

3 Perfect competition, imperfectly competitive markets and monopoly

Case studies

Case study 3.1

- 1 An improved home delivery service; advertising competition.
- 2 In May 2011, Tesco set out a seven-part business strategy, the main elements of which were: (i) to grow the UK core; (ii) to be the creator of highly valued brands; (iii) to be an outstanding international retailer in stores and online; (iv) to grow retail services in all our markets; (v) to put our responsibilities to the communities we serve at the heart of what we do; (vi) to build our team so that we create more value; and (vii) to be as strong in everything we sell as we are in food.

You can find out more on Tesco's business strategy at <http://businesscasestudies.co.uk/tesco/vision-values-and-business-strategies/strategy.html#axzz3uqtQoVwN>. Also look up Tesco's Strategic Report. The 2015 Report can be accessed at www.tescopl.com/files/pdf/reports/ar15/download_strategic_report.pdf.

Use Tesco's recent profits when judging the success of Tesco's business strategy. On 7 October 2015, the *Guardian* reported that 'Tesco has had a traumatic year, hit by an accounting scandal and the fierce grocery price war. It has been losing sales to discount retailers such as Aldi and Lidl and last year posted a record £6.4 billion loss, one of the biggest in British corporate history. The company was forced to sell off its South Korean business Homeplus for £4 billion to alleviate the £8.6 billion debt that has reduced its credit rating to junk status.'

Case study 3.2

- 1 Although higher cigarette prices are seemingly in the public interest because they will lead to a fall in smoking, they may significantly reduce competition. The resulting higher profits made by cigarette manufacturers may be used to promote sales amongst poor people living in developing countries.
- 2 The firms mentioned in the passage are the cigarette manufactures Imperial Tobacco and Gallaher, and the retailers Tesco, Sainsbury's and ASDA. However, other firms were also involved.

On 17 April 2010, the *Guardian* reported:

A dozen tobacco manufacturers and retailers, from supermarkets to petrol station operators, have been fined a record £225m for unlawfully inflating the cost of cigarettes.

The largest fine, of £112m, has been imposed on Imperial Tobacco, makers of Lambert & Butler and Golden Virginia, followed by a fine of £50m imposed on Gallaher, home to Benson & Hedges and Silk Cut and owned by Japan Tobacco. Between them the two companies make close to nine out of every 10 cigarettes and roll-ups smoked in the UK. The tobacco market in the UK is worth an estimated £13bn. Also fined were the retailers ASDA, Co-operative Group, First Quench, Morrisons, One Stop Stores (formerly T&S Stores), Sainsbury's, Shell, Somerfield and TM Retail — with the heaviest fines of £14m being imposed on both ASDA and the

Co-op. Sainsbury's alerted the OFT to the infringements, and as the first to apply to the OFT for leniency it received complete immunity from fines.

In addition, Gallaher, ASDA, First Quench, One Stop Stores, Somerfield and TM Retail received reductions in their fines because, following the OFT's initial report two years ago, they each admitted liability in respect of the infringements alleged against them and agreed to a streamlined procedure enabling parts of the case to be resolved more quickly, reducing the costs of the investigation.

However, a year later, the *Independent* reported:

The Office of Fair Trading suffered a setback yesterday after a consortium of leading tobacco and retail groups overturned a previous ruling of unlawful pricing. Imperial Tobacco, the maker of Golden Virginia rolling tobacco and Superkings, saw its £112.3m penalty reversed, and Co-op, Morrisons, ASDA and Royal Dutch Shell were also successful in overturning their cases in front of the Competition Appeal Tribunal.

Case study 3.3

- 1 Creative destruction in the book market is illustrated, first, by the growth of large book sellers such as Waterstones and later by the growth of online retailing, particularly by Amazon. However, from the 1980s onward, companies such as Waterstones sold books at prices well below the publishers' recommended prices. Small bookshops could not compete and many closed down. But more recently, the large book retailers themselves have faced increasing competition from the growth of the online retailer Amazon. Many people who wish to buy books now pop into bookshops to browse, rather than to buy, before going home to order the books they want online.
- 2 The growth of Amazon has benefited customers through bringing down the price of books and through introducing fast distribution of books and other goods to customers' front doors. On the debit side, sales have fallen in traditional shopping areas such as high streets and some shopping malls. This has reduced consumer choice, particularly for those without access to broadband communication. Amazon also uses its market power to bid down the prices it pays to suppliers, and this may again restrict consumer choice.

Case study 3.4

- 1 According to Justin Potts:

Apple's largest advantages are the name, and the users. When Apple released the first iPhone in 2007, it was revolutionary. Millions flocked to buy these, and every year, it happens again. There's something special about owning an Apple product. Their products are so simple, yet complex in their own way. They're engineered to the max, and you can feel it when you use them. Telling someone you own an Android doesn't have the same effect as telling someone you own an iPhone. It's the name. People have create this whole vision in their head of what 'Apple' is, and when they hear it, they visualise that, and it gives them an effect of awe.

On 29 June 2007, Apple first marketed the iPhone. This was arguably the first smartphone, though a more primitive phone with many similar features had been introduced without success in 1994.

Since 2007, the smartphone has completely changed the way that mobile phones are used. These days most smartphone users couldn't imagine life without them. In the space of 40 years, the mobile has evolved from a huge car-phone, the weight of a small sack of cement, to a small and sleek device, the weight of a pair of socks.

The one thing Apple does not compete on is price, though the company does claim that its premium prices offer value for money. Apple relies on brand name competition and quality competition and not on price competition.

- 2 It was impossible to undertake this research at the time these answers were written, on dates which preceded the book's publication.

