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An Analysis of the Four Market Structures' Varying Pricing Strategies

Objective: Client requested a SNYPUR Informational Report detailing an in-depth analysis of the four market structures of microeconomic theory, the relating pricing strategies that are suitable for each of these structures, and a real world example of each market structure.



Abstract: There are four producer market structures within microeconomic theory that each entail a different pricing strategy based on the level of differentiation in goods, information, and market power between buyers and sellers in the market. These four market structures are: monopoly, oligopoly, monopolistic competition, and perfect competition. In a monopoly, one firm controls the entire market and has the power to control its prices. Similar to a monopoly, an oligopoly has a small number of sellers that have each have much (not complete) market power and, as a result, can dictate their prices. In monopolistic competition, there are several firms in the market that can control their own prices but do not realize long-run economic profit. Perfect competition is the only perfect market where sellers have no market power and cannot control their prices due to the perfectly elastic demand curve of the market.



Monopoly

Description

In a monopoly, one firm produces a completely unique good that has no substitutes. As a result of their exclusive good or service, this single firm has complete or total market power. There is an insurmountably steep barrier of entry into a monopolistic market. Monopolies make a considerable profit in the short run and realize an economic profit in the long-run due to the lack of competitors. Although other producers are enticed by the clear profits that the monopolistic firm is making in the short-run, they are incapable of entering the market due to their inability to replicate or substitute the uniqueness of the good that the monopolistic firm produces. Monopolies are considered imperfect markets due to the high barrier of entry and because they do not produce at the socially optimal level of output which causes a deadweight loss.

Pricing Strategies for Monopolies

Monopolies are able to realize profit in the short-run because they operate at the point where their marginal revenue equals marginal cost. This is the golden rule of profit maximization. Operating at the intersection between marginal cost and marginal revenue allows monopolies to receive a profit that is the equal to the difference between the average total cost of the good and the demand curve above the intersection. Monopolies' pricing strategies are considered allocatively inefficient because of the deadweight loss created by the preclusion of transactions by operating at the intersection of marginal revenue and marginal cost.

Since no firms are able to join the market in the long-term, the monopoly is able to continue its short-term profit gains into the future which allows them to realize long-term economic profit. Due to the market power that monopolies have, they are considered price makers. This means that they have the ability to control and change the price of their goods. In the event of a price change, monopolies must adjust the



quantity produced since they face a more inelastic demand curve (especially in comparison to perfect competition markets).

Oligopoly

Description

Oligopolies are a markets where a small number of producers have much market power. The firms' products can be either identical or differentiated. An oligopolistic market has very high barriers of entry due to the fact its too costly for new sellers to enter and/or because it is practically impossible to replicate the good or service that the few sellers produce.

Pricing Strategies for Oligopolies

Oligopolies have a relatively more complex pricing strategy than its counterparts. In an oligopoly, the prices that the firms choose are all interdependent on the decisions of the other sellers. The markets are very dynamic and information becomes very useful in determining the firms' respective pricing (Shubik 1975). Depending on what another seller sets its prices to, the other firms may then decide to lower or raise its prices in order to lure more consumers to their products. This is interdependency on information can lead to cooperation or collusion between firms in order to maximize their profits. Oligopolies are able to have higher prices than the competitive markets but cheaper prices than a monopoly. Oligopolies are able to realize long-term profit due to the high barriers of entry preventing new sellers from entering the market which allows them to perpetuate their short-run profits.

Monopolistic Competition

Description

Monopolistic competition describes a market where there are many firms that produce different, yet substitutable products. Relative to oligopoly and monopoly, monopolistic



competition has a much lower barrier of entry due to the substitutability of the goods produced by the sellers in the market. Firms are able to realize a short-term profit in monopolistic competition. However, they realize zero economic profit in the long-run. These firms have a small amount of market power because they are capable of controlling their prices (Copeland 1940).

Pricing Strategies for Monopolistic Competition

This market faces a downward sloping demand curve which allows the firms to choose their prices. Like the monopoly, sellers in monopolistic competition operate at the point where marginal revenue equals marginal cost. This allows firms to realize a short-run profit. However, due to the low barrier of entry for new sellers that will (infinitely) flood the market in the long-run due to the perceived opportunity for short-run profit, sellers realize zero economic profit in the long-run.

An increase in the amount of sellers in the long-run will flood the market with more substitute goods which necessitates perpetual differentiation of a seller's goods, thus leading to a higher average total cost in the long-run. Additionally, with an infinite amount of sellers that can flood the market in the long-run, each firm's demand curve will shrink (or shift left) in the long-run. Higher total costs coupled with lower demand for a seller's ordinary product leads to firms realizing zero economic profit in the long-run.

Perfect Competition

Description

In a perfectly competitive market, goods are completely identical which means they are all perfect substitutes. There are many firms that produce the same good in the market. Due to the high substitutability of the goods, there are very low barriers of entry. Perfectly competitive markets are considered allocatively efficient because the



model has no deadweight loss. Additionally, the market is considered to be perfect because of the complete information between buyers and sellers and the little to no barriers of entry (Dasgupta 1981).

Pricing Strategies for Perfect Competition

Firms do not choose their own prices due to the abundance of goods sold by the myriad of sellers in the market. Demand is perfectly elastic in perfect competition. Ergo, firms will take whatever price consumers are willing to pay. If producers decide to increase prices beyond what consumers are willing to pay, then consumers will simply go to one of the cheaper sellers in the market. In perfect competition, demand is equal to the marginal revenue of the firm. Firms set their prices at the point where marginal cost intersects with the demand/marginal revenue.

