Price and Output Determination under Perfect Competition

Perfect competition refers to a market situation where there are a large number of buyers and sellers dealing in homogenous products.

Moreover, under perfect competition, there are no legal, social, or technological barriers on the entry or exit of organizations.

In perfect competition, sellers and buyers are fully aware about the current market price of a product. Therefore, none of them sell or buy at a higher rate. As a result, the same price prevails in the market under perfect competition.

Under perfect competition, the buyers and sellers cannot influence the market price by increasing or decreasing their purchases or output, respectively. The market price of products in perfect competition is determined by the industry. This implies that in perfect competition, the market price of products is determined by taking into account two market forces, namely market demand and market supply.

Demand under Perfect Competition:

Demand refers to the quantity of a product that consumers are willing to purchase at a particular price, while other factors remain constant. A consumer demands more quantity at lower price and less quantity at higher price. Therefore, the demand varies at different prices.

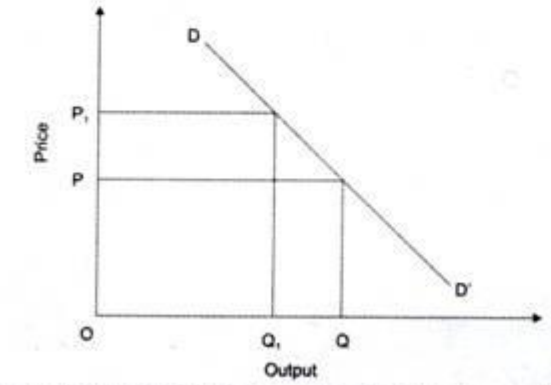


Figure-1: Demand Curve under Perfect Competition

As shown in Figure-1, when price is OP, the quantity demanded is OQ. On the other hand, when price increases to OP1, the quantity demanded reduces to OQ1. Therefore, under perfect competition, the demand curve (DD') slopes downward.

Supply under Perfect Competition:

Supply refers to quantity of a product that producers are willing to supply at a particular price. Generally, the supply of a product increases at high price and decreases at low price.

Figure-2 shows the supply curve under perfect competition:

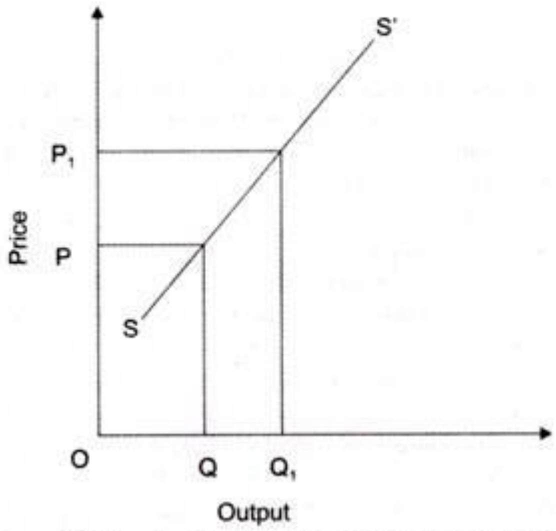


Figure-2: Supply Curve under Perfect Competition

In Figure-2, the quantity supplied is OQ at price OP. When price increases to OP1, the quantity supplied increases to OQ1. This is because the producers are able to earn large profits by supplying products at higher price. Therefore, under perfect competition, the supply curves (SS') slopes upward.

Price Determination under Perfect Competition (3 Periods)

i. Very Short Period:

Refers to a time period in which quantity supplied of a product cannot be increased with increase in its demand.

In simple terms, in very short period of time, the supply of a product is fixed. For example, a confectioner has 20 pastries at a particular time.

After an hour, a customer requires 40 pieces of pastries. In such a case, the confectioner cannot prepare 20 more pastries in an hour and can only supply 20 pastries. Therefore, the supply is fixed, which is 20 in the given example. The price determined in very short period is known as market price.

ii. Short Period:

Refers to a time period in which the level of supply of a particular product can be increased, but only as per the production capacity of an organization. For example, an organization can produce 50 mobile phones in a day. This is the maximum production capacity of the organization.

Suppose the demand of mobile phones increases to 150 per day for three days. In such a scenario, the organization cannot install new machines or hire more labor in three days to meet the additional demand. Thus, the supply is fixed even in short period and the price determined in this period is known as sub-normal price.

