Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.1 Competition and Market Power

4.1.1 Spectrum of competition

Notes

Characteristics of monopoly, oligopoly, imperfect and perfect competition

Monopoly:

- Monopolies can be characterised by:
  - Profit maximisation. A monopolist earns supernormal profits in both the short run and the long run.
  - Sole seller in a market (a **pure monopoly**)
  - High barriers to entry
  - Price maker
  - Price discrimination
- In the UK, when one firm dominates the market with more than 25% market share, the firm has **monopoly power**. For example, Google dominates the search engine market, with 90% share.
- Monopoly power can be gained when there are multiple suppliers. If two large firms in an oligopoly (several large sellers) have greater than 25% market share, they are said to have monopoly power. For example, Sainsbury's and Asda have more than 25% market share combined, so they are said to have monopoly power.
- There are very few examples of pure monopolies, but several firms have monopoly power.
- Monopoly power is influenced by factors such as:

  - **Barriers to entry:** The higher the barriers to entry, the easier it is for firms to maintain monopoly power. Examples of barriers to entry which can maintain monopoly power are:
    - **Economies of scale:** As firms grow larger, the average cost of production falls because of economies of scale. This means existing large firms have a cost advantage over new entrants to the market, which maintains their monopoly power. It deters new firms from entering the market, because they are not able to compete with existing firms.
    - **Limit pricing:** This involves the existing firm setting the price of their good below the production costs of new entrants, to make sure new firms cannot enter profitably.
    - **Owning a resource:** Early entrants to a market can establish their monopoly power by gaining control of a resource. For example, BT

owns the network of cables so new firms would find it very difficult to enter the market.

- **Sunk costs:** If unrecoverable costs, such as advertising, are high in an industry, then new firms will be deterred from entering the market, because if they are unable to compete, they do not get the value of the costs back.
- **Brand loyalty:** If consumers are very loyal to a brand, which can be increased with **advertising**, it is difficult for new firms to gain market share.
- **Set-up costs:** If it is expensive to establish the firm, then new firms will be unlikely to enter the market.

- **The number of competitors:** The fewer the number of firms, the lower the barriers to entry, and the harder it is to gain a large market share.
- **Advertising:** Advertising can increase consumer loyalty, making demand price inelastic, and creating a barrier to entry.
- **The degree of product differentiation:** The more the product can be differentiated, through quality, pricing and branding, the easier it is to gain market share. This is because the more unique the product seems, the fewer competitors the firm faces.

- **Oligopoly:**

- **High barriers to entry and exit**
  There are high barriers of entry to and exit from an oligopoly. High barriers to entry make the market less competitive.
- **High concentration ratio**
  In an oligopoly, only a few firms supply the majority of the market. For example, in the UK the supermarket industry is an oligopoly. The high concentration ratio makes the market less competitive.
- **Interdependence of firms**
  Firms are interdependent in an oligopoly. This means that the actions of one firm affect another firm's behaviour.
- **Product differentiation**
  Firms differentiate their products from other firms using branding. The degree of product differentiation can change how far the market is an oligopoly.

- **Imperfect competition**

- A monopolistically competitive market has imperfect competition. Firms are short run profit maximisers.

- Firms sell non-homogeneous products due to branding (there is **product differentiation)**. However, there are a lot of relatively close substitutes. This makes the XED of the goods and services sold high.
- The model is based on the assumption that there are a large number of buyers and sellers, which are relatively small and act independently. Each seller has the same degree of market power as other sellers, but their market power is relatively weak.
- Firms in a monopolistically competitive market compete using non-price competition.
- There are no barriers to entry to and exit from the market.
- Since firms have a downward sloping demand curve, they can raise their price without losing all of their customers. This is because firms have some degree of price setting power.
- Buyers and sellers in a monopolistically competitive market have imperfect information.
- Examples of monopolistic competition include hairdressers and regional plumbers.

