Competition and Monopoly

AS Economics Presentation

2005

Key Issues

- The basics of different market structures
- The growth of businesses (internal & external)
- Understanding the growth of monopoly power
- Price and non-price competition in markets
- The possible disadvantages and advantages of monopoly power
- Role of competition policy

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Different market structures

- **Competitive markets** - where many firms compete fiercely with each other and have no real control over the price in the market
- **Pure monopoly** - where there is just one firm in the market, a sole supplier, who can set prices
- **Oligopoly** – where a market is dominated by a few large businesses
- **Duopoly** – where two firms dominate the market

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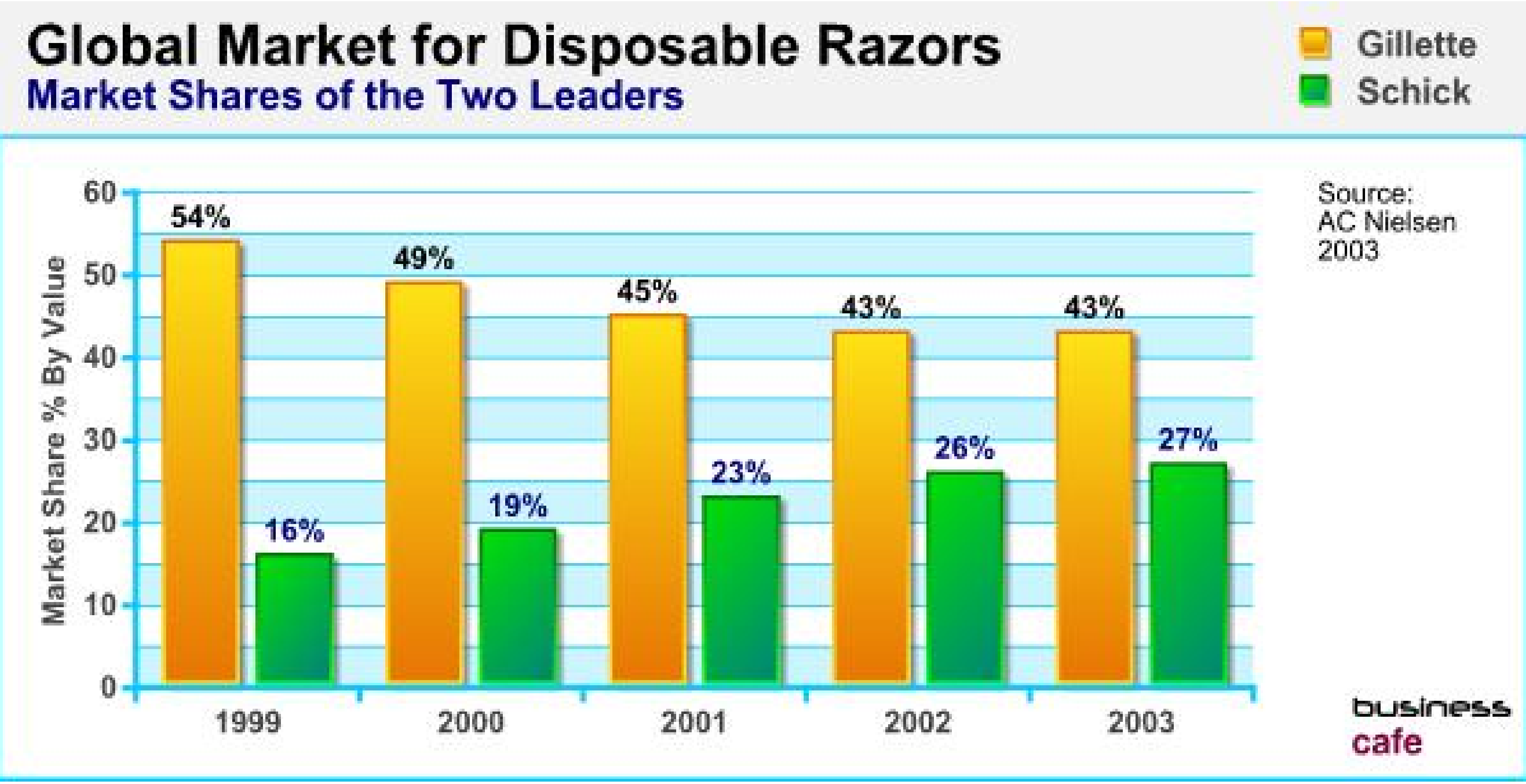
Market Share in Disposable Razors



