

both already established in the industry and the potential ones, are homogeneous. It is further assumed that the collusive oligopolists seek to maximise long-run profits. There is a given determinate demand curve for the industry product which remains unaltered and stable during price adjustments by the existing firms or change in price as a result of entry of new firms. Corresponding to this stable demand curve, there is marginal revenue curve.

The problem facing the collusive oligopolists is at what level limit price be set which prevents the entry of new firms. According to Bain, the limit price is determined by (a) the costs of the potential entrants, (b) price elasticity of demand for the industry product, (c) the size of the market, that is, the magnitude of demand for the product, (d) the number of established firms in the industry, and (e) on the level and shape of the long-run average cost (LAC). Figure 48.1 illustrates the essential features of limit-pricing theory. DD' is the market

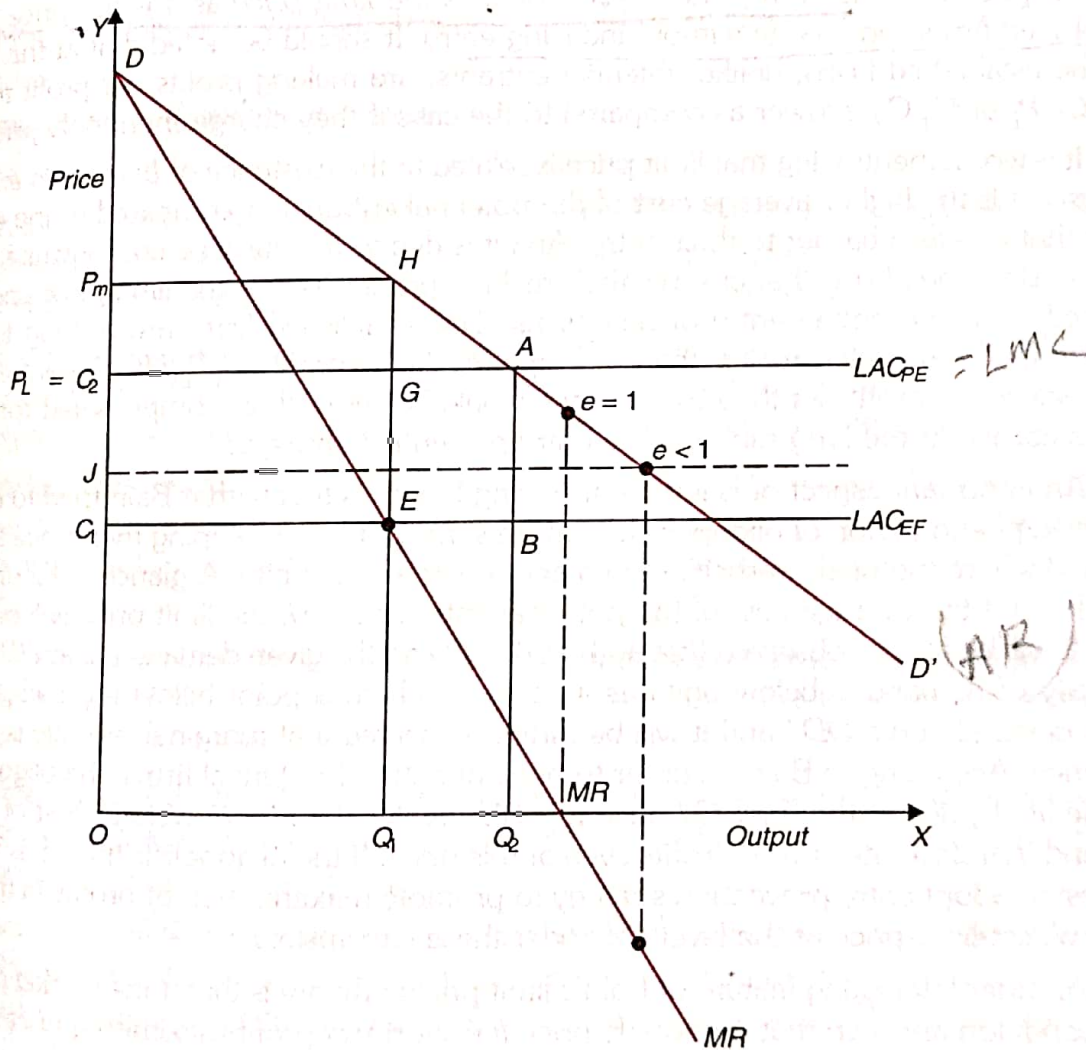


Fig. 48.1. Limit Pricing Model

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demand facing the collusive oligopoly and MR is the corresponding revenue curve. Suppose the LAC_{EF} is the long-run average cost of the *existing* established collusive oligopolists. As the LAC_{EF} is constant, LMC will be equal to it. If the collusive oligopoly wishes to maximise short-run profits it will set the price corresponding to the intersection (of LAC_{EF} (which is equal to LMC_{EF}) with the marginal revenue curve MR). It will be seen from Figure 48.1 that this short-run profit maximising price is equal to P_m (which is the monopoly price because we are considering the case of collusive oligopoly). But this short-run profit maximising price P_m is greater than the long-run average cost LAC_{PE} of the potential entrants. Consequently, the price P_m will attract entry of new firms in the industry. With entry of new firms, the established