Course Title: Microeconomics-II

Course Code: ECON4006

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Topic: Bain’s Limit Pricing Model

What is Limit Price

- A **limit price** (or **limit pricing**) is a **price**, or **pricing** strategy, where products are sold by a supplier at a **price** low enough to make it unprofitable for other players to enter the market. It is used by monopolists to discourage entry into a market, and is illegal in many countries.
- The quantity produced by the incumbent firm to act as a deterrent to entry is usually larger than would be optimal for a monopolist, but might still produce higher economic profits than would be earned under perfect competition.

Bain’s Model of Limit Pricing

- Bain formulated his ‘limit-price’ theory in an article published in 1949, several years before his major work Barriers to New Competition which was published in 1956.
- In the 1949 article his aim was to explain why firms over a long period of time were keeping their price at a level of demand where the elasticity was below unity, that is, they did not charge the price which would maximize their revenue.
- His conclusion was that the traditional theory was unable to explain this empirical fact due to the omission from the pricing decision of an important factor, namely the threat of potential entry.

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- This behaviour can be explained by assuming that there are barriers to entry, and that the existing firms do not set the monopoly price but the ‘limit price’, that is, the highest price which the established firms believe they can charge without inducing entry.

Assumptions of the Model

- There is a determinate long-run demand curve for industry output, which is unaffected by price adjustments of sellers or by entry.
- There is effective collusion among the established oligopolists.
- The established firms can compute a limit price, below which entry will not occur.
- Above the limit price, entry is attracted and there is considerable uncertainty concerning the sales of the established firms.
- The established firms seek the maximization of their own long-run profit.

Determinants of Limit Price

- Costs of the potential entrant.
- The market elasticity of demand.
- The shape and level of the LAC.
- The size of the market.
- The number of firms in the industry.

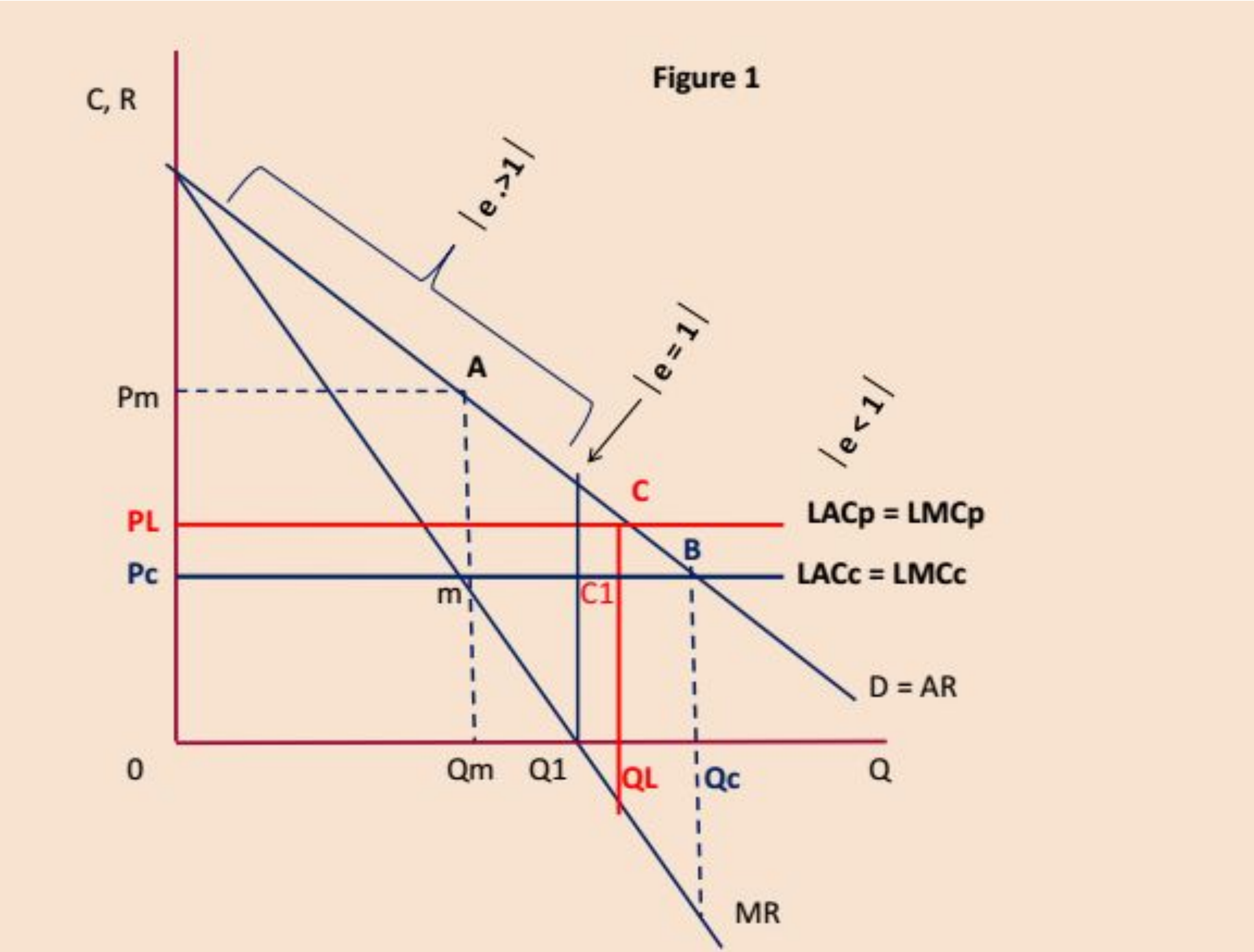

Figure 1
C, R
|e.>1|
|e=1|
|e<1|
A
Pm
C
PL
LACp = LMCp
B
Pc
LACc = LMCc
m
C1
D = AR
0
Qm
Q1
QL
Qc
Q
MR

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- Here LAC_c represents the longrun average cost curve of the constant cost industry.
- P_c represents the perfectly competitive market price.
- P_m represents the monopoly market price.
- P_L represents the limit price and it lies between the monopoly and competitive price.