Edexcel Economics A-level

Unit 3: Business Behaviour

Topic 3: Market Structures and Contestability

3.3 Oligopoly

Notes

Characteristics of an oligopoly:

High barriers to entry and exit

There are high barriers of entry to and exit from an oligopoly. This makes 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.

Types of barrier to entry and exit:

- Barriers to entry aim to block new entrants to the market. it increases producer surplus and reduces contestability.
- The greater the **economies of scale** that a firm exploits, the less likely it is that a new firm will enter the market. This is because they would produce comparatively expensively, so they cannot compete.
- **Legal barriers** can act as a barrier to entry. For example, patents and exclusive rights to production (such as with television) mean other firms cannot enter the market. Some industries, such as the taxi industry, gain market licences to operate. Since new firms have to gain a licence, there is a barrier to entry.

- Consumer loyalty and **branding** can make a market less contestable. This is since demand becomes more price inelastic, and consumers are less likely to try other brands. Sometimes a brand can become associated with a product, such as 'Hoover' with vacuum cleaners.

- **Predatory pricing** 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.

- **Limit pricing** discourages the entry of other firms. It ensures the price of a good is below that which a new firm entering the market would be able to sustain. Potential firms are therefore unable to compete with existing firms.

- Some firms might employ **anti-competitive practices,** such as refusing to supply retailers which stock competitors.

- **Vertical integration** means one firm gains control of more of the market, which creates a barrier to entry. It could result in one firm gaining **control of important technologies**, and they might prevent other firms gaining access to them.

- Firms might saturate the market with their goods using **brand proliferation.** This disguises consumers from the actual market concentration. For example, the many brands of the laundry soap market are provided by only a few large conglomerates.

- Barriers to exit prevent firms from leaving a market quickly and cheaply.

- They include the cost to **write off assets and pay leases.** Firms have to continue paying leases and contracts, even after closure. It could make it cheaper to stay in the industry than to leave. This makes the market less contestable.

- **Losing a brand** and consumer loyalty is hard to put a monetary value on, but is still considered a cost of leaving the market.

- **The cost of making workers redundant** might discourage firms from leaving an industry.

- For example, Amazon created barriers to entry by exploiting their workers and having exclusivity with the Kindle. They gained a large market share and a strong buying power. By lowering the price of the Kindle when it was launched, they made a loss in the short run, to increase their long run revenue.

Calculation of n-firm concentration ratios and their significance:

- The concentration ratio of a market is the combined market share of the top few firms in a market.
- For example, the market share for each of the top supermarkets in the UK is shown in the table below:

Supermarket	Market share (12 weeks to 29 March 2015)
Tesco	28.4%
Asda	17.1%
Sainsbury's	16.4%
Morrisons	10.9%
The Co-operative	6.0%
Aldi	5.3%
Waitrose	5.1%
Lidl	3.7%
Iceland	2.1%
	Data adapted from BBC News http://www.bbc.co.uk/news/business-32218170

- If the 4 firm concentration ratio was calculated, the market share of the 4 largest firms would be added together: 28.4% + 17.1% + 16.4% + 10.9% = 72.8%.
- The 2 firm concentration ratio is the market share of the 2 largest firms added together: 28.4% + 17.1% = 45.5%.
- The higher the concentration ratio, the less competitive the market, since fewer firms are supplying the bulk of the market.

Reasons for collusive and non-collusive behaviour:

- 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.

- 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.

Overt and tacit collusion; cartels and price leadership:

- 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

Costs of collusion	Benefits of collusion
There is a loss of consumer welfare, since prices are raised and output is reduced.	Industry standards could improve. This is especially true in the pharmaceutical industry and for car safety technology.

	This is because firms can collaborate on technology and improve it.
The absence of competition means efficiency falls. This increases the average cost of production.	Excess profits could be used for investment, which might improve efficiency in the long run. Alternatively, they might be used on dividends.
It reinforces the monopoly power of existing firms and makes it hard for new firms to enter.	It saves on duplicate research and development.
A lower quantity supplied leads to a loss of allocative efficiency.	By increasing their size, firms can exploit economies of scale, which will lead to lower prices.

- 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.

Types of price competition :

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).

- **Predatory pricing**

  Predatory pricing is illegal. It 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.

- **Limit pricing**

  This is not necessarily illegal. Low prices discourage the entry of other firms, so there are low profits. It ensures the price of a good is below that which a new firm entering the market would be able to sustain. Potential firms are therefore unable to compete with existing firms. This can be evaluated by considering how the low profits of existing firms might dissatisfy shareholders, since they receive lower dividends.

Types of non-price competition:

- These aim 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.