

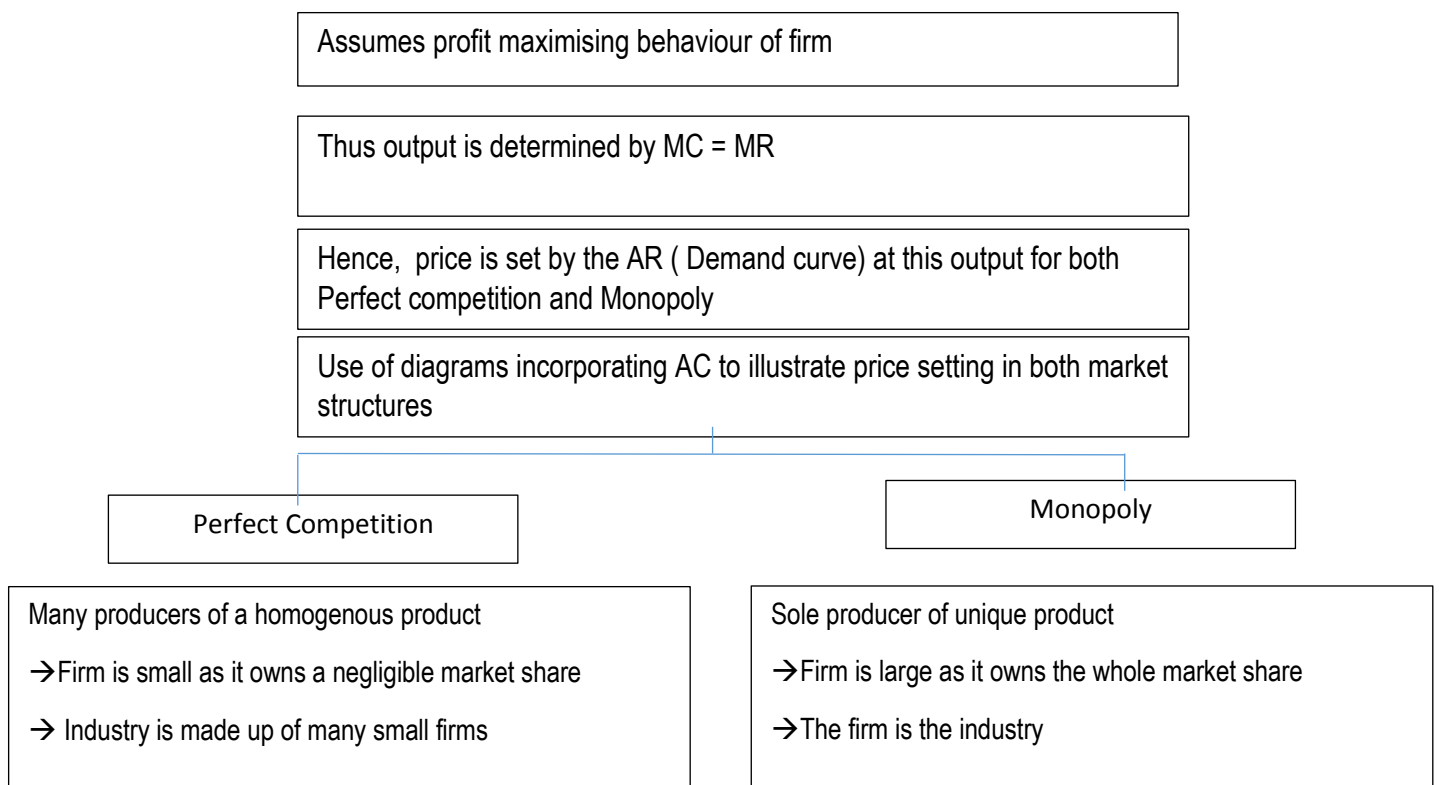
Question 2

- a. Differentiate between the key features of the economic models of perfect competition and monopoly, illustrating your answer with examples. [10]
- b. Discuss whether the determination of a firm's price and output is more dependent on the competition that it faces or the firm's objectives. [15]

Define and explain each market structure concept. The key differences that should be explained include those regarding the market structure including barriers to entry, number of producers, market dominance and market outcomes e.g. the ability or otherwise to set price and to make normal or abnormal profits in both the short and long run.

Knowledge, Application, Understanding and Analysis		
L3	Clear differentiation between monopoly and perfect competition with examples. The analysis should refer to the market structure (e.g. barriers to entry etc) and the market outcomes (abnormal v normal profits etc).	7-10
L2	Undeveloped differentiation, e.g. of either market structure or of market outcomes but not both, and without underlying analysis.	5-6
L1	For an answer that has some basic correct facts such as an unexplained list of key features.	1-4

Suggested Answer Model (a)



Horizontal AR curve

- Firm is a price taker
- Firm has no market power.
- Goods produced by firm has many perfect substitutes in the market

Ease of entry & exit

- Existence of supernormal profits → entry of new firms
- Industry supply increases → SS curve shifts right
- market price falls
- Abnormal profits of firm competed away
- Firms have no market power.