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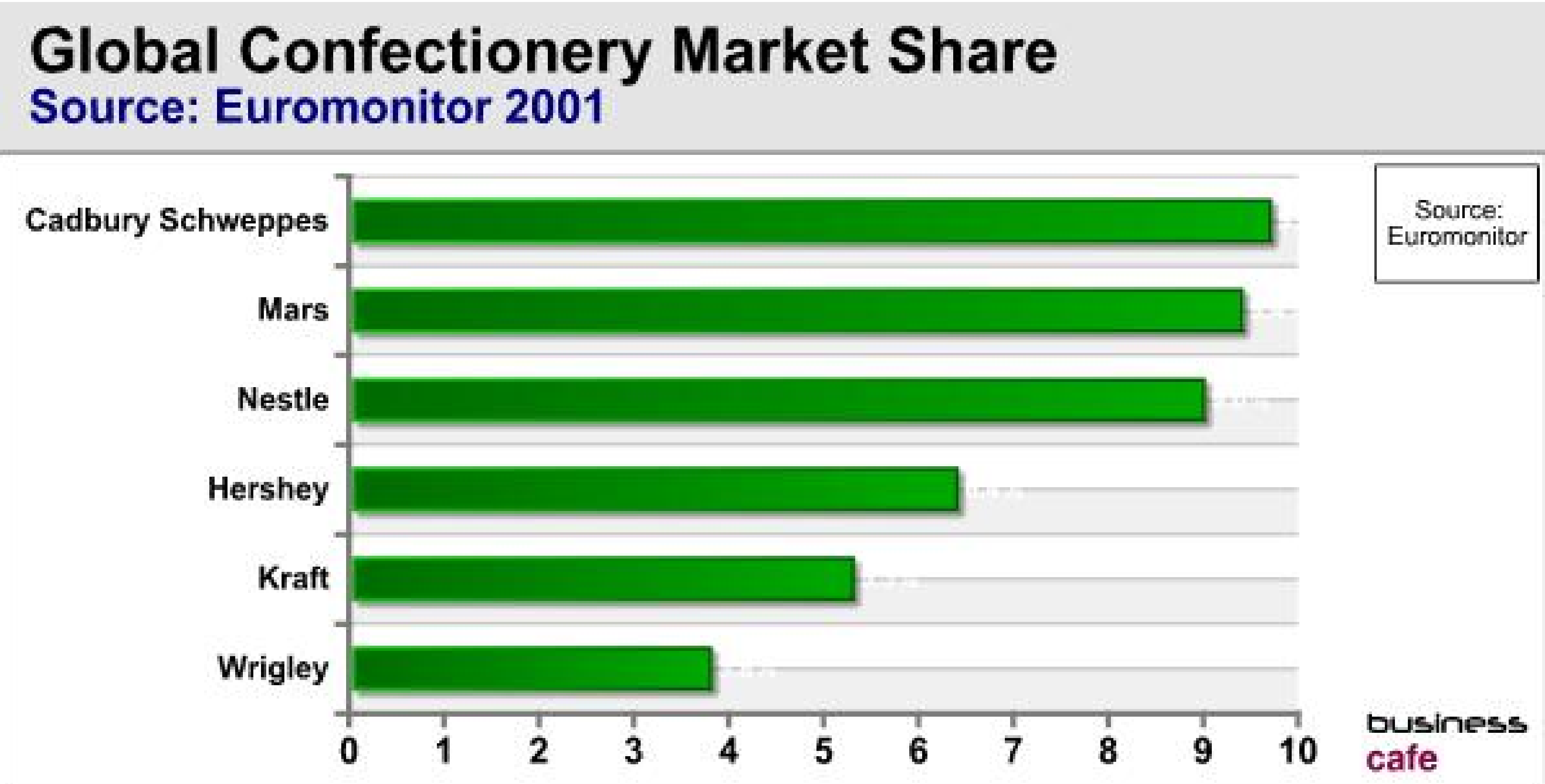