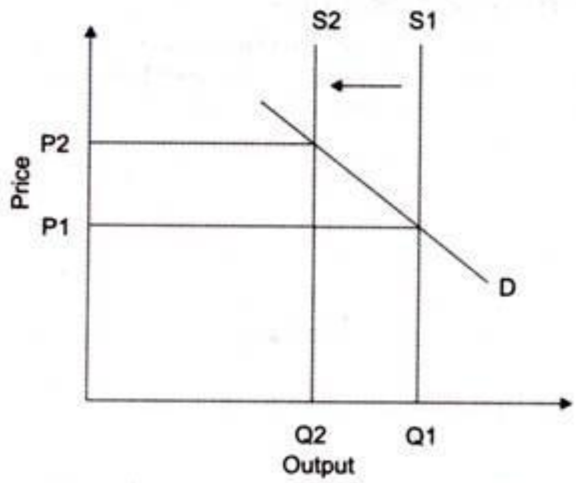


Figure-4: Demand Determined Price in Very Short Period

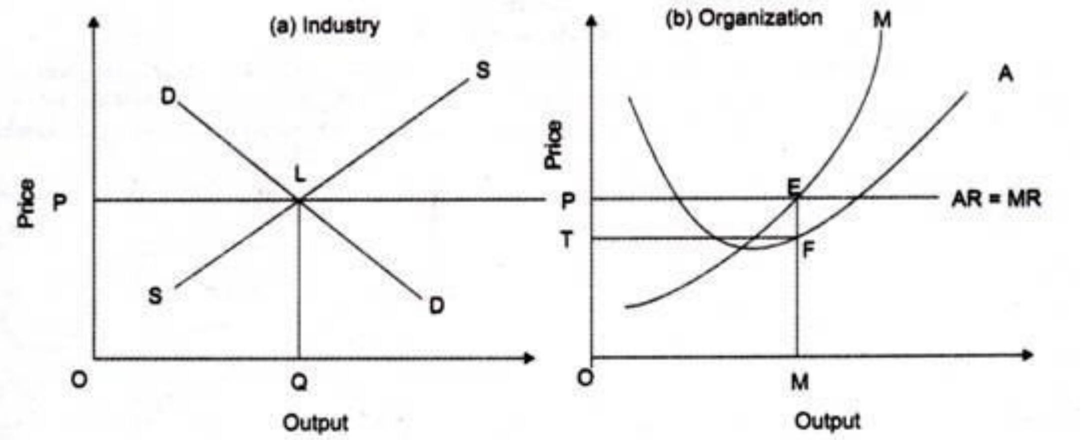


Figure-6: Equilibrium under Short Run

iii. Long Period:

Refers to a period in which the supply of a product can be increased or decreased with the changing level of demand. In this period, organizations can install new machines or hire more labor to meet the supply requirements.

Generally, in the long period, demand is determined by change in the size of population and change in customer's tastes and preferences.' On the other hand, organizations can reduce production level if there is decrease in demand. Therefore, it can be said that in the long period, the price of a product is influenced by supply. The price in the long period is called normal price.

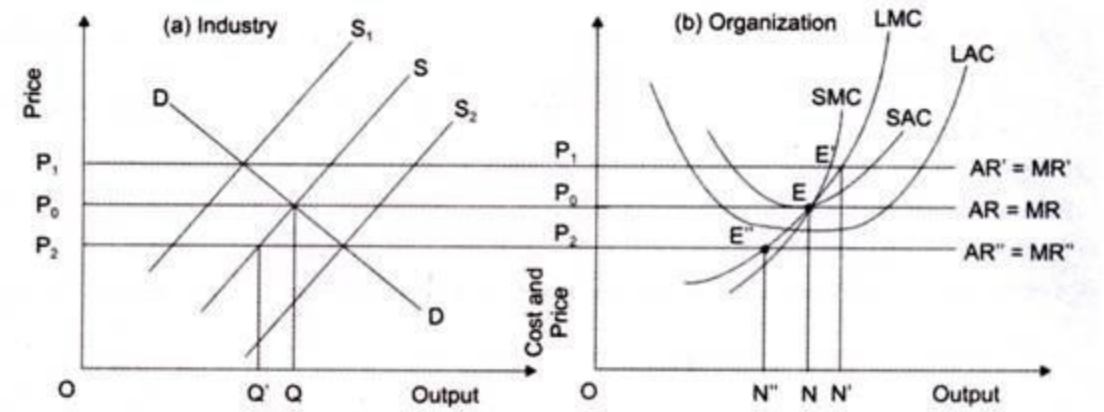


Figure-8: Equilibrium in the Long Run

Pricing Policy

A pricing policy is a standing answer to recurring question. A systematic approach to pricing requires the decision that an individual pricing situation be generalised and codified into a policy coverage of all the principal pricing problems. Policies can and should be tailored to various competitive situations. A policy approach which is becoming normal for sales activities is comparatively rare in pricing.

