

Ch. 10 outline

Competitive price-searcher markets

Three key assumptions about competitive price-searcher markets

1. Barriers to entry are low
2. Firms can raise price without losing all of its customers
3. Firms produce differentiated products (Coca-Cola and Pepsi are in the soft drink market but their products are different. Wendy's, Burger King and McDonald's all produce hamburgers but they are not identical hamburgers. Burger King's are flame-broiled, Wendy's are bigger (supposedly), and McDonald's are ... I can't think of anything nice to say about McDonald's...but the fact that I don't like McDonald's hamburgers proves that they are a different product than Burger King's)

Demand faced by competitive price searchers (CPS) is highly elastic. Think about how my opinion of McDonald's hamburgers would change if all the other hamburger establishments were to triple their prices. McDonald's hamburgers would probably taste much better.

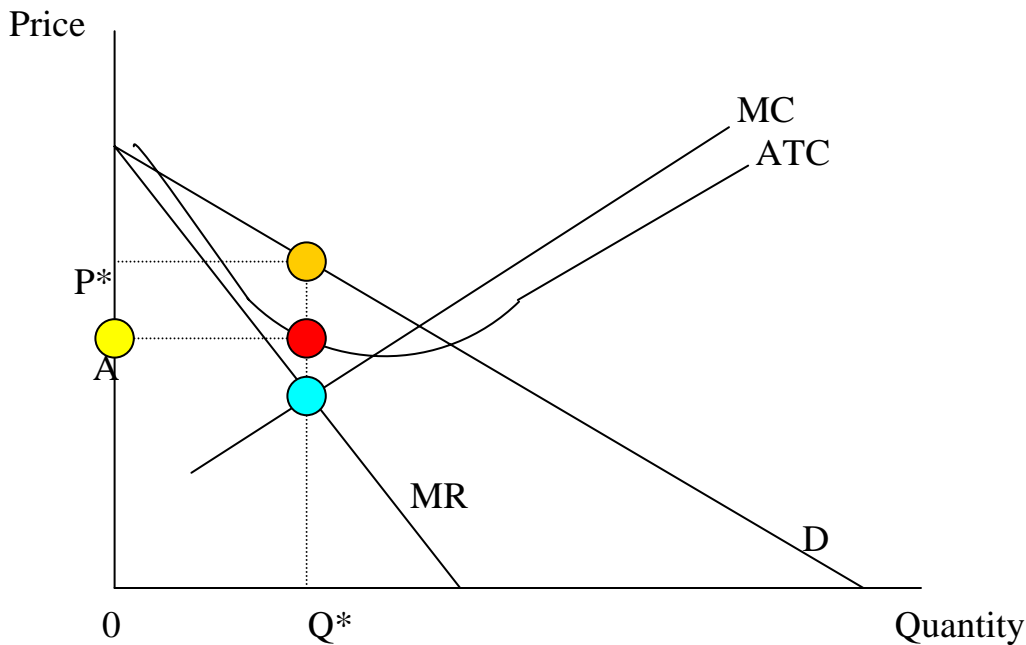
Although a price searcher can set the price for its products, market forces determine how much of the good would be sold at that price. If Burger King sets price at \$7.00 a hamburger (which it can do since it is a price searcher), I don't think that they will sell many hamburgers.

Sellers in CPS markets face competition from firms in existence and from firms that may want to enter the market. Burger King faces competition from McDonald's and Wendy's as well as any enterprising businesspeople who believe that they can make profits by opening a new hamburger establishment. Because of these facts competitive forces play a large part in CPS markets.

Price and output in CPS markets

Any firm in the CPS market will expand output until Marginal Revenue (MR) equals Marginal Cost (MC). This is because a firm will increase Total Revenue (TR) as long as MR is greater than MC.

For now, be aware that a firm's MR curve lies inside of its demand curve.