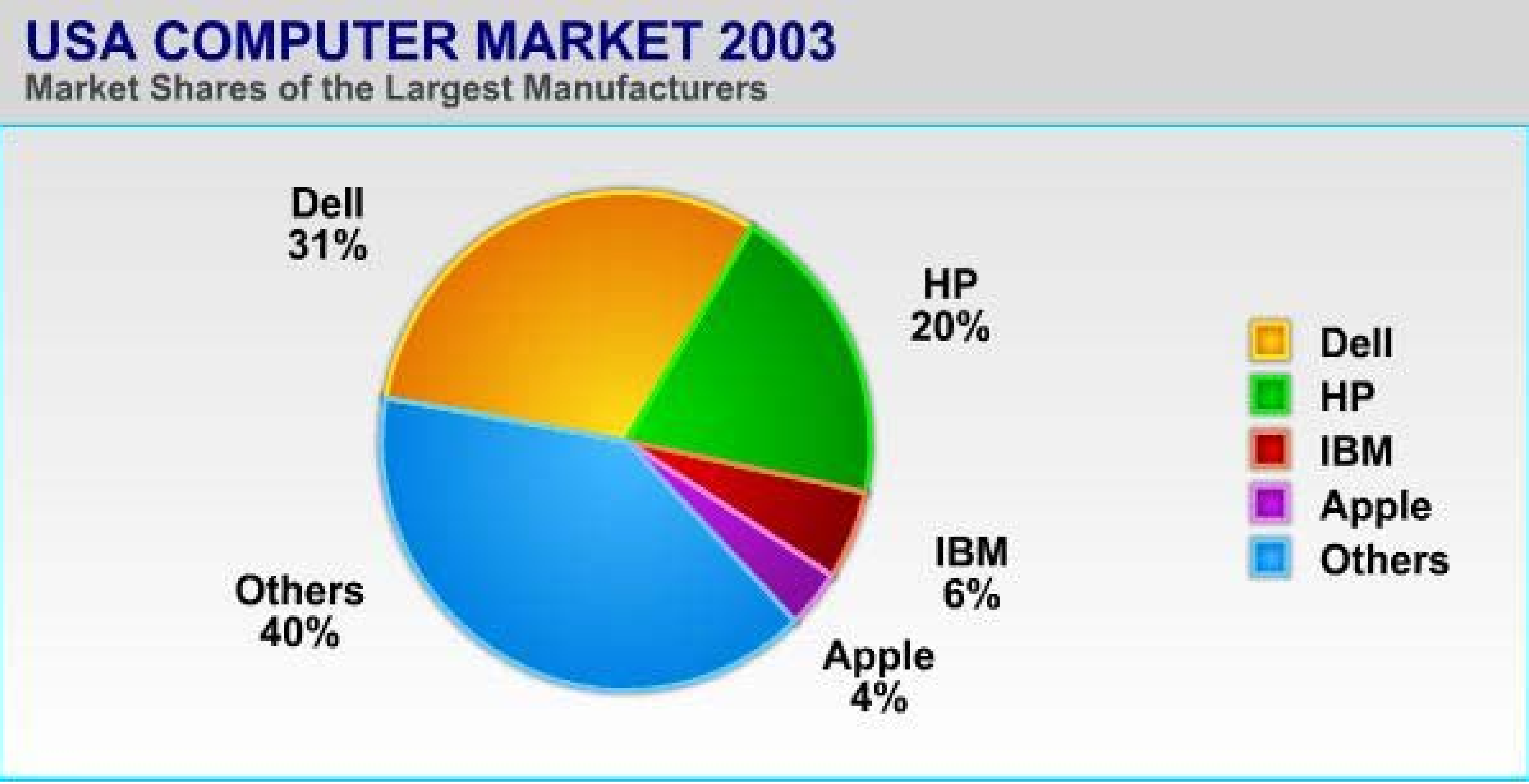
Global Market Share in Confectionery



