Limit Pricing Theory

- Traditional theory only discusses actual entry, not potential entry of new firms. This leads to normal profit in the long run in perfect and monopolistic competition.

- According to Bain explains why firms over a long period of time were keeping their price at a level of demand where the elasticity was below unity, that is, they did not charge the price which would maximize their revenue.

Assumption

- Oligopoly with price leader
- Firms types: small, medium and large firm
- There is effective collusion among the established Oligopolists.
- The established firms can compute a limit price, below which entry will not occur.
- Economics of scale: small firms have high AC, large firm have lower AC
- Large firm is the price leadership which is follow by the small firms

Limit pricing figure
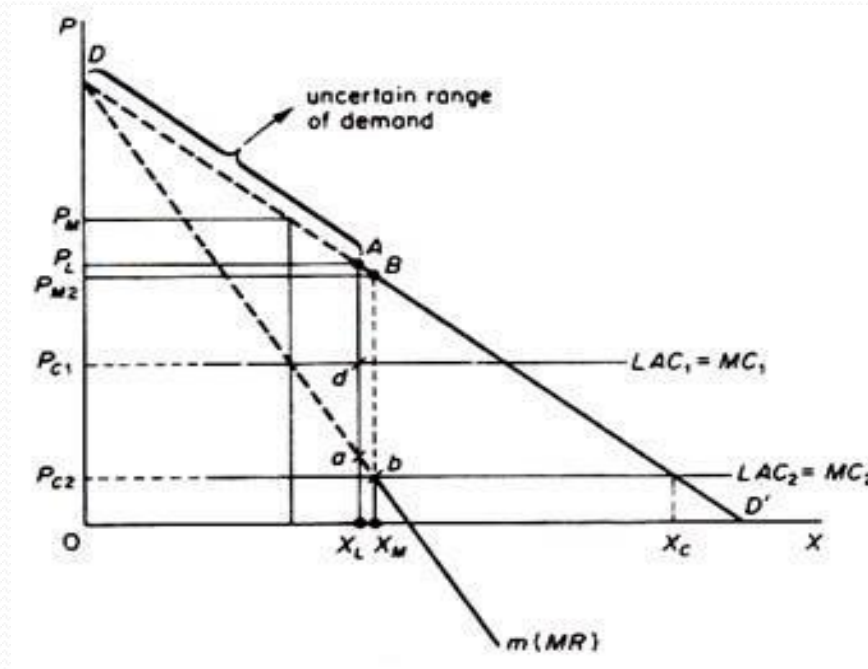
Limit pricing theory

- In figure:

- Both AR and MR cure are downward sloping

- LAC=LMC

- PC firm: P=oPc. Equilibrium at B, Q=Qc, AR=LACc. Normal profit

- Monopoly firm: P=Pm, equilibrium at m, MC=MR, Increase MC.Q=Qm. Abnormal profits=PcPmA m.

- Limit price firm: price fixed at PL>Pc, but >Pm. Point of entry of potential firms. Abnormal profits=PcPLCC1< monopoly profits, but> perfect competition

Limit pricing theory

- Monopoly price is fixed at the elastic part of the demand curve.
- Monopoly firm makes large abnormal profit.
- Attracts new firms, and monopoly loses its market.
- If firm fix a price <Pm but >Pc.
- They still earn some abnormal profits, but not maximum profits.
- At this price, D curve is inelastic (MR<0)
- Firms make only normal profits, price of new entry.
- Oligopoly market remain stable.