

UNIT – III

INTRODUCTION TO MARKET AND PRICING STRATEGIES

Pricing

Introduction

Pricing is an important, if not the most important function of all enterprises. Since every enterprise is engaged in the production of some goods or/and service. Incurring some expenditure, it must set a price for the same to sell it in the market. It is only in extreme cases that the firm has no say in pricing its product; because there is severe or rather perfect competition in the market of the good happens to be of such public significance that its price is decided by the government. In an overwhelmingly large number of cases, the individual producer plays the role in pricing its product.

It is said that if a firm were good in setting its product price it would certainly flourish in the market. This is because the price is such a parameter that it exerts a direct influence on the products demand as well as on its supply, leading to firm's turnover (sales) and profit. Every manager endeavors to find the price, which would best meet with his firm's objective. If the price is set too high the seller may not find enough customers to buy his product. On the other hand, if the price is set too low the seller may not be able to recover his costs. There is a need for the right price further, since demand and supply conditions are variable over time what is a right price today may not be so tomorrow hence, pricing decision must be reviewed and reformulated from time to time.

Price

Price denotes the exchange value of a unit of good expressed in terms of money. Thus the current price of a maruti car around Rs. 2,00,000, the price of a hair cut is Rs. 25 the price of a economics book is Rs. 150 and so on. Nevertheless, if one gives a little, if one gives a little thought to this subject, one would realize that there is nothing like a unique price for any good. Instead, there are multiple prices.

Price concepts

Price of a well-defined product varies over the types of the buyers, place it is received, credit sale or cash sale, time taken between final production and sale, etc.

It should be obvious to the readers, that the price difference on account of the above four factors are more significant. The multiple prices is more serious in the case of items like cars refrigerators, coal, furniture and bricks and is of little significance for items like shaving blade, soaps, tooth pastes, creams and stationeries. Differences in various prices of any good are due to differences in transport cost, storage cost accessories, interest cost,

intermediaries' profits etc. Once can still conceive of a basic price, which would be exclusive of all these items of cost and then rationalize other prices by adding the cost of special items attached to the particular transaction, in what follows we shall explain the determination of this basis price alone and thus resolve the problem of multiple prices.

Price determinants – Demand and supply

The price of a product is determined by the demand for and supply of that product. According to Marshall the role of these two determinants is like that of a pair of scissors in cutting cloth. It is possible that at times, while one pair is held fixed, the other is moving to cut the cloth. Similarly, it is conceivable that there could be situations under which either demand or supply is playing a passive role, and the other, which is active, alone appear to be determining the price. However, just as one pair of scissors alone can never cut a cloth, demand or supply alone is insufficient to determine the price.

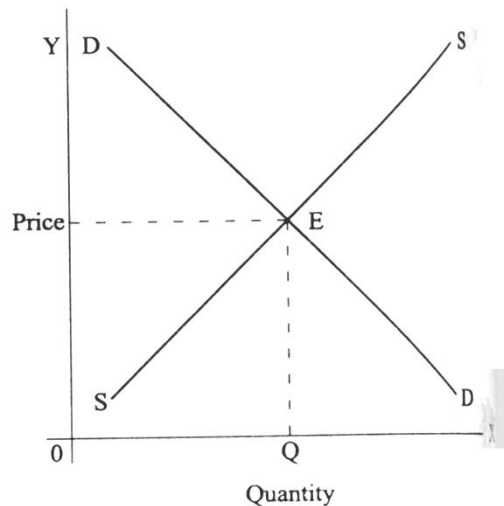
Equilibrium Price

The price at which demand and supply of a commodity is equal known as equilibrium price. The demand and supply schedules of a good are shown in the table below.

Demand supply schedule

Price	Demand	Supply
50	100	200
40	120	180
30	150	150
20	200	110
10	300	50

Of the five possible prices in the above example, price Rs.30 would be the market-clearing price. No other price could prevail in the market. If price is Rs. 50 supply would exceed demand and consequently the producers of this good would not find enough customers for their demand, thereby they would accumulate unwanted inventories of output, which, in turn, would lead to competition among the producers, forcing price to Rs.30. Similarly if price were Rs.10, there would be excess demand, which would give rise to competition among the buyers of good, forcing price to Rs.30. At price Rs.30, demand equals supply and thus both producers and consumers are satisfied. The economist calls such a price as equilibrium price.



It was seen in unit 1 that the demand for a good depends on, a number of factors and thus, every factor, which influences either demand or supply is in fact a determinant of price. Accordingly, a change in demand or/and supply causes price change.

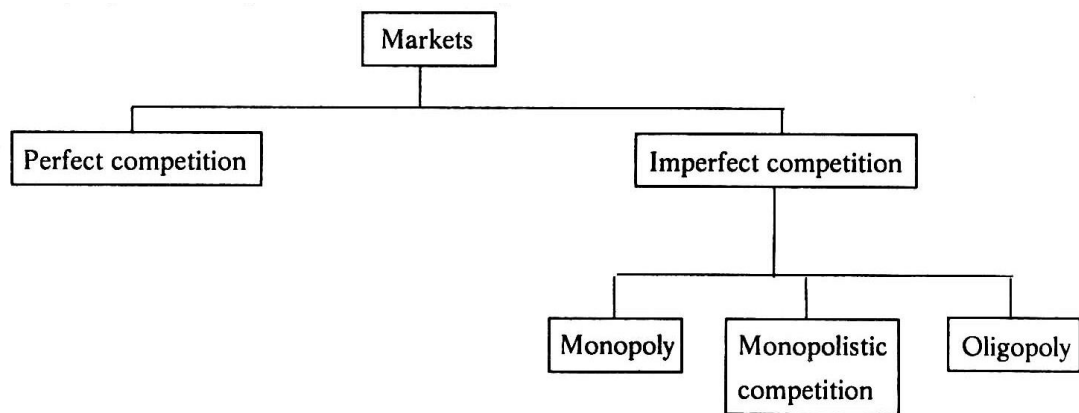
MARKET

Market is a place where buyer and seller meet, goods and services are offered for the sale and transfer of ownership occurs. A market may be also defined as the demand made by a certain group of potential buyers for a good or service. The former one is a narrow concept and later one, a broader concept. Economists describe a market as a collection of buyers and sellers who transact over a particular product or product class (the housing market, the clothing market, the grain market etc.). For business purpose we define a market as people or organizations with wants (needs) to satisfy, money to spend, and the willingness to spend it. Broadly, market represents the structure and nature of buyers and sellers for a commodity/service and the process by which the price of the commodity or service is established. In this sense, we are referring to the structure of competition and the process of price determination for a commodity or service. The determination of price for a commodity or service depends upon the structure of the market for that commodity or service (i.e., competitive structure of the market). Hence the understanding on the market structure and the nature of competition are a pre-requisite in price determination.

