

MARKET STRUCTURE

- (a) Explain how firms can increase market power? [10]
(b) Discuss the extent to which the performance of firms is determined by their market power. [15]
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Approach: Students are expected to explain various strategies that firms may employ to increase their market power. Answers can be categorised under demand and supply factors (At least 3)

Suggested outline

Introduction

Market power refers to a firm's ability to influence the market price without losing all of its sales. Market power is measured by the no of producers, size of the firms, level of barriers to entry and the availability of substitute goods.

Firms can increase their market power through erecting artificial barriers to entry through strategic entry deterrence and control of raw materials. Firms can also seek to increase their market power by mergers with other firms.

Body

Demand factors

Mergers

- Firms can also increase their market power through mergers with other firms. A merger refers to two or more companies or organisations combining together, resulting in a larger firm.
- Duplication of operations is removed to reduce costs. Cost advantage over rivals, enables firm to increase its market power.
- Merged firm controls a larger market share, better able to raise prices.
- Eg.

Strategic deterrence

- Incumbent firms engage in aggressive advertising campaigns to increase brand loyalty and brand awareness amongst its consumers.
- Advertising campaigns - leads to higher demand for product, increasing the consumer base for firm.
- Make the demand for the firm's product relatively price-inelastic due to greater brand loyalty.
- Deters potential competitors from entering industry, as new firms would have to incur a sizeable cost for advertising (BTE) to be able to successfully penetrate the market.
- Pursuing other objectives like output-maximising to raise customer base and increase market share, or enable firm to enjoy IEOS when producing a large output (especially for new firms). Includes predatory pricing when firm is trying to drive out competition in a foreign market. Aim is to reap long-run profits by sacrificing short-run profits.
- Eg.

Supply Factors

Control of raw materials

- Firms can also increase their market power by controlling necessary raw materials.
- Will limit any entry of potential firms or existing rivals could face rising/higher cost of production. This will increase the market power of the incumbent firm.
- Eg. DeBeers

Conclusion

Level	Descriptors	Marks
L1	For a descriptive answer with no or limited link to how firms can increase market power. Concept errors.	1-4
L2	For an underdeveloped (lacking in scope or depth) answer that explains <u>at least 2</u> methods firms can use to increase their market power. Mere description of barriers with no linkage to what firms can do to protect these advantages – max 5 marks	5-6
L3	For a well-developed answer that explains <u>at least three methods</u> firms can use to increase their market power. With examples provided 3 well-developed points <u>with brief examples</u> – max 8 marks Well-developed explanation with at least 3 factors and <u>no examples</u> – max 7 marks	7-10

(b) Discuss the extent to which the performance of firms is determined by their market power. [15]

Approach: *Students are expected to highlight how performance of firms, in the form of profits and efficiency, are influenced by variations in market power (MC/PC vs Monopoly/oligopoly?). Students are then expected to highlight factors besides its market power that could influence its performance.*

Suggested Outline

Introduction

- Performance of firms in a market is often measured by looking at several different criteria – type of profits in the long run, allocative efficiency, productive efficiency and dynamic efficiency. For different groups of agents in society, performance of a firm would focus on different areas.

Body

Thesis: The performance of firms in a market is determined by market power

Performance

1. Profits:

- A competitive market, for example **perfect competition**, has a large number of buyers and sellers, homogeneity of product and no barriers of entry.
- Flatter demand curve facing firm due to low barriers to entry suggests no/limited market power for firms to raise prices (price-taker) to earn supernormal profits in long run.
- Would only make normal profits in the long run as the supernormal profits would entice competitors who can easily enter and exit the industry. Due to low barriers to entry firms lack market power in influencing prices. As a price taker, a single firm has no power to raise prices to earn more profits.
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[Diagram showing PC OR Monopolistic Comp Eg. earning normal profits in LR]

- **In contrast**, firms in an **oligopolistic** industry and a **monopoly** are likely to earn supernormal profits in the long run due to the high level of barriers (steep DD curve facing firm) new firms are prevented from entering thus conferring market power to existing firm/s
- This allows firms to restrict output to raise prices, the market power to do so allows them the possibility to earn supernormal profits in the long run.

[Diagram showing Monopoly OR Oligopoly eg. earning supernormal profits in LR]

- **Extent** of market power is determined by barriers to entry. The greater the degree of BTEs the more market power a firm has in setting higher prices thereby earning greater supernormal profits in the long run

2. Productive efficiency

- Productive efficiency is achieved when the firms in an economy are producing the maximum output for the given amount of inputs, or producing a given output with the least cost combination of inputs.
- All firms may be productively efficient.
- However, under perfect competition, where firms have a **lack of market power**; in the long run, competition **forces perfectly competitive firms** to produce at the point of minimum average total cost of production and to charge that price which is just consistent with these costs.

- Firms with greater market power (monopoly) may tend to be more X-inefficient. Given greater market power may imply limited competition therefore complacency in minimising costs may set in.

