

LECTURE 4.1

MARKET POWER AND OPTIMAL PRICING

PRICING BEHAVIOURS

In a competitive market:

$$P = MC$$

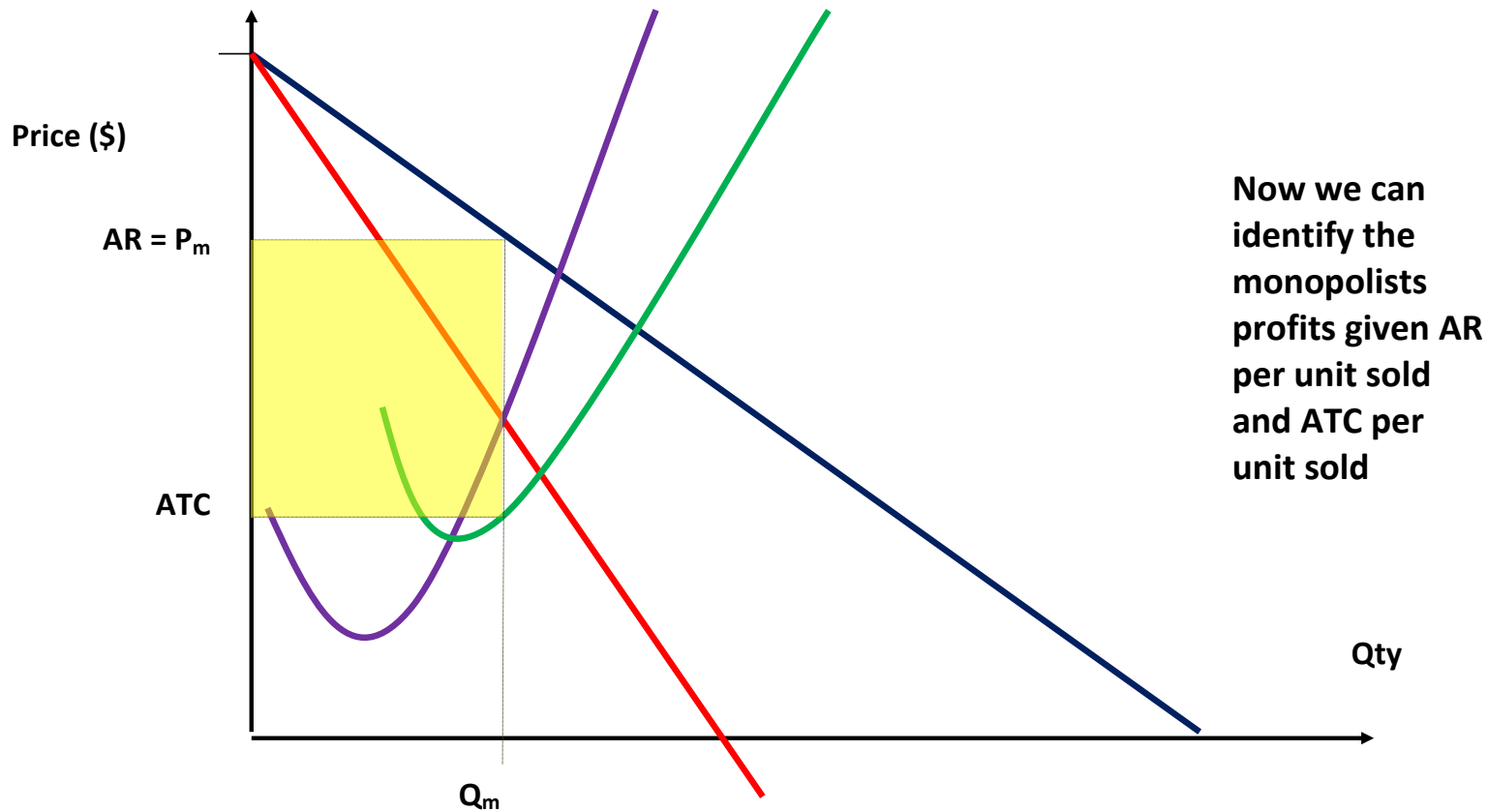
For price to exceed marginal cost, firms must have market power.

We have seen that profit maximisation for a firm with market power requires:

$$\text{Marginal revenue} = \text{Marginal cost}$$

Note that such a strategy leaves some consumer surplus on the table

SINGLE PRICE MONOPOLIST



Now we can identify the monopolists profits given AR per unit sold and ATC per unit sold

There are a number of features of this diagram including....

- Demand curve
- Relationship between the **MC** and **AC** curves
- Profit maximising choice

PROFIT MAXIMISING PRICING

As demand becomes less elastic the mark up over marginal cost becomes higher.

Recall:

$$MR = p \left[1 - \frac{1}{\eta} \right] = MC$$

Set higher prices for groups with less elastic demand:

$$\frac{p - MC}{p} = \frac{1}{\eta}$$

PROFIT MAXIMISING PRICING

Over the long-run entry means elasticity tends to ∞ .

$$\frac{MC}{P} = \left[1 - \frac{1}{\eta} \right]$$

$$\frac{MC}{P} = \left[\frac{\eta - 1}{\eta} \right]$$

$$\frac{P}{MC} = \left[\frac{\eta}{\eta - 1} \right]$$

$$\lim_{\eta \rightarrow \infty} \frac{P}{MC} = \lim_{\eta \rightarrow \infty} \left[\frac{\eta}{\eta - 1} \right] = 1$$

PROFIT MAXIMISING PRICING

That is, in the limit :

$$P = MC$$

Conversely, the less elastic demand is the greater will be the mark-up over marginal cost.