Different Market Structures

Market structure describes the competitive environment in the market for any good or service. A market consists of all firms and individuals who are willing and able to buy or sell a particular product. This includes firms and individuals currently engaged in buying and selling a particular product, as well as potential entrants.

The determination of price is affected by the competitive structure of the market. This is because the firm operates in a market and not in isolation. In making decisions concerning economic variables it is affected, as are all institutions in society by its environment.



Perfect Competition

Perfect competition refers to a market structure where competition among the sellers and buyers prevails in its most perfect form. In a perfectly competitive market, a single market price prevails for the commodity, which is determined by the forces of total demand and total supply in the market.

Characteristics of Perfect Competition

The following features characterize a perfectly competitive market:

- 1. A large number of buyers and sellers:** The number of buyers and sellers is large and the share of each one of them in the market is so small that none has any influence on the market price.
- 2. Homogeneous product:** The product of each seller is totally undifferentiated from those of the others.
- 3. Free entry and exit:** Any buyer and seller is free to enter or leave the market of the commodity.
- 4. Perfect knowledge:** All buyers and sellers have perfect knowledge about the market for the commodity.
- 5. Indifference:** No buyer has a preference to buy from a particular seller and no seller to sell to a particular buyer.
- 6. Non-existence of transport costs:** Perfectly competitive market also assumes the non-existence of transport costs.
- 7. Perfect mobility of factors of production:** Factors of production must be in a position to move freely into or out of industry and from one firm to the other.

Under such a market no single buyer or seller plays a significant role in price determination. On the other hand all of them jointly determine the price. The price is determined in the industry, which is composed of all the buyers and seller for the commodity. The demand curve facing the industry is the sum of all consumers' demands at various prices. The industry supply curve is the sum of all sellers' supplies at various prices.

Pure competition and perfect competition

The term perfect competition is used in a wider sense. Pure competition has only limited assumptions. When the assumptions, that large number of buyers and sellers, homogeneous products, free entry and exit are satisfied, there exists pure competition. Competition becomes perfect only when all the assumptions (features) are satisfied. Generally pure competition can be seen in agricultural products.

Equilibrium of a firm and industry under perfect competition

Equilibrium is a position where the firm has no incentive either to expand or contract its output. The firm is said to be in equilibrium when it earn maximum profit. There are two conditions for attaining equilibrium by a firm. They are:

Marginal cost is an additional cost incurred by a firm for producing an additional unit of output. Marginal revenue is the additional revenue accrued to a firm when it sells one additional unit of output. A firm increases its output so long as its marginal cost becomes equal to marginal revenue. When marginal cost is more than marginal revenue, the firm reduces output as its costs exceed the revenue. It is only at the point where marginal cost is equal to marginal revenue, and then the firm attains equilibrium. Secondly, the marginal cost curve must cut the marginal revenue curve from below. If marginal cost curve cuts the marginal revenue curve from above, the firm is having the scope to increase its output as the marginal cost curve slopes downwards. It is only with the upward sloping marginal cost curve, there the firm attains equilibrium. The reason is that the marginal cost curve when rising cuts the marginal revenue curve from below.

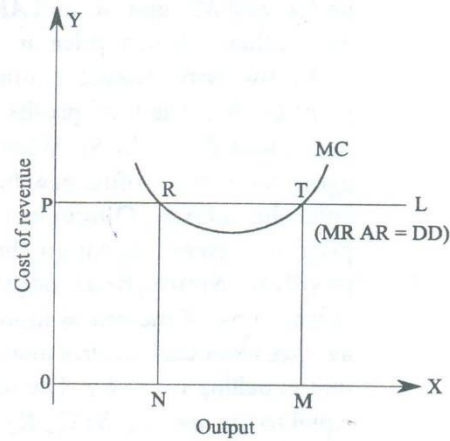


Fig. 6.2

The equilibrium of a perfectly competitive firm may be explained with the help of the fig. 6.2.

In the given fig. PL and MC represent the Price line and Marginal cost curve. PL also represents Marginal revenue, Average revenue and demand. As Marginal revenue, Average revenue and demand are the same in perfect competition, all are equal to the price line. Marginal cost curve is U- shaped curve cutting MR curve at R and T. At point R marginal cost becomes equal to marginal revenue. But MC curve cuts the MR curve from above. So this is not the equilibrium position. The downward sloping marginal cost curve indicates that the firm can reduce its cost of production by increasing output. As the firm expands its output, it will reach equilibrium at point T. At this point, on price line PL; the two conditions of equilibrium are satisfied. Here the marginal cost and marginal revenue of the firm remain equal. The firm is producing maximum output and is in equilibrium at this stage. If the firm continues its output beyond this stage, its marginal cost exceeds marginal revenue resulting in losses. As the firm has no idea of expanding or contracting its size of out, the firm is said to be in equilibrium at point T.

Pricing under perfect competition

The price or value of a commodity under perfect competition is determined by the demand for and the supply of that commodity.

Under perfect competition there is large number of sellers trading in a homogeneous product. Each firm supplies only very small portion of the market demand. No single buyer or seller is powerful enough to influence the price. The demand of all consumers and the supply of all firms together determine the price. The individual seller is only a price taker and not a price maker. An individual firm has no price policy of its own. Thus, the main problem of a firm in a perfectly competitive market is not to determine the price of its product but to adjust its output to the given price, so that the profit is maximum. Marshall however gives great importance to the time element for the determination of price. He

divided the time periods on the basis of supply and ignored the forces of demand. He classified the time into four periods to determine the price as follows.

1. Very short period or Market period
2. Short period
3. Long period
4. Very long period or secular period

Very short period: It is the period in which the supply is more or less fixed because the time available to the firm to adjust the supply of the commodity to its changed demand is extremely short; say a single day or a few days. The price determined in this period is known as Market Price.

Short Period: In this period, the time available to firms to adjust the supply of the commodity to its changed demand is, of course, greater than that in the market period. In this period altering the variable factors like raw materials, labour, etc can change supply. During this period new firms cannot enter into the industry.

Long period: In this period, a sufficiently long time is available to the firms to adjust the supply of the commodity fully to the changed demand. In this period not only variable factors of production but also fixed factors of production can be changed. In this period new firms can also enter the industry. The price determined in this period is known as long run normal price.