US Computer Market Share



The growth of firms (internal growth)

- The Internal (Organic) Expansion of a Business
  - Firms can generate higher sales and increased market share by expanding their operations and exploiting possible economies of scale
  - This is internal rather than external growth (i.e. organic growth)
  - Tends to be a slower means of expansion contrasted to mergers and acquisitions

The growth of firms (external growth)

- Horizontal Integration
  - Where two firms join at the same stage of production in one industry.
  - For example two car manufacturers may decide to merge, or a leading bank successfully takes-over another bank.

The growth of firms (external growth)

- Vertical Integration
  – Where a firm develops market dominance by integrating with different stages of production in the industry e.g. by buying its suppliers or controlling the main retail outlets
  – A good example is the oil industry where many of the leading companies are both producers and refiners of crude oil.

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Vertical integration

Farm Business

Food Processing

Food Retailing

Basics of Competitive Markets

- Many suppliers – none with dominant market power
- High cross price elasticity of demand – because consumers have plenty of choice over a wide range of substitute products
- Low barriers to entry and exit – new firms can enter the market if profits are high enough
- Product differentiation – giving the consumer plenty of choice among competing products
- Intense price and non-price competition – as firms battle for market share and market dominance

Welfare effects of competitive markets

- Lower prices - because of the large number of competing firms
  - Suppliers face highly elastic demand curves
- Low barriers to entry
  - The entry of new firms provides extra competition and ensures prices are kept low
- Economic efficiency
  - Firms attempt to minimize their costs and move towards productive efficiency
  - Faster rate of technological progress - This is known as dynamic efficiency

The case for greater competition in markets

- The interest of each producer is to serve consumers better than its rivals.
- This rivalry benefits consumers both directly in terms of better deals and as producers strive to increase their efficiency, coming up with new and better ways of doing things
- Freeing competition opens the way for the dynamic benefits in terms of greater efficiency, innovation and choice.
- (Adapted from the Office of Fair Trading web site)

The economic and social case against monopoly

- (1) Monopolists earn extra profits at the expense of economic efficiency by setting prices above those that would exist in competitive markets
- (2) This abuse of market power can lead to a misallocation of resources (market failure)
- (3) If there is an oligopoly, the leading firms may engage in collusive behaviour designed to keep market prices higher than under competition
- (4) The monopolist is extracting a price from consumers that is above the cost of resources used in making the product (i.e. there is often a high “mark-up” on price)

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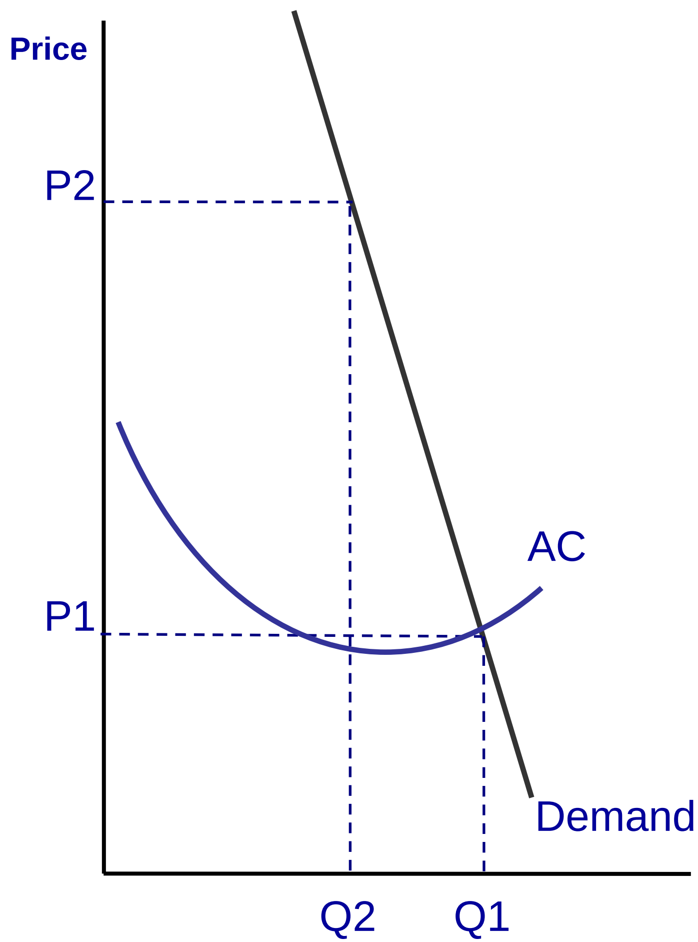
The economic and social case against monopoly

