4.1 — Modeling Market Power

ECON 306 · Microeconomic Analysis · Fall 2020

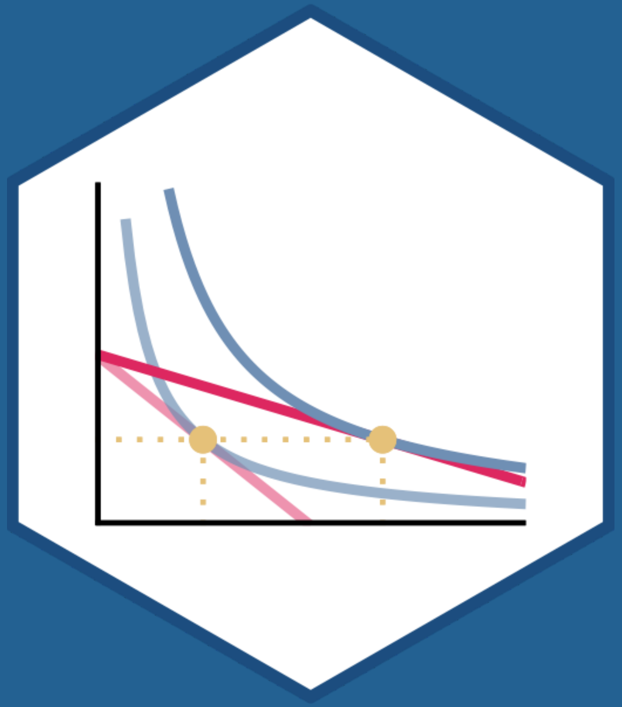
Ryan Safner

Assistant Professor of Economics

safner@hood.edu

ryansafner/microF20

microF20.classes.ryansafner.com



Outline

Market Power

Imperfect Competition

Monopoly

Perfect Competition

Less Competitive ⟷ More Competitive

Imperfect Competition

"Imperfect Competition"

Monopoly

Perfect Competition

Less Competitive

More Competitive

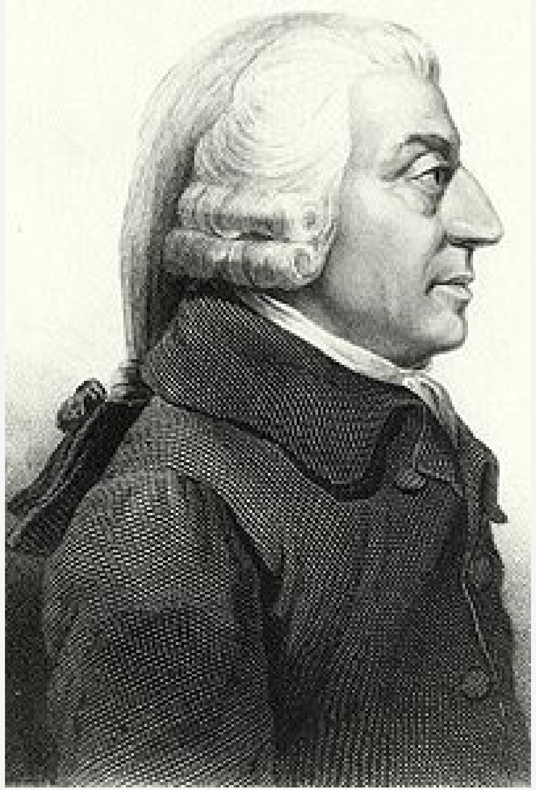
Imperfect Competition

Imperfect Competition

Competitive Markets, Recap

- In a competitive market, we modeled firms as **"price-takers"** since there were so many of them selling identical products
    - Had to charge market price, could choose optimal q^* to maximize π
- **Marginal cost pricing**, which is **allocatively efficient** for *society*
    - $p = MC$
    - $MSB = MSC$
- In the long-run, **free entry and exit** caused prices to equal (average & marginal) costs and pushed economic profits to zero

Market Power



Adam Smith

1723-1790

> "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices," (Book I, Chapter 2.2).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

Market Power vs. Competition

- All sellers *would like to* raise prices and extract more revenue from consumers

- **Competition** from other sellers (and potential **entrants**) drives prices to equal costs & economic profits to zero

- If a firm in a competitive market raised $p > MC(q)$, would lose *all* of its customers!

- **Market power**: ability to raise $p > MC(q)$ (and *not* lose *all* customers)

Modeling Firms with Market Power

- Firms that have market power behave *differently* than firms in a competitive market
  - Today: understanding how to model that different behavior
- Start with simple assumption of a *single* seller: **monopoly**
- Next class:
  - *causes* of market power
  - *consequences* of market power

Modeling Firms with Market Power

- A firm with market power is a **"price-maker"**
  - Can choose quantity q^* *and* price p^*
- We can also call it a **"price-searcher"**
  - Assuming the same objective as before, firms with market power must **search** for (q^*, p^*) that **maximizes** π
- With a monopoly, we can safely ignore the effects that *other* firms have on the firm's behavior (because there are none!)
  - Easiest starting point
  - Later we will have to complicate matters

The Monopolist's Problem

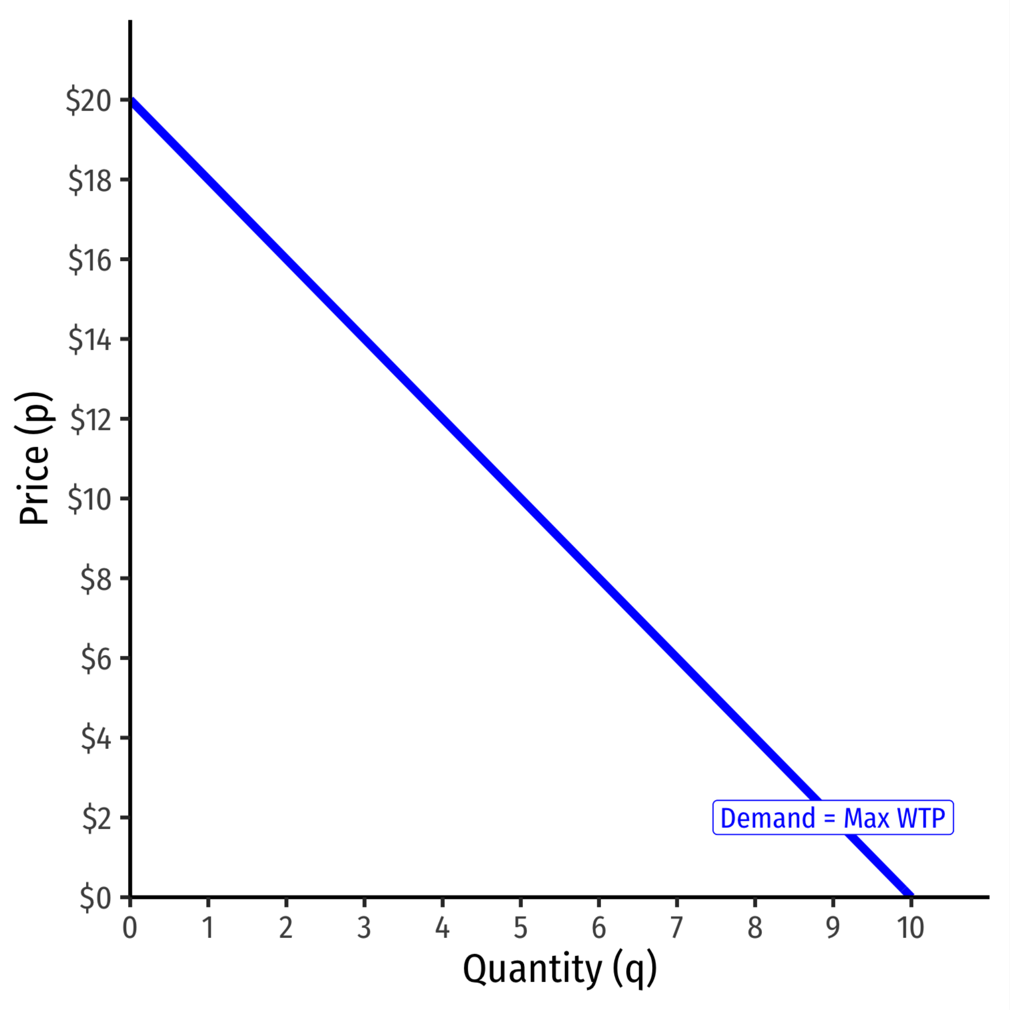
- The ***monopolist's* profit maximization problem**:

