Limit pricing and oligopolies

Limit pricing is the type of pricing wherein firms discourage entrants to the market by choosing a low price that is below short-run profit maximizing price but above the competitive level. Firms who engage in limit pricing are forfeiting current profits to earn future profits. The output is being maintained despite the presence of entrants. However, there are still issues whether the application of limit pricing models is profitable for firms (2002).

A firm engages in limit pricing by choosing its price and output while an entrant cannot sufficiently cover the average total cost of the remaining market demand. An established firm that is threatened by an entry in a single-period could use limit price as the highest price. This will block the entry. As first explained by Modigliani in 1958, it was assumed that entrants would expect that incumbent firm will continue production at an entry-limiting output with an entry present. It is the same as the Cournot Competition wherein firms believe that its competitors will continue production at the current levels (McAuliffe, 1997).

On the other hand, " classic limit pricing" is another pricing policy where limit pricing allows established firms to earn economic profits while they are preventing the occurrence of entry. It happens if there are economies of sale in production even if the entrants and the incumbent firms have the same costs (McAuliffe, 1997).

Another model is explained by Gaskin in 1971, called the dynamic limit pricing. It happens if there are threats from potential competition to a firm for current and future periods. The firms would now depend the rate of entry

from the difference between the current price and their marginal costs. If a firm would want to earn high profits at current period, it will set a high price.

However, the number of entry will also increase while the price and profit are likely to decrease in the future. On the other hand, if an established firm decided for a lower price, both the entry and the profits will decrease. Moreover, if the firms do not have any cost over the entrants, it will lose its position then the market will be competitive. The competitive outcome of the market however is not astonishing at all since only the price is used by the firm (McAuliffe, 1997).

Both in the classic and dynamic limit pricing, the market power of the established firms are restricted due to the potential competition. In the end, they have no choice but to set the price under monopoly level. However, the expectation from an entrant that a firm would always maintain its output is not always true.

After the entry period, both firms would earn high profits through high prices and restricted output. An established firm therefore with maintained output after the existence of an entry is not always a threat for an entrant. Otherwise, the established firm should bind for the current period in order to obtain high profits with high output for the next periods (McAuliffe, 1997).

Successful limit pricing could affect the market structure however few firms do set prices equal to or below the monopoly level to discourage entry. Major American companies use different strategies such as advertising and product proliferation   to discourage entry (McAuliffe, 1997).

Competition is important in the American economy system but what if there is only a small number of competing companies? This condition falls under the oligopoly market. Unlike the monopoly where there is only one seller and many buyers, in oligopoly there is more than one seller (Schenk). In oligopoly, there may be homogenous or heterogeneous products; however entry is deterred by legal restrictions such as banking, minimum efficient scale such as overnight mail service , or strategic behavior (2008).

Oligopoly has different models such as the Cournot-Nash Equilibrium of Duopoly and the Collusive Oligopoly. Cournot focused only on duopoly where there are only two firms competing assuming that both sell the same products produced at zero marginal cost. Both firm engage in output that is profit-maximizing expecting that the output of the other firms is maintained or held constant (Lipsey and Crystal, 2007). Under Cournot-Nash equilibrium, duopolists are competing for the quantities where each produces less than a monopoly. However, the sum of the production of both duopolists is more than the monopoly but their economic profits are less than the monopoly.

The price is always less than monopoly level but not more than the competitive price (2008). Under Cournot equilibrium, firms would earn less than a monopoly because the duopolists' outputs are more then the monopoly output. They would earn however more than the perfectly competitive firms since they could decrease the price upon increasing output (Lipsey and Crystal, 2007). Each competing firm is expected to adjust their outputs. However, if they cannot make any more adjustments then equilibrium is reached (Hobbs, 2001).

Unlike Cournot-Nash equilibrium with doupolists as competing firms, in collusive oligopoly the firms cooperate in order to have a monopoly power. They may agree in setting price and dividing the output therefore gaining the quantity a monopoly produces and earning the economic profits a monopoly can. The firms are now earning more than doupoly profits (2008). There are many factors for collusion such as the number of sellers, personalities, equalityof shares, costs of each firm, and others. There is a possibly that a collusion might disintegrate especially if the firm begin competing andcheatingwith the other firms (Schenk).

Monopolies in the U. S. are most likely to be regulated by the government unlike the oligopolies. Price-fixing by the collusive oligopolies however is not allowed unless for agricultural cooperatives and professional sports league (2006). Collusion oligopolies, just like the doupoly, could turn into competition as well. Firms begin violating the production limits and producing more than they have to. Besides, the price tends to be lower. In the end, the collusion becomes unsuccessful.

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