In this lesson we will:

- Study how firms operate under monopolistic competition
- Examine different cases of price discrimination

Although most industries in the US are very competitive, firms in these industries usually produce differentiated products and are therefore price searchers. Think of examples.

Since firms offer similar products (close substitutes), if they increase their prices many consumers will switch to other products. What type of demand do these firms face?

- Firms can attract customers by lowering their price, through advertisement, etc.

When a price searcher reduces its price: (1) it will be able to sell a larger quantity; (2) it would receive a lower price for all the units that it sells.

- Its demand curve and its marginal revenue curve are both downward sloping.
- The firm will produce where MC = MR. Complete table 1 to show this.

<table>
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<th>Price</th>
<th>Quantity</th>
<th>Revenue</th>
<th>Marginal Revenue</th>
<th>Marginal Cost</th>
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If a monopolistic competitor makes profit in the short run, in the long run more competitors will enter the market, which will reduce demand for its product (figure 8-1).

The monopolistic competitor produces $Q^M$, where $MC = MR$, for price $P^M$ and makes economic profit in the short run.

In the long run more firms will enter the market and will reduce the demand of the firm until profit is drive to zero.

Firms often fail when their competitors develop a better product. (Examples: J.C. v. Wal-Mart and Lucent v. Nortel.)
The complex decisions of the entrepreneurs:
- Even if no competition exists the market may be contestable. How will firms react?
- Since entrepreneurs cannot observe MC and MR they must experiment. How?
- Entrepreneurs must decide on firm’s structure, size and .... What characteristics does s/he need? They must offer consumers competitive value per dollar.
- When barriers to entry are low, neither price takers nor searchers will be able to earn economic profit in the long run, but they can reduce cost to earn profit in short run (how?)
- Price searchers advertise (why don’t price takers advertise?), which ultimately translate to a higher price for consumers (use a graph to illustrate how this happens)

Illustrate what will happen if a price searcher is making a loss in the short run.

Businesses sometimes price discriminate, which means that they charge different customers different prices. Three degrees of discrimination exist:
- First-degree discrimination: Charging each customer a different price based on his or her maximum willingness to pay. Can firms do this? How can they find MWPs?
- Second-degree discrimination: Charging members of groups with a more elastic demand a lower price than members of group with a more inelastic demand (think of some examples). Firms must distinguish between groups and prevents resale. How?
- Third-degree discrimination: Charging a lower price per unit for customers who buy in bulk. Can you think of some examples? What are the advantages of doing this?

Price Discrimination and Welfare:
- Price discrimination can take many forms and can be very subtle (examples: airline discrimination, negotiation, bulk purchases, etc.)
- Car dealers and sellers in less developed countries often try to price discriminate through negotiation. What are the effects of first-degree price discrimination on consumer surplus and welfare?
- Second-degree price discrimination can increase overall welfare. High elasticity groups benefits while inelastic groups suffer from a higher price (see figure 8-2)
- Third-degree price discrimination is a good marketing scheme (why?). What type of companies and households benefits from this discrimination?

Figure 8-2: 2nd degree price discrimination

Figure 8-2 shows a firm that faces two groups with different price elasticities. The firm could charge both groups $P^3$ and sell $Q^3$.

Instead, it can charge the inelastic group $P^1$ and the elastic group $P^2$, which will increase its profit and raise the quantity it sells to $Q^1 + Q^2$. 