Objectives of implementing the policies

Many businesses have long-term ambitions in addition to short-term goals. A company's pricing policy can be an essential tool for achieving a range of goals, including:

- **Profit:** Making a profit and increasing revenue is usually one of the most fundamental business goals. As a result, profit maximization in the foreseeable future may be essential for some companies.
- **Consumer satisfaction:** Customers have different standards for what they expect to pay for a product. That is why companies may price their products and services following the expectations of their customers.
- **Limiting competition:** Depending on the structure of a company, it may be able to manufacture a product at a price point that no other company can match. Companies can use the policy to take over the market or become the major supplier of a good or provider of a service.
- **Gaining market share:** Businesses may also design a policy to maximize their market share because gaining a sizable portion of the market has strategic and monetary advantages.

Importance of Price Policy

A well-formed price policy has special importance if price rises in a continuous process in planned economy. It has not only influenced the living standard of people but due to increase in the expenditure of full planning, the prescribed aims and objectives of the planning are disturbed.

1. To maintain appropriate living standard, price control is essential.
2. To maintain planning process in a fine manner, price should be controlled at all costs.
3. Protect from monetary fluctuations, i.e. fluctuation defects are created, so to remove them appropriate price control is required.
4. Establishment of balance in demand and supply; if not hardship develops with consumer, producer and investor. So balance is needed in a proper way.
5. It is necessary to control the consumer price for well distribution management.
6. The major objective of economic planning is multi faced development of national resources. Thus price policy should be quite independent as price regulation can adjust this motto.

Meaning of Pricing:

Pricing is a process of fixing the value that a manufacturer will receive in the exchange of services and goods. Pricing method is exercised to adjust the cost of the producer's offerings suitable to both the manufacturer and the customer. The pricing depends on the company's average prices, and the buyer's perceived value of an item, as compared to the perceived value of competitors product.

Every businessperson starts a business with a motive and intention of earning profits. This ambition can be acquired by the pricing method of a firm. While fixing the cost of a product and services the following point should be considered:

- The identity of the goods and services
- The cost of similar goods and services in the market
- The target audience for whom the goods and services are produces
- The total cost of production (raw material, labour cost, machinery cost, transit, inventory cost etc).
- External elements like government rules and regulations, policies, economy, etc.,

Objectives of Pricing:

- **Survival-** The objective of pricing for any company is to fix a price that is reasonable for the consumers and also for the producer to survive in the market. Every company is in danger of getting ruled out from the market because of rigorous competition, change in customer's preferences and taste. Therefore, while determining the cost of a product all the variables and fixed cost should be taken into consideration. Once the survival phase is over the company can strive for extra profits.
- **Expansion of current profits-**Most of the company tries to enlarge their profit margin by evaluating the demand and supply of services and goods in the market. So the pricing is fixed according to the product's demand and the substitute for that product. If the demand is high, the price will also be high.
- **Ruling the market-** Firm's impose low figure for the goods and services to get hold of large market size. The technique helps to increase the sale by increasing the demand and leading to low production cost.
- **A market for an innovative idea-** Here, the company charge a high price for their product and services that are highly innovative and use cutting-edge technology. The price is high because of high production cost. Mobile phone, electronic gadgets are a few examples.

What is Pricing Method?

Pricing method is a technique that a company apply to evaluate the cost of their products. This process is the most challenging challenge encountered by a company, as the price should match the current market structure and also compliment the expenses of a company and gain profits. Also, it has to take the competitor's product pricing into consideration so, choosing the correct pricing method is essential.

Types of Pricing Method:

The pricing method is divided into two parts:

- **Cost Oriented Pricing Method**– It is the base for evaluating the price of the finished goods, and most of the company apply this method to calculate the cost of the product. This method is divided further into the following ways.
    - **Cost-Plus Pricing-** In this pricing, the manufacturer calculates the cost of production sustained and includes a fixed percentage (also known as mark up) to obtain the selling price. The mark up of profit is evaluated on the total cost (fixed and variable cost).
    - **Markup Pricing-** Here, the fixed number or a percentage of the total cost of a product is added to the product's end price to get the selling price of a product.
    - **Target-Returning Pricing-** The company or a firm fix the cost of the product to achieve the Rate of Return on Investment.
- **Market-Oriented Pricing Method-** Under this category, the is determined on the base of market research
    - **Perceived-Value Pricing-** In this method, the producer establish the cost taking into consideration the customer's approach towards the goods and services, including other elements such as product quality, advertisement, promotion, distribution, etc. that impacts the customer's point of view.
    - **Value pricing-** Here, the company produces a product that is high in quality but low in price.
    - **Going-Rate Pricing-** In this method, the company reviews the competitor's rate as a foundation in deciding the rate of their product. Usually, the cost of the product will be more or less the same as the competitors.
    - **Auction Type Pricing-** With more usage of internet, this contemporary pricing method is blooming day by day. Many online platforms like OLX, Quickr, eBay, etc. use online sites to buy and sell the product to the customer.