1. **Choose:** < output and price: $(q^\star, p^\star)$ >

2. **In order to maximize:** < profits: π >

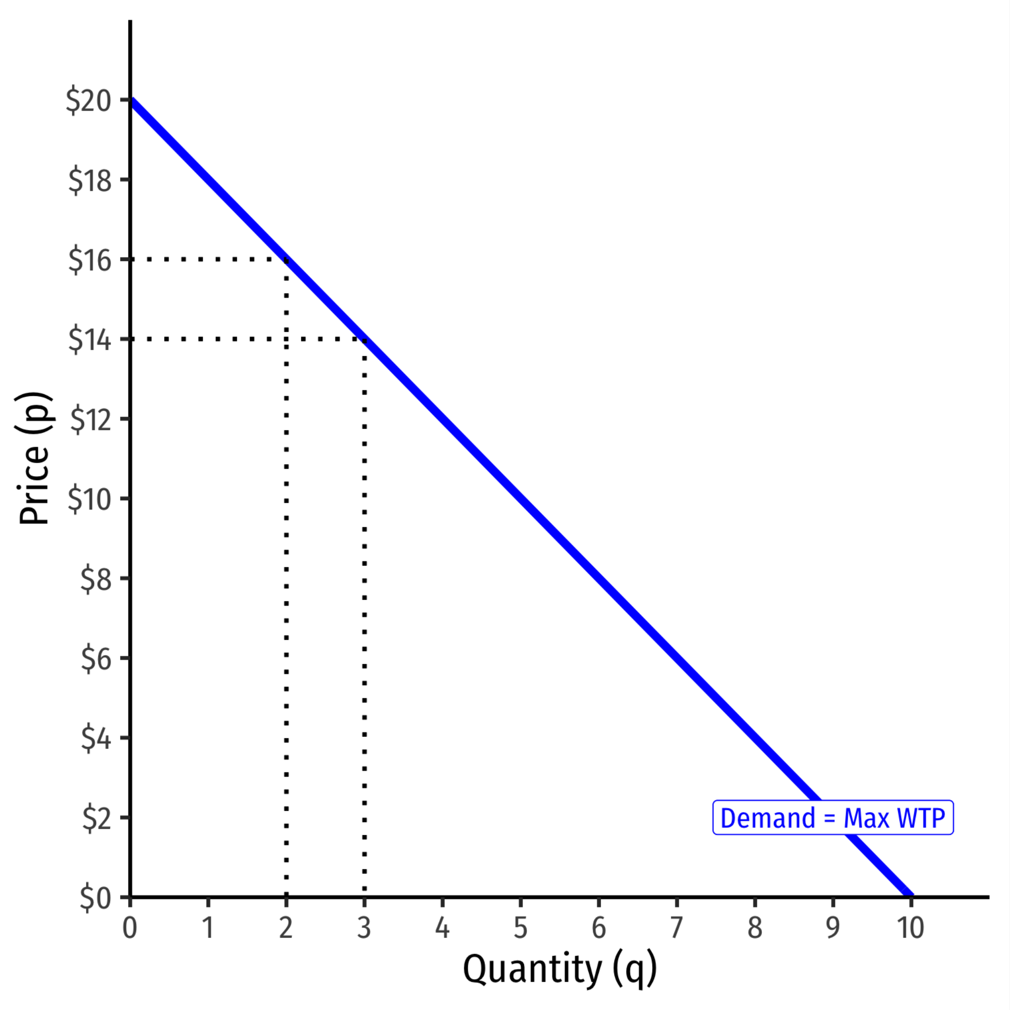
Marginal Revenues

Market Power and Revenues I



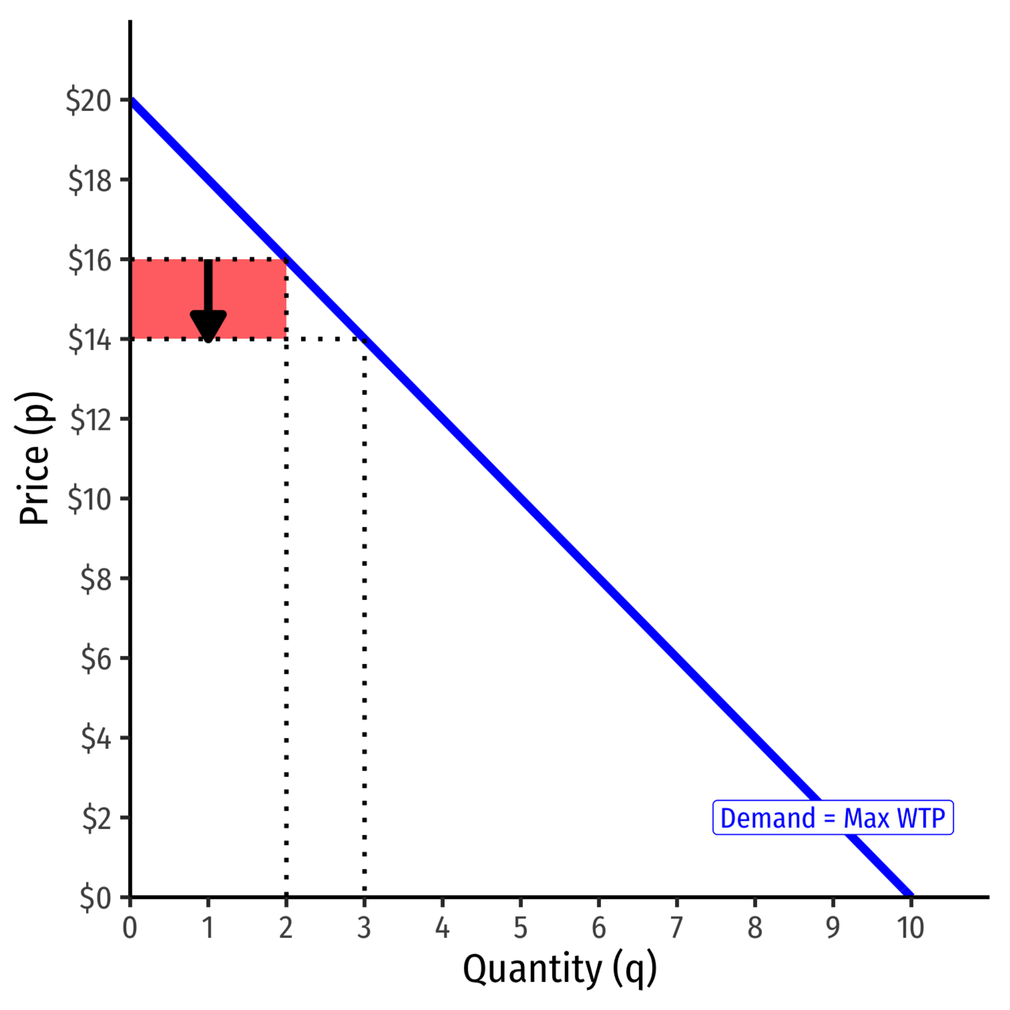
- Firms are constrained by relationship between quantity and price that consumers are willing to pay
- Market (inverse) demand describes maximum price consumers are willing to pay for a given quantity
- Implications:
    - Even a monopoly can't set a price "as high as it wants"
    - Even a monopoly can still earn losses!

Market Power and Revenues II



- As firm chooses to produce more q, must lower the price on *all* units to sell them

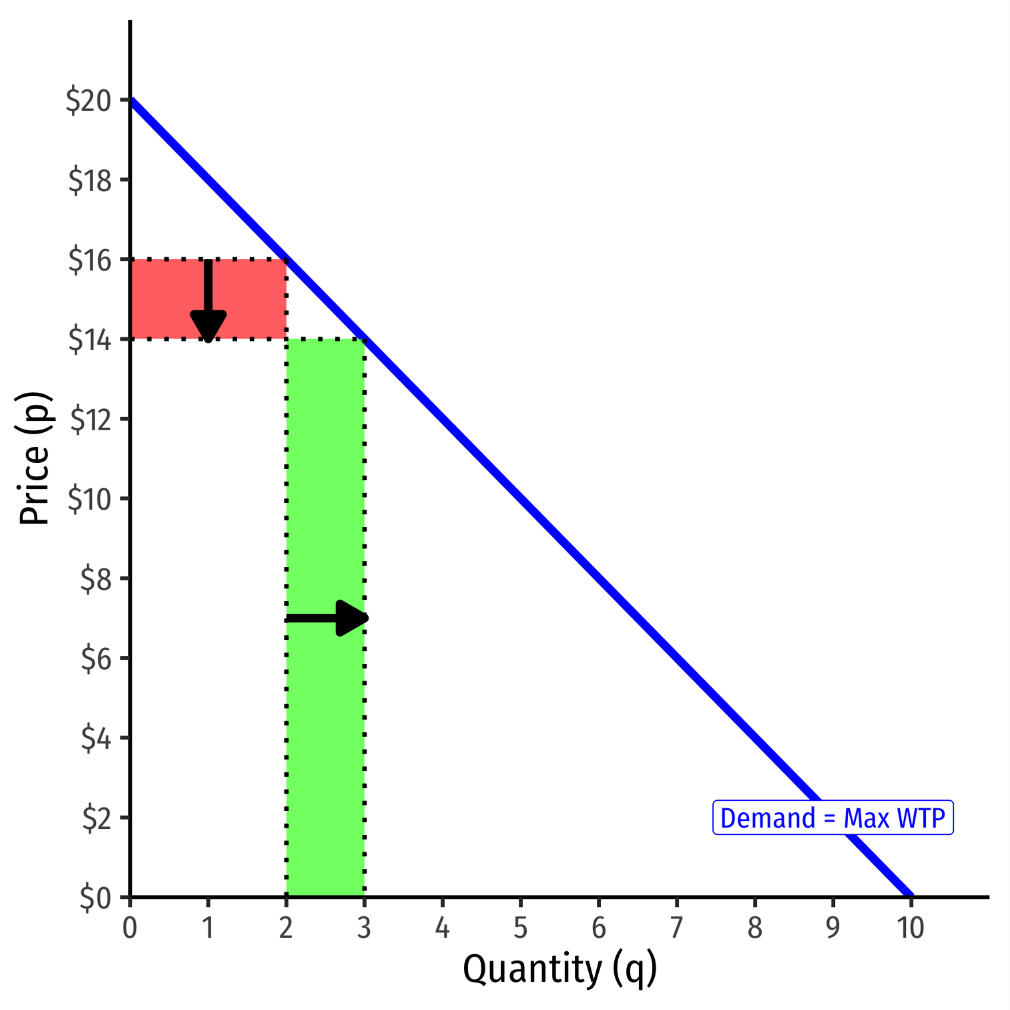
Market Power and Revenues II



- As firm chooses to produce more q, must lower the price on *all* units to sell them

- Price effect: lost revenue from lowering price on all sales

Market Power and Revenues II



- As firm chooses to produce more q, must lower the price on *all* units to sell them
- Price effect: lost revenue from lowering price on all sales
- Output effect: gained revenue from increase in sales

Marginal Revenue I

- If a firm increases output, Δq, revenues would change by:

$$\Delta R(q) = p\Delta q + q\Delta p$$

- Output effect: increases number of units sold (Δq) times price p per unit
- Price effect: lowers price per unit (Δp) on *all* units sold (q)
- Divide both sides by Δq to get **Marginal Revenue,** $MR(q)$:

$$\frac{\Delta R(q)}{\Delta q} = MR(q) = p + \frac{\Delta p}{\Delta q} q$$

- Compare: demand for a **competitive** firm is perfectly elastic: $\frac{\Delta p}{\Delta q} = 0$, so we saw $MR(q) = p$!

