Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.2 Market Power and Market Failure

4.2.1 Market failure

Notes

- **Significance of market power:**

    - **Cartels, collusion, restrictive practices and tacit agreement**

- Collusive behaviour occurs if firms agree to work together on something. For example, they might choose to set a price or fix the quantity of output they produce, which minimises the competitive pressure they face.
- Collusion leads to a lower consumer surplus, higher prices and greater profits for the firms colluding. It can allow oligopolists to act as a monopolist and maximise their joint profits.
- Firms in an oligopoly have a strong incentive to collude. By making agreements, they can maximise their own benefits and restrict their output, to cause the market price to increase. This deters new entrants and is anti-competitive.
- Collusion is more likely to happen where there are only a few firms, they face similar costs, there are high entry barriers, it is not easy to be caught and there is an ineffective competition policy. Moreover, there should be consumer inertia. All of these factors make the market stable.

  Non-collusive behaviour occurs when the firms are competing. This establishes a competitive oligopoly. This is more likely to occur where there are several firms, one firm has a significant cost advantage, products are homogeneous and the market is saturated. Firms grow by taking market share from rivals.

- Collusion can be overt or tacit.
- Overt collusion is when a formal agreement is made between firms. It works best when there are only a few dominant firms, so one does not refuse. It is illegal in the EU, US and several other countries. For example, it is often suspected that fuel companies partake in overt collusion. This could be in the form of price fixing, which maximises their joint profits, cuts the cost of competition, such as by preventing firms using wasteful advertising, and reduces uncertainty.
- Tacit collusion occurs when there is no formal agreement, but collusion is implied. For example, in the UK supermarket industry, firms are competing in a price war. Price wars are harmful to supermarkets and their suppliers. Some application points for price wars can be found here:

  Grocery price war pushes Waitrose profits down 24%

[Supermarket price war blamed for food producers folding]
[Supermarket price war hits Asda sales]

- A **cartel** is a group of two or more firms which have agreed to control prices, limit output, or prevent the entrance of new firms into the market. A famous example of a cartel is OPEC, which fixed their output of oil. This was possible since they controlled over 70% of the supply of oil in the world. This reduces uncertainty for firms, which would otherwise exist without a cartel.

  Cartels can lead to higher prices for consumers and restricted outputs. Some cartels might involve dividing the market up, so firms agree not to compete in each other's markets.

- **Price leadership** occurs when one firm changes their prices, and other firms follow. This firm is usually the dominant firm in the market. Other firms are often forced into changing their prices too, otherwise they risk losing their market share. This explains why there is price stability in an oligopoly; other firms risk losing market share if they do not follow the price change. The price leader is often the one judge to have the best knowledge of prevailing market conditions.

- **Price wars:** A price war is a type of price competition, which involves firms constantly cutting their prices below that of its competitors. Their competitors then lower their prices to match. Further price cuts by one firm will lead to more and more firms cutting their prices. An example of this is the UK supermarket industry (see notes above).

- **Non-price competition** aims to increase the loyalty to a brand, which makes demand for a good more price inelastic.
  For example, firms might improve the quality of their customer service, such as having more available delivery times. They might keep their shops open for longer, so consumers can visit when it is convenient.

  Special offers, such as buy one get one free, free gifts, or loyalty cards, might be used to attract consumers and increase demand.

  Advertising and marketing might be used to make their 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.

- **Barriers to entry:** Firms might try to drive competitors out of the industry in order to increase their own market share. Barriers to entry are designed to prevent new firms entering the market profitably. This increases producer surplus.

○ Monopsony power

- A monopsony is a single buyer in a market. For example, Network Rail for track maintenance and the government for teachers are examples of a monopsony. Moreover, supermarkets have monopsony power when buying produce from farmers, which means they are able to negotiate low prices.
- It is assumed that monopsonists are profit maximisers.
- A firm with monopsony power is able to negotiate lower prices, because their suppliers have nowhere else to sell to (there is only one buyer).
- Firms with monopsony power are able to set the market price.