- **Perfect competition:**

- A **perfectly competitive market** has the following characteristics:
    - Many buyers and sellers
    - Sellers are **price takers**
    - Free entry to and exit from the market
    - Perfect knowledge
    - Homogeneous goods
    - Firms are short run profit maximisers
    - Factors of production are perfectly mobile
- In this market, price is determined by the interaction of demand and supply.
- In a competitive market, profits are likely to be lower than a market with only a few large firms. This is because each firm in a competitive market has a very small market share. Therefore, their market power is very small. If the firms make a profit, new firms will enter the market, due to low barriers to entry, because the market seems profitable. The new firms will increase supply in the market, which lowers the average price. This means that the existing firms' profits will be competed away.

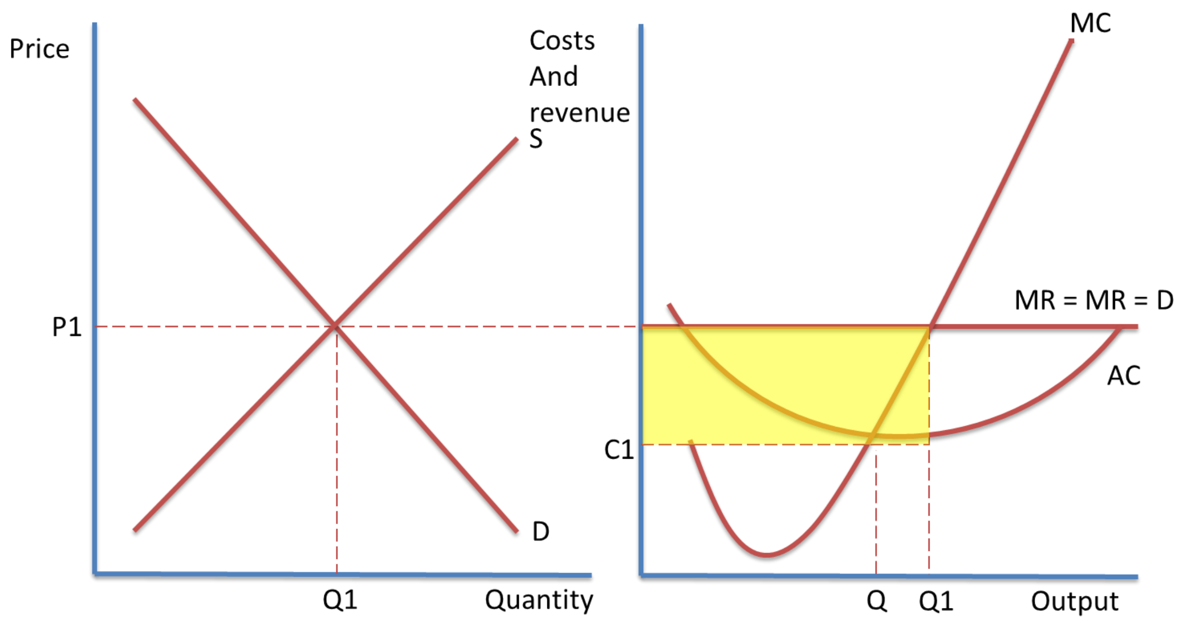
How the model of perfect competition helps to explain how markets work

- Generally, it is rare to see an example of perfect competition in the real world. However, commodity markets are close to the model, since many commodities are homogenous. There is little variation with wheat, for example.

- **Profit maximising equilibrium in the short run and long run:**

- In the short run, firms can make supernormal profits. In the long run where profits are competed away, only normal profits are made.