This CPS firm will produce a quantity where $MR = MC$. In this graph, $MR = MC$ at the blue dot and that quantity is given by Q^* . From here, we take the quantity that the firm wants to produce (Q^*) and find out the price that the firm will charge by going to the demand curve. The intersection of the Q^* and the demand curve is given by the orange dot. The corresponding price is P^* . We have now found the profit-maximizing price and quantity for the firm. Because we have the ATC curve on this graph we can figure out the firm's profits. Remember that $\text{profit} = TR - TC$. TR on this graph is just P^* times Q^* . Total costs is just A times Q^* . If you want numbers let $A = 6$, $P^* = 10$, and $Q^* = 15$. $TR = 150$, $TC = 90$, and $\text{profit} = 60$. If you are looking for the area on the graph that represents TR is the rectangle from zero to Q^* to orange dot to P^* . The area for TC is the rectangle from zero to Q^* to red dot to A (yellow dot). The area for profit is the rectangle from A (yellow dot) to red dot to orange dot to P^* .

Because there are low barriers to entry in the CPS model, the price will be driven down in the long-run to where it equals a point on the ATC curve. It's profit maximizing output level is such that $P > MC$, and that the output level does not hit the minimum of the ATC curve.

The question then is how does a CPS market compare to a CPT (competitive price taker) market? At one point in time CPS markets were thought to be inefficient because they did not minimize ATC. However, price cost is not the only cost to take into consideration. Consumers may value diversity and convenience of products as well as the price, and they may be willing to pay a little extra for more variety.

Entrepreneurship

Entrepreneurship is the forgotten element in these economic models. People have to make decisions quickly sometimes or the opportunity will be missed. A successful entrepreneur is one who uses the available information to the best of his knowledge. In the economic models we can tell you what happens when an entrepreneur makes a decision but we cannot tell you why he chooses to make that decision. There are as many unknown factors driving the entrepreneur as there are visible factors. Successful entrepreneurs make good judgments about resource uses and people's demands; poor entrepreneurs waste resources and incorrectly judge people's demands. As a result, poor entrepreneurs rarely stay in business because the market system drives them out.

Price Discrimination

Price discrimination is when a seller sells a product at one price to one set of consumers and then sells it at a different price to another set of consumers. However, to gain from price discrimination sellers must be able to do two things:

1. Identify the two different groups with different elasticities of demand
2. Prevent those people who pay the lower price from reselling the good to the people that the firm charges a higher price to

Is it possible to accomplish this goal? Yes. Think about the airline industry. Airlines routinely charge more for shorter trips (usually business trips) and charge less for longer trips (usually vacations). Airlines know that businesspeople have tight schedules, which create a more inelastic demand than those people who are going on vacations and can be more flexible (instead of going to Sweden this year we'll just stay home because it's too expensive). So the airlines have identified two groups with different elasticities of demand. They now have to find a way to keep the vacationers

from buying airline tickets and then selling them to business travelers. If vacationers could buy airline tickets at \$300 and it cost business travelers \$600, a smart person could buy a ticket at \$300 from the airline and then sell it to the business traveler for \$500. This allows the smart person to make \$200 and the business traveler to save \$100. If this occurred the airline would not be able to price discriminate because eventually the only tickets that it would sell would be the \$300 tickets. So how do airlines keep vacationers from selling to business travelers? Possibly by offering round-trip packages based on the amount of days that people will be gone. If the business traveler only needs to be away for three days, that round-trip ticket for seven days is not going to do him much good. This is also why one-way tickets are about as expensive as round-trip tickets in some cases.

So is price discrimination only beneficial to the producers of the good? Not entirely. Price discrimination can lead to an increase in the gains from trade (or a decrease in deadweight loss if you prefer) that arise from CPS markets.

Competition among firms: How it increases prosperity

There are three ways that competition increases prosperity.

1. Competition places pressure on producers to use resources wisely and to produce goods that consumers want.
2. Competition provides firms with a strong incentive to improve the quality of their products and attempt to find ways to lower their costs.
3. Competition causes firms to discover the correct plant size and business structure to keep per-unit costs low.