Secular Period: In this period, a very long time is available to adjust the supply fully to change in demand. This is very long period consisting of a number of decades. As the period is very long it is difficult to lay down principles determining the price.

Price Determination in the market period

The price determined in very short period is known as Market price. Market price is determined by the equilibrium between demand and supply in a market period. The nature of the commodity determines the nature of supply curve in a market period. Under this period goods are classified in to (a) Perishable goods and (b) Non-perishable goods.

Perishable Goods: In the very short period, the supply of perishable goods like fish, milk vegetables etc. cannot be increased. And it cannot be decreased also. As a result the supply curve under very short period will be parallel to the Y-axis or Vertical to X-axis. Supply is perfectly inelastic. The price determination of perishable goods in very short period may be shown with the help of the following fig. 6.5

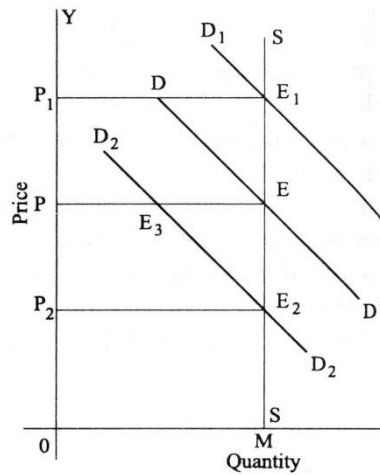
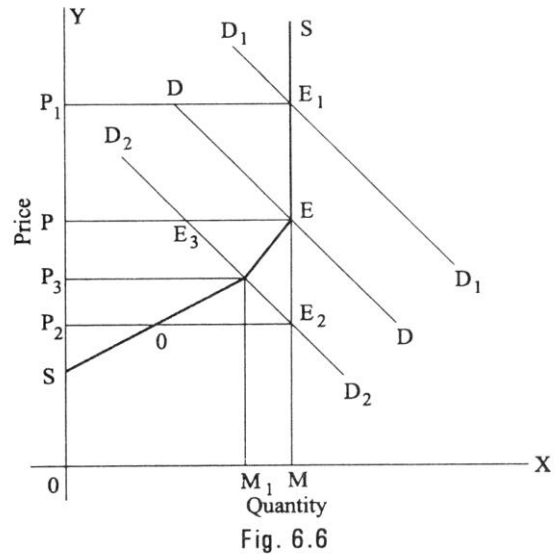


Fig. 6.5

In this figure quantity is represented along X-axis and price is represented along Y-axis. MS is the very short period supply curve of perishable goods. DD is demand curve. It intersects supply curve at E. The price is OP. The quantity exchanged is OM. D1 D1 represents increased demand. This curve cuts the supply curve at E1. Even at the new equilibrium, supply is OM only. But price increases to OP1. So, when demand increases, the price will increase but not the supply. If demand decreases new demand curve will be D2 D2. This curve cuts the supply curve at E2. Even at this new equilibrium, the supply is OM only. But price falls to OP2. Hence in very short period, given the supply, it is the change in demand that influences price. The price determined in a very short period is called Market Price.

Non-perishable goods: In the very short period, the supply of non-perishable goods like cloth, pen, watches etc. cannot be increased. But if price falls, preserving some stock can decrease their supply. If price falls too much, the whole stock will be held back from the market and carried over to the next market period. The price below, which the seller will refuse to sell, is called Reserve Price.

The Price determination of non-perishable goods in very short period may be shown with the help of the following fig 6.6.



In the given figure quantity is shown on X-axis and the price on Y-axis. SES is the supply curve. It slopes upward up to the point E. From E it becomes a vertical straight line. This is because the quantity existing with sellers is OM, the maximum amount they have is thus OM. Till OM quantity (i.e., point E) the supply curve sloped upward. At the point S, nothing is offered for sale.

It means that the seller will hold the entire stock if the price is OS. OS is thus the reserve price. As the price rises, supply increases up to point E. At OP price (Point E), the entire stock is offered for sale.

Suppose demand increases, the DD curve shifts upward. It becomes D₁D₁ price rises to OP₁. If demand decreases, the demand curve becomes D₂D₂. It intersects the supply curve at E₃. The price will fall to OP₃. We find that at OS price, supply is zero. It is the reserve price.

Price Determination in the short period

Short period is a period in which supply can be increased by altering the variable factors. In this period fixed costs will remain constant. The supply is increased when price rises and vice versa. So the supply curve slopes upwards from left to right.

The price in short period may be explained with the help of a diagram.

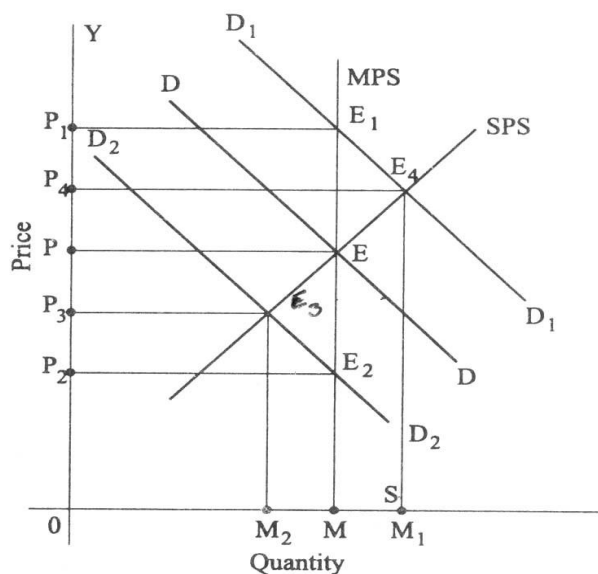


Fig. 6.7

In the given diagram MPS is the market period supply curve. DD is the initial demand curve. It intersects MPS curve at E. The price is OP and out put OM. Suppose demand increases, the demand curve shifts upwards and becomes D1D1. In the very short period, supply remains fixed on OM. The new demand curve D1D1 intersects MPS at E1. The price will rise to OP1. This is what happen in the very short-period.

As the price rises from OP to OP1, firms expand output. As firms can vary some factors but not all, the law of variable proportions operates. This results in new short-run supply curve SPS. It interests D1 D1 curve at E4. The price will fall from OP1 to OP4.

It the demand decreases, DD curve shifts downward and becomes D2D2. It interests MPS curve at E2. The price will fall to OP2. This is what happens in market period. In the short period, the supply curve is SPS. D2D2 curve interests SPS curve at E3. The short period price is higher than the market period price.