- The diagram below shows the **short run equilibrium** for a perfectly competitive market. The firm is a price taker, and it accepts the industry price of P1. In the short run, the firm produces an output of Q1. The yellow shaded rectangle shows the area of supernormal profits earned in the short run. It is assumed that firms are short run

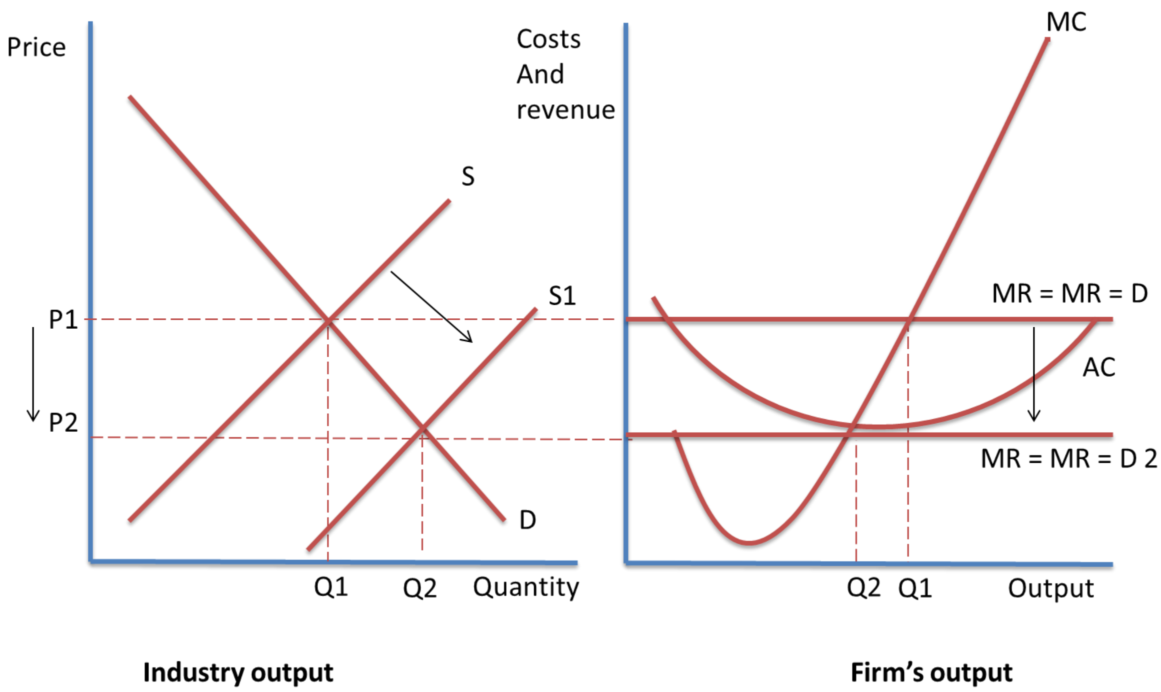


Industry output **Firm's output**

profit maximisers.

- The diagram below shows the **long run equilibrium** for a perfectly competitive market. The supernormal profits made by existing firms means that new firms have an incentive to enter the industry. Since there are no barriers to entry in a perfectly competitive market, new firms are able to enter the industry.

- This causes the supply in the market to increase, as shown by the shift in the supply curve from S to S1. The price level in the market falls as a consequence. Since firms are price takers, they must accept this new, lower price.
- In the long run, competitive pressure ensures equilibrium is established. The supernormal profits have been competed away, so firms only make normal profits in the long run.
- The new equilibrium at P=MC means firms produce at the new output of Q2 in the long run.



- **Advantages and disadvantages of a perfectly competitive market:**

Advantages	Disadvantages
In the long run, there is a lower price. P =MC, so there is **allocative efficiency.**	In the long run, dynamic efficiency might be limited due to the lack of supernormal profits.
Since firms produce at the bottom of the AC curve, there is **productive efficiency.**	Since firms are small, there are few or no economies of scale.
The supernormal profits produced in the short run might increase dynamic efficiency through investment.	The assumptions of the model rarely apply in real life. In reality, branding, product differentiation, adverts and positive and negative externalities,

	mean that competition is imperfect.

