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Economics Revision Focus: 2004

A2 Economics

Price Makers and Price Takers

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Revision Focus on Pricing

A2 Syllabus Requirements:

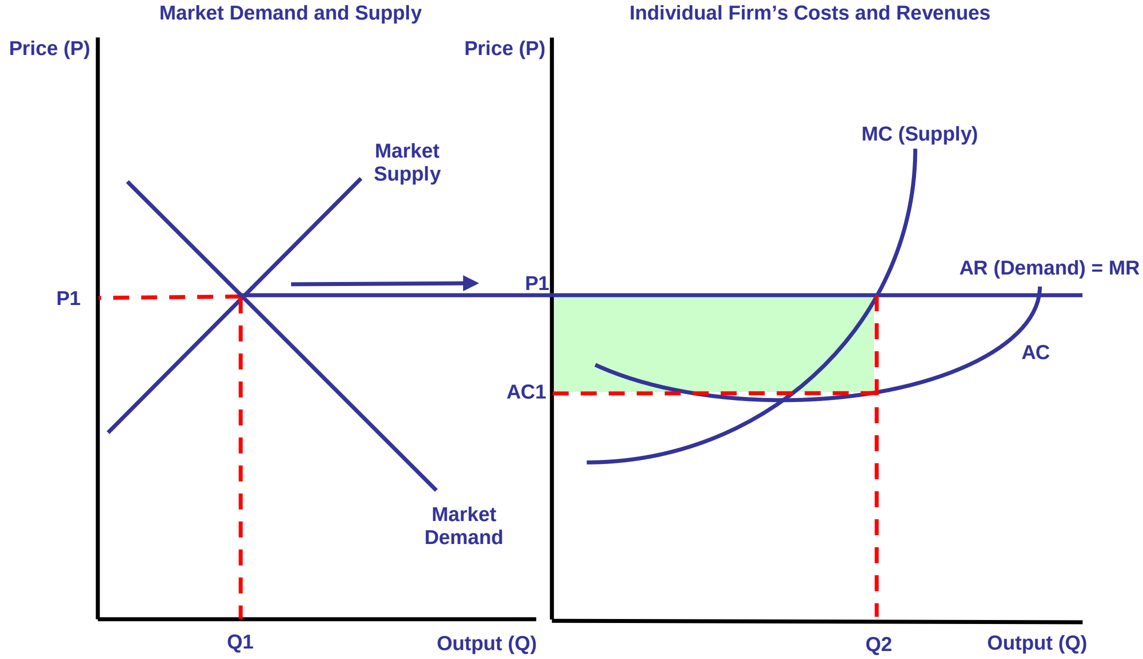
Candidates should understand the factors which affect the **ability of a firm to fix the price of its product**

- This topic focuses on the **pricing decisions** of individual firms in different markets
- The factors that determine the variety of pricing decisions open to a business nearly always come back to **two main driving forces**
- (i) The **market structure** in which a business operates
- (ii) The **objectives** that a business may be pursuing at a given time
- "Fixing the price" does not necessarily imply some anti-competitive type of behaviour! It refers to the power that a firm might have to exercise some **discretion** in the prices it charges to different groups of consumers for one or more products
- In reality, most businesses are **multi-product firms** servicing a variety of different markets. Indeed markets can become **highly segmented** – each with different characteristics – so the factors will vary from industry to industry