Marginal Revenue II

- If we have a linear inverse demand function of the form

$$p = a + bq$$

  - a is the choke price (intercept)
  - b is the slope

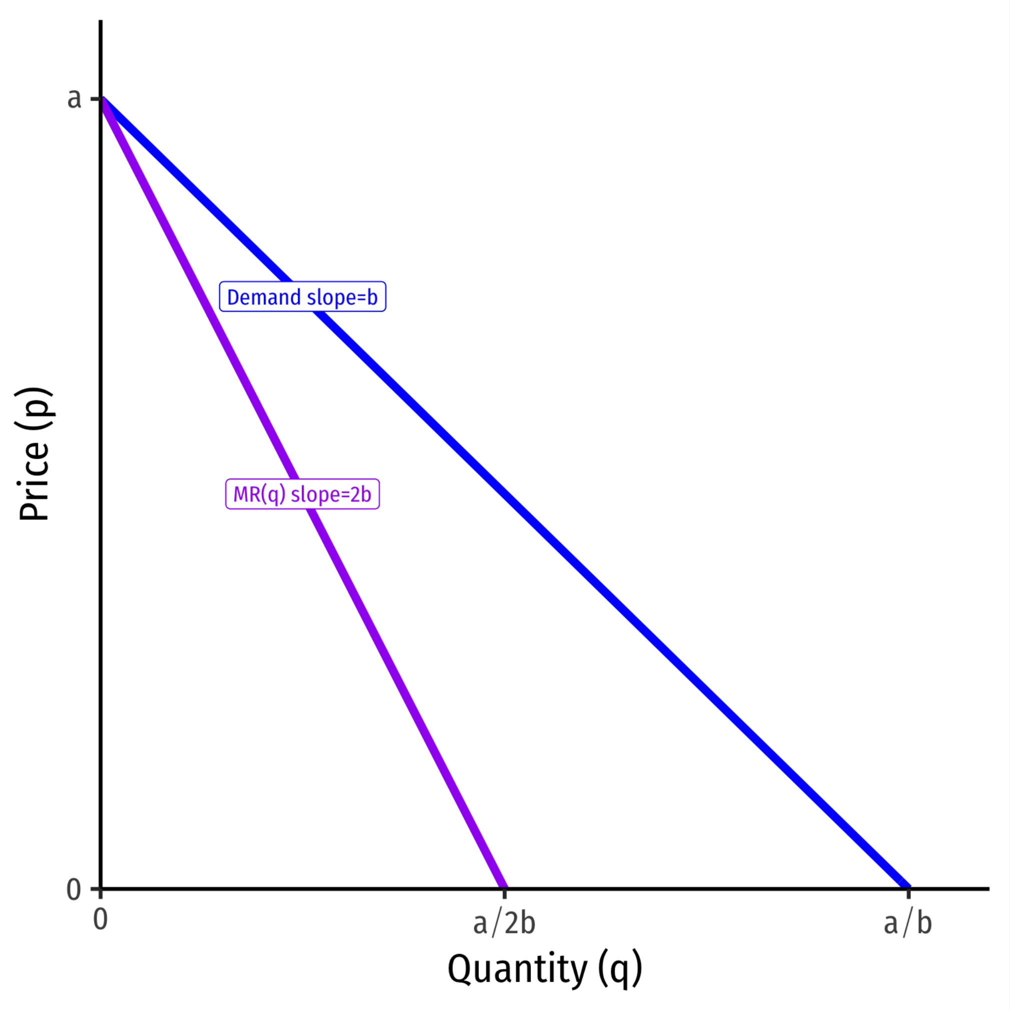
- Marginal revenue again is defined as:

$$MR(q) = p + \frac{\Delta p}{\Delta q} q$$

- Recognize that $\frac{\Delta p}{\Delta q} = \left(\frac{rise}{run}\right)$ is the slope, b,

$$\begin{aligned} MR(q) &= p + (b)q \\ MR(q) &= (a + bq) + bq \\ \mathbf{MR(q)} &= \mathbf{a + 2bq} \end{aligned}$$

Marginal Revenue III



$$p(q) = a + bq$$
$$MR(q) = a + 2bq$$

- Marginal revenue starts at same intercept as Demand (a) with twice the slope $(2b)$
- Don't forget the slopes (b) are always negative!

Marginal Revenue: Example

Example: Suppose the market demand is given by:

$$q = 12.5 - 0.25p$$

1. Find the function for a monopolist's marginal revenue curve.

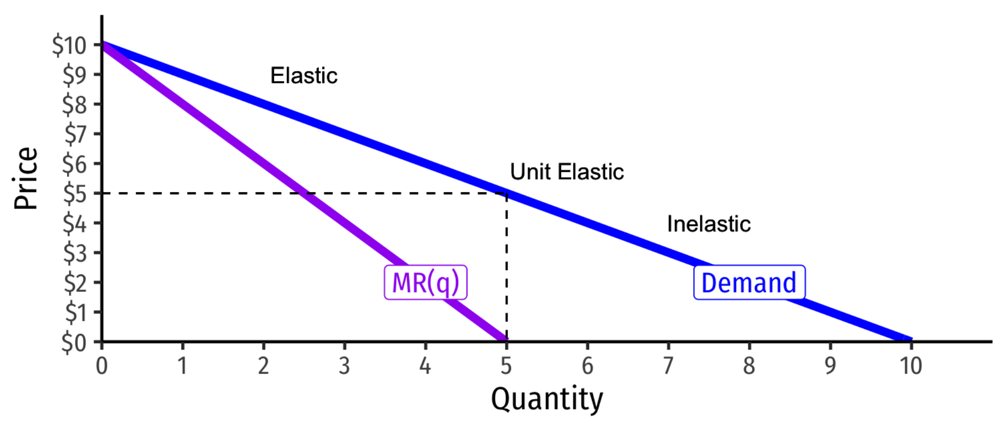
2. Calculate the monopolist's marginal revenue if the firm produces 6 units, and 7 units.

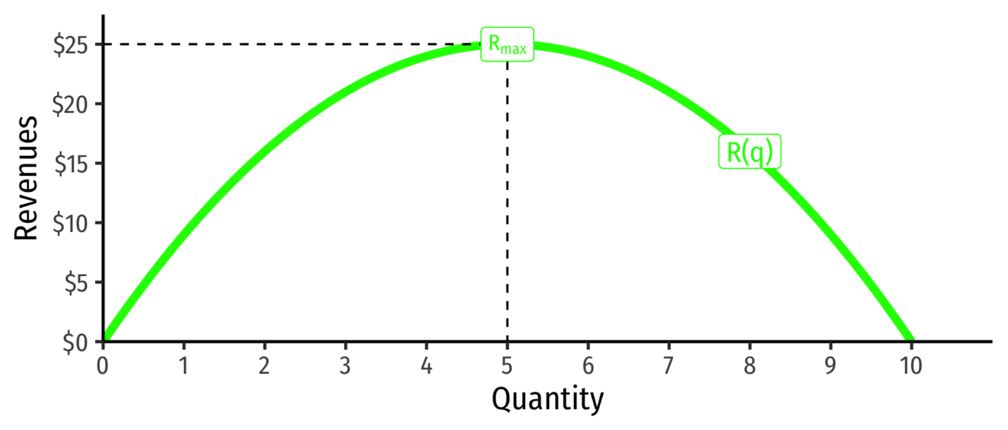
Price Elasticity & Price Mark Up

Revenues and Price Elasticity of Demand

Demand Price Elasticity	MR(q)	R(q)
$\lvert\epsilon\rvert > 1$ Elastic	Positive	Increasing
$\lvert\epsilon\rvert = 1$ Unit	0	Maximized
$\lvert\epsilon\rvert < 1$ Inelastic	Negative	Decreasing

- Strong relationship between **price elasticity of demand** and revenues
- **Monopolists *only* produce where demand is elastic, with positive MR(q)!**
    - See appendix in today's class page for a proof





Market Power and Mark Up

- Perfect competition: $p = MC(q)$ (**allocatively efficient**)
- **Market power** defined as firm(s)' ability to raise **mark up** $p > MC(q)$
  - Even a monopolist is constrained by market demand
- **Size of markup depends on price elasticity of demand**
  - $\downarrow$ price elasticity: $\uparrow$ markup

> i.e. the *less* responsive to prices consumers are, the *higher* the price the firm can charge