The impact of market structure on pricing strategies and consumers

Pricing strategies:

- **Cost plus (calculating mark up on unit cost)**

When a retailer wants to know the gross profit margin of a sale in advance, they might use cost-plus pricing. A benefit of this is that the retailer reduces the uncertainty of profits, since they know costs will be covered if they can sell the good. However, it could lead to a fall in the quantity sold, the revenues and profits and market share of the firm since the price is uncompetitive.

- **Price skimming**

This is a short term pricing strategy which is used most commonly when a new product is launched. This is when the product has little or no competition, so a high price is set temporarily before competitors enter the market. It is most common where technology has changed or a product is distinctive. It is only used in the short term, because the high profits earned in the market act as a signal to other firms to enter the market, so competition increases.

- **Penetration**

This involves setting a low price initially, which is below the intentional price, in order to attract customers. It aims to encourage customers to switch to this brand since the price is low, and once consumer loyalty is gained, the price is increased again.

- **Predatory**

This involves firms setting low prices to drive out firms already in the industry. In the short run, it leads to them making losses. As firms leave, the remaining firms raise their prices slowly to regain their revenue. They price their goods and services below their average costs. This reduces contestability. Firms with monopoly power are likely to use predatory pricing to weaken potential competitors.

- **Competitive**

This is when prices are set based on the prices of competitors, and it is used when the products are similar.

- **Psychological**

This is a pricing strategy which uses the emotional and not rational reactions to the price of a good. For example, a good might be priced at 99p rather than £1, since the 99p price tag seems a lot cheaper than the £1 price tag, even though there is only a penny difference. Therefore, consumers might be more inclined to purchase the good.

- **Factors that determine the most appropriate pricing strategy for a particular situation:**

  - **Number of Unique Selling Points/amount of differentiation**

If a product is unique or highly differentiated, the business is more likely to put a premium price on the product. If there are several similar goods in a market, prices are likely to be lower, since firms will only be able to differentiate on price rather than characteristics of the product.

  - **Price elasticity of demand**

A good with a low price elasticity of demand (PED) is not very responsive to changes in price. This is more likely to have a high price, since the price does not affect the quantity sold significantly. A good with a high PED is more likely to have a lower price, since the quantity sold is more dependent on the price.

Goods with a strong brand image are more price inelastic, since consumers are more loyal towards the brand. Therefore, the business can charge premium prices.

  - **Stage in the product life cycle**

When a product has been newly launched, a business might use penetration pricing if there is a lot of competition. This is with the aim of encouraging customers to buy their product instead of that of the competition. If the product is new and has no competition, the business might use price skimming, especially if initial demand is likely to be high. During growth and maturity, the price is more likely to be competitive. During the stages of decline, the price is more likely to be lower in order to sell off the remaining stock.

Non-price competition

- **Product differentiation**

Firms differentiate their products from other firms using branding. The degree of product differentiation can change how far the market is an oligopoly. It involves branding, packaging, advertising and product placement. If product differentiation is successful, it could shift the demand curve to the right, due to the increase in demand from consumers. Alternatively, the demand curve might become more price inelastic, especially if the business can increase consumer loyalty.

- **Advertising and other promotional methods**

Advertising can result in an increase in demand and an increase in the equilibrium price and quantity of the market.

Advertising and marketing might be used to make the brand more known and influence consumer preferences. However, it is difficult to know what the effect of increased advertising spending will be. For some firms, it might be ineffective. This would make them incur large sunk costs**,** which are unrecoverable.

Brands are used to differentiate between products. If firms can increase brand loyalty, demand becomes more price inelastic. Increasing brand loyalty means firms can attract and keep customers, which can increase their market share.

- **Distribution methods**

This can be used to make demand more price inelastic. It allows firms to charge a higher price for their products, so they can maximise their revenue and profit. Alternatively, the firm can pass higher prices onto the consumer without losing their revenue. It results in an inelastic demand curve. Distribution methods are rapidly changing, especially in relation to the digital economy.