Downward sloping price inelastic AR curve

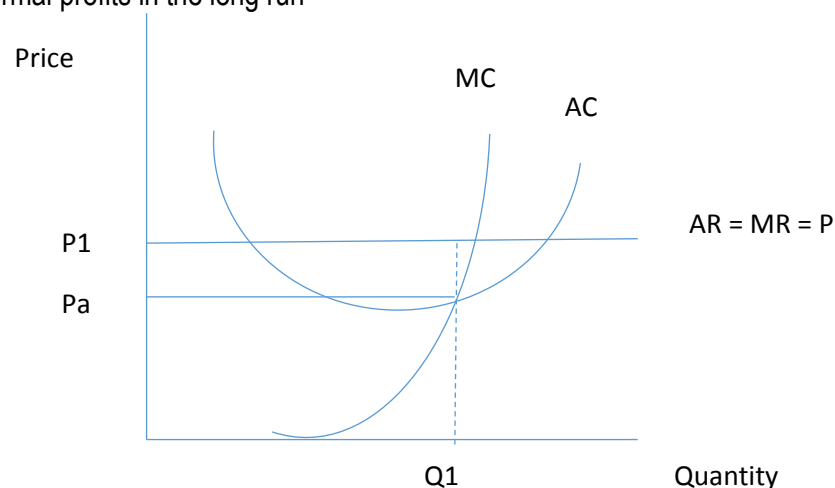
- Firm is a price maker
- Firm has significant market power → able to restrict output to raise price
- Existing firm may respond by non-price competition to make it's AR even more inelastic
- Goods produced by firm has no substitutes in the market

Formidable barriers to entry

- abnormal profits can be preserved

Impact on price and output determination:

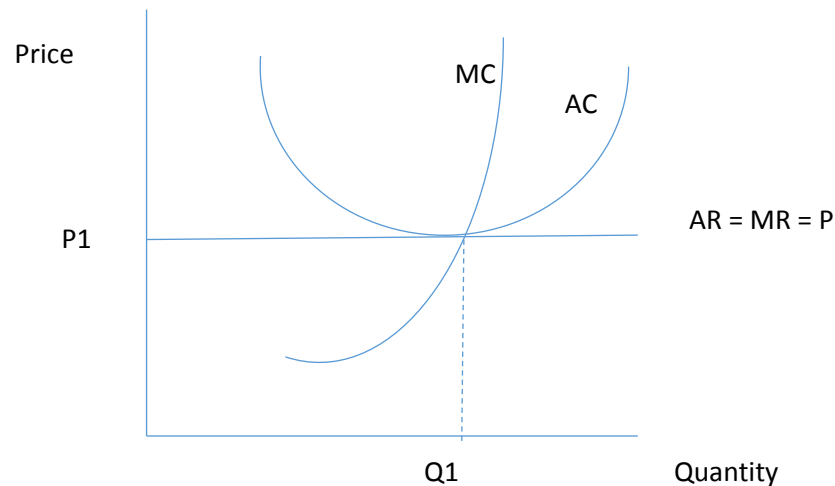
- No market power and many perfect substitutes available → perfectly price elastic demand curve
- Earn only normal profits in the long run



If existing firms are earning supernormal profit in the short run (figure above), new firms will be attracted into the industry → The supply curve of the industry will shift rightward. The market price, the AR and the MR faced by the firm will be reduced.

Supernormal profit is thus reduced. The rightward shift of the supply curve of the industry continues until the market price, the AR and the MR faced by the firm is tangent to the LRAC curve and normal profit is made. When the firms in perfect competition make only normal profit, there is no incentive for new firms to enter the market. Long run equilibrium is attained. In the long run, the firm will be producing at output OQ and charging a price of OP, as illustrated by figure below. At OQ, the price charged is just enough to cover AC. Hence the firm is earning normal profit.

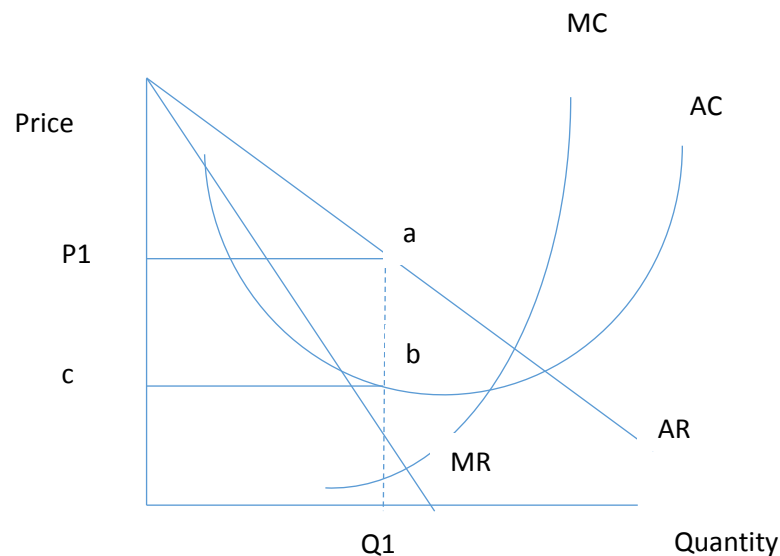
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Impact on price and output determination:

- Significant market power and absent of substitutes, low PED
- The monopolist can make supernormal, normal or subnormal profits in the **short run**.
- The monopolist can persevere supernormal profit even in the **long run** because of formidable barriers to entry. Figure below shows a monopoly in long run equilibrium and making long run supernormal profit of P_1abc .

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CONCLUSION

Several differences in the characteristics of perfect competition and monopoly separate the two market structures. This would have important implications on threat of competition that a firm faces or the firm's objectives.

- (b) Discuss whether the determination of a firm's price and output is more dependent on the competition that it faces or the firm's objectives. [15]

Introduction

Summarise comparison of PC against oligopoly/monopoly/ monopolistic competitive

- Differences in characteristics
- Imperfect information
- Barriers to entry → size of market power
- number of firms
- PC firms are price takers ; imperfectly competitive firms are price maker

Development

Determinants of a firm's price and output

Perfect competition

Imperfect competition e.g. Monopoly

Dev 1 : Determination of firm's price and output in PC and monopoly can be similar and is dependent on firm's profit-maximising objective.

Economic Theory suggests that PC firms and imperfectly competitive firms can make their output decision based on same objective of profit maximizing → implies that they can have similar objectives.

Maximize profits → Profits = TR – TC → Produce output where MC = MR

Dev 2: Determination of firm's price and output in PC and monopoly are likely to be different .

While PC firms are likely to practise profit maximization, firms in imperfect market structures e.g. monopoly are likely to practise other objectives

Explain why PC firms are likely to practice profit maximization :

Able to max profit : Perfect Competition → Maximize profits $\text{Profits} = \text{TR} - \text{TC}$ → Take price as dictated by the industry and set output where $\text{MC} = \text{MR}$

In theory → able to max profit In theory, able to get perfect info → can get MR and MC info → profit max

Want/Need to max profit : In theory → Want / Need to max profit In theory → LR can only make normal profits. Use cost and revenue diagram to show → If PC firm does not max profit → must leave industry → competed out.

Explain why imperfect competitive firms e.g. monopolists are not likely to practice profit maximization :

Imperfect competition → In theory, imperfect competitive firms may have other objectives than to max profits

Not able to max profit : May not be able to max profit → Not able to get info on MC and MR → estimate the average cost of output → adds a profit margin → Cost plus pricing

Not want to : Need not necessarily want to max profit → Other objectives → Managerial and behaviour aims

- 1) Aim to maximize sales revenue – market share dominance
- 2) Subjected to government control – practise AC/MC pricing

Not want to : Need not necessarily want to max profit → objective is to deter entry . Hence the threat of competition determines the firm's price and output.

- 3) Keep out potential rivals through predatory pricing
- 4) Reduce potential competition in highly contestable markets – practise limit pricing
- 5) Not invite unwanted attention from potential rivals and govt – do not want to make excessive profits → choose a output and price that do not max profits

Synthesis/ Conclusion:

Address the qn → In theory, both may aim to maximize profits. However, economic theory suggests that imperfect competitive firms may have other managerial and behavioural objectives

PC firm has the ability to maximise profit due to perfect information. It also has to maximise profit if it wants to remain in production. State-owned monopoly may be required by regulation to practise MC pricing. For these firms, their P and Q are more dependent on the firms' objective.

In reality, objectives likely to differ for firms in imperfect markets because firms in imperfect markets are not likely to have enough information to be able to maximize profits. Hence, imperfectly competitive firm's price and output is more dependent on the threat of competition

Mark Scheme

Level	Knowledge, Application, Understanding, Analysis	Marks
L3	For an answer that uses appropriate analysis to explain how market structure and a firm's objectives determine a firm's price and output.	7-11
L2	For an answer that gives a descriptive explanation of how market structure and a firm's objectives determine a firm's price and output.	5-6
L1	For an answer that shows knowledge of price and output determination in different market structure, and under alternative objectives of the firms	1-4 (3)
E2	For an answer that arrives at an analytically well-reasoned judgement about whether the determination of price and output is more dependent on the competition or the firm's objectives	2-4
E1	For an answer that makes some attempt at a judgement about whether the determination of price and output is more dependent on the competition or the firm's objectives.	1-2