- **Differential Pricing-** This method is applied when the pricing has to be different for different groups or customers. Here, the pricing might differ according to the region, area, product, time etc.

Price determination under monopoly

In monopolistic competition, since the product is differentiated between firms, each firm does not have a perfectly elastic demand for its products. In such a market, all firms determine the price of their own products. Therefore, it faces a downward sloping demand curve. Overall, we can say that the elasticity of demand increases as the differentiation between products decreases.

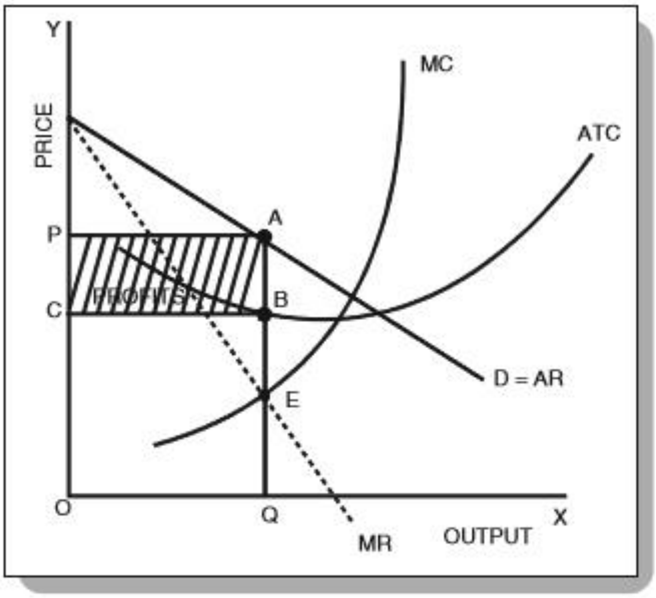


Fig. 1 : Short run equilibrium of a firm in monopolistic competition : Super-normal profits

Fig. 1 above depicts a firm facing a downward sloping, but flat demand curve. It also has a U-shaped short-run cost curve.

Conditions for the Equilibrium of an individual firm

The conditions for price-output determination and equilibrium of an individual firm are as follows:

1. MC = MR
2. The MC curve cuts the MR curve from below.

In Fig. 1, we can see that the MC curve cuts the MR curve at point E. At this point,

- Equilibrium price = OP and
- Equilibrium output = OQ

Now, since the per unit cost is BQ, we have

- Per unit super-normal profit (price-cost) = AB or PC.
- Total super-normal profit = APCB

The following figure depicts a firm earning losses in the short-run.

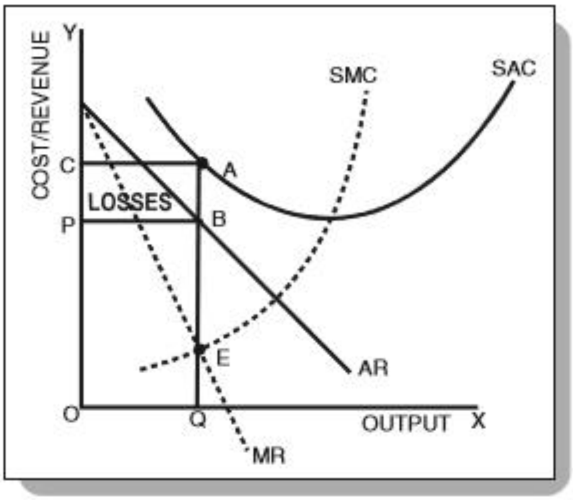


Fig. 2 : Short run equilibrium of a firm in Monopolistic Competition – With losses

From Fig. 2, we can see that the per unit cost is higher than the price of the firm. Therefore,

- AQ > OP (or BQ)
- Loss per unit = AQ – BQ = AB
- Total losses = ACPB

Long-run equilibrium

If firms in a monopolistic competition earn super-normal profits in the short-run, then new firms will have an incentive to enter the industry. As these firms enter, the profits per firm decrease as the total demand gets shared between a larger number of firms. This continues until all firms earn only normal profits. Therefore, in the long-run, firms, in such a market, earn only normal profits.

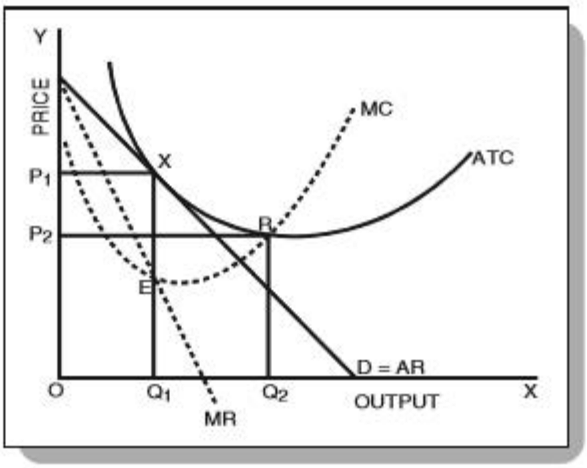


Fig. 3 : The long-term equilibrium of a firm in monopolistic competition

As we can see in Fig. 3 above, the average revenue (AR) curve touches the average cost (ATC) curve at point X. This corresponds to quantity Q_1 and price P_1. Now, at equilibrium (MC = MR), all super-normal profits are zero since the average revenue = average costs. Therefore, all firms earn zero super-normal profits or earn only normal profits.

