RVHS Preliminary Exam 2. Y6H2 Economics, 2017.

<u>Question 3</u>

'There is little difference between perfect and imperfect markets. They all have profit maximisation as an aim, they all are subject to competition and they all exploit resources to benefit the producers rather than the consumers.'

Discuss the validity of this statement. [25]

LORMS

	Knowledge, Application / Understanding and Analysis	
L3	Developed discussion of all 3 aspects of the proposition (i) objectives of firms, (ii) exposure to competition, (iii) benefits to economic agents (consumers vs producers) with a consideration of the similarities and differences of both perfect and imperfect markets. "Developed" answers are expected to show economic analysis and exemplification of situations when (aspects of) the statement might be valid or invalid.	**15-20**
L2	Undeveloped discussion or Developed explanation which concentrated probably on the differences with limited discussion of the comparability.	**9-14**
L1	Knowledge of the 3 aspects of the proposition but largely unexplained.	**1-8**

E3	Analytically well-reasoned judgement about the relative validity of the 3 aspects of the proposition, drawing to a clear conclusion.	**4-5**
E2	Some attempt at a judgement about the validity of the 3 aspects in the proposition.	**2-3**
E1	Unsupported statement about the validity of the proposition.	**1**

‘There is little difference between perfect and imperfect markets. They all have profit maximisation as an aim, they all are subject to competition and they all exploit resources to benefit the producers rather than the consumers.’

Discuss the validity of this statement. [25]

<u>Introduction:</u>

- Perfect markets: firms operating under the market structure of perfect competition
- Imperfect markets: firms operating under monopolistic competition, oligopoly and monopoly
- Perfect and imperfect markets possess both similarities and difference on the three aspects flagged out in the question:
    (i) objectives of firms,
    (ii) exposure to competition
    (iii) benefits to economic agents (consumers vs producers).

<u>(i) Profit maximisation vs alternative objectives</u>

Proposition is valid: all firms whether in perfect or imperfect markets are similar in that they all have a profit maximisation as an objective.

- Marginalist principle: rational firms make output and pricing decision based on profit-maximising condition MR=MC.
- At profit-maximising level of output, Qe, the additional revenue generated for every extra unit of output produced (MR) equals the additional cost incurred from producing each extra unit of output (MC).
- This would be true across firms in both perfect and imperfect markets.

Proposition may be invalid: firms may have alternative aims other than the profit motive.

- These include objectives to (a) protective or gain market share or (b) objectives based on the managerial theories of firms.
- (a) Some firms may choose not to profit-maximise in order to protect or gain market share. E.g. firms deliberately charging lower price to deter potential entrants into the market or to drive rival firms out of the market.
- (b) managerial theories of firm: in large, professionally-managed organisations, there is separation of control (by professional managers) and ownership (by shareholders) which leads to a deviation between objectives of the owners vs the managers.
- E.g. managers might focus on sales-maximisation rather than profit-maximisation as an objective especially for sales managers and commissioned-based employees because their salary are often linked to sales target.

<u>(ii) Exposure to competition</u>

Proposition is valid: both perfect and imperfect markets are similar since they are all subject to competition

- In traditional theories of firm: perfect competition is subject to the highest level of competition, making its performance in terms of allocative, productive efficiencies a yardstick against which other market structures are measured.
- However, in the theory of contestable markets, all firms even those in imperfect markets such as oligopoly and monopoly can be subject to competition.
- Contestable market: market in which there are only a few firms such as monopolies and oligopolies, because of the threat of new entrants, behave in a competitive manner.
- When oligopoly and monopoly firms are seen to be making supernormal profits, the existence of potential short term entrants of competitors will drive down prices and return profits to normal levels.

Proposition is invalid: perfect and imperfect markets are subject to different levels of competition (high vs low/no competition)

- Traditional theory of firms: Firms in perfect market i.e. perfect competition are subject to the high competition due to lack of barriers to entry
- At the other end of the spectrum, firms in imperfect markets e.g. Monopoly faces no competition due to high barriers to entry.

(iii) benefits to economic agents (consumers vs producers).

Proposition is invalid: that firms in perfect and imperfect markets all exploit resources to benefit the producers rather than the consumers.

- Firms in perfect markets i.e. perfect competition due to their characteristics of large numbers of firms, homogenous products and perfect information, have no market power or control over price i.e. they are price takers. No barriers to entry also means perfectly competitive firm only earn normal profit in the long run.
- These led to all perfect competition being allocative efficient (P=MC) which maximises societal welfare, i.e. consumer and producer surplus are both maximised.

- In contrast, firms in imperfect markets e.g. monopoly has high market power to set prices since they are the dominant firm selling unique products without close substitutes in markets with imperfect information. Their ability to erect strong barriers to entry also means monopolies can continue to earn supernormal profits in the long run.
- These led to allocative inefficiency where the prices charged by monopolies are above the MC of production (P>MC) leading to deadweight loss to society. Consumers are made worse off with the higher price, lower output and consumer surplus are captured by the producers.
- This problem may be amplified in cases where firms have market power to price discriminate, resulting in further net reduction in consumer welfare.
- However, the supernormal profits earned by firms in imperfect markets provide the financial resources for firms to engage in innovation, improving dynamic efficiency and consumer choices of quality and variety of goods and services.
- Hence, the proposition whether the producers have all the benefits are debatable depending on the degree of market power and possible government intervention.