

## Price-Searcher Markets with Low Entry Barriers

**Full Length Text** — Part: 5 Chapter: 22  
**Micro Only Text** — Part: 3 Chapter: 10

To Accompany "Economics: Private and Public Choice 11th ed."  
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson  
Slides authored and animated by:  
James Gwartney, David Macpherson, & Charles Skipton

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## Competitive Price-Searcher Markets

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## Competitive Price-Searcher Markets

- Firms in competitive *price-searcher* markets with low entry barriers face a downward sloping demand curve.
- Firms are free to set price, but face strong competitive pressure.
- Competition exists from existing firms and potential rivals.
- An alternative term for such markets is *monopolistic competition*.

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### Product Differentiation

- Price-searchers produce **differentiated products** – products that differ in design, dependability, location, ease of purchase, etc.
- Rival firms produce similar products (good substitutes) and therefore each firm confronts a **highly elastic demand curve**.

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### Price and Output

- A profit-maximizing price searcher will expand output as long as **marginal revenue exceeds marginal cost**.
  - Price will be lowered and output expanded until **MR = MC**.
- The price charged by a price searcher will be greater than its **marginal cost**.

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### Marginal Revenue of a Price Searcher

- Consider the market for a product with initial price  $P_1$  & output  $q_1$ . Total revenue ( $TR$ ) =  $P_1 \times q_1$ .
- With a downward sloping demand curve, price reductions that increase sales will exert two conflicting influences on  $TR$ .
- As the price falls from  $P_1$  to  $P_2$ , output increases from  $q_1$  to  $q_2$ . What effect does this have on  $TR$ ?
- First,  $TR$  will rise because of an increase in the number of units sold  $(q_2 - q_1) \times P_2$ .
- However,  $TR$  will decline by  $[(P_1 - P_2) \times q_1]$  as  $q_1$  units once sold at the higher price ( $P_1$ ) are now sold at the lower price ( $P_2$ ).
- Depending on the size of the respective shaded regions, **total revenue** may increase or decrease.

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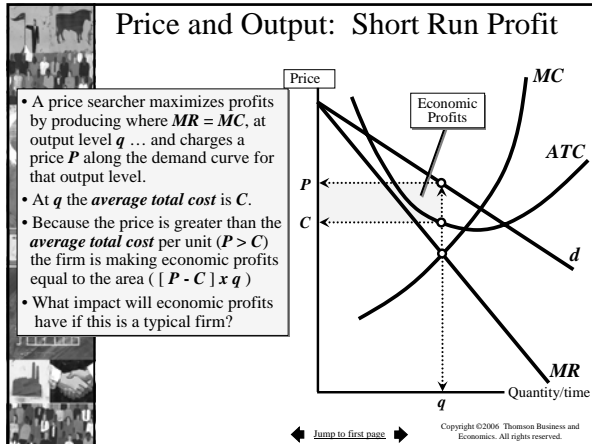
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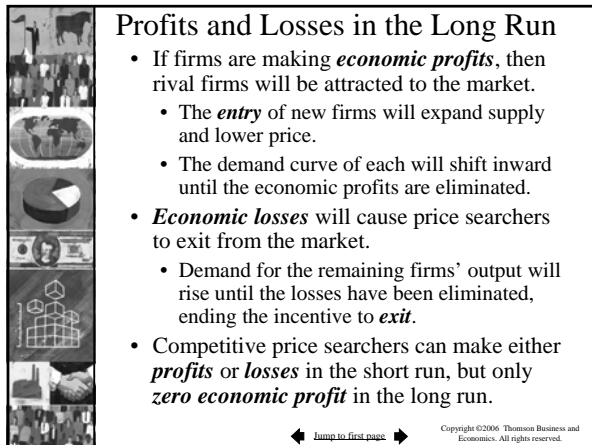
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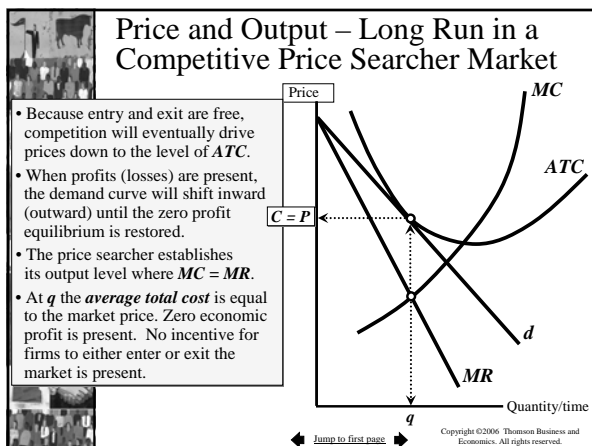
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## Dynamic Competition, Innovation, and Business Failures

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## Business Failures and Economic Progress

- Business failures are usually reported as *bad news* about the economy.
- Though business failures are painful for those directly involved, they release resources so they can be employed more productively elsewhere.
- The assets and workers of failed firms become available for use by others supplying goods that consumers value more relative to costs.
- Without this release of resources, economic expansion would be slowed.