Price determination in the long period (Normal Price)

Market price may fluctuate due to a sudden change either on the supply side or on the demand side. A big arrival of milk may decrease the price of that production in the market period. Similarly, a sudden cold wave may raise the price of woolen garments. This type of temporary change in supply and demand may cause changes in market price. In the absence of such disturbing causes, the price tends to come back to a certain level. Marshall called this level is normal price level. In the words of Marshall Normal value (Price) of a commodity is that which economics force would tend to bring about in the long period.

In order to describe how long run normal price is determined, it is useful to refer to the market period as short period also. The market period is so short that no adjustment in the output can be made. Here cost of production has no influence on price. A short period is sufficient only to allow the firms to make only limited output adjustment. In the long period, supply conditions are fully sufficient to meet the changes in demand. In the long period, all factors are alterable and the new firms may enter into or old firms leave the; industry.

In the long period all costs are variable costs. So supply will be increased only when price is equal to average cost.

Hence, in long period normal price will be equal to minimum average cost of the industry. Will this price be more or less than the short period normal price? The answer depends on the stage of returns to which the industry is subject. There are three stages of return on the stage of returns to which the industry is subject. There are three stages of returns.

1. Increasing returns or decreasing costs.
2. Constant Returns or Constant costs.
3. Diminishing returns or increasing costs.

1. Determination of long period normal price in decreasing cost industry:

At this stage, average cost falls due to an increase in the output. So, the supply curve at this stage will slope downwards from left to right. The long period Normal price determination at this stage can be explained with the help of a diagram.

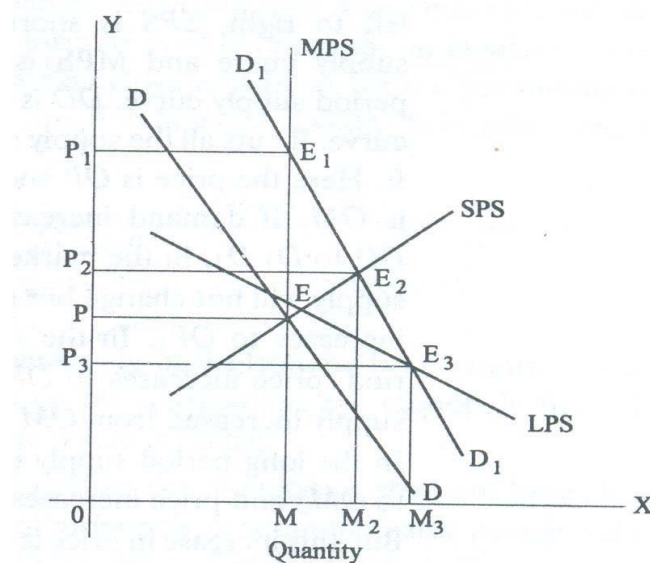


Fig. 6.8

In the diagram, MPS represents market period supply curve. DD is demand curve. DD cuts LPS, SPS and MPS at point E. At point E the supply is OM and the price is OP. If demand increases from DD to D₁D₁ market price increases to OP₁. In the short period it is OP₂. In the long period supply increases considerably to OM₃. So price has fallen to OP₃, which is less than the price of market period.

2. Determination of Long Period Normal Price in Constant Cost Industry:

In this case average cost does not change even though the output increases. Hence long period supply curve is horizontal to X-axis. The determination of long period normal price can be explained with the help of the diagram. In the fig. 6.9, LPS is horizontal to X-axis. MPS represents market period supply curve, and SPS represents short period supply curve. At point 'E' the output is OM and price is OP. If demand increases from DD to D₁D₁ market price increases to OP₁. In the short period, supply increases and hence the price will be OP₂. In the long run supply is adjusted fully to meet increased demand. The price remains constant at OP because costs are constant at OP and market is perfect market.

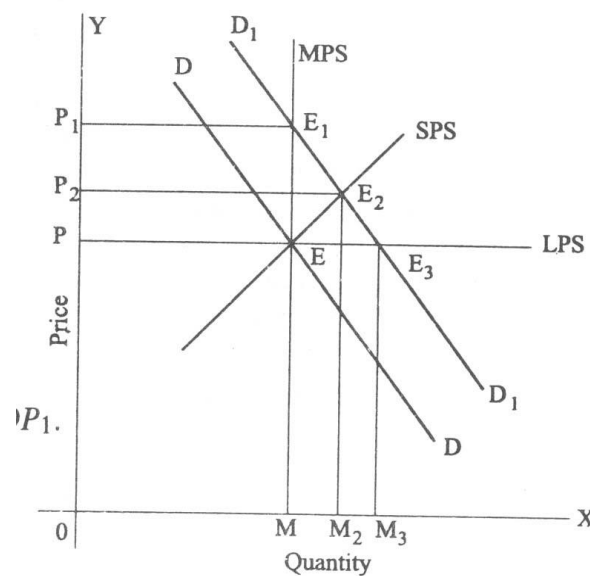
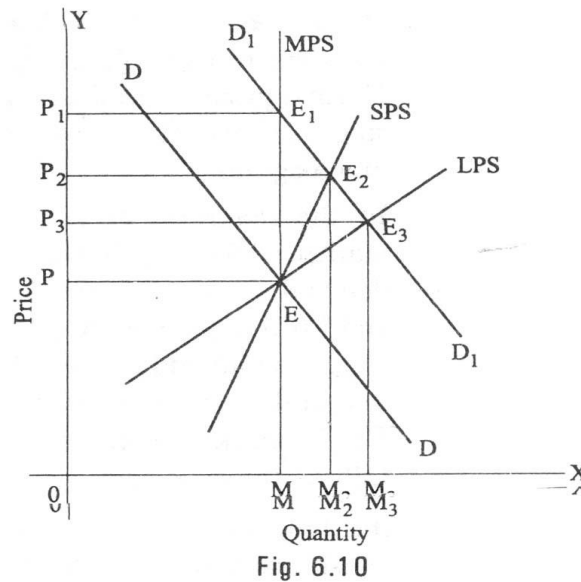


Fig. 6.9

3. Determination of long period normal price in increase cost industry:

If the industry is subject to increasing costs (diminishing returns) the supply curve slopes upwards from left to right like an ordinary supply curve. The determination of long period normal price in increasing cost industry can be explained with the help of the following diagram. In the diagram LPS represents long period supply curve. The industry is subject to diminishing return or increasing costs. So, LPS slopes upwards from left to right. SPS is

short period supply curve and MPS is market period supply curve. DD is demand curve. It cuts all the supply curves at E. Here the price is OP and output is OM. If demand increases from DD to D₁D₁ in the market period, supply will not change but the price increases to OP₁. In the short period, price increase but the price increases to OP₁. In the short period, price increases to OP₂ as the supply increased from OM to OM₂. In the long period supply increases to OM₃ and price increases to OP₃. But this increase in price is less than the price increase in a market period or short period.



