

JJC J2H2 Prelim Exam Question 2

Microsoft Corporation reported a 27.8% increase in sales the last quarter of 2016 with the release of the new Office 2016 edition. It was reported that a purchase of a single copy of Office 2016 costs \$229 for students and \$349 for home users. Meanwhile, Office Professional 2016 which is targeted at business users includes additional access to Outlook and Publisher and cost \$619.

Source: *Microsoft, 2016*

- a) Explain whether the above pricing policies by Microsoft Corporation could be considered as price discrimination. [10]
- b) Using examples, discuss whether a lack of contestability in an industry is desirable for society. [15]

Answers for part a

Price discrimination is the practice of charging different prices for the same good for reasons not associated with cost differences, either by charging different prices for different units of output or charging different groups of people different prices. To be considered to be practising PD, a firm must satisfy three conditions: able to control market price, able to separate the markets to prevent reselling and also ensure a different price elasticity of demand in the separate markets.

Body:

Pricing policy #1: Office 2016 is charged to home users and free to students and teachers

Identify type of price discrimination:

- Third degree price discrimination - Two different groups of consumers' students and the home population
- Single license copy of Microsoft 365 provided to both group of users are same

Explain how the three conditions for PD are satisfied:

First Condition

- Microsoft Corporation is a **price setter** (i.e. able to influence prices of Microsoft 365)
- High barrier to entry into the industry due to the fixed high cost involving in the research and development area
- Protected by Intellectual Property law and through the patent licensing of their software and technology

Second Condition

- Different groups of consumers can be clearly segregated through the conditions being imposed by Microsoft Corporation.
- Students will have to register themselves with Microsoft Corporation using their school email
- Impossible for the student to resell the single license of Microsoft 365 as once accessed it via their computer, the license will be invalid

Third Condition

- Students who purchase the Microsoft 2016 are likely to have a lower income as compared to the normal home users. Demand is more price elastic as the price of the single license of Microsoft 2016 take up a larger proportion of their income.
- Home consumers tend to have a higher income as compared to the students. Therefore their demand is more price inelastic as the price of the single license of Microsoft 365 take up a smaller proportion of their income.

Pricing policy #2: Office 365 Business Class charged at a higher price to business user compared to home users

- Not a form of price discrimination because there are cost differences between providing Office Professional to home and business users. Office Professional business class includes additional access to Outlook and Publisher for business.
- Higher cost will be incurred for Microsoft Corporation as they will still need to manage the servers of the business email and ensure a higher quality video call in Skype for business.

Conclusion:

Microsoft Corporation are probably practising PD with regards to the normal Office 2016 for students and the other type of consumers as they fulfil the three conditions of price discrimination and that both group of consumers will enjoy the same production. However, the act of charging higher prices for Office Professional for Business class and normal Office 2016 is not PD as it is a different production for the two group of consumers.

Marking Scheme

Level	Knowledge, Application, Understanding, and Analysis	Marks
L3	Well-developed analytical explanation of the pricing policies of Microsoft Corporation on Office 2016 between different users and Office 365 between Microsoft Professional for Business Class.	8 – 10
L2	Descriptive explanation of the pricing policies of Microsoft Corporation on Office 2016 between different users and Office Professional for Business users.	5 – 7
L1	For an answer that shows descriptive knowledge of the different types of pricing policies of Microsoft Corporation	1 – 4

(a) Using examples, discuss whether a lack of contestability in different industries is desirable for society.

[15]

Answers for part b

Introduction

- Define contestability of a market:
 - Contestable markets are those that are served by a small number of firms but that are characterised by competitive equilibria and thus allocative and productively efficient outcomes because of the ease particularly of short-term entry but also exit in the market.
 - Contestable markets are characterised by 'hit-and-run' competition.
 - Primarily determined by the level of barriers to entry and not the number of firms in the industry. Hence a lack of contestability would mean that market has a high level of barriers to entry which allows incumbent firms to raise prices due to the lack of entry of potential competitors.
- Society's interest comprises consumer's and producer's welfare in addition to issues like equity. Besides prices, consumer welfare is also affected by consumer choices and quality of service.

Body:

Thesis: Lack of contestability is desirable for the society

Point 1: Desirable as it allows firm to reap internal EOS

- Firms located in industries that lack contestability would also operate on a larger scale of production and would be able to reap internal economies of scale.
- With specialisation, the production process is more efficient, leading to lower unit costs. Firms are able to enjoy higher profit margins due to lower unit costs of production. This means that its MC, could be lower than that of a PC industry
- In this case, it is not true that the monopolist always charge a higher price

Examples: It is desirable to a large extent if the industry give rises to natural monopoly for example the utilities market such as water, electricity and gas.