Test yourself

Test yourself 3.1

Statements A, B and D involve a firm's possible maximising objectives, while statement E specifies a minimising object. Maximising and minimising objectives are incompatible with the satisficing principle, so all these statements provide incorrect answers. Only statement C is consistent with a firm having satisficing objective, so this is the correct answer.

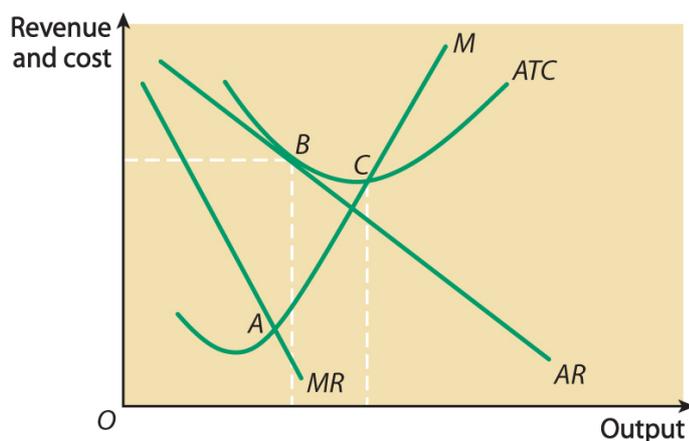
Test yourself 3.2

The correct answer is provided by statement B. The demand for raw cotton is a derived demand, derived from the demand for clothing. If the demand for clothing is increasing, the demand increases for cotton, a major raw material used in the manufacture of clothes. Assuming that the demand curve for cotton shifts to the right along an upward-sloping supply curve, the price of cotton increases.

This means that statement B provides the only possible correct answer to the question. However, the event on the right-hand side of statement B (a rise in profits) is also likely to be correct. Higher prices caused by increased demand usually lead to higher profits. None of the other possible answers contains this possibility.

Test yourself 3.3

As the diagram below shows, a firm making normal profit produces to the left (and above) the lowest point on its *ATC* curve. This level of output is productively inefficient. Productive efficiency occurs at point *C* in the diagram. The firm making only normal profit only produces at point *B* on its *ATC* curve. This means that as well as being productively inefficient (failing to minimise average costs), it is also allocatively inefficient ($P > MC$). The firm's marginal cost is shown at point *A*.



Long-run profit maximisation
in monopolistic competition

Questions

- 1 A necessary condition for profit maximisation in all market structures, monopolistic competition and oligopoly as well as perfect competition and monopoly, is that firms must produce and sell the level of output at which $MR = MC$. This means that the addition to sales revenue received from the last unit sold (marginal revenue) equals exactly the addition to total cost incurred from the production of the last unit of output (marginal cost). For all market structures:

$MR > MC$ profits rise when output increases

$MR < MC$ profits rise when output reduces

so only when:

$MR = MC$ are profits maximised.

When $MR > MC$ or $MR < MC$ the firm fails to maximise profit. These are examples of disequilibrium. To maximise profit the firm must change its level of output until it reaches the point at which $MR = MC$. Once this is reached, the firm has no incentive to change output, unless some event disturbs either costs or revenues.

- 2 If firms undertake price competition, the main effect may be self-defeating price wars from which consumers but not firms benefit. For this reason firms, especially those in monopolistic competition and oligopoly markets, often prefer to use other methods of competition, such as quality competition, after-sales service competition and advertising competition, though these may also lead to retaliation.
- 3 **Technical efficiency:** A production process is technically efficient if it maximises the output produced from the available inputs or factors of production.

Productive efficiency: To achieve productive efficiency, a firm must use the techniques and factors of production which are available, at lowest possible cost per unit of output.

X-efficiency: This type of efficiency occurs when, at any level of output, all unnecessary production costs have been eliminated. All points on a firm's long-run average cost curve (including the productively efficient point where unit cost is lowest) are X-efficient.

Allocative efficiency: This occurs when $P = MC$ in all industries and markets in the economy. In this situation, subject to assumptions such as a given distribution of income and wealth, it is impossible to increase economic welfare by reallocating productive resources between industries.

Static efficiency: This is efficiency measured at a particular point in time.

Dynamic efficiency: This relates to improvements in the various forms of static efficiency, particularly productive efficiency, achieved over time.

- 4 Consumer surplus, defined as the difference between the prices consumers pay and the maximum prices they would be prepared to pay, is a measure of consumer welfare. Likewise, producer surplus, defined as the difference between the prices that firms receive and the minimum prices they would be prepared to receive, is a measure of producer welfare. Producer surplus often takes the form of monopoly profit. If, by raising the prices they charge, firms exploit consumers by transferring consumer surplus into producer surplus, this is bad. A counter-argument is that producer surplus can be good if it leads to increased investment financed by profits. Above-normal profits also enable firms to become more dynamically efficient. The answer to the question therefore depends on the assumptions made when interpreting the question.
- 5 Judged by efficiency criteria, and assuming an absence of economies of scale, perfect competition would be preferable to monopoly because it is more technically, productively and allocatively efficient, and it will also be X-efficient whereas monopoly may be X-

inefficient. Perfect competition, if it existed, would also lead to lower prices, which means that consumers would enjoy more consumer surplus (a welfare criterion). However, we only arrive at this conclusion by accepting a number of completely unrealistic assumptions about perfect competition. When these assumptions are dropped, monopoly may be justified through the lower costs and prices which result from its dynamic efficiency and its ability to enjoy economies of scale. But if real-world monopolies simply seek an easy life and are prepared to be X-inefficient, it is less easy to justify monopoly.