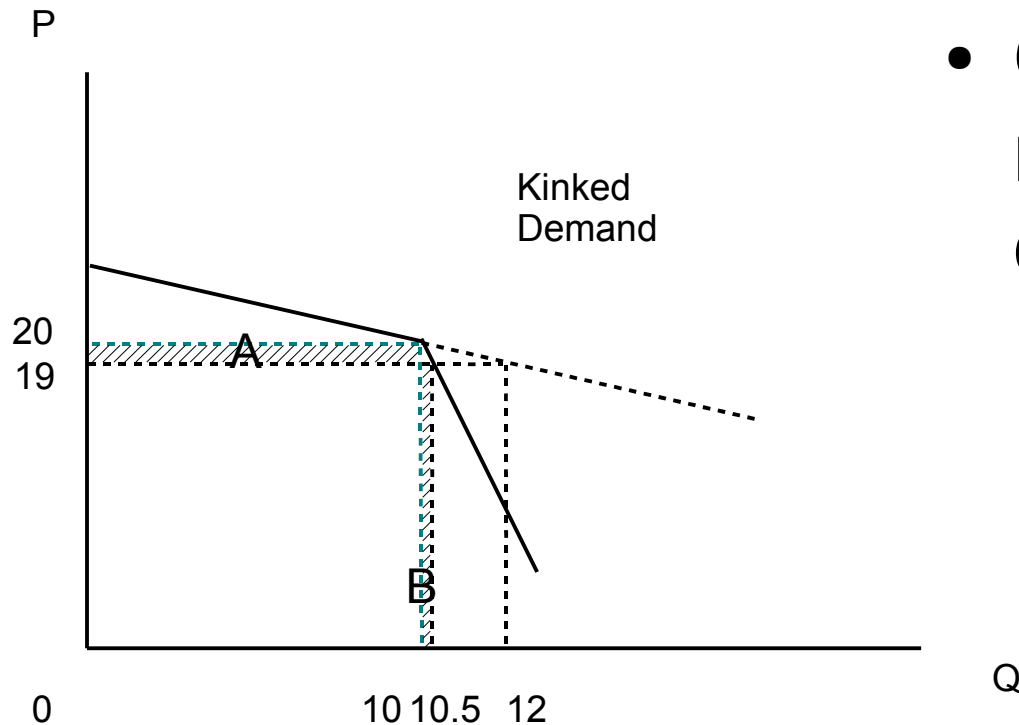


- Note that the revenue gained, B, is \$36, (19×2), more than the revenue lost \$10 ($\1×10).

Oligopolistic Markets

Kinked Demand Curve

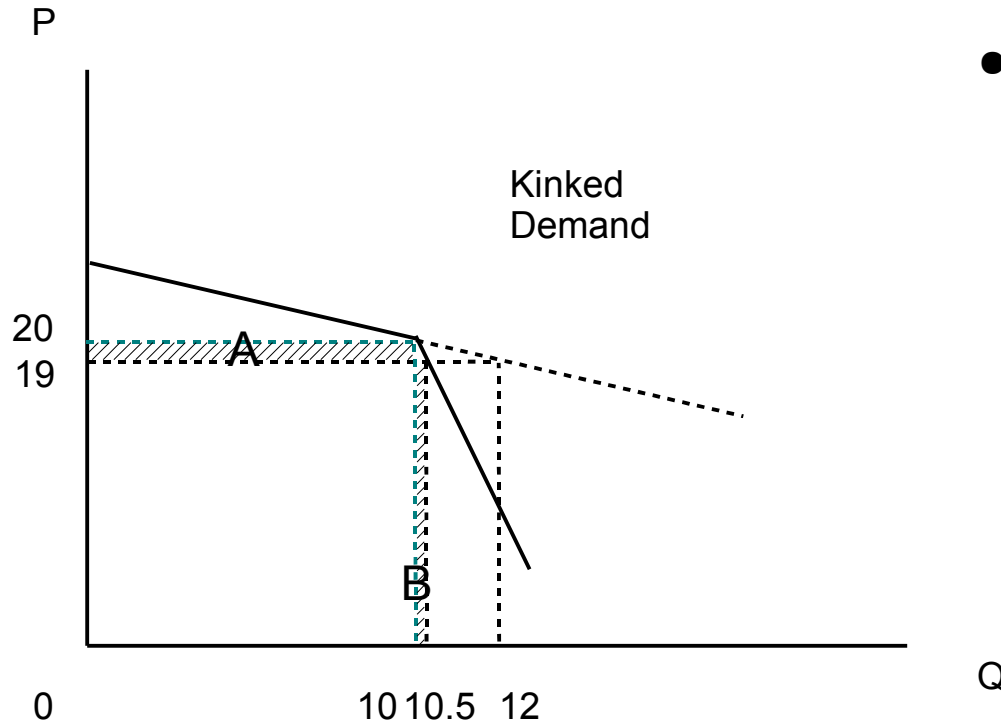
- Of course, every firm matches the price cut.