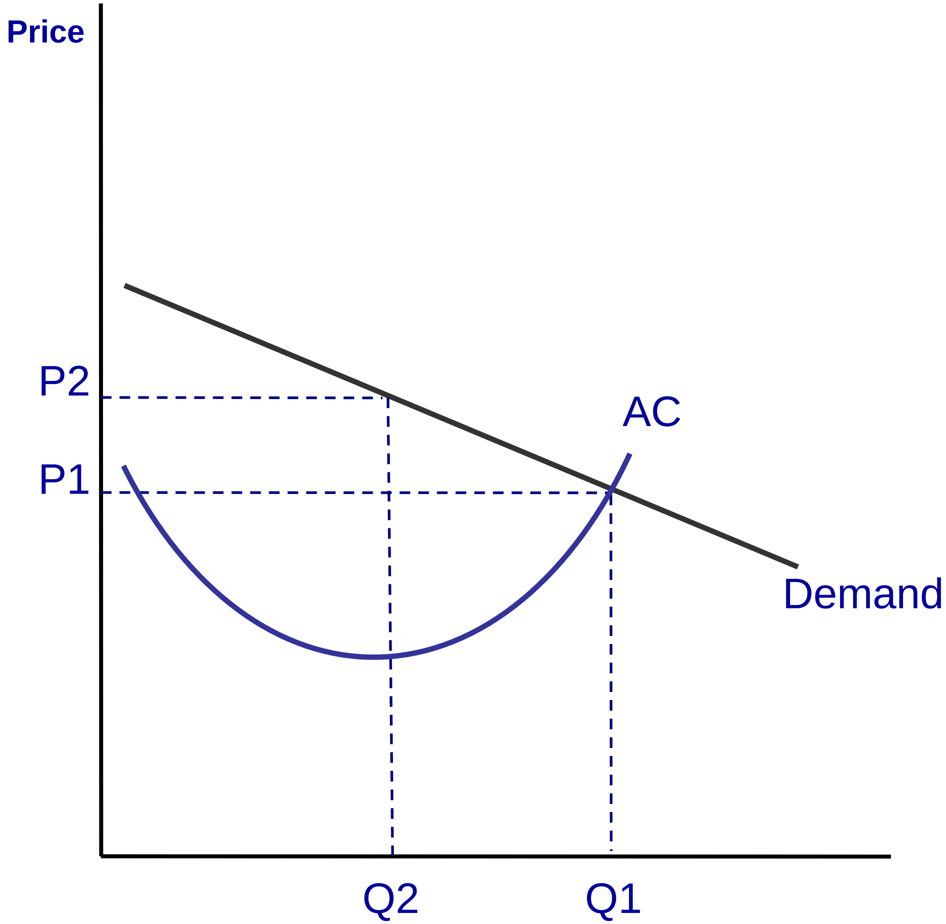
- (3) Consumers' needs and wants are not being satisfied, as the product is being under-consumed – leading to a loss of allocative efficiency
- (4) The higher average cost of production if there are inefficiencies in production mean that the firm is not making optimum use of its scarce resources
- (5) If the market does not allocate resources optimally because of monopoly power, then it is said to experience "market failure"