It is important to note that in the long-run, a firm is in an equilibrium position having excess capacity. In simple words, it produces a lower quantity than its full capacity. From Fig. 3 above, we can see that the firm can increase its output from Q_1 to Q_2 and reduce average costs. However, it does not do so because it reduces the average revenue more than the average costs. Hence, we can conclude that in monopolistic competition, firms do not operate optimally. There always exists an excess capacity of production with each firm.

In case of losses in the short-run, the firms making a loss will exit from the market. This continues until the remaining firms make normal profits only.

MONOPOLY

A monopoly is a market where one firm (or manufacturer) is the sole supplier of certain goods or services. This firm faces no competition due to which it can set its own prices, thereby exercising full control over the market. The monopolist aims to generate high profits by selling products (or services) that do not have close substitutes.

Types of Monopoly

The different types of monopolies are discussed as follows:

#1 – Simple monopoly

A simple monopoly charges uniform prices for its product (or service) from all the buyers. In this, the monopolist firm usually operates in one market and its consumers are price takers.

#2 – Pure monopoly

A **pure monopoly** is the rarest form wherein the product (or service) being sold has no close substitutes. Moreover, competitors are discouraged from entering the market often due to high initial costs.

#3 – Natural monopoly

A natural monopoly depends on unique **raw materials** or sophisticated technology to manufacture its products. In this, the monopolist firm utilizes its copyright and patents to prevent competition. In addition, such firms usually provide public utilities (like electricity, gas, etc.), adhere to government regulations, and incur high costs on research and innovation.

#4 – Legal monopoly

A legal monopoly is one wherein the monopolist firm reserves the right to manufacture a product by way of a patent, trademark or copyright. Since the monopolist is the inventor of such a product (or process), it is the exclusive supplier in the market. Patents allow time to firms to recover the high costs of development and research.

#5 – Public or industrial monopoly

A public monopoly is set up by the government to supply important products and services. The government creates such monopolies for the following reasons:

- The costs associated with production and deliveries are too high.
- The presence of a sole supplier is considered to be more reliable and beneficial for the general public.

Public monopolies are created when the government nationalizes certain industries to serve the interest of the people.

Price discrimination in a monopoly

Price discrimination in a monopoly is a practice of charging different prices for the same product. Monopolies usually have more control over suppliers than regular sellers, which means they can significantly influence the suppliers' selling prices.

Benefits of price discrimination in monopoly

Here are some ways price discrimination can benefit monopolies:

Increases profit

Price discrimination typically helps increase the monopoly firm's profit by maximizing its total revenue. A monopolist charges some customers higher prices rather than a uniform fee for all buyers. Price discrimination among customers with inconsistent demands can minimize the risk of setting up a uniformly high price. A high price may mean that only a few customers can afford a product or service. Monopoly firms can charge higher fees to infrequent customers to increase the total revenue.

Increases customer satisfaction

Customers usually associate a higher price with an excellent customer experience. Price discrimination may increase buyers' loyalty because the firm can charge different prices for each of them, giving a few premium experiences. It can also encourage customers to shift towards a monopoly product or service over alternative products because they get more satisfaction.

Concentrates on core market segments

Price discrimination encourages monopolists to focus on marketing their products and services towards specific groups of people. It is usually more efficient than working to fulfil everyone's expectations in the market. Price discrimination is a strategy firms can use to improve their total revenue, profit, and productivity. It often leads to market segmentation, minimizes competition, and increases profit.

Increases investments

Price discrimination encourages monopolists to make more investments, like new marketing efforts, to reach their target market. Investment projects can generate more revenue and increase a monopoly's profits. For example, a monopoly can invest in its supply chain logistics to ensure sufficient and timely supply to meet customers' demands.

Empowers consumers

Price discrimination can empower consumers because they may have the freedom to choose what they pay for products. It allows consumers to determine their priorities of price, quality, and other aspects of choice. A monopolist can control the price of its product or service and manage the consumer's demand. For example, they can increase the demand by increasing or lowering the price depending on the situation.