Oligopolistic Markets

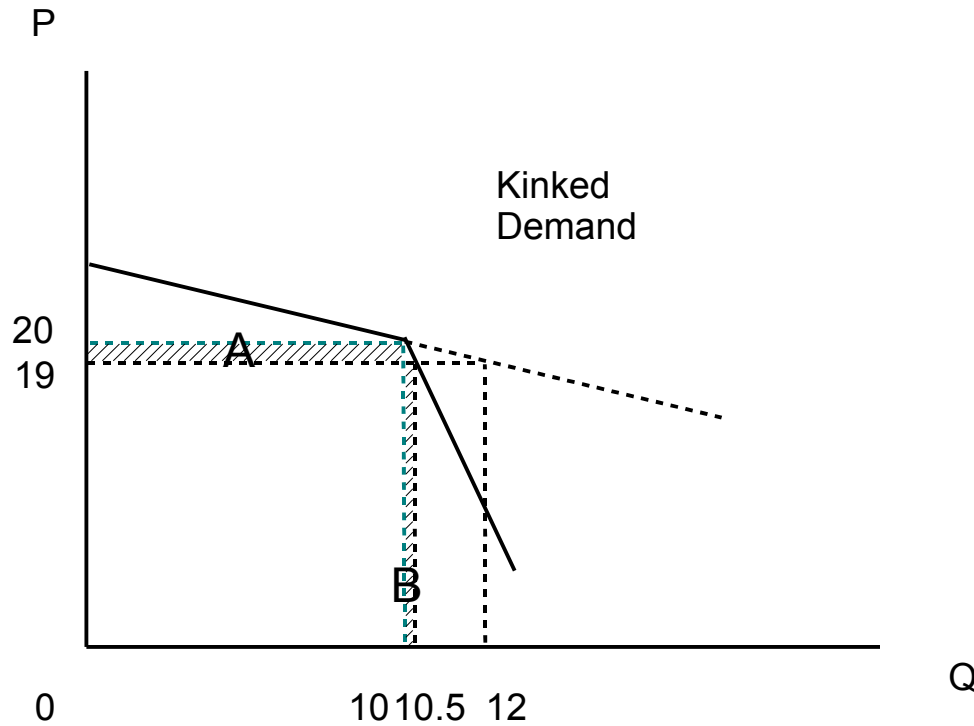
Kinked Demand Curve

- Consequently, TR decreases from \$200 to \$199.5.



Oligopolistic Markets

Kinked Demand Curve



- Note the revenue gain of \$9.5 ($\$19 \times .5$) is less than the revenue loss of \$10 ($\1×10).

Oligopolistic Markets

Operational Considerations/Pricing

- Other pricing practices have evolved to maximize profit by encouraging price coordination without explicit collusion.

Oligopolistic Markets

Operational Considerations/Pricing

- Pricing Practices to Facilitate Cooperation.
 - Price Matching
 - Sale-Price Guarantees
 - Public Pricing
 - Price Leadership

Oligopolistic Markets

Operational Considerations/Pricing

- Price Matching

- A public announcement to the effect that this firm will match any price offered by competitors.
- Reneging on this offer would cause considerable costs in legal fees and loss of goodwill.
Therefore, this threat becomes highly credible

Oligopolistic Markets

Operational Considerations/Pricing

- Sales-Price Guarantee
 - A promise to buyers to give the sales price today for any sales that may occur in the near future such as 30 days.
 - Makes cutting prices very costly since past customers are entitled to rebates.

Oligopolistic Markets

Operational Considerations/Pricing

- Public Pricing
 - By public posting of prices, firms inform other firms of changes in prices which allows quick detection of cheaters.

Oligopolistic Markets

Operational Considerations/Pricing

- Price Leadership
 - One major firm sets the price, other firms follow suit as it is in their best interest to do so.

Oligopolistic Markets

Strategic Considerations

- Firms that experience low profitability may attempt to coordinate pricing, production and other decisions, through explicit communication.
- This is called collusion.
- Firms band together in groupings called cartels.

Oligopolistic Markets

Strategic Considerations

- The strategy is to act as one firm, a monopoly.
- To do so, they must agree on cutting production and allocating profits (centralized cartel), or

Oligopolistic Markets

Strategic Considerations

- by allocating market share (market sharing cartel).
- The incentive to cheat often dooms cartels unless some enforcement mechanism is present.

Oligopolistic Markets

Economic Efficiency

- Productional efficiency is not achieved.
- Allocational efficiency is not achieved.

The End