Monopoly

The word monopoly is made up of two syllables, Mono and poly. Mono means single while poly implies selling. Thus monopoly is a form of market organization in which there is only one seller of the commodity. There are no close substitutes for the commodity sold by the seller. Pure monopoly is a market situation in which a single firm sells a product for which there is no good substitute.

Features of monopoly

The following are the features of monopoly.

1. **Single person or a firm:** A single person or a firm controls the total supply of the commodity. There will be no competition for monopoly firm. The monopolist firm is the only firm in the whole industry.
2. **No close substitute:** The goods sold by the monopolist shall not have closely competition substitutes. Even if price of monopoly product increase people will not go in far substitute. For example: If the price of electric bulb increase slightly, consumer will not go in for kerosene lamp.

3. **Large number of Buyers:** Under monopoly, there may be a large number of buyers in the market who compete among themselves.
4. **Price Maker:** Since the monopolist controls the whole supply of a commodity, he is a price-maker, and then he can alter the price.
5. **Supply and Price:** The monopolist can fix either the supply or the price. He cannot fix both. If he charges a very high price, he can sell a small amount. If he wants to sell more, he has to charge a low price. He cannot sell as much as he wishes for any price he pleases.
6. **Downward Sloping Demand Curve:** The demand curve (average revenue curve) of monopolist slopes downward from left to right. It means that he can sell more only by lowering price.

Types of Monopoly

Monopoly may be classified into various types. The different types of monopolies are explained below:

1. **Legal Monopoly:** If monopoly arises on account of legal support or as a matter of legal privilege, it is called Legal Monopoly. Ex. Patent rights, special brands, trade means, copyright etc.
2. **Voluntary Monopoly:** To get the advantages of monopoly some private firms come together voluntarily to control the supply of a commodity. These are called voluntary monopolies. Generally, these monopolies arise with industrial combinations. These voluntary monopolies are of three kinds (a) cartel (b) trust (c) holding company. It may be called artificial monopoly.
3. **Government Monopoly:** Sometimes the government will take the responsibility of supplying a commodity and avoid private interference. Ex. Water, electricity. These monopolies, created to satisfy social wants, are formed on social considerations. These are also called Social Monopolies.
4. **Private Monopoly:** If the total supply of a good is produced by a single private person or firm, it is called private monopoly. Hindustan Lever Ltd. Is having the monopoly power to produce Lux Soap.
5. **Limited Monopoly:** if the monopolist is having limited power in fixing the price of his product, it is called as 'Limited Monopoly'. It may be due to the fear of distant substitutes or government intervention or the entry of rivals firms.
6. **Unlimited Monopoly:** If the monopolist is having unlimited power in fixing the price of his good or service, it is called unlimited monopoly. Ex. A doctor in a village.
7. **Single Price Monopoly:** When the monopolist charges same price for all units of his product, it is called single price monopoly. Ex. Tata Company charges the same price to all the Tata Indiacars of the same model.
8. **Discriminating Monopoly:** When a Monopolist charges different prices to different consumers for the same product, it is called discriminating monopoly. A doctor may take Rs.20 from a rich man and only Rs.2 from a poor man for the same treatment.

9. Natural Monopoly: Sometimes monopoly may arise due to scarcity of natural resources. Nature provides raw materials only in some places. The owner of the place will become monopolist. For Ex. Diamond mine in South Africa.

Pricing under Monopoly

Monopoly refers to a market situation where there is only one seller. He has complete control over the supply of a commodity. He is therefore in a position to fix any price. Under monopoly there is no distinction between a firm and an industry. This is because the entire industry consists of a single firm.

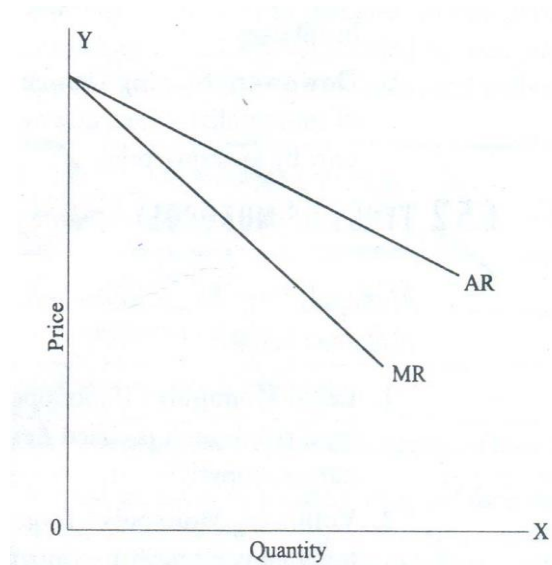


Fig. 6.11

Being the sole producer, the monopolist has complete control over the supply of the commodity. He has also the power to influence the market price. He can raise the price by reducing his output and lower the price by increasing his output. Thus he is a price-maker. He can fix the price to his maximum advantages. But he cannot fix both the supply and the price, simultaneously. He can do one thing at a time. If he fixes the price, his output will be determined by the market demand for his commodity. On the other hand, if he fixes the output to be sold, its market will determine the price for the commodity. Thus his decision to fix either the price or the output is determined by the market demand.

The market demand curve of the monopolist (the average revenue curve) is downward sloping. Its corresponding marginal revenue curve is also downward sloping. But the marginal revenue curve lies below the average revenue curve as shown in the figure. The monopolist faces the down-sloping demand curve because to sell more output, he must reduce the price of his product. The firm's demand curve and industry's demand curve are one and the same. The average cost and marginal cost curve are U shaped curve. Marginal cost falls and rises steeply when compared to average cost.

Price output determination (Equilibrium Point)

The monopolistic firm attains equilibrium when its marginal cost becomes equal to the marginal revenue. The monopolist always desires to make maximum profits. He makes maximum profits when $MC=MR$. He does not increase his output if his revenue exceeds his costs. But when the costs exceed the revenue, the monopolist firm incurs losses. Hence the monopolist curtails his production. He produces up to that point where additional cost is equal to the additional revenue ($MR=MC$). Thus point is called equilibrium point. The price output determination under monopoly may be explained with the help of a diagram.