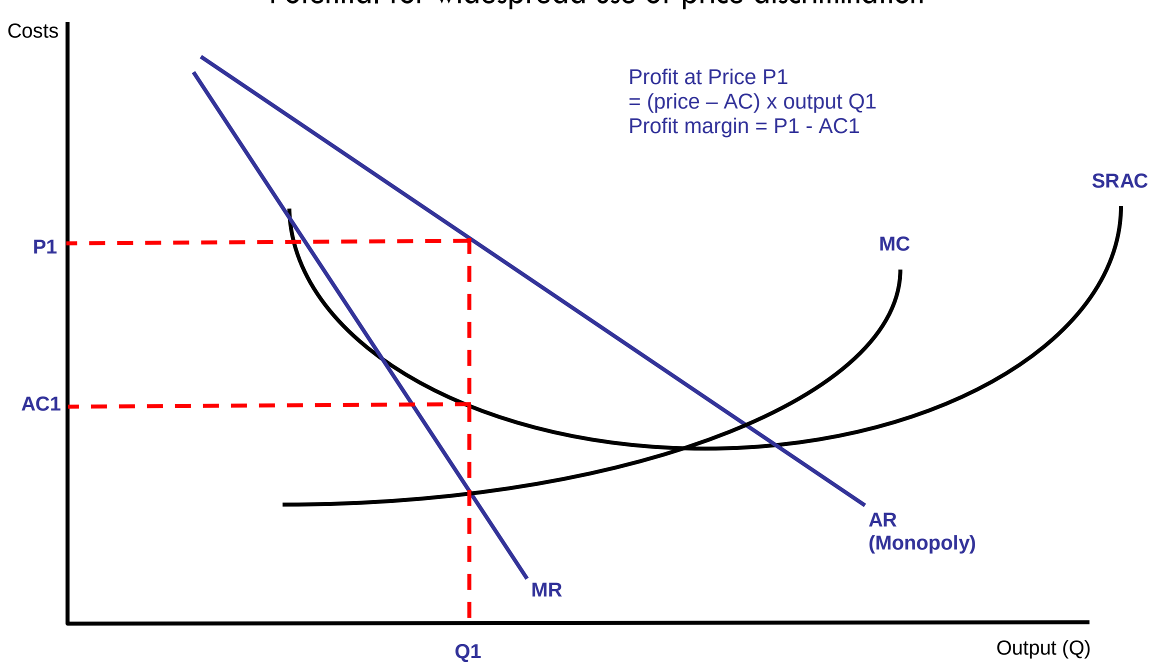
The key factors affecting the pricing power of a business

Market Structure

- **Perfect (pure) competition**
  - Price–taking firms each with no influence over the ruling market price (see diagram below)
  - Free entry and exist of businesses in the long run – drives down profits towards a normal profit equilibrium level
  - Each supplier produces homogeneous products – each a perfect substitute – hence the perfectly elastic demand curve for the individual supplier



- o **Pure monopoly**
  - Market dominance – price setting power
  - Ability to earn supernormal profits in short and long run (see monopoly price and output diagram below)
  - Market position may be protected through the use of entry barriers
  - Potential for widespread use of price discrimination



- o **Oligopoly**
  - Competition among the few (high likelihood of a few dominant firms)
  - Each firm has some market power, branded products, entry barriers exist

- Key factor - ***interdependent nature of pricing decisions*** between rival firms
- Each firm must consider ***strategic behaviour of other "players" in the market***
- Objective might be protecting market share or increasing market share
- Game theory can help to model different types of behaviour (both price and non-price competition)
- Kinked demand curve model is another possibility

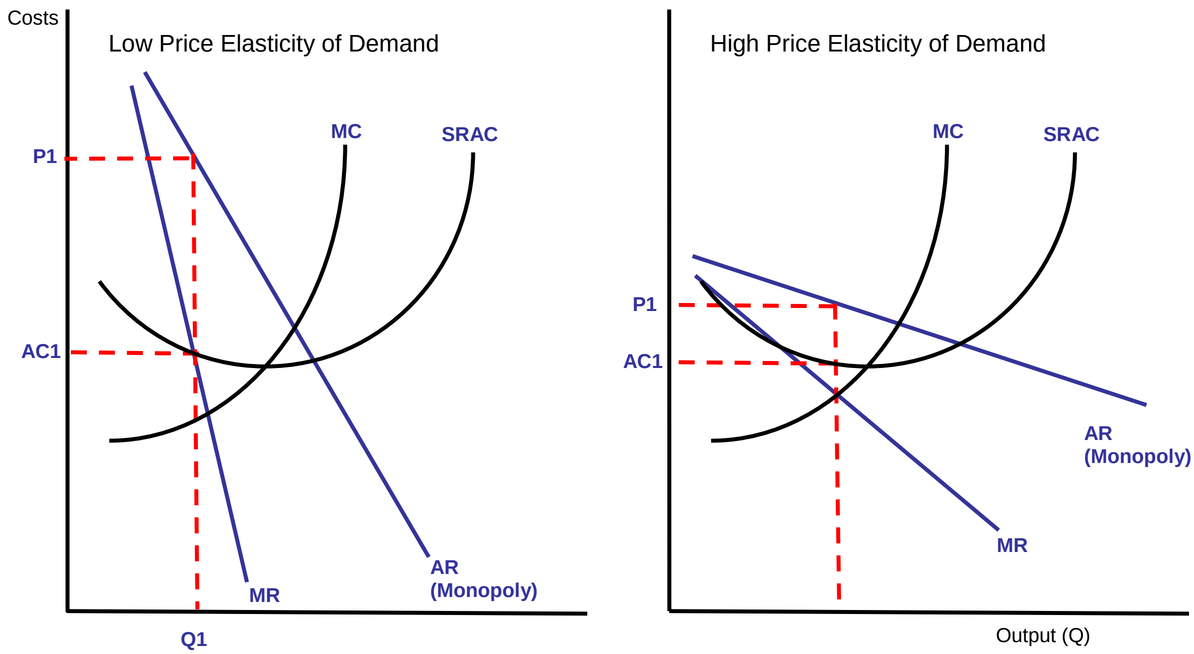
- **Contestable markets**
  - Markets where the entry and exit costs are low
  - Potential for hit and run entry to cream off profits if incumbent firms are being inefficient (e.g. exploiting the consumer by charging monopoly price, failure to control production costs and other inefficiencies including lack of innovation)
  - Always the threat of new entry from new suppliers or new products – this affects the current behaviour of existing firms (may force them to price more competitively – less scope for monopoly pricing)
  - There are barriers to contestability in most markets – but the higher the barriers, the greater the pricing power in the hands of the incumbent firms because the risks of "hit and run entry" from new rivals is lower