3. **Dynamic Efficiency (Variety of products and Innovation)**

- Absence of barriers to entry implies that there are no super-normal profits to make in the long run and this means that firms do not have the resources to engage in innovation. So Firms in a perfectly competitive market lack the ability to innovate. No product or process innovation.
- Oligopolies and monopolies can maintain supernormal profits in the long run, this is due to their ability to raise prices and therefore earn supernormal profits. As a result, more able to carry out research and development to create new products and increase the variety of products available to consumers. Therefore they can improve product type and improve production processes.
- ***Firms under monopolistic competition have the highest incentive to differentiate because the monopolistically competitive firm competes directly with many other small sellers in the same market.***
- ***Evaluate extent of DE***
- *Depending on whether the firms are a collusive or competitive oligopoly, the incentive to innovate is different. Under a collusive oligopoly, firms may agree to limit advertising expenditure or even product development, because retaliatory advertising and extensive spending on R&D by each and every firm may be self-cancelling and reduce total industry profits.*
- *On the other hand, competitive oligopolies may have an incentive to create new products to differentiate their product in order to raise the demand for their product and capture a greater market share. Firms that do not innovate or try and create some sense of brand loyalty may see themselves losing market share to their rivals.*

Allocative Efficiency

- *Explain Allocative Efficiency*
- Allocative efficiency is only present under perfect competition due to the presence of many competitors all selling the same product. A PC firm faces a perfectly price elastic demand curve, where the marginal revenue of selling a product is exactly equal to the marginal cost for selling an additional unit. Assuming a profit maximising firm, the PC firm will charge consumers at $P=MC$.
- For a firm that has very little market power, in the face of significant competition (PC) and the inability to exert any influence over increasing its price it will be more likely for the firm to set prices closer to its MC rendering it closer to allocative efficiency.
- Hence, it is possible to assert that the extent of how allocatively efficient a firm might be, as reflected by the slope of its demand curve, would be that the less market power it has the more allocatively efficient it will be.

Anti-thesis: The performance of firms in a market is not determined by market power – Other factors

Regulation:

- Governments often play a regulatory role in protecting the welfare of consumers in society. In cases where an industry is considered crucial such as utilities but is a natural monopoly, the government is likely to regulate the market to force these firms to produce a larger output at a lower price than they otherwise would have if unregulated. (AC pricing? MC pricing? Affects supernormal profits and efficiency)
- A firm's performance could also be affected if a firm is nationalised. Nationalisation may give rise to inefficiency due to government bureaucracy and corruption. In the absence of the profit

motive, governments may not run nationalized companies as efficiently as a private company. Hence, firms could become **X-inefficient** as they become lax with cost controls.

- A firm's performance in this case would be determined by government intervention in the market.

Alternative objectives of firms:

- The traditional theory of firms assumes that the main objective of firms is to profit maximise. However, in reality, firms may choose alternative goals other than profit maximisation particularly in the short run.

Contestability:

- The theory of contestable markets argues that what is crucial in determining a firm's behaviour and hence performance is not the actual amount of competition but whether there is the real threat of competition.

Prevailing economic conditions, nature of goods sold, etc:

- E.g. during a recession, demand for luxury goods sold will fall while demand for inferior goods will rise. A firm which has high market power (e.g. oligopolistic firm) but selling luxury goods may suffer from losses while a firm which has little market power (e.g. monopolistic competitive firm) but selling inferior goods may earn profits. This shows that market power is not the factor that determines the performance of firms.

Conclusion/Synthesis:

- In theory, the performance of a firm in a market is influenced by market power.
- However, there are several other factors in reality that affect the performance of firms. Governments can choose to regulate monopolies to ensure that the welfare of consumers are protected, managers can choose to pursue alternative objectives to maximise their own benefits rather than to profit maximise and the threat of competition could alter a firm's behaviour and hence performance.
- The view that the performance of firms in a market is determined by market power is likely to hold true under conditions that firms do not deviate from the traditional objective of profit maximisation and in the absence of government intervention.

Level	Descriptors
L1 (1 – 2)	<ul style="list-style-type: none"> • Largely irrelevant answer with a few valid points.
(3 – 5)	<ul style="list-style-type: none"> • Some knowledge of how market power in different markets affects firms' performance but there may be conceptual errors or lack of development. • Little or no attempt to compare across market structures. • No consideration of how market power is not the only factor that determines the performance of firms in a market.
L2 (6 – 8)	<ul style="list-style-type: none"> • Accurate explanation of how market power in different markets affects firms' performance with adequate development. • Considers performance of firms in terms of impact of at least 2 criteria (firms' profitability and/or society's concerns of efficiency (productive or allocative or dynamic) and/or consumer's welfare (variety or product innovation).) • Some attempt to compare across market structures. Answer mentions at least 2 market structures. • For 8m there must be consideration of at least 1 other factor of how market power is not the only factor that determines the performance of firms in a market.

L3 (9)	<ul style="list-style-type: none"> • Well-developed explanation of how market power in different markets affects firms' performance. • Considers performance of firms in terms impact on at least 3 different criteria (firms' profitability and society's concerns of efficiency (productive or allocative) and consumer's welfare (variety or product innovation).) Including at least 1 type of efficiency. • Good comparison of how degree of market power across market structures affects the performance of firms. • Good consideration of at least 1 other factor of how competition is not the only factor that determines the performance of firms in a market.
(10 – 11)	<ul style="list-style-type: none"> • Excellent explanation of how market power in different markets affects firms' performance. • Considers performance of firms in terms impact on all 3 different criteria (firms' profitability and society's concerns of efficiency (productive or allocative) and consumer's welfare (variety or product innovation).) • Excellent comparison of how market power across all 4 market structures affects the performance of firms. • Excellent consideration (at least 2 factors) of how competition is not the only factor that determines the performance of firms in a market.
Evaluation	
E1 (1–2)	Mainly unexplained judgment.
E2 (3–4)	Well-explained judgment on whether competition is the only factor that affects the performance of firms.