The Lerner Index and Inverse Elasticity Rule I

- **Lerner Index** measures market power as % of firm's price that is **markup** above $MC(q)$

$$L = \frac{p - MC(q)}{p} = -\frac{1}{\epsilon}$$

- i.e. $L \times 100\%$ of firm's price is markup

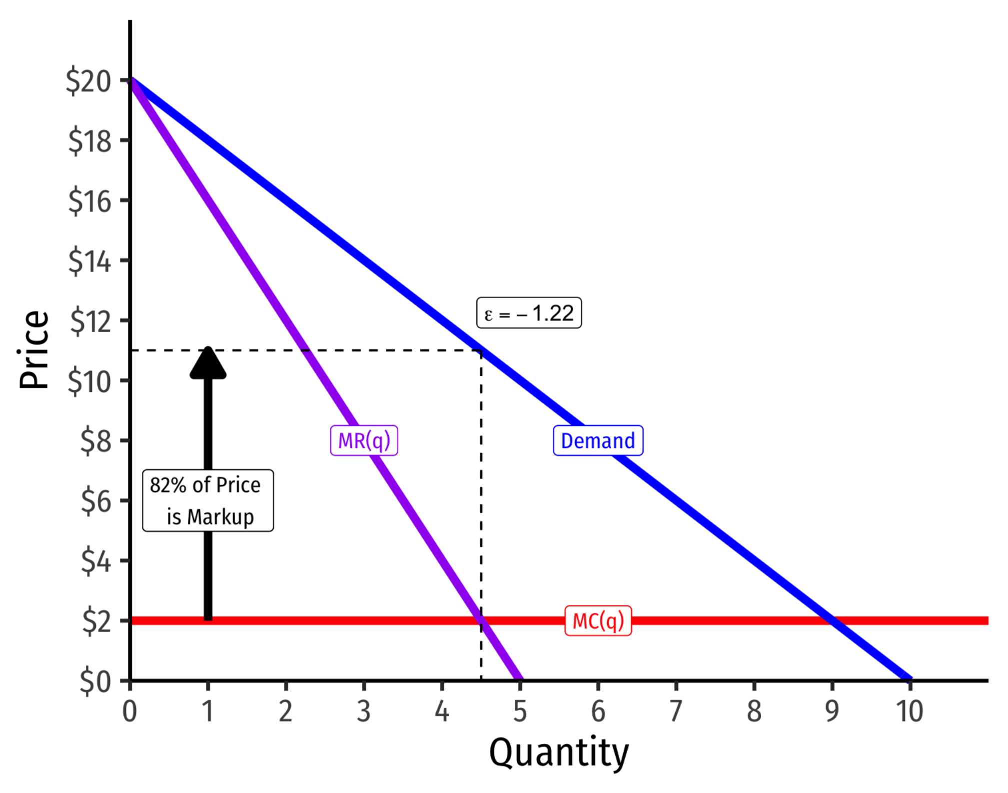
- $L = 0 \implies$ perfect competition
  - 0% of price is markup, since $P = MC(q)$
- As $L \to 1 \implies$ more market power
  - 100% of price is markup

See today's class notes for the derivation.

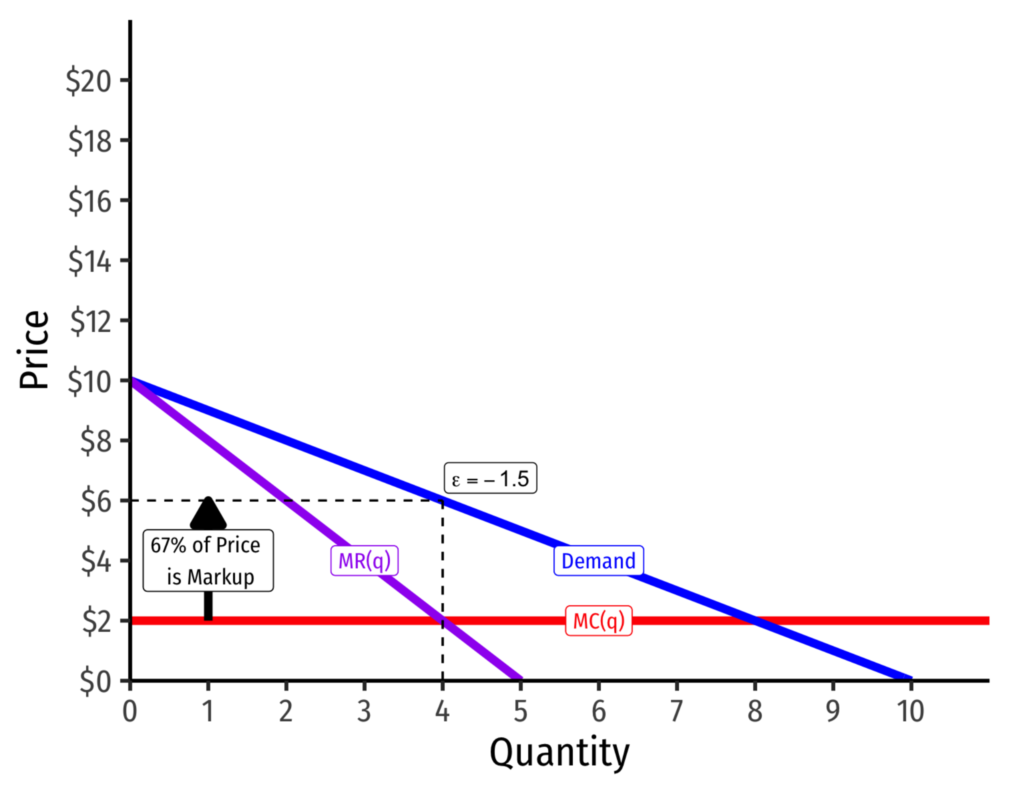
The Lerner Index and Inverse Elasticity Rule II

The more (less) elastic a good, the less (more) the optimal markup: $L = \frac{p - MC(q)}{p} = -\frac{1}{\epsilon}$

Demand *Less* Elastic at p^*



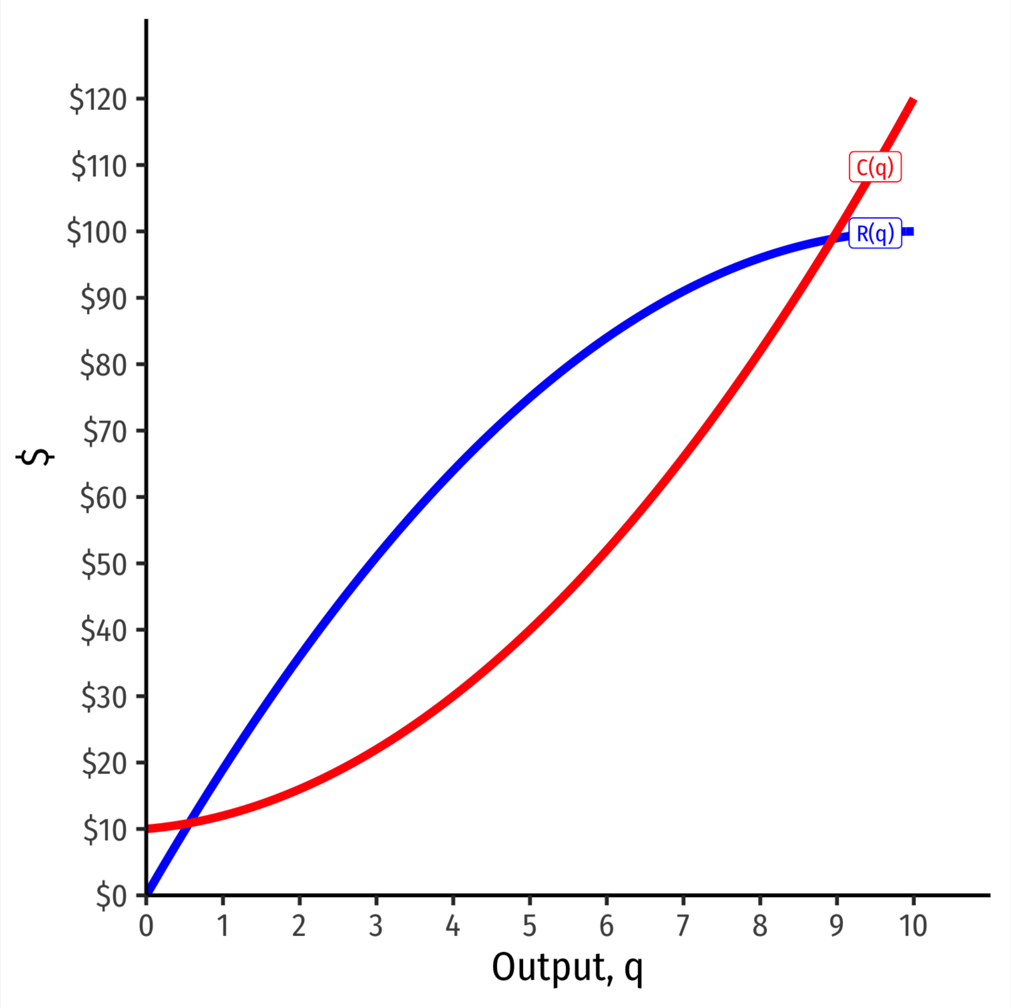
Demand *More* Elastic at p^*



Profit Maximization Rules, Redux

Visualizing Total Profit As R(q)-C(q)