In the diagram 6.12 the quantity supplied or demanded is shown along X-axis. The cost or revenue is shown along Y-axis. AC and MC are the average cost and marginal cost curves respectively. AR and MR curves slope downwards from left to right. AC and MC are U-shaped curves. The monopolistic firm attains equilibrium when its marginal cost is equal to marginal revenue ($MC=MR$). Under monopoly, the MC curve may cut the MR curve from below or from a side. In the diagram, the above condition is satisfied at point E. At point E, $MC=MR$. The firm is in equilibrium. The equilibrium output is OM.

The above diagram (Average revenue) = MQ or OP

Average cost = MR

Profit per unit = Average Revenue - Average cost = $MQ - MR = QR$

Total Profit = $QRXS = PQRS$

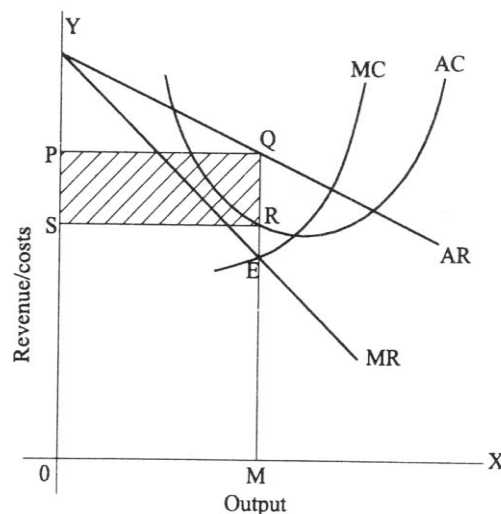


Fig. 6.12

The area PQRS represents the maximum profit earned by the monopoly firm.

But it is not always possible for a monopolist to earn super-normal profits. If the demand and cost situations are not favorable, the monopolist may realize short run losses.

Through the monopolist is a price marker, due to weak demand and high costs; he suffers a loss equal to PABC.

If $AR > AC$ -> Abnormal or super normal profits.

If $AR = AC$ -> Normal Profit

If $AR < AC$ -> Loss

In the long run the firm has time to adjust his plant size or to use existing plant so as to maximize profits.

Monopolistic competition

Perfect competition and pure monopoly are rare phenomena in the real world. Instead, almost every market seems to exhibit characteristics of both perfect competition and monopoly. Hence in the real world it is the state of imperfect competition lying between these two extreme limits that work. Edward. H. Chamberlain developed the theory of monopolistic competition, which presents a more realistic picture of the actual market structure and the nature of competition.

Characteristics of Monopolistic Competition

The important characteristics of monopolistic competition are:

- 1. Existence of Many firms:** Industry consists of a large number of sellers, each one of whom does not feel dependent upon others. Every firm acts independently without bothering about the reactions of its rivals. The size is so large that an individual firm has only a relatively small part in the total market, so that each firm has very limited control over the price of the product. As the number is relatively large it is difficult for these firms to determine its price- output policies without considering the possible reactions of the rival forms. A monopolistically competitive firm follows an independent price policy.
- 2. Product Differentiation:** Product differentiation means that products are different in some ways, but not altogether so. The products are not identical but the same time they will not be entirely different from each other. IT really means that there are various monopolist firms competing with each other. An example of monopolistic competition and product differentiation is the toothpaste produced by various firms. The product of each firm is different from that of its rivals in one or more respects.

Different toothpastes like Colgate, Close-up, Forehans, Cibaca, etc., provide an example of monopolistic competition. These products are relatively close substitute for each other but not perfect substitutes. Consumers have definite preferences for the particular varieties or brands of products offered for sale by various sellers. Advertisement, packing, trademarks, brand names etc. help differentiation of products even if they are physically identical.

3. **Large Number of Buyers:** There are large number buyers in the market. But the buyers have their own brand preferences. So the sellers are able to exercise a certain degree of monopoly over them. Each seller has to plan various incentive schemes to retain the customers who patronize his products.
4. **Free Entry and Exist of Firms:** As in the perfect competition, in the monopolistic competition too, there is freedom of entry and exit. That is, there is no barrier as found under monopoly.
5. **Selling costs:** Since the products are close substitute much effort is needed to retain the existing consumers and to create new demand. So each firm has to spend a lot on selling cost, which includes cost on advertising and other sale promotion activities.
6. **Imperfect Knowledge:** Imperfect knowledge about the product leads to monopolistic competition. If the buyers are fully aware of the quality of the product they cannot be influenced much by advertisement or other sales promotion techniques. But in the business world we can see that though the quality of certain products is the same, effective advertisement and sales promotion techniques make certain brands monopolistic. For examples, effective dealer service backed by advertisement-helped popularization of some brands through the quality of almost all the cement available in the market remains the same.
7. **The Group:** Under perfect competition the term industry refers to all collection of firms producing a homogenous product. But under monopolistic competition the products of various firms are not identical though they are close substitutes. Prof. Chamberlin called the collection of firms producing close substitute products as a group.

Price – Output Determination under Monopolistic Competition

Since under monopolistic competition different firms produce different varieties of products, different prices for them will be determined in the market depending upon the demand and cost conditions. Each firm will set the price and output of its own product. Here also the profit will be maximized when marginal revenue is equal to marginal cost.

Short-run equilibrium of the firm:

In the short-run the firm is in equilibrium when marginal Revenue = Marginal Cost. In Fig 6.15 AR is the average revenue curve. NMR marginal revenue curve, SMC short-run marginal cost curve, SAC short-run average cost curve, MR and SMC intersect at point E where output is OM and price MQ (i.e. OP). Thus the equilibrium output or the maximum

profit output is OM and the price MQ or OP. When the price (average revenue) is above average cost a firm will be making supernormal profit. From the figure it can be seen that AR is above AC in the equilibrium point. As AR is above AC, this firm is making abnormal profits in the short-run. The abnormal profit per unit is QR, i.e., the difference between AR and AC at equilibrium point and the total supernormal profit is OR X OM. This total abnormal profits is represented by the rectangle PQRS. As the demand curve here is highly elastic, the excess price over marginal cost is rather low. But in monopoly the demand curve is inelastic. So the gap between price and marginal cost will be rather large.