The economic case against monopoly

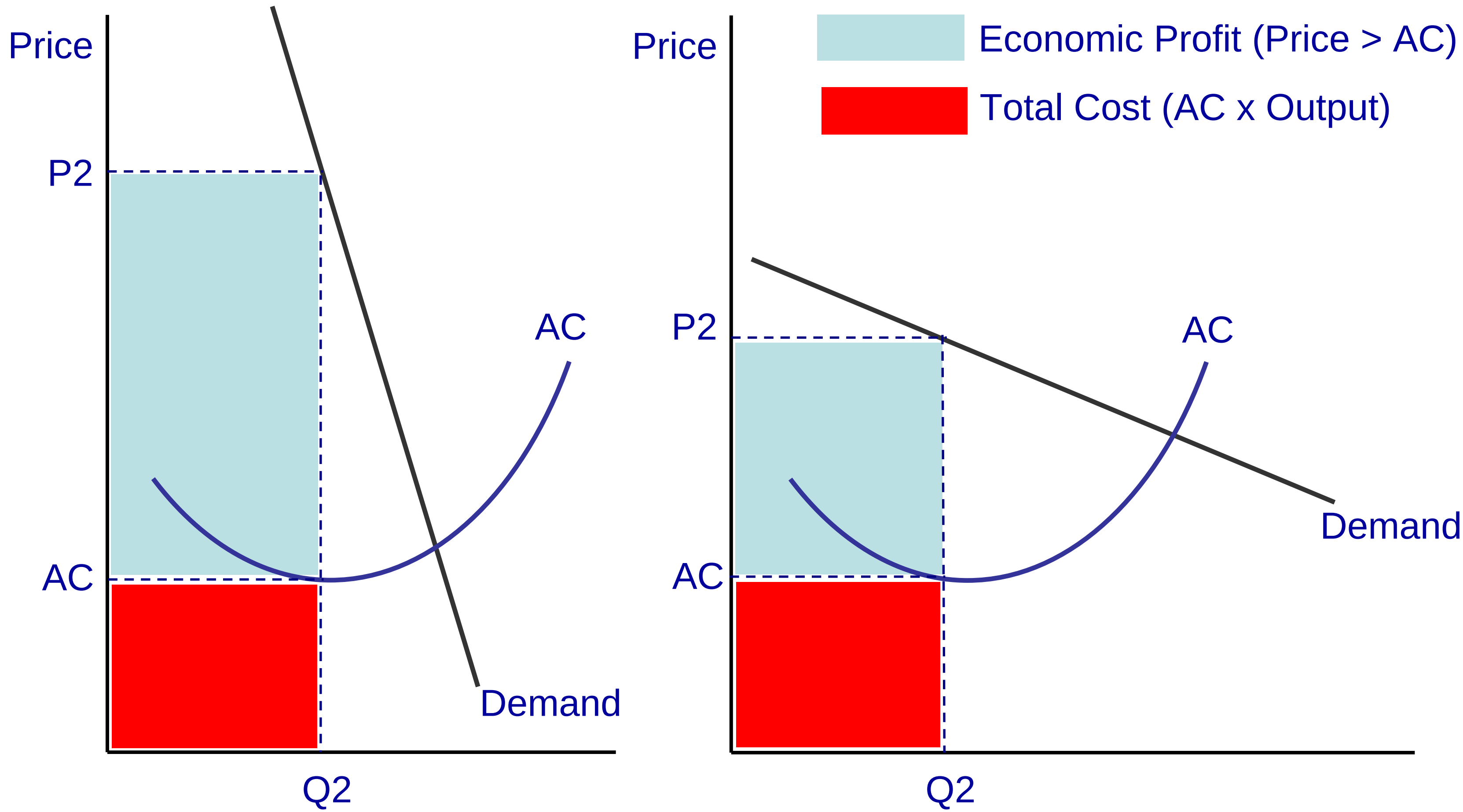
Relatively Inelastic Demand



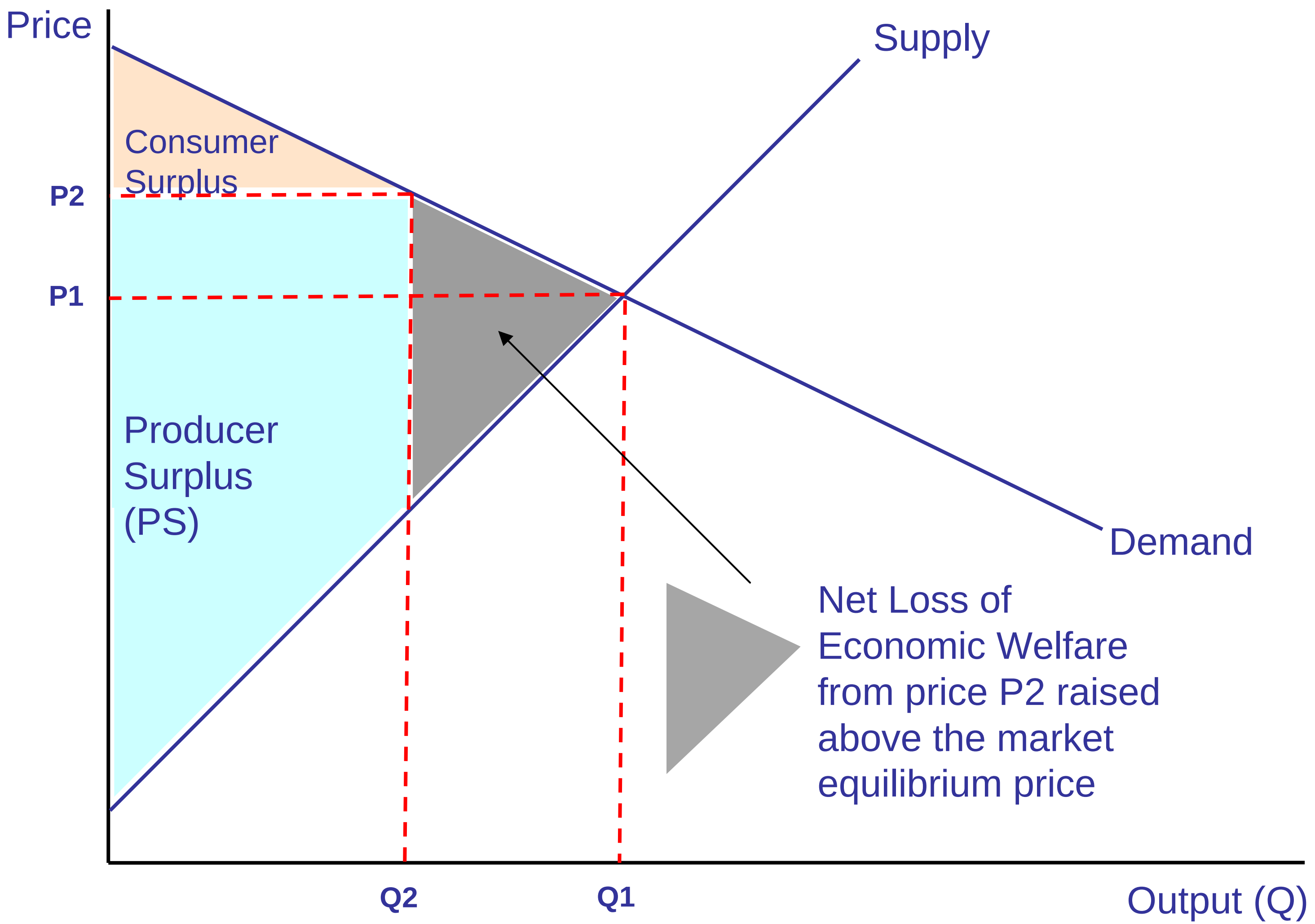
Relatively Elastic Demand



Prices and profit margins



Monopoly and the loss of allocative efficiency



Barriers to entry – protecting monopoly power

- Entry barriers are the means by which potential competition is blocked
- Patents
  - Patents to prevent the entry of rivals
  - They give the owner an exclusive right to prevent others from using patented products, inventions, or processes
- Vertical Integration
  - Control over supplies and distribution can be important
- Predatory Pricing
  - Firms may adopt predatory pricing policies by lowering prices to a level that would force any new entrants to operate at a loss
- Advertising and Marketing
  - Developing consumer loyalty with branded products can make successful entry into the market by new firms much more expensive

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Potential benefits from monopoly

- Economies of scale and investment
  - Monopoly suppliers might be better placed to exploit economies of scale – which means that consumers may benefit from lower prices
- Research and development and innovation
  - Higher profits leads to faster rate of technological development that will reduce costs and produce better quality products for consumers

Potential benefits from monopoly

- The natural monopoly justification
  - A natural monopoly occurs in an industry where costs per unit falls over a wide range of output levels such that there may be room only for one supplier to fully exploit the economies of scale in the market and therefore achieve productive efficiency