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## Questions for Thought:

1. What are the distinguishing characteristics of competitive price searcher markets? Indicate a market that approximates these conditions.
2. Price searchers can set the price of their product. Does this mean that price searchers will charge the highest possible price for their product? What price will maximize the profits of a price searcher?
3. In price-searcher markets with low barriers to entry, will the firms be able to make economic profit in the long run? Why or why not? What do competitive price searchers have to do in order to make economic profit?

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**Questions for Thought:**

4. When competitive forces are present, sometimes firms will make losses and be driven out of business. Would our standard of living be higher if the government provided subsidies to troubled firms so that they would not have to go out of business? Why or why not?

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**Contestable Markets and the Competitive Process**

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**Contestable Markets**

- A **contestable market** is one in which entry and exit costs are low and there are no legal barriers to entry.
  - *Example:* Airline industry
- Actual and potential competition leads to:
  - Zero economic profits
  - Efficient production

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## Complex Decision Making and the Entrepreneur

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## Entrepreneurs

- Entrepreneurial judgment is necessary when there is no decision rule that can be applied using only information that is freely available.
- For this reason, we are unable to incorporate fully the function of the entrepreneur into economic models.
- There simply is no way to model these complex decisions that involve uncertainty, discovery, and business judgment.

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## Entrepreneurship and Economic Progress

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### Entrepreneurs and Economic Progress

- Entrepreneurs who discover and introduce lower-cost production methods and new products that are highly valued relative to cost promote economic progress.
- Entrepreneurs also have a strong incentive to discover the type of business structure, size of firm, and scope of operation that can best keep the per-unit cost of products or services low.

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### Evaluating Competitive Price-Searcher Markets

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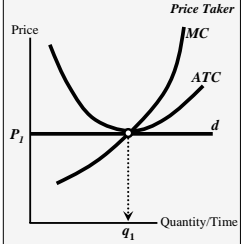
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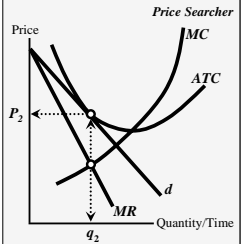


### Comparing Price Searchers & Takers

- Below, we show the long-run equilibrium for both price taker & price searcher markets with low entry barriers. For both,  $P = ATC$  and there are no economic profits.
- As the price-searcher faces a downward-sloping demand curve, its profit-maximizing price exceeds  $MC$ . In contrast with the price-taker market, price-searcher output is too small to minimize  $ATC$  in long-run equilibrium.



*Price Taker*



*Price Searcher*

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### Comparing Price Searchers & Takers

- Even though the two markets have the same cost structure, the price in the price-searcher market is higher than that in the price-taker market ( $P_2 > P_1$ ).
- Some consider this price discrepancy a sign of inefficiency; others perceive it as a premium society pays for variety and convenience (*product differentiation*).

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### Allocative Efficiency

- *Allocative efficiency* is achieved when the most desired goods are produced at the lowest possible cost.
- Criticism of traditional theory of competitive price-searcher markets:
  - *price > marginal cost* at the profit maximizing output level
  - per-unit cost may not be minimized
  - excessive advertising is encouraged

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### Allocative Efficiency

- Recently economists have been more positive about competitive price-searcher markets.
  - Consumers value a wider variety of styles and quality (*product differentiation*).
  - Advertising often reduces search time and provides valuable information.
  - Price searchers have an incentive to innovate and operate efficiently.

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## A Special Case: *Price Discrimination*

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## Price Discrimination

- **Price discrimination:**  
When a seller charges different consumers different prices for the same good or service.
- **Price discrimination** can only occur when a price searcher is able to
  - identify groups of customers with different price elasticities of demand, and,
  - prevent customers re-trading the product.

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## Price Discrimination

- Sellers may gain from **price discrimination** by charging
  - higher prices to groups of customers with **more inelastic demand**.
  - lower prices to groups of customers with **more elastic demand**.
- **Price discrimination** generally leads to more output and additional gains from trade.

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**Questions for Thought:**

3. Which of the following is a necessary condition for long run equilibrium in **both** competitive price searcher and competitive price taker markets?
  - a. Price must equal *marginal cost (MC)*.
  - b. The typical firm in the market must be earning zero economic profit.
  - c. All of the firms in the market must be charging the same price.
4. "If a movie theater is going to increase its revenues by charging students a lower price than other customers, the demand of students must be more elastic than the demand of other customers." Is this statement *true*?

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**Questions for Thought:**

5. Which of the following indicates that a firm operating in the highly competitive retail sector is providing goods and services that consumers value highly relative to their cost?
  - a. The firm is making losses and its sales are declining.
  - b. The wages earned by the employees of the firm are low.
  - c. The firm is highly profitable and its sales have grown rapidly.

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**End  
Chapter 22**

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