Looking ahead: Pricing Strategies
Econ 201/Haworth

When a monopoly firm sets price, we've assumed the following profit max process.

1. Firm chooses output by producing where MR = MC
2. Firm sets price by using the demand curve and output from step 1
3. Firm calculates profit (where we can use $\pi = (P - AC)Q$)

This approach to setting the monopoly price is called linear pricing. We could also call it the MR = MC approach, or setting one (same) price for each unit sold.

Thus far, what do we know about this approach?
    (1) The monopoly will not produce on the inelastic segment of the demand curve
    (2) The monopoly will set a price that's greater than MC (i.e. P > MC)
    (3) The monopoly will generate some deadweight loss (DWL)

Here's our end result on a graph (where CS = Consumer Surplus):
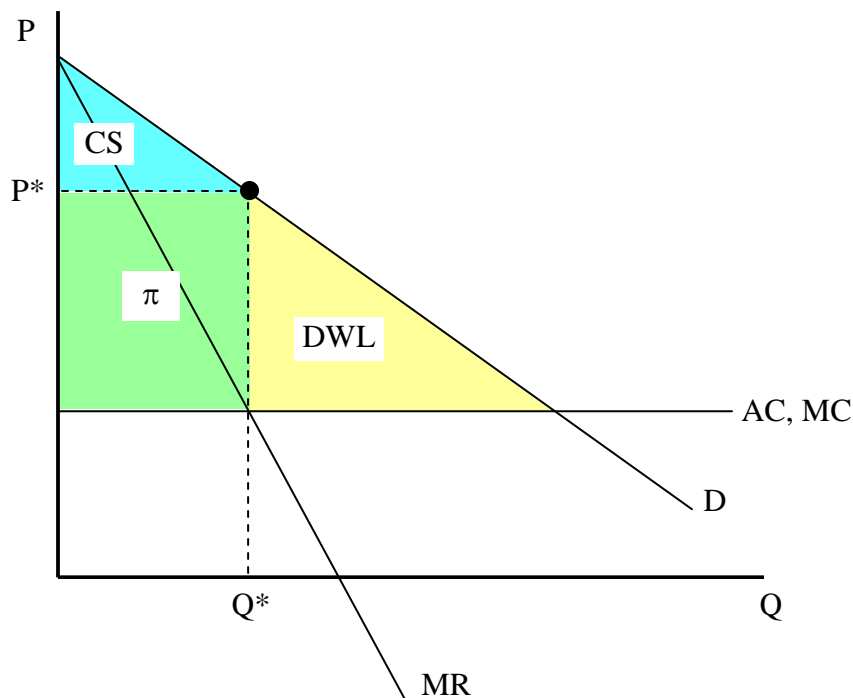
Does a monopoly firm necessarily use only this linear pricing or MR = MC approach? One thing that differentiates a monopoly firm from a perfectly competitive firm is that the monopoly is a price setter. That means the monopoly can choose any approach it wants when setting price and isn't restricted to only choosing linear pricing.

E.g., if the monopoly could find a way to transform DWL or CS from the graph into profit, then we would have to assume that this monopoly would certainly do that.

The question is how? Is it possible for a monopoly firm to set price in a different way, so as to gain additional areas as profit? E.g., transform at least some of CS and/or DWL into profit without losing any of the current π box.

As you'd expect, the answer is yes.

In the next section, where we discuss pricing strategies, we look at how the monopoly firm can do that through an approach we'll generally call nonlinear pricing – which you can think of as basically meaning "not using linear pricing".