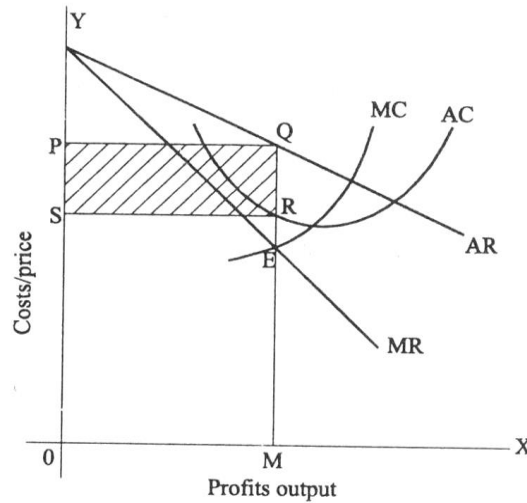


Fig. 6.15

If the demand and cost conditions are less favorable the monopolistically competitive firm may incur loss in the short-run fig 6.16 Illustrates this. A firm incurs loss when the price is less than the average cost of production. MQ is the average cost and OS (i.e. MR) is the price per unit at equilibrium output OM. QR is the loss per unit. The total loss at an output OM is OR X OM. The rectangle PQRS represents the total losses in the short run.

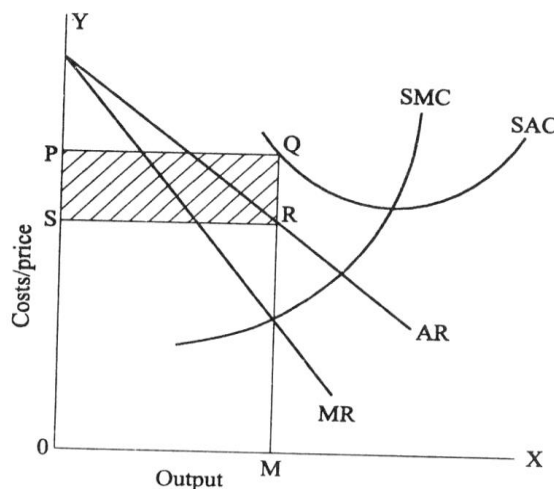


Fig. 6.16

**Long – Run
Firm:**

Equilibrium of the

A monopolistically competitive firm will be long – run equilibrium at the output level where marginal cost equal to marginal revenue. Monopolistically competitive firm in the long run attains equilibrium where $MC=MR$ and $AC=AR$ Fig 6.17 shows this trend.

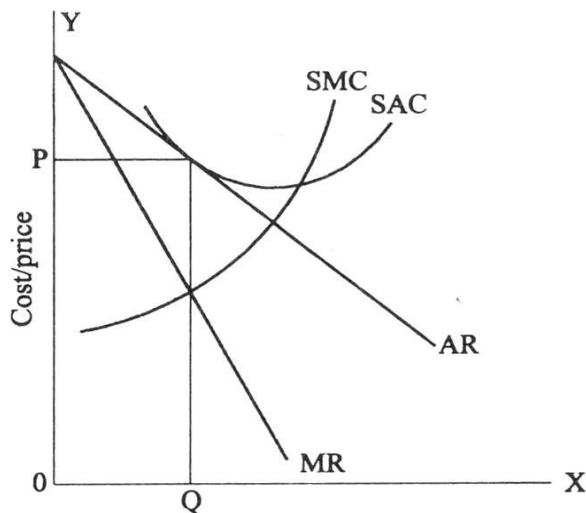


Fig. 6.17

Oligopoly

The term oligopoly is derived from two Greek words, oligos meaning a few, and pollen meaning to sell. Oligopoly is the form of imperfect competition where there are a few firms in the market, producing either a homogeneous product or producing products, which are close but not perfect substitute of each other.

Characteristics of Oligopoly

The main features of oligopoly are:

1. **Few Firms:** There are only a few firms in the industry. Each firm contributes a sizeable share of the total market. Any decision taken by one firm influence the actions of other firms in the industry. The various firms in the industry compete with each other.
2. **Interdependence:** As there are only very few firms, any steps taken by one firm to increase sales, by reducing price or by changing product design or by increasing advertisement expenditure will naturally affect the sales of other firms in the industry. An immediate retaliatory action can be anticipated from the other firms in the industry every time when one firm takes such a decision. He has to take this into account when he takes decisions. So the decisions of all the firms in the industry are interdependent.

3. **Indeterminate Demand Curve:** The interdependence of the firms makes their demand curve indeterminate. When one firm reduces price other firms also will make a cut in their prices. So the firm cannot be certain about the demand for its product. Thus the demand curve facing an oligopolistic firm loses its definiteness and thus is indeterminate as it constantly changes due to the reactions of the rival firms.
4. **Advertising and selling costs:** Advertising plays a greater role in the oligopoly market when compared to other market systems. According to Prof. William J. Baumol "it is only oligopoly that advertising comes fully into its own". A huge expenditure on advertising and sales promotion techniques is needed both to retain the present market share and to increase it. So Baumol concludes "under oligopoly, advertising can become a life-and-death matter where a firm which fails to keep up with the advertising budget of its competitors may find its customers drifting off to rival products."
5. **Price Rigidity:** In the oligopoly market price remain rigid. If one firm reduced price it is with the intention of attracting the customers of other firms in the industry. In order to retain their consumers they will also reduce price. Thus the pricing decision of one firm results in a loss to all the firms in the industry. If one firm increases price. Other firms will remain silent thereby allowing that firm to lose its customers. Hence, no firm will be ready to change the prevailing price. It causes price rigidity in the oligopoly market.

Duopoly

Duopoly refers to a market situation in which there are only two sellers. As there are only two sellers any decision taken by one seller will have reaction from the other. Eg. Coca-Cola and Pepsi. Usually these two sellers may agree to co-operate each other and share the market equally between them, so that they can avoid harmful competition.