Costs	**Benefits**
It is the monopsony power of supermarkets that has led to many farmers losing profits. Farmers lose out to supermarket price wars, because supermarkets keep negotiating lower prices from farmers, in order to lower their own prices and compete with other supermarkets. Supplying firms are unlikely to make more than normal profit.	The NHS has monopsony power when buying drugs from pharmaceutical companies. They are able to negotiate lower prices for the drugs. This saves money which can be invested elsewhere, such as in R&D. Moreover, the NHS can then cover more treatments within their budget.
Employees are likely to lose out with lower wages. For example, those trained to be coal miners had little choice of who to work for. This meant their labour could be exploited by the employer. However, now this has been offset with the power of trade unions, which are able to negotiate higher wages and good working conditions.	By lowering the price paid to suppliers, consumers might receive lower prices.
Workers might become unproductive if wages are low.	

○ **Natural monopolies**

If there is a natural monopoly, it might be more efficient for only one firm to provide the good or service, since having duplicates of the same infrastructure might be wasteful. For example, it might be considered inefficient and wasteful to have two lots of water suppliers.

○ **Power in the labour market**

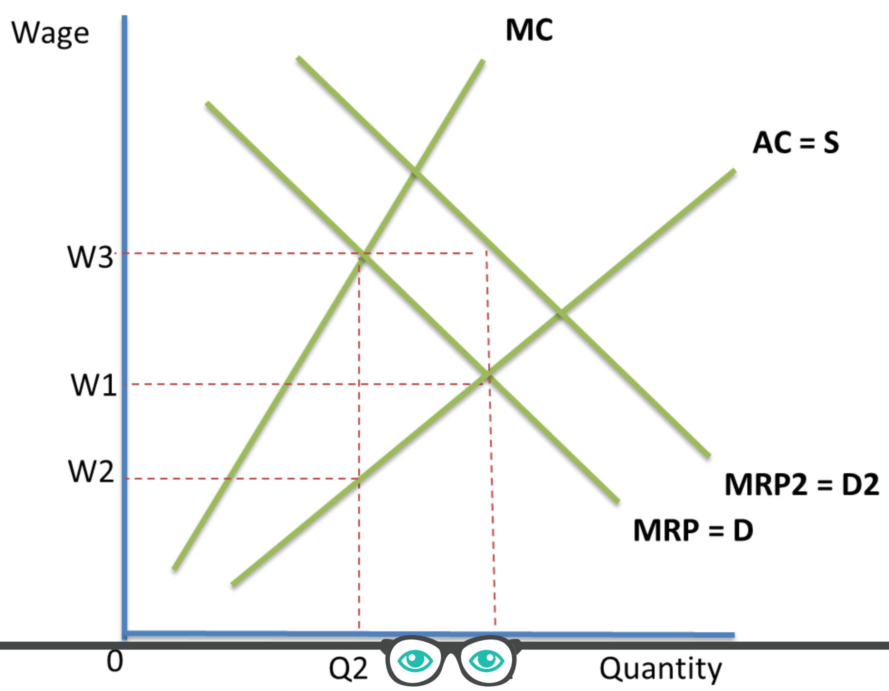
Trade union power: If trade unions are pushing for higher wages above the market equilibrium, the labour market is likely to be more flexible. Trade unions can also increase job security. Higher wages can be demanded by limiting the supply of labour, by closing firms, or by threatening strike action. Higher wages could cause unemployment, however. Trade unions can counter-balance exploitative monopsony power.

These could attract workers to the labour market, because they know their employment rights will be defended. However, the limits on workers, such as limiting their ability to strike, might cause some people to withdraw from the labour market.

Trade unions aim to protect workers, secure jobs, improve working conditions and try and achieve higher wages.

If trade unions try and increase wage rates too much, firms might no longer be able to afford to employ workers. This could cause them to close down or reduce the number of workers they employ. Some workers might prefer a low paid job rather than be without employment.

In a market where an employer has monopsony power, workers are only paid W2, and only Q2 number of workers is employed. This is the profit maximising level.



A trade union aims to increase marginal revenue product in the market, as well as increase wages to the level of MRP (W3). This is to stop the exploitation of labour. The perfectly competitive level of employment and wage rate is W1, Q1.