[Explain how Public Utilities Board is a form of natural monopoly and as they enter the market and expand quickly to enjoy internal economies of scale.]

Point 2: Desirable as it allows firm to engage in research and development.

- With the supernormal profits earned, firms located in industries that lack contestability have greater ability to engage in innovation to improve the quality of products and differentiate products to cater to the different tastes and preferences of consumers.
- Benefit consumers in terms of better quality of goods as well as a wider variety of goods and services produced.

Examples: It is desirable to a large extent. For example, in the automobile market, different companies such as BMW have introduced new safety mechanisms to improve the safety of drivers and passengers and improved engine systems to enhance fuel efficiency. This would lead to greater consumer welfare.

Point 3: Desirable as it prevents wastage of resources

- Incur less advertising expenditure to avoid wastage of resources and prevent hurting consumers' welfare as it does not bring about any improvements in the product.

Examples: For firms located in contestability industries like restaurants, bubble tea shops and even hair salons, they will have to engage in aggressive advertising in order to establish the brand loyalty and increase the demand for their product.

Anti-Thesis: Lack of contestability is not desirable for the society

Point 1: Not desirable as it promotes allocative inefficiency

- Explain how allocative efficiency (AE) is achieved
- Firm located in industries that lack contestability are also often dominant firms with great market power and are able to charge higher prices where $P > MC$
- Make consumers worse off in terms of higher prices

Point 2: Not desirable as it promotes inequity

- Due to a lack of contestability in the industry, the firm is also able to make supernormal profits, not only in the short run but also the long run.
- Results in a less than equitable income distribution as there is seen to be an accumulation of wealth by the minority (producers) at the expense of the majority (consumers), making the public 'worse off'.
- Unlike the other industries with contestability, they have less power to exploit consumers by raising prices and restricting output.

Examples: This is particularly true in the case of industries which lack contestability, for example, Microsoft in the operating software market due to patent rights would tend to charge consumers a high price for the use of Microsoft software even though they may enjoy a lower marginal cost.

Due to a lack of contestability (in which potential entrants are deterred), oil retailers like Shell Petrol, Exxon Mobile are also able to collude to set higher prices, enabling them to earn higher profits at the expense of the consumers who have to pay higher prices for petrol.

Point 3: Not desirable due to lack of variety

- May only produce one type of good. As a result, consumers lose out due to lesser variety of goods enjoyed in the market.
- On the other hand, firms in the monopolistic competition industry due to contestability will compete to provide better quality products to their customers which are more reliable and with more appealing features and variety.

Example: There are many different brands of bubble tea shop in Singapore. The biggest competitors in the industry are LiHo! and Koi whereby both constantly compete to come up with new favours to cater to the consumers taste and preference.

Conclusion

Stand

In conclusion, firms that locate in industry that lack contestability bring about both benefits and costs to society. Although benefits are reaped in terms of greater innovation and greater economies of scale enjoyed, there is a trade-off in terms of potential abuse of market power and greater inequity depending on various criteria.

Criteria of Judgement: Any 2 – 3 points

Different type of industries

Different objectives of firms

Government regulation

Marking Scheme for part b

Level	Knowledge, Application, Understanding and Analysis	Marks
L3	For a well-developed explanation of how a lack of contestability in different industry is desirable and is not desirable for society. Answer uses well-reasoned criteria of judgment to assess the reasons why it is desirable and why it is not desirable with well-explained examples.	8 – 10
L2	For a descriptive explanation of how a lack of contestability in different industry is desirable and is not desirable for society. Answer compares the desirability with examples.	5 – 7
L1	For an answer that shows a descriptive knowledge of how a lack of contestability in different industry is desirable and is not desirable for society.	1 – 4
Level	Evaluation	Marks
E3	For an evaluative assessment which synthesises economic arguments to arrive at well-reasoned judgments about the lack of contestability in different industries and how it may affect different industries. These include consideration of a firm's other objectives and the possibility of government intervention.	4 – 5
E2	For an answer that makes some attempt at an evaluative appraisal about the lack of contestability in different industries and how it may affect different industries.	2 – 3
E1	For an unsupported judgment about the lack of contestability in different industries.	1