Price and Cross-price Elasticity of Demand
Elasticity of demand remains a fundamental factor affecting a firm's pricing power

When demand is price inelastic, the business can raise price without losing a disproportionate level of demand / sales (see left hand diagram on next page)

When demand is price elastic, the potential to raise price and extract consumer surplus, turning it into higher producer surplus / profit is much reduced – see the right hand diagram on the next page

Cross price elasticity of demand is linked to this – i.e. the percentage change in demand for good X resulting from a given percentage change in the price of a related product (in particular the relative price of a substitute)



When the cross-elasticity of demand is low, the "substitution-effect" arising from changes in relative prices is weak consumers are less likely to switch their demand, giving the firm greater price power.

- **Product differentiation** – moving away from homogeneous products
- **Product life-cycles**
  - Some consumers very willing to pay premium prices for new products (known as "early-adopters"
  - Products towards the end of their life-cycle – more elastic demand, lower prices
- Impact of marketing and advertising on consumer loyalty / brand loyalty

The Regulatory System
In markets where firms have price-setting power, government appointed regulatory agencies may intervene directly or indirectly in the price-setting process

- **The regulatory agencies** covering privatised utilities such as gas, electricity, telecommunications and the rail industry – most of these regulators have at times enforced price-capping formulae limiting the extent to which the utilities can increase prices. Some of the regulators have now lifted price controls because they believe that there is now sufficient competition in the market (a good example is the gas industry)

- **The competition authorities** – one of the main features of competition policy both in the UK and the European Union is to come down hard on anti-competitive behaviour such as price-fixing (cartel behaviour) – the strength of competition policy enforcement affects the "environment" in which a firm sets prices and engages in other forms of competition

The International Environment
Most businesses face competition either from domestic rivals or from international competitors. Increasingly the pricing decisions of one business are influenced by the strength of competition from overseas suppliers. The process of **globalisation** has made this a key factor in many industries

The Economic Cycle

The pricing power of a business (or a group of firms within a market) is also affected by macroeconomic variables including the strength of domestic and global demand at different stages of the economic cycle.

When demand is strong and rising (e.g. during the upturn phase of the economic cycle), a business will have more "pricing power" than when demand is much weaker and falling (e.g. during a recession). Often a market may be affected by a demand-side "shock" which takes away the pricing power of suppliers. The airline industry in the wake of the terrorist attacks in 2001 could be considered as an example of this.

Summary of the main factors affecting a firm's pricing power

Category	Influence on Pricing Policy
Costs	In order to make a profit, a business should ensure that its products are priced above their average cost. In the short-term, it may be acceptable to price below AC if this price exceeds marginal cost – so that the sale still produces a positive contribution to fixed costs.
Competitors	If the business is a monopolist, then it has price-setting power. At the other extreme, if a firm operates under conditions of perfect competition, it has no choice and must accept the market price. The reality is usually somewhere in between. In such cases the chosen price needs to be considered relative to those of close competitors and with one eye to the likely reaction of rival firms when a business changes its pricing strategy.
Customers	Consideration of customer expectations about price must be addressed. Ideally, a business should attempt to quantify its demand curve to estimate what volume of sales will be achieved at given prices and also the price elasticity of demand when prices change
Business Objectives	Possible pricing objectives include: To maximise profits or to achieve a target return on a capital investment project To achieve a target sales figure in a given time period To achieve a target market share To match the competition, rather than lead the market