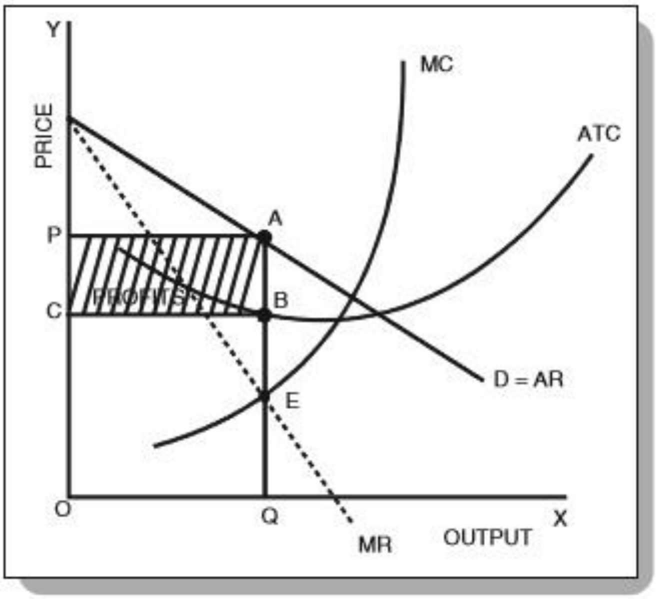
Controls demand

Monopolies also use price discrimination to manage the demand for a product or service. For example, transport services such as taxis can be more expensive during the rush hours to manage demand. They can also offer incentives to encourage customers to travel at different times. For example, they can set lower prices before and after rush hours.

DETERMINATION OF PRICE UNDER MONOPOLY

Price-output determination under Monopolistic Competition: Equilibrium of a firm

In monopolistic competition, since the product is differentiated between firms, each firm does not have a perfectly elastic demand for its products. In such a market, all firms determine the price of their own products. Therefore, it faces a downward sloping demand curve. Overall, we can say that the elasticity of demand increases as the differentiation between products decreases.



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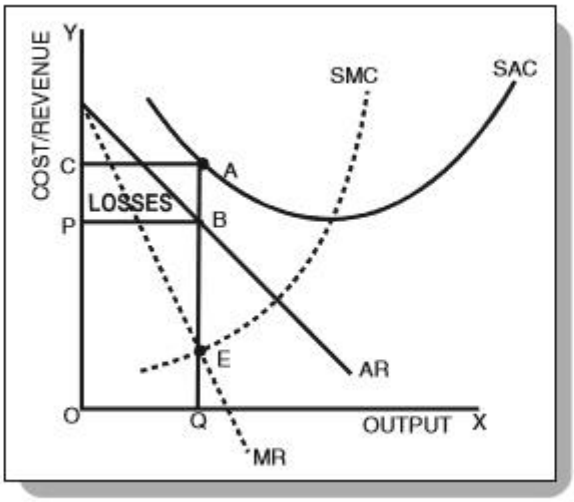

Fig. 2 : Short run equilibrium of a firm in Monopolistic Competition – With losses

From Fig. 2, we can see that the per unit cost is higher than the price of the firm. Therefore,

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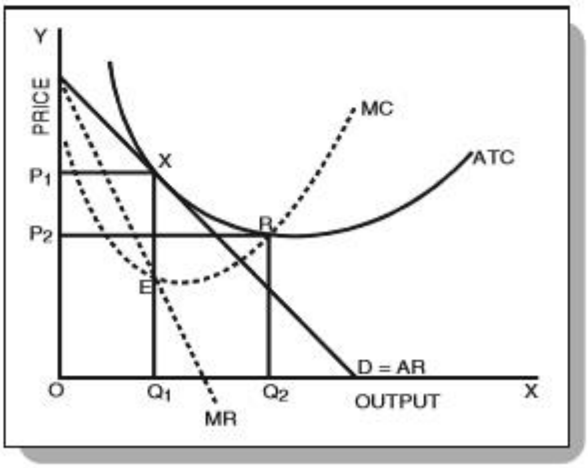
Long-run equilibrium

If firms in a monopolistic competition earn super-normal profits in the short-run, then new firms will have an incentive to enter the industry. As these firms enter, the profits per firm decrease as the total demand gets shared between a larger number of firms. This continues until all firms earn only normal profits. Therefore, in the long-run, firms, in such a market, earn only normal profits.



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In case of losses in the short-run, the firms making a loss will exit from the market. This continues until the remaining firms make normal profits only.

Monopolistic Competition

Monopolistic competition exists when many companies offer competing products or services that are similar, but not perfect, substitutes.

The barriers to entry in a monopolistic competitive industry are low, and the decisions of any one firm do not directly affect its competitors. The competing companies differentiate themselves based on pricing and marketing decisions.

Understanding Monopolistic Competition

Monopolistic competition exists between a monopoly and perfect competition, combines elements of each, and includes companies with similar, but not identical, product offerings.