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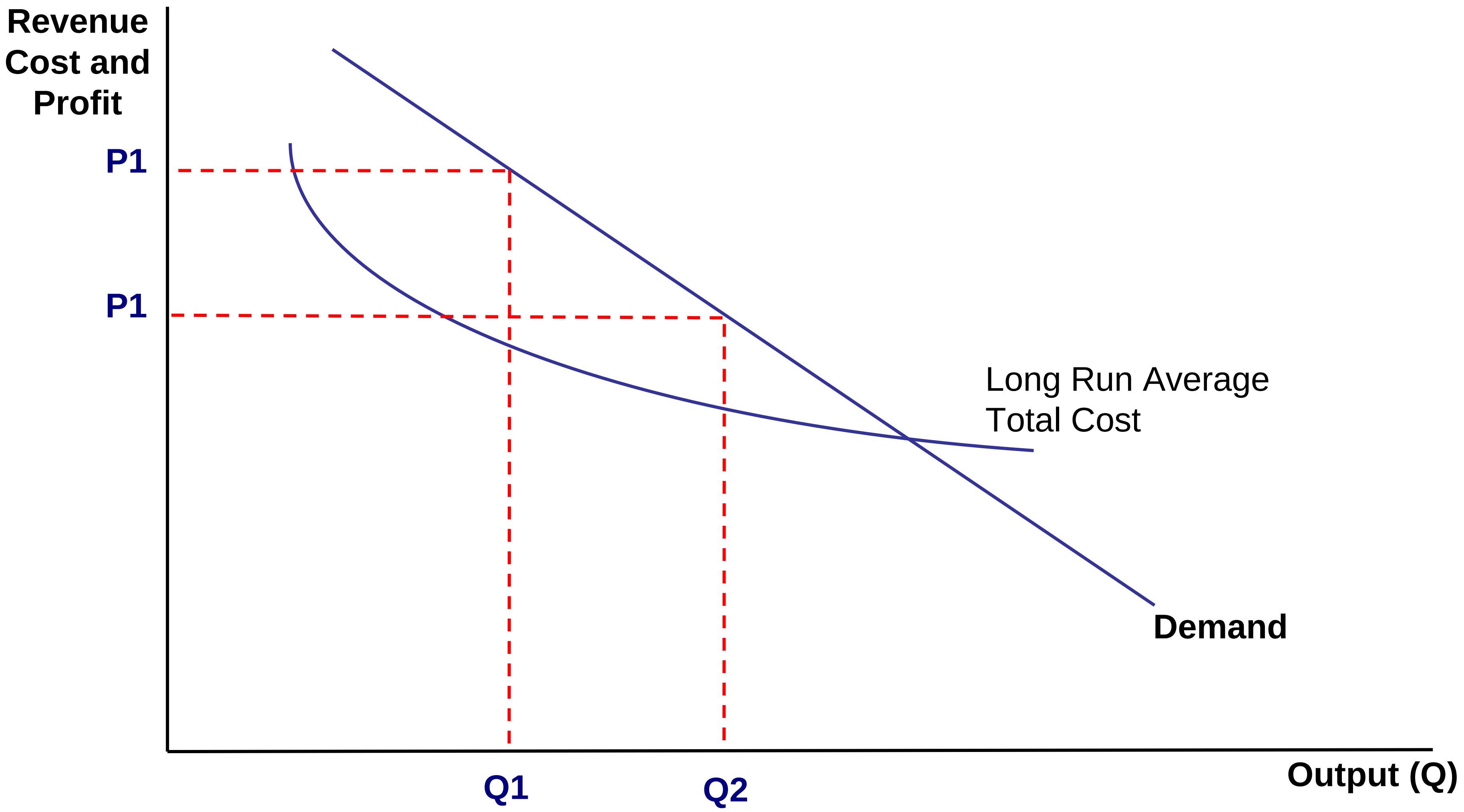
Potential benefits from monopoly

- The threat of competition
  - Provided the market is contestable and open to new competition, a firm that has built up a monopoly position still faces the threat of competition and this will keep prices down and costs under control

Costs for a natural monopoly



Natural monopolies

- A natural monopoly exists when there is great scope for economies of scale
- Associated with industries where there is a high ratio of fixed to variable costs
- For example, the fixed costs of establishing a national distribution network for a product might be enormous, but the cost of supplying extra units of output may be very small
- With a pure natural monopoly, there may only be room for one firm to fully exploit the economies of scale

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