**Essay Question 19**

**Explain how, in economic theory, firms in imperfect markets would determine the price that would maximize profits. [10]**

**Economic principle to conduct price and output determination: profit maximization rule**

Introduction (**requirements of the question / economic principles**

Imperfect market structures are market structures that have imperfect market information (price and cost of production) and immobility of factors of production (occupational and geographical). The firms under these forms of market structures possess certain degree of market power which will affect the production equilibrium that will determine the price level set by the firm. Regardless of the types of market structures, the firm will base on the notion of profit maximization to determine production equilibrium when the firms aim to maximize profit.

Main Body

**1. Explain the various types of market structures**

Under the imperfect market structures, it can be classified as monopolistic, oligopolistic or monopolistic competitive market where the industry may have one firm, few firms or many firms. For the monopoly, the produce of the firm is unique and there is high degree of market power while the product of the firm in the oligopoly is classified as homogeneous or differentiated and has strong market powers. However, the product of the firms in the monopolistic competitive market is classified as differentiated and there is small degree of market power.

**2. Explain how the firms in the imperfect market is affected by the market power of the firms**

Due to the influence of the market power, the firms in the imperfect market structure will have a downward-sloping MR and AR, indicating that the firm is capable of practicing price-setting whereby the firm can either decrease price to increase quantity demanded or increase price but face a lower level of quantity demanded. For the monopoly and oligopoly, the market power is derived from the barriers to entry while the market power for the monopolistic competition is based on product differentiation.

**3. Explain how the price level is determined by the production equilibrium based on profit maximization**

Based on this downward-sloping MR and AR, the firms in the imperfect market can set the price level when the production equilibrium is attained; abiding to the profit-maximising rule, Under this rule, the firm will increase production when the MR is greater than the MC since additional net profit can be earned and decrease production level when the MR is less than MC since additional net loss may be incurred. Thus, it will attain production equilibrium at the level of output where MR is equal to MC

**MR > MC – presence of additional net profit – increase production**

**MR < MC – presence of additional net loss – decrease production**

**MR = MC – production equilibrium**

AR=DD=P

Q0

Qty

MR

MC

Price

PC

P0

As seen from the diagram, it can be observed that the MR and AR are downward-sloping while the MC is upward-sloping as there is a higher rate of utilization of resource capacity. The production equilibrium is set at the quantity level of Q0 while the price level is set at P0 where MR = MC, abiding the rule of profit maximization when the firm determines price and output level.

optional (different profit level)

The firms in the imperfect market structures will make different levels of profit in the short-run and long run when it attains production equilibrium. In the short run, it can make subnormal profit, normal profit or supernormal profit. But in the long run, the firm can make only normal or supernormal profit as the firm will have to shut down when it incurs subnormal profit.

(production and allocative efficiency)

It is imperative to note that the firm in the imperfect market structure will not be able to attain allocative efficiency as the price level is set at profit-maximising level does not equal to the marginal cost. It is not able to attain production efficiency in the short-run as the firm is producing at the excess capacity at the profit-maximising level of output though they are able to achieve production efficiency in the long run from the profit-maximizing level of production.

Conclusion

In sum, the profit-maximising rule will influence how the firm determines its price strategy in the imperfect market structure. The downward-sloping AR and MR condition will mean that the firms may not satisfy other aims of the firms when it set price level based on profit-maximising rule.

**until the price and output is set – what would you want to discuss further**

**why the price is higher at the rural area and why it is lower at the urban city?**

**variation of price-elasticity of MR and AR - degree of substitution – affected by number of firms – the price is higher when the MR and AR is price-inelastic and the price is lower when the MR and AR is price-elastic**