- $\pi(q) = R(q) - C(q)$



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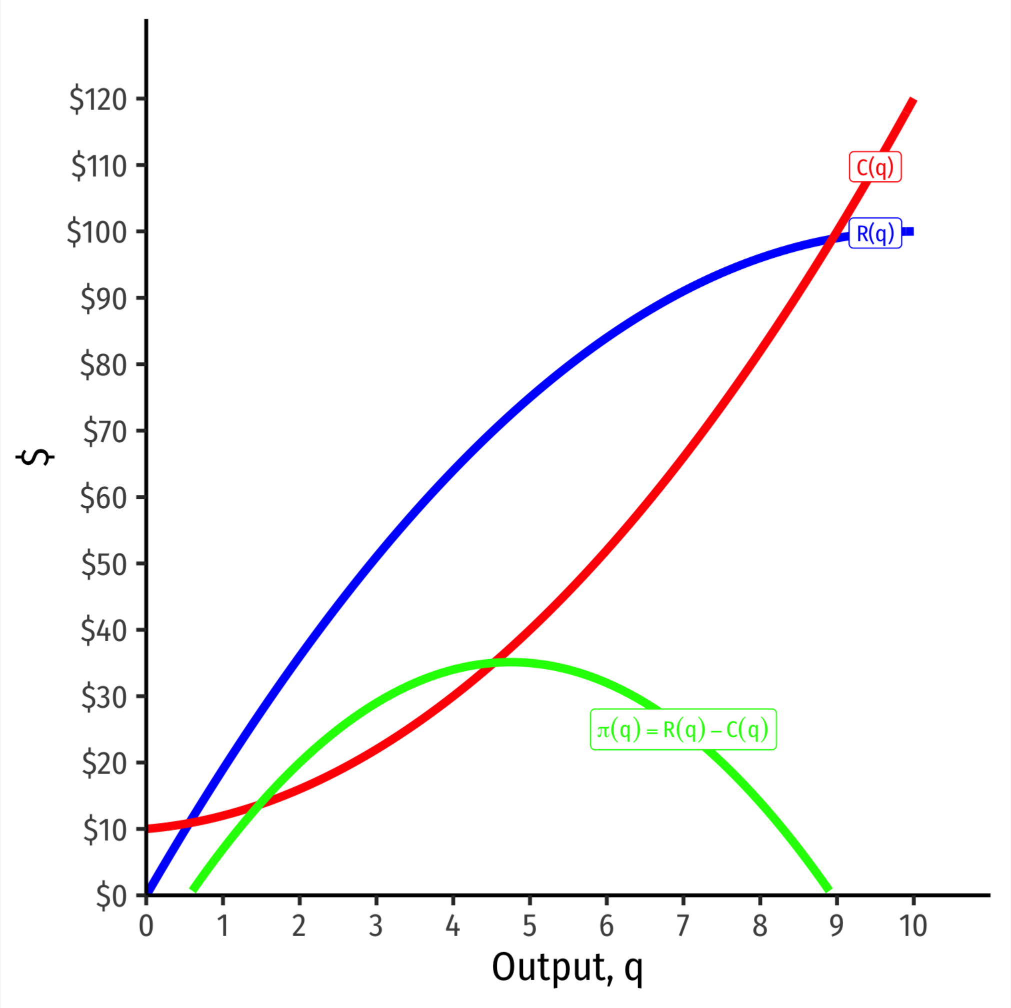
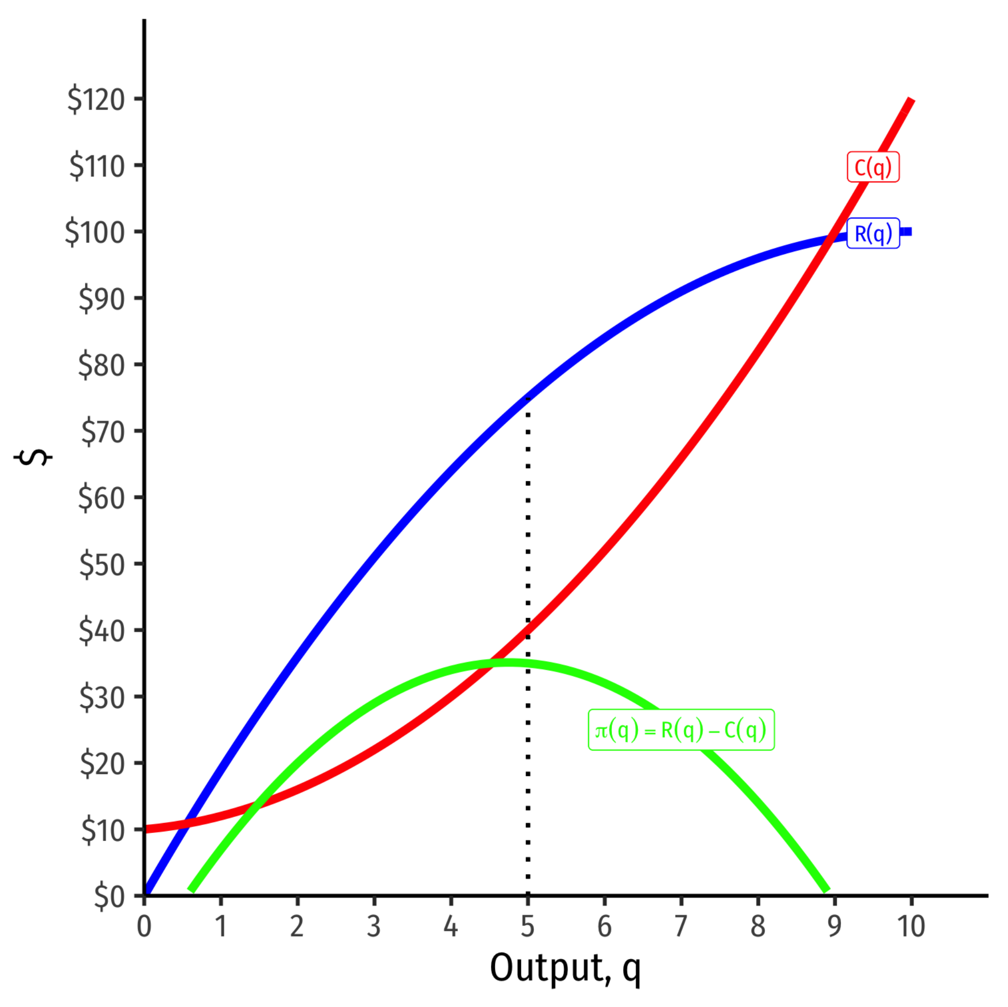


Visualizing Total Profit As R(q)-C(q)

- $\pi(q) = R(q) - C(q)$
- Graph: find q^* to max $\pi \implies q^*$ where max distance between $R(q)$ and $C(q)$



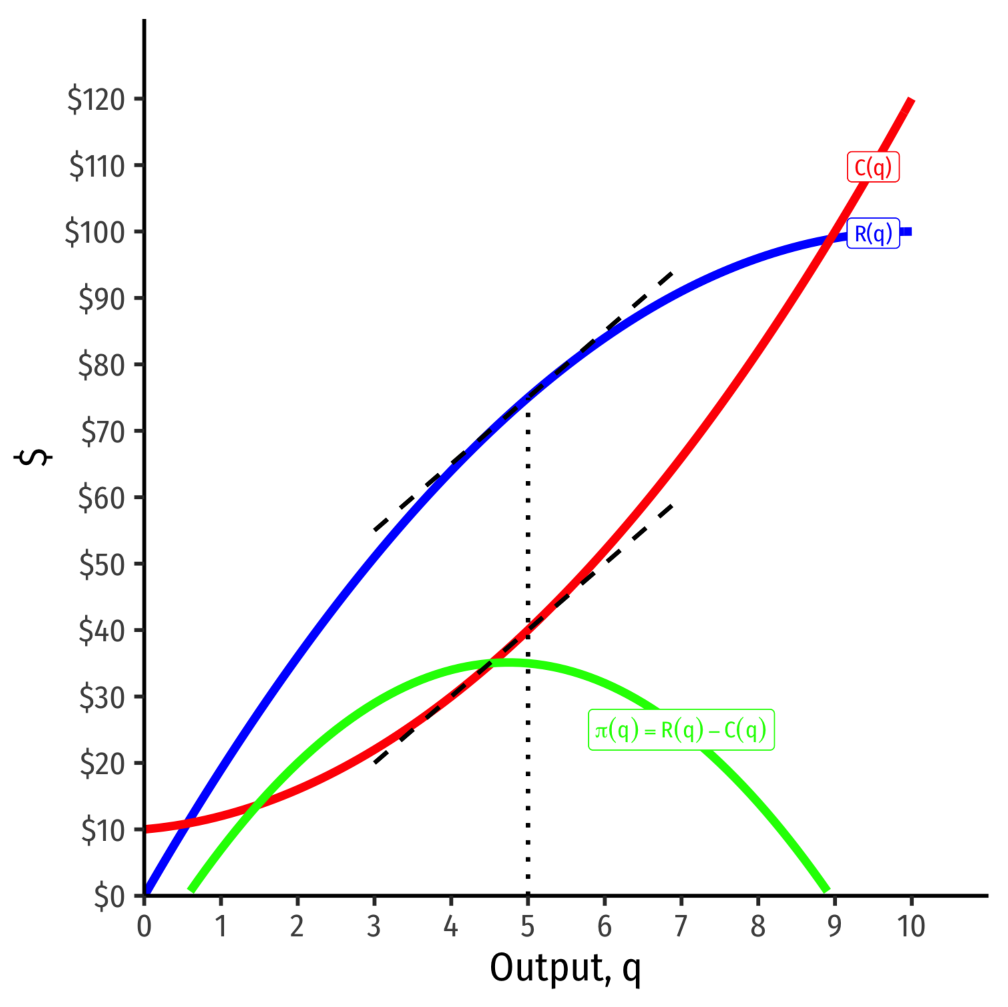
Visualizing Total Profit As R(q)-C(q)

- $\pi(q) = R(q) - C(q)$

- Graph: find q^* to max $\pi \implies q^*$ where max distance between $R(q)$ and $C(q)$

