

# Price policy in oligopoly

Economics



## **Price-output behavior in Oligopoly**

The kinked demand curve: This model was developed in 1939 by the economist Sweezy. It assumes that an oligopolist will expect rival firms to follow any price decrease it makes but not follow any increase. Thus the elasticity of demand for the firm's product is much greater above the ruling price than below it, and hence there is a kink in the demand curve faced by the firm.

For straight line demand curves the marginal revenue line lies halfway between the demand curve and the vertical axis. It is thus easy to show that the kink in the demand curve implies a discontinuity, i. e. a sudden drop, in the marginal revenue curve of the firm.

Marginal cost could thus vary greatly but still pass through this discontinuity in marginal revenue. Equally, changes in market demand could shift demand curves in and out without affecting the height of the kink. In short, profit maximizing at  $MC = MR$  could leave price unaffected despite considerable fluctuations in costs and demand.

The model has been used to explain why prices appear to fluctuate less in oligopolistic markets than in competitive markets. The model has serious flaws, however: again it implies a knowledge of marginal costs and revenue not possessed by real firms; it is not clear that entrepreneurs hold such pessimistic expectations of the reactions of their competitors: the evidence on price stickiness is not as clear cut as many believe. But the greatest flaw is that the model does not explain price determination, i. e. it does not

explain how the prevailing price was established or what happens when the price is eventually changed.

**Collusive Pricing:** Rivalry usually results in lower profits than could be achieved through firms cooperating with one another. Such cooperation to limit competition is known as “ collusion”, and many economists believe that this is often a more realistic assumption than rivalry. The outcome will then be like pure monopoly if each firm assumes that the rivals will match any price increase or price decrease. The firm will have to agree on price and output.

**Types of collusion:**

Overt collusion (Cartel) - illegal in Canada, it is a more formal type of collusion.

-Secret collusion

“ Gentlemen’s agreements”

**Obstacles to collusion:**

+Differences in demand and costs. It is hard to agree on prices if firm faces different demand curves or has different costs.

+A large number of firms (easier with a duopoly). It becomes harder to both come to an agreement and police an agreement as number of firms increase.

+Difficulties in controlling cheating, particularly during recessions. Cheating is always a real possibility; however, recessions make it hard for everybody and firms may cut prices in sheer desperation and therefore break the cartel.

+Large profits might attract new entrants. High profits in the collusive industry attract other firms into the industry. The new entrants may not be part of the collusive agreement and therefore by undercutting the collusive price may obtain a large chunk of the market. One way in which the incumbent firms may stop this is by charging a price that is low enough to deter entry (Limit pricing).

Price Leadership: Collusion may take the form of price leadership where, instead of competing through price, firms accept one of the firms in the industry as a price leader and simply keep their own prices in line with that firm's. More specifically, price leadership is a model of a pricing practice in many oligopolistic industries. The largest firm publishes its price list ahead of its competitors, who then follow those prices. This is also called parallel pricing. By definition, price leadership requires one firm to be a leader. Because of laws against collusion, firms in an industry cannot communicate this directly. That is why the largest firm often becomes the price leader.

Price leadership is notoriously difficult to prove as firm will argue that simultaneous price changes are not the result of collusion but the need to respond quickly to changes in the market and the competitive threat of rivals. However, price leadership may not always work. If the low price leader ends up much better off than those firms that follow, they may not set prices according to the dominant firm. A price war may result. A price war is a

pricing campaign designed to drive competing firms out of a market by repeatedly cutting prices.

**Price changes are infrequent because of the potential risk of others not following:**

- Cost-plus pricing
- Non-price competition
- Allocative and productive efficiency
- Dynamic efficiency
- Oligopoly, Technology, and R&D

Some of the tactics used in this kind of collusion is as follows:

Infrequent changes in price – if the leader changes prices too often it runs the risk of followers not “ following” each time it changes price.

Communication: Price changes are communicated by the regular media. The CEO of the price leader may have a press conference complaining that prices are too low and therefore give a signal to the other firms that it is time for prices to go up.

Limit pricing and contestable markets: A contestable market is one in which if price is raised sufficiently new entrants will be attracted to the market. Thus, to avoid unwelcome competition incumbent firms may hold price below the level at which short-run profits are maximized. Obviously, the extent to which price must be limited depends on barriers to entry; the greater these are the higher the price can be set without attracting new entrants.

A problem with limit-price models is that barriers to entry are not easily measured. In particular, the extent to which advertising, excess capacity and the threat of predatory pricing by incumbent firms is and can be used to ward off would-be entrants is hotly disputed by industrial economists.

The theoretical extreme is a perfectly contestable market in which any profit at all immediately attracts new entry. As incumbents can retaliate by lowering price to average cost entrants will dash into the market in such a way only if they will suffer no sunk costs upon withdrawal. For example, a window cleaner's ladder is a fixed cost but need not be a sunk cost if there is a good market for second-hand ladders.

Research suggests that actual competition has a far greater influence on price than potential competition and that very few industries have insignificant sunk costs, e. g. airport facilities and advertising constitute fixed costs in civil aviation.

Cost-plus pricing/ Mark-up pricing: Cost-plus pricing centers on what is known as mark-up or rule-of-thumb. More specifically, the oligopolist uses a formula to estimate cost per unit of output and a mark-up is applied to cost determine price. Units cost, however, vary with output and therefore the firm must assume some typical or target level of output. A mark-up, usually in the form of a percentage,, is applied to average total cost in determining price.

This cost-plus method of pricing is consisted with collusion or price leadership. If producer in an industry have roughly similar costs, adherence to a common pricing formula will result in highly similar prices and price changes.

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Cost-plus pricing has special advantages for multiproduct firms, which would otherwise be faced with difficult and costly process of estimating demand and cost condition for perhaps hundreds of different products. In practice, it is virtually impossible to allocate correctly certain common overhead costs such as power, lighting, insurance, and taxes to specific products.

To sum up, oligopoly is an important market structure in modern economies because there are many industries in which the minimum efficiency scale is simply too large to support many competing firms. The challenge to public policy is to keep oligopolists competing rather than colluding, and using their competitive energies to improve products and to lower costs, rather than merely to erect entry barriers.