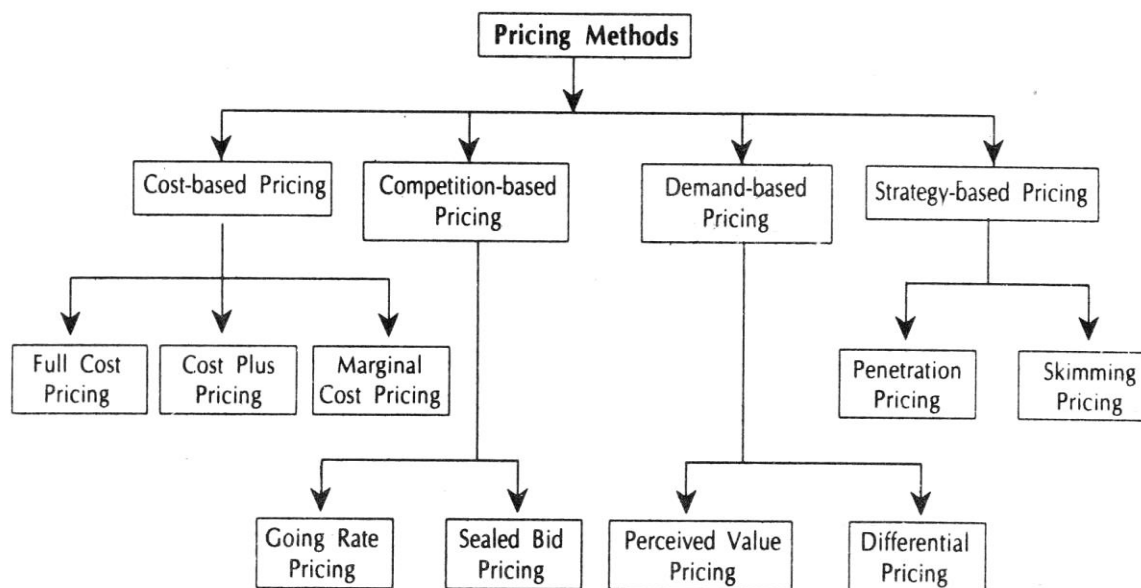
The duopoly price, in the long run, may be a monopoly price or competitive price, or it may settle at any level between the monopoly price and competitive price. In the short period, duopoly price may even fall below the level competitive price with the both the firms earning less than even the normal price.

PRICING METHODS

The micro – economic principle of profit maximization suggests pricing by the marginal analysis. That is by equating MR to MC. However the pricing methods followed by the firms in practice around the world rarely follow this procedure. This is for two reasons; uncertainty with regard to demand and cost function and the deviation from the objective of short run profit maximization.

It was seen that there is no unique theory of firm behavior. While profit certainly on important variable for which every firm cares. Maximization of short – run profit is not a popular objective of a firm today. At the most firms seek maximum profit in the long run. If so the problem is dynamic and its solution requires accurate knowledge of demand and cost conditions over time. Which is impossible to come by?

In view of these problems economic prices are a rare phenomenon. Instead, firms set prices for their products through several alternative means. The important pricing methods followed in practice are shown in the chart.



Cost Based Pricing

There are three versions of the cost – based pricing. Full – cost or break even pricing, cost plus pricing and the marginal cost pricing. Under the first version, price just equals the average (total) cost. In the second version, some mark-up is added to the average cost in arriving at the price. In the last version, price is set equal to the marginal cost. While all these methods appear to be easy and straight forward, they are in fact associated with a number of difficulties. Even though difficulties are there, the cost- oriented pricing is quite popular today.

The cost – based pricing has several strengths as well as limitations. The advantages are its simplicity, acceptability and consistency with the target rate of return on investment and the price stability in general. The limitations are difficulties in getting accurate estimates of cost (particularly of the future cost rather than the historic cost) Volatile nature of the variable cost and its ignoring of the demand side of the market etc.

Competition based pricing

Some commodities are priced according to the competition in their markets. Thus we have the going rate method of price and the sealed bid pricing technique. Under the former a firm prices its new product according to the prevailing prices of comparable products in the market. If the product is new in the country, then its import cost – inclusive of the costs of certificates, insurance, and freight and customs duty, is used as the basis for pricing, Incidentally, the price is not necessarily equal to the import cost, but to the firm is either new in the country, or is a close substitute or complimentary to some other products, the prices of hitherto existing bands or / and of the related goods are taken in to a account while deciding its price. Thus, when television was first manufactures in India, its import cost must have been a guiding force in its price determination. Similarly, when

maruti car was first manufactured in India, it must have taken into account the prices of existing cars, price of petrol, price of car accessories, etc. Needless to say, the going rate price could be below or above the average cost and it could even be an economic price.

The sealed bid pricing method is quite popular in the case of construction activities and in the disposition of used produces. In this method the prospective seller (buyers) are asked to quote their prices through a sealed cover, all the offers are opened at a preannounce time in the presence of all the competitors, and the one who quoted the least is awarded the contract (purchase / sale deed). As it sound, this method is totally competition based and if the competitors unit by any change, the buyers (seller) may have to pay (receive) an exorbitantly high (too low) price, thus there is a great degree of risk attached to this method of pricing.

Demand Based Pricing

The demand – based pricing and strategy – based pricing are quite related. The seller knows rather well that the demand for its product is a decreasing function of the price its sets for product. Thus if seller wishes to sell more he must reduce the price of his product, and if he wants a good price for his product, he could sell only a limited quantity of his good. Demand oriented pricing rules imply establishment of prices in accordance with consumer preference and perceptions and the intensity of demand.

Two general types demand oriented pricing rules can be identified.

- i. Perceived value pricing and
- ii. Differential pricing

Perceived value pricing considers the buyer's perception of the value of the product as the basis of pricing. Here the pricing rule is that the firm must develop procedures for measuring the relative value of the product as perceived by consumers. Differential pricing is nothing but price discrimination. It involves selling a product or service for different prices in different market segments. Price differentiation depends on geographical location of the consumers, type of consumer, purchasing quantity, season, time of the service etc. E.g. Telephone charges, APSRTC charges.

Strategy based pricing (new product pricing)

A firm which produces a new product, if it is also new to industry, can earn very good profits if it handles marketing carefully, because of the uniqueness of the product. The price fixed for the new product must keep the competitors away. Earn good profits for the firm over the life of the product and must help to get the product accepted. The company can select either skimming pricing or penetration pricing.

While there are some firms, which follow the strategy of price penetration, there are some others who opt for price – skimming. Under the former, firms sell their new product at a low price in the beginning in order to catch the attention of consumers, once the product image and credibility is established, the seller slowly starts jacking up the price to reap good profits in future. Under this strategy, a firm might well sell its product below the cost of production and thus runs into losses to start with but eventually it recovers all its losses and even makes good overall profits. The Rin washing soap perhaps falls into this category. This soap was sold at a rather low price in the beginning and the firm even distributed free samples. Today, it is quite an expensive brand and yet it is selling very well. Under the price – skimming strategy, the new product is priced high in the beginning, and its price is reduced gradually as it faces a dearth of buyers such a strategy may be beneficial for products, which are fancy, but of poor quality and / or of insignificant use over a period of time.

A prudent producer follows a good mix of the various pricing methods rather than adopting any one of them. This is because no method is perfect and every method has certain good features further a firm might adopt one method at one time and another method at some other accession.