- Slopes must be equal:

$$MR(q) = MC(q)$$

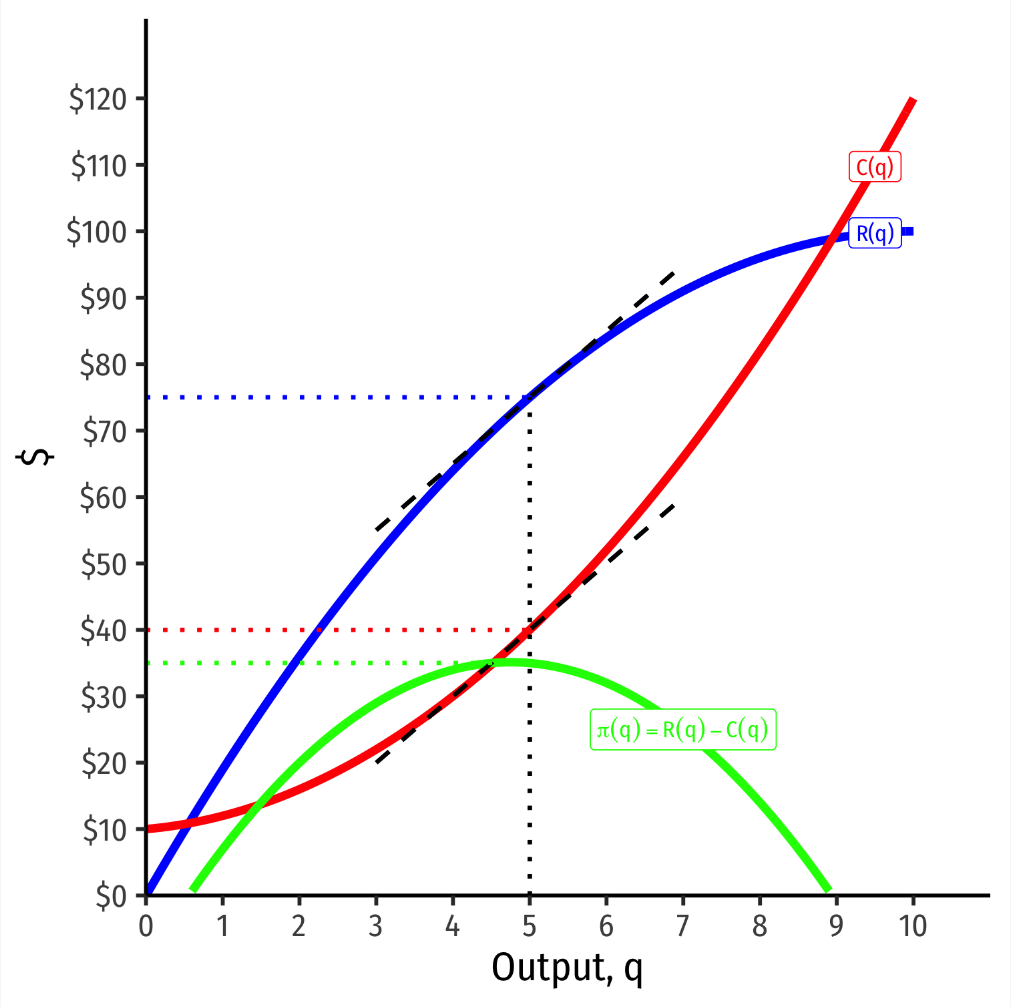


Visualizing Total Profit As R(q)-C(q)

- $\pi(q) = R(q) - C(q)$
- Graph: find q^* to max $\pi \implies q^*$ where max distance between $R(q)$ and $C(q)$
- Slopes must be equal:

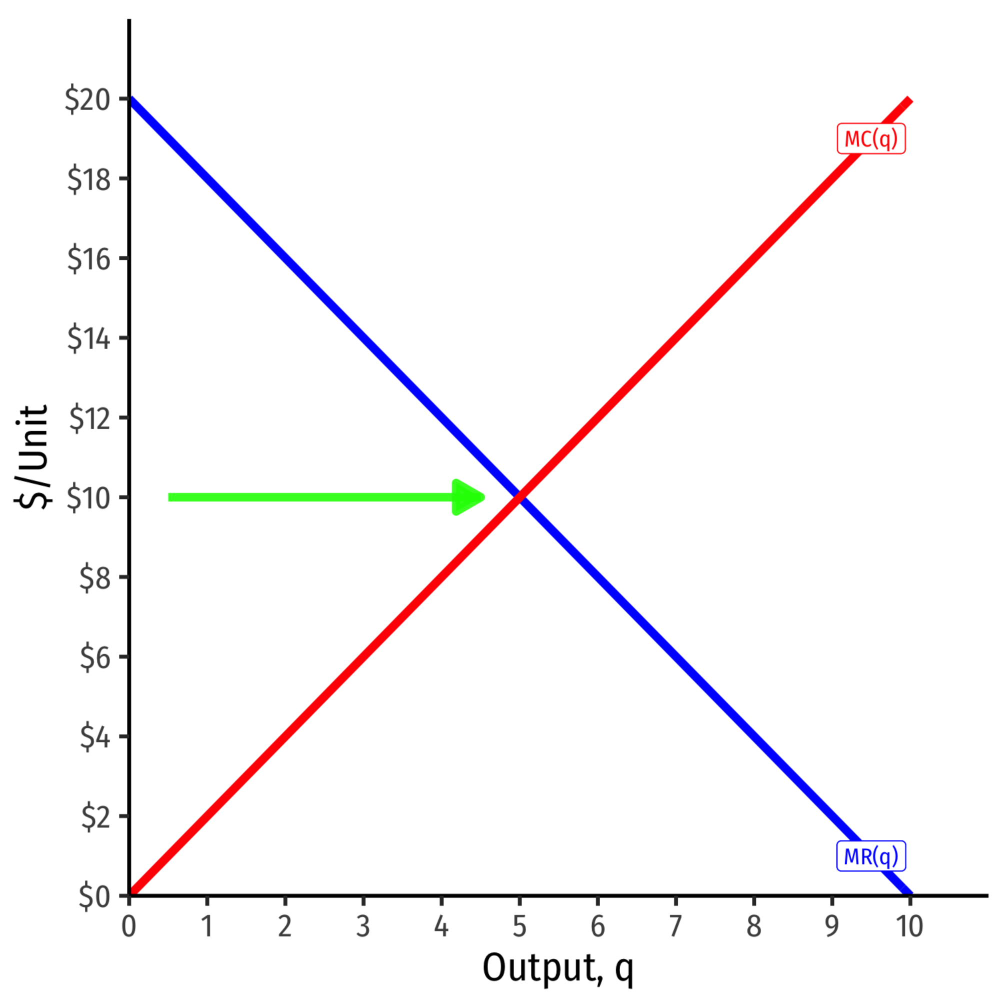
$$MR(q) = MC(q)$$

- At $q^* = 5$:
  - $R(q) = 75$
  - $C(q) = 40$
  - $\pi(q) = 35$



Visualizing Marginal Profit As MR(q)-MC(q)

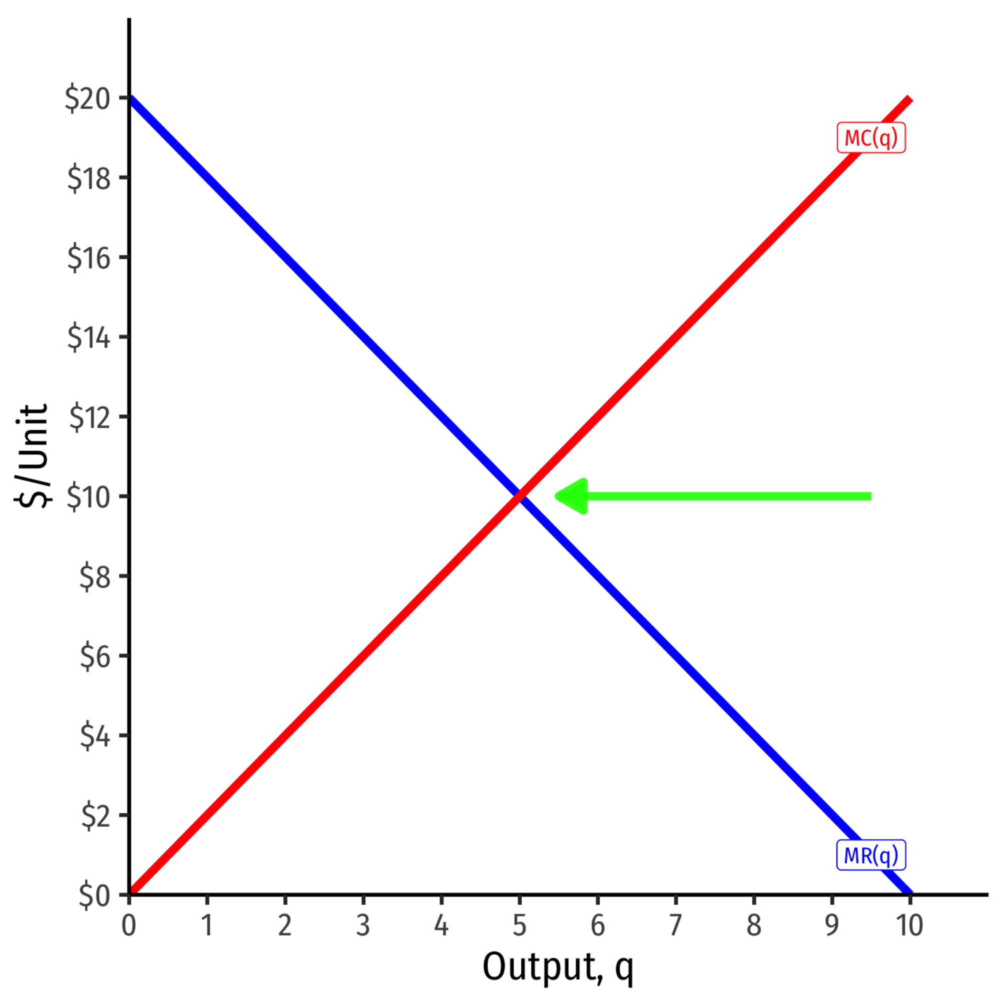
- At low output $q < q^*$, can increase π by producing *more*
- $MR(q) > MC(q)$