Restaurants, hair salons, household items, and clothing are examples of industries with monopolistic competition. Items like dish soap or hamburgers are sold, marketed, and priced by many competing companies.

Price Discrimination?

Price discrimination is a selling strategy that charges customers different prices for the same product or service based on what the seller thinks they can get the customer to agree to. In pure price discrimination, the seller charges each customer the maximum price they will pay. In more common forms of price discrimination, the seller places customers in groups based on certain attributes and charges each group a different price.

Understanding Price Discrimination

Price discrimination is practiced based on the seller's belief that customers in certain groups can be asked to pay more or less based on certain demographics or on how they value the product or service in question.

Price discrimination is most valuable when the profit that is earned as a result of separating the markets is greater than the profit that is earned as a result of keeping the markets combined. Whether price discrimination works and for how long the various groups are willing to pay different prices for the same product depends on the relative elasticities of demand in the sub-markets. Consumers in a relatively inelastic submarket pay a higher price, while those in a relatively elastic sub-market pay a lower price.

Equilibrium under Monopolistic Competition

Before determining a firm's equilibrium under Monopolistic Competition, it is important to note that there are two possible demand curves – both sloping downwards. In this article, we will look at a firm's short-run and long-run equilibrium under Monopolistic Competition.

Equilibrium under Monopolistic Competition

The two types of demand curves of a firm under monopolistic competition are due to the following reasons:

- When a firm revises the price of its product, the rival firms don't always increase the prices of their products too. Therefore, the demand curve has a smaller slope and the demand for the product is more elastic.
- If the rival firms follow the price revision by the first firm, then the demand for its product becomes less elastic. In such cases, the firm needs to slash its prices further to achieve an increase in demand. In this case, the demand curve has a steeper slope.

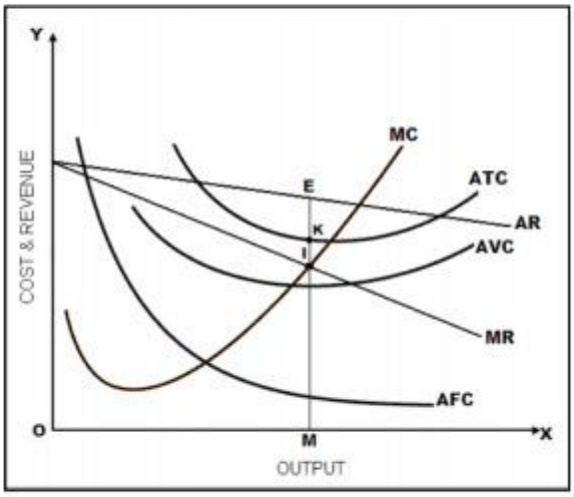
A Firm's Short-Run Equilibrium under Monopolistic Competition

Under Monopolistic Competition, the revenue curves are downward sloping (like under Monopoly). This is because, in order to sell more, the firm has to decrease the price.

A firm under Monopolistic Competition can either earn normal profits, super-normal profits, or incur losses. Also, like under Monopoly, a firm earns super-normal profits if the demand for its product is very high.

Also, in the short-run, new firms cannot enter the group and enhance the supply of the product group. Therefore, they cannot compete away the super-normal profits of the firm. Also, in the short-run, a firm faces certain fixed costs. These can include production as well as selling costs.

Short Run Equilibrium under Monopolistic Competition



In the figure above, you can see that the AR and MR curves of the firm have negative slopes. Further, the AVC curve includes the production costs as well as the variable components of selling expenses. Furthermore.

The MC curve cuts the AVC curve at its lowest point. Also, the ATC curve represents the average of the total cost of the firm including the fixed selling expenses.

The MC curve intersects the MR curve from below at point I. Hence, the firm decides to produce a quantity of OM and charge a price of EM per unit.

By doing so, the firm earns a profit of EK per unit and the entry of rival firms do not compete it out. However, based on the relative location of the cost and revenue curves, it is possible that the firm is in equilibrium with:

- Only normal profit
- Covering a part of fixed costs. Therefore, incurring a loss less than its fixed costs
- Loss equal to the fixed costs (where AR is tangent to the AVC curve)

Oligopoly Definition and Meaning

Oligopoly is defined as a market structure with a small number of firms, none of which can keep the others from having significant influence.

Meaning of Oligopoly Market

An Oligopoly market situation is also called 'competition among the few'. In this article, we will look at Oligopoly definition and some important characteristics of this market structure.
An oligopoly is an industry which is dominated by a few firms. In this market, there are a few firms which sell homogeneous or differentiated products.

Also, as there are few sellers in the market, every seller influences the behavior of the other firms and other firms influence it.

Oligopoly is either perfect or imperfect/differentiated. In India, some examples of an oligopolistic market are automobiles, cement, steel, aluminum, etc.