Case Study

Monopoly

Luxottica, the world's largest manufacturer and supplier of eyewear, owns the most sought after brands in the eyewear industry. Luxottica designs and produces eyewear for Ray-Ban, Oakley, , Vogue Eyewear, Giorgio Armani, Burberry, Bulgari, Chanel, Dolce&Gabbana, DKNY, Ferrari, Michael Kors, Miu Miu, Paul Smith, Prada, Ralph Lauren, Starck Eyes, Tiffany & Co., Tory Burch, Valentino, Versace, and more. The eyewear conglomerate vertically integrated to control its manufacturing, distribution, and design in order to minimize its external costs (Luxottica 2019). By insourcing the core aspects of its business, Luxottica gradually gained more market power by surpassing its competitors in net income year over year.

Over time, Luxottica either bought out its competitors from its rapidly increasing market share or ran them out of business due to the high demand of their products. Today, Luxottica has over 80% of the market share in the international eyeglass



market. Luxottica is one of the best examples of a monopoly. It is more likely than not that any pair of eyeglasses someone owns was either manufactured by Luxottica or purchased by one of their retailers. Luxottica has set the barrier of entry into the market extremely high and made it practically impossible for another company to economically establish themselves as a competitor in the long-run.

Oligopoly

OPEC, the Organization of Petroleum Exporting Countries, is the quintessential example of an oligopoly. The group consists of 14 countries including, Algeria, Angola, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Republic of the Congo, Saudi Arabia, United Arab Emirates, Venezuela. OPEC controls around 55% of the world's crude oil trade in the market and controls just over 80% of the world's crude oil reserves (OPEC 2019). Given the countries' prominence in the oil market, they have a formidable amount of bargaining power over the oil market and the wellbeing of the international oil and energy markets.

OPEC operates as a cartel, which is a group of producers that collude to price-fix, or keep prices as high as possible. The countries within OPEC cooperate internally on what their designated oil production and subsequent prices. OPEC's supreme influence in the international oil markets was showcased during the two oil crises of the 1970s. In 1973, OPEC declared an oil embargo against the countries that were supporting Israel in the Arab-Israeli War of 1973.

The price of a barrel of oil shot up by 300%. This caused a decline in production in the United States, along with revealing the energy insecurity that the country had at the time. The embargo exacerbated the effects of the stock market crash from earlier in 1973. Then in 1979, in the wake of the Iranian Revolution, OPEC's output was severely cutback due to Iran's internal instability. This caused the price of oil to skyrocket like it did earlier in 1973, except this time it was due to limited production caused by uncontrolled circumstances, not punitive measures. The barrier of entry into the oil



market is very high considering that a country cannot control its access to oil reserves nor can it do much to establish themselves as a prominent exporter against OPEC.

Monopolistic Competition

The clothing industry showcases monopolistic competition well. There are a myriad of companies within the industry. The sellers range in size from a local, family-owned t-shirt printing business to chic fashion houses to the athletic apparel behemoths like Nike and Adidas. Within the clothing industry, there is much differentiation between the goods and products sold. However, the rigidity of the monopolistic competition model that suggests that firms do not realize long-run economic profit is untrue for sellers in the clothing industry. It is abundantly clear that mega producers and industry leaders like Nike or Ralph Lauren realize economic profit in the long-run (Mcfarlane 2018).

The barriers of entry into the clothing market are very low if not nonexistent. Anyone can produce their own clothing with very little upfront capital. Most clothing items are differentiated (for the most part) and articles of clothing each have the same utility (positively not normatively) so the substitutability is infinite. Larger corporations like Reebok or Vans have market power. They are considered industry leaders and have the ability to change and control their prices, within reason. However, these larger clothing sellers do not have enough market power to retain all of their customers if they decided to drastically raise their prices. There are a myriad of producers that provide decent substitutes for their goods.

Perfect Competition

The market for fruits and vegetables are the perennial example of perfect competition. It is practically impossible for buyers to discern between the different goods in the market. Goods are completely identical; there is no differentiation. A consumer is unable to tell which seller produced a batch of kiwis compared to another batch



purchased across town. In essence, buyers are indifferent (assuming quality is consistent or unchanged) in the fruits and vegetables market. As a result, sellers are forced to take whatever price consumers are willing to pay. Assuming all sellers are rational economic agents, producers are incapable of controlling their prices. If the price of eggplants goes up at a convenient store as a result of one producer wanting to cut back their production, buyers will simply buy their eggplants elsewhere.

Conclusion

In closing, there are four key market structures that each have their own pricing strategy. The structures lie on a spectrum that vary in market power which directly affects their ability to control their prices and their profit. For monopolies and oligopolies, long-run economic profit is realized and there is considerable market power, thus, they can effectively control their prices. In monopoly and oligopoly, there is very little substitutability which allows firms to maintain their market power.

In monopolistic competition, like the clothing industry, companies have little market power which enables them to control their prices, slightly. However, sellers in monopolistic competition do not realize long-run profit due to the high substitutability of their products. Lastly, perfect competition is the only perfect market where sellers cannot control their prices and there is no market power for any producers. Sellers do not realize any economic profit in the long-run.



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