Visualizing Marginal Profit As MR(q)-MC(q)

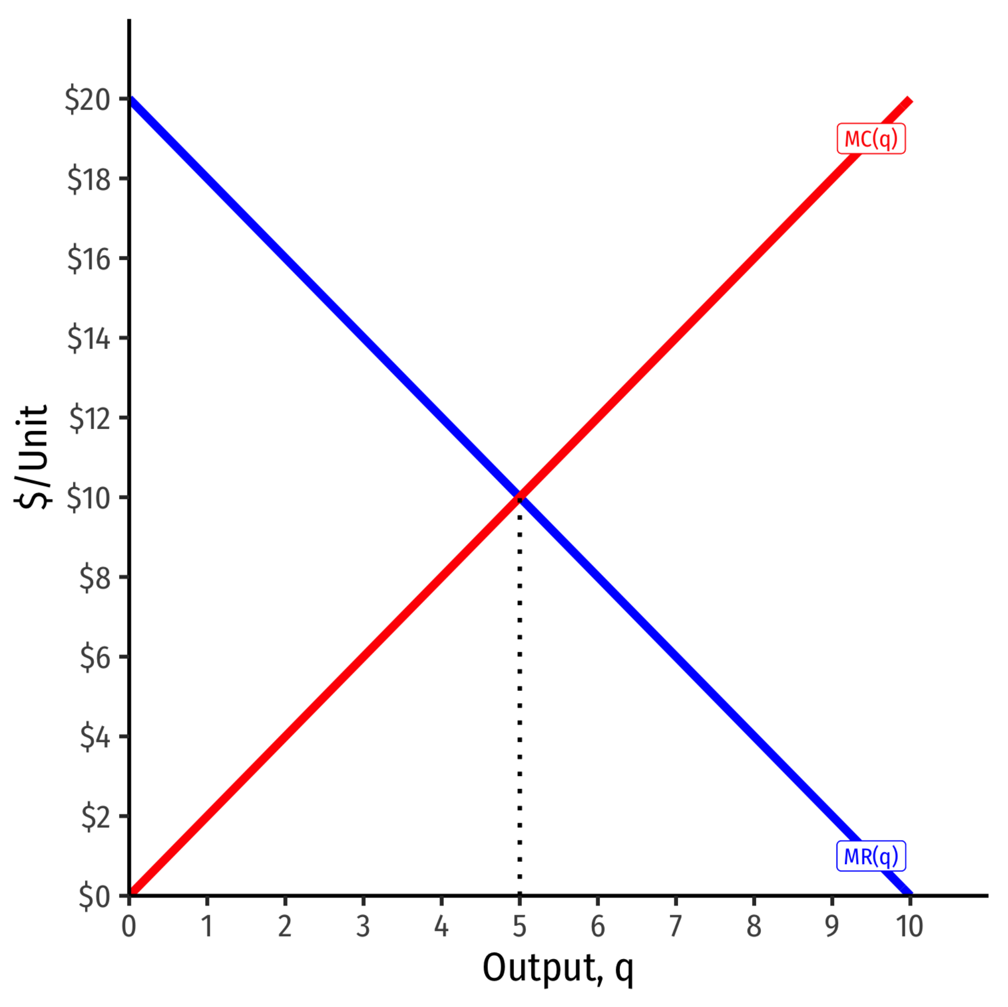
- At high output $q > q^*$, can increase π by producing *less*

- $MR(q) < MC(q)$

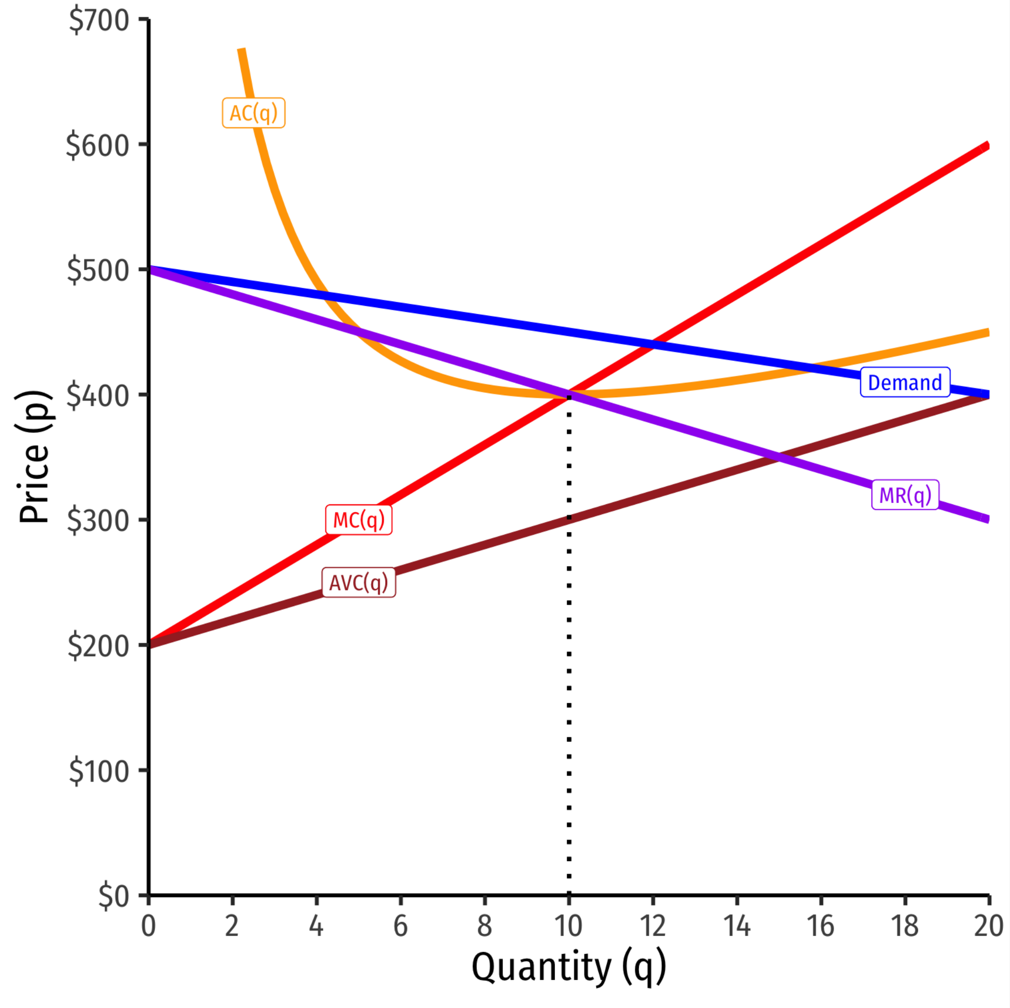


Visualizing Marginal Profit As MR(q)-MC(q)

- π is *maximized* where $MR(q) = MC(q)$

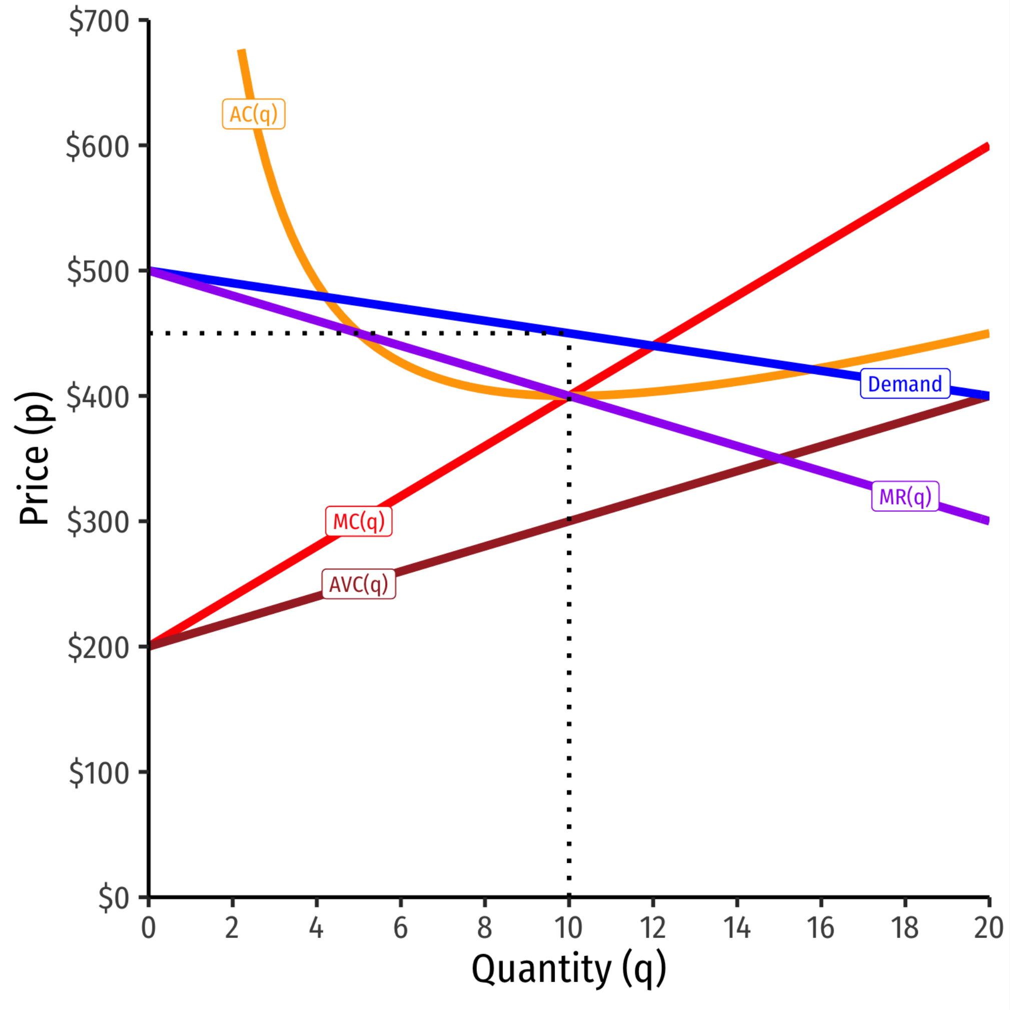


Profit-Maximizing Price and Quantity (Graph)