Characteristics of Oligopoly

Now that the Oligopoly definition is clear, it's time to look at the characteristics of Oligopoly:

Few firms

Under Oligopoly, there are a few large firms although the exact number of firms is undefined. Also, there is severe competition since each firm produces a significant portion of the total output.

Barriers to Entry

Under Oligopoly, a firm can earn super-normal profits in the long run as there are barriers to entry like patents, licenses, control over crucial raw materials, etc. These barriers prevent the entry of new firms into the industry.

Non-Price Competition

Firms try to avoid price competition due to the fear of price wars in Oligopoly and hence depend on non-price methods like advertising, after sales services, warranties, etc. This ensures that firms can influence demand and build brand recognition.

Interdependence

Under Oligopoly, since a few firms hold a significant share in the total output of the industry, each firm is affected by the price and output decisions of rival firms. Therefore, there is a lot of interdependence among firms in an oligopoly. Hence, a firm takes into account the action and reaction of its competing firms while determining its price and output levels.

KINKED DEMAND CURVE

A **kinked demand curve** refers to a demand curve that is not linear but has different degrees of elasticity at different price levels. It has higher elasticity for prices above the market price and lower elasticity for prices below the market price.

In many oligopolist markets, it has been observed that prices tend to remain inflexible for a very long time. Even in the face of declining costs, they tend to change infrequently. American economist Sweezy came up with the kinked demand curve hypothesis to explain the reason behind this price rigidity under oligopoly.

According to the kinked demand curve hypothesis, the demand curve facing an oligopolist has a kink at the level of the prevailing price. This kink exists because of two reasons:

1. The segment above the prevailing price level is highly elastic.
2. The segment below the prevailing price level is inelastic.

The following figure shows a kinked demand curve dD with a kink at point P.

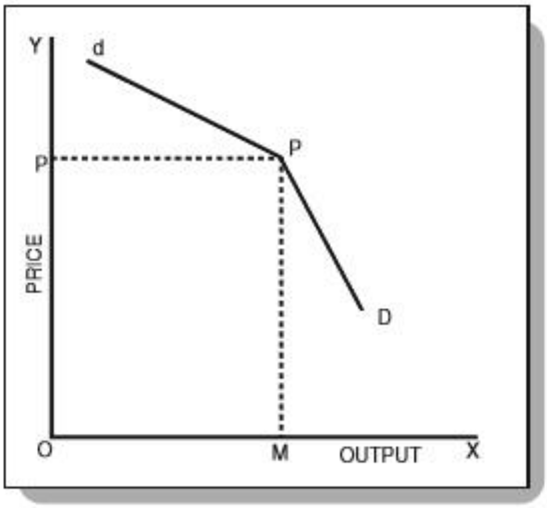


Fig. 1 : Kinked Demand Curve under oligopoly

From the figure, we know that

i. The prevailing price level = P
ii. The firm produces and sells output = OM
iii. Also, the upper segment (dP) of the demand curve (dD) is elastic.
iv. The lower segment (PD) of the demand curve (dD) is relatively inelastic.

This difference in elasticities is due to an assumption of the kinked demand curve hypothesis.

Browse more Topics under Determination Of Prices

- Intro to Determination of Prices
- Changes in Demand

- Changes in Supply
- Simultaneous changes in Demand and Supply
- Features of Perfect Competition
- Price Determination under Perfect Competition
- Long Run Equilibrium of Competitive Firm and Industry
- Monopoly Market
- Monopolist's Revenue Curve
- Price Discrimination
- Monopolistic Competition
- Oligopoly

Assumption:

Each firm in an oligopoly believes the following two things:

a. If a firm lowers the price below the prevailing level, then the competitors will follow him.
b. If a firm increases the price above the prevailing level, then the competitors will not follow him.

There is logical reasoning behind this assumption. When an oligopolist lowers the price of his product, the competitors feel that if they don't follow the price cut, then their customers will leave them and buy from the firm who is offering a lower price.

Therefore, they lower their prices too in order to maintain their customers. Hence, the lower portion of the curve is inelastic. It implies that if an oligopolist lowers the price, he can obtain very little sales.

On the other hand, when a firm increases the price of its product, it experiences a substantial reduction in sales. The reason is simple – consumers will buy the same/similar product from its competitors.

This increases the competitors' sales and they will have no motivation to match the price rise. Therefore, the firm that raises the price suffers a loss and hence refrain from increasing the price. This behavior of oligopolists can help us understand the elasticity of the upper portion of the demand curve (dP). The figure shows that if a firm raises the price of a product, then it experiences a large fall in sales.

Hence, no firm in an oligopolistic market will try to increase the price and a kink is formed at the prevailing price. This is how the kinked demand curve hypothesis explains the rigid or sticky prices.