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Dynamic Limit Pricing

In 1901, the United States Steel Corporation controlled almost 70 percent of the U.S. market and enjoyed profits (as a percentage of sales) of 25 percent. Rather than protect this market share through limit pricing, U.S. Steel adopted a strategy of setting the profit-maximizing price each period and enjoyed the higher short-term profits associated with such a strategy. As one would expect, this strategy resulted in entry by smaller firms who essentially took the price set by U.S. Steel as given and maximized their own profits. Over time, as the size of this competitive fringe grew, U.S. Steel gradually found it optimal to lower its price—not as a limit pricing strategy, but because its reduced market share and more elastic demand resulted in a lower optimal price. By the 1930s, U.S. Steel's market share had dropped to about 30 percent and its profits (as a percentage of sales) had fallen to less than 10 percent.

Looking at the discounted cash flows, most economists agree that U.S. Steel's policy of charging a high price and accepting entry by other firms was probably its best strategy. Among other things, U.S. Steel did not enjoy any significant cost advantages over rivals and could not credibly commit to maintain a high market share in the face of entry. Consequently, attempts to thwart entry by limit pricing would have reduced the firm's immediate profits without substantially retarding entry. More recently, McCraw and Reinhardt have pointed out another reason why U.S. Steel did not attempt to limit price: It was concerned that legal (antitrust) actions would have resulted if it aggressively fought entry.

Sources: T. K. McCraw and F. Reinhardt, "Losing to Win: U.S. Steel's Pricing, Investment Decisions, and Market Share, 1901–1938." *Economic History* 49 (1989), pp. 593–619; H. Yamawaki, "Dominant Firm Pricing and Fringe Expansion: The Case of the U.S. Iron and Steel Industry, 1907–1930." *The Review of Economics and Statistics* 67, no. 3 (1985), pp. 429–37.