- Profit-maximizing quantity is always q^* where $MR(q) = MC(q)$

Profit-Maximizing Price and Quantity (Graph)

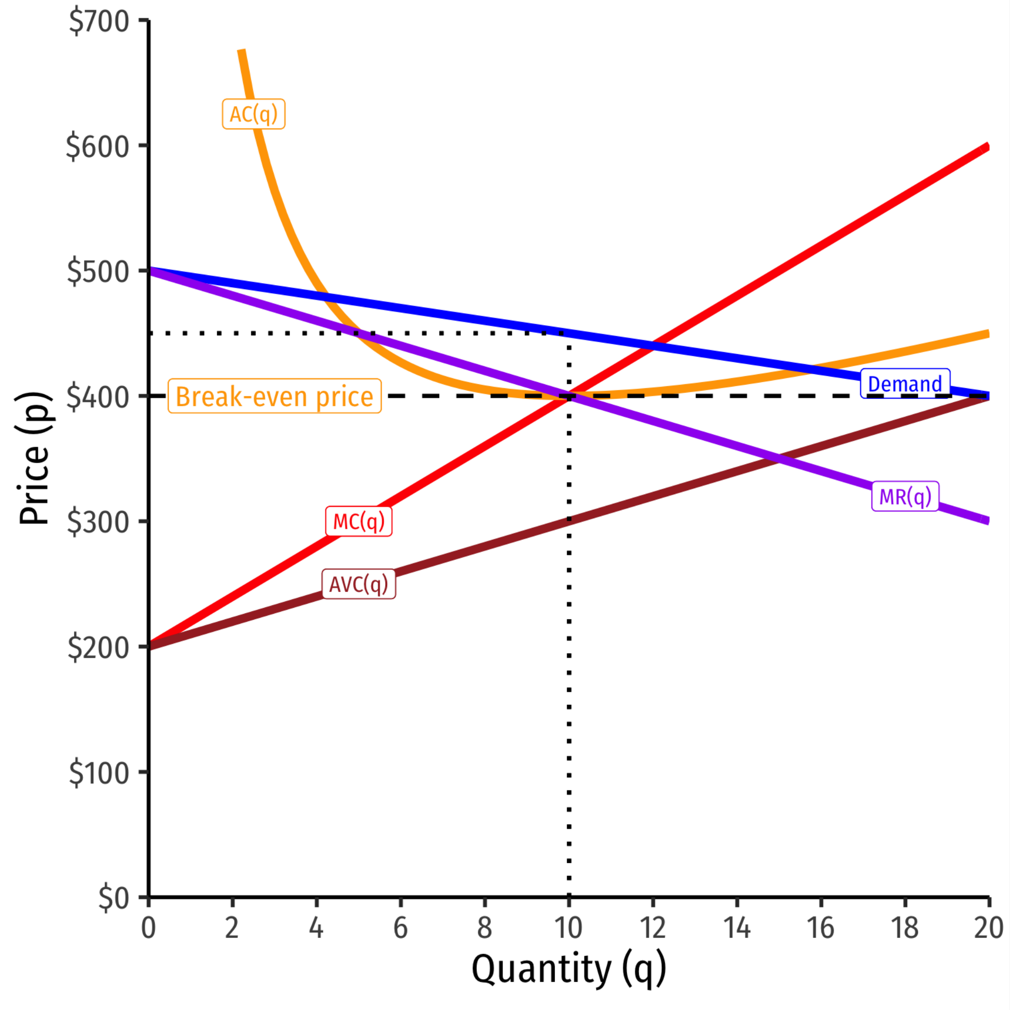


- Profit-maximizing quantity is always q^* where $MR(q) = MC(q)$

- But monopolist faces *entire* market demand

  - Can charge as high as consumers are WTP Market Demand

Profit-Maximizing Price and Quantity (Graph)



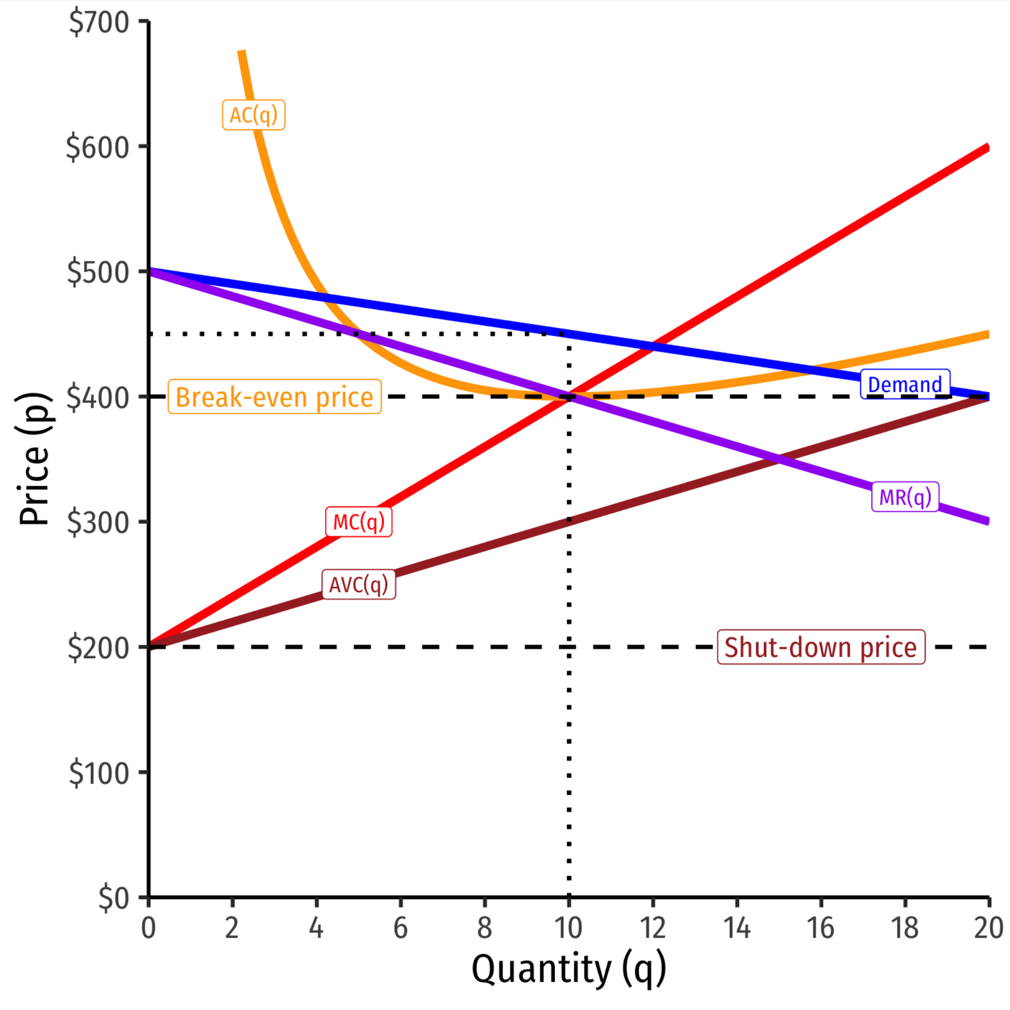
- Profit-maximizing quantity is always q^* where $MR(q) = MC(q)$

- But monopolist faces *entire* market demand

  - Can charge as high as consumers are WTP Market Demand

- Break even price $p = AC(q)_{min}$

Profit-Maximizing Price and Quantity (Graph)



- Profit-maximizing quantity is always q^* where $MR(q) = MC(q)$
- But monopolist faces *entire* market demand
  - Can charge as high as consumers are WTP Market Demand
- Break even price $p = AC(q)_{min}$
- Shut-down price $p = AVC(q)_{min}$

Monopolist's Supply Decisions

1. Produce the optimal amount of output q^* where $MR(q) = MC(q)$

2. **Raise price to maximum consumers are WTP:** $p^* = Demand(q^*)$

3. Calculate profit with average cost: $\pi = [p - AC(q)]q$

4. Shut down in the *short run* if $p < AVC(q)$

   - Minimum of AVC curve where $MC(q) = AVC(q)$

5. Exit in the *long run* if $p < AC(q)$

   - Minimum of AC curve where $MC(q) = AC(q)$

The Profit Maximizing Quantity & Price: Example

Example: Consider the market for iPhones. Suppose Apple's costs are:

$$C(q) = 2.5q^2 + 25,000$$
$$MC(q) = 5q$$

The demand for iPhones is given by (quantity is in millions of iPhones):

$$q = 300 - 0.2p$$

1. Find Apple's profit-maximizing quantity and price.
2. How much total profit does Apple earn?
3. How much of Apple's price is markup over (marginal) cost?
4. What is the price elasticity of demand at Apple's profit-maximizing output?