

Webnote 2112

Consumer power *How do firms compete?* *(Producer Power)*



PC

1. Efficient lowest point on AC (see economies of scale)
2. Homogenous
3. Large number of small firms
4. No barriers to entry + exit of industry
5. Nearest example: farmer
6. No price power / Price taker



MISTIC

1. Inefficient (not at lowest point on AC)
2. Branded products
3. Large number of small firms
4. No major barriers to entry
5. Bakery in Kaiserswerth
6. Little price power



O

1. Inefficient (economies of scale may result in lower unit costs than PC or monopolistic- see fig 1 below)
2. Branded products
3. Small number of large firms
4. major barriers to entry e.g set up costs for airline
5. Collusion: coca cola – Heineken, VW, Microsoft etc
6. Price power



M

1. Inefficient (economies of scale may result in lower unit costs than PC or monopolistic- see fig 1 below)
2. Branded products if in final goods market
3. 1- 4 or 5 firms dominate industry (up to circa 100 firms possible)
4. major barriers to entry e.g set up costs e.g. Energy provider
6. Major barriers e.g cost of set up
- 7 Price power –unless a legal monopoly



Price taker



Price maker

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Key Objective Competition:

4 Models

Perfect Competition

Imperfect models:

Monopolistic

Oligopoly



4 KEY Questions for each model:

1. Price + Output:

What is the price and output of the firm and is it good for society ($mb=mc$)? Note the firm locates its price and output using the profit maximization formula: $MR=MC$

2. Profit maximizer:

with supernormal profits ($AR>AC$) or not?

Firms can have other goals e.g. sales revenue maximization or sales growth maximisation?

3. Efficiency:

Allocatively efficient or not ($mc = ar$)?

(Productively efficient or not (mc cuts ac at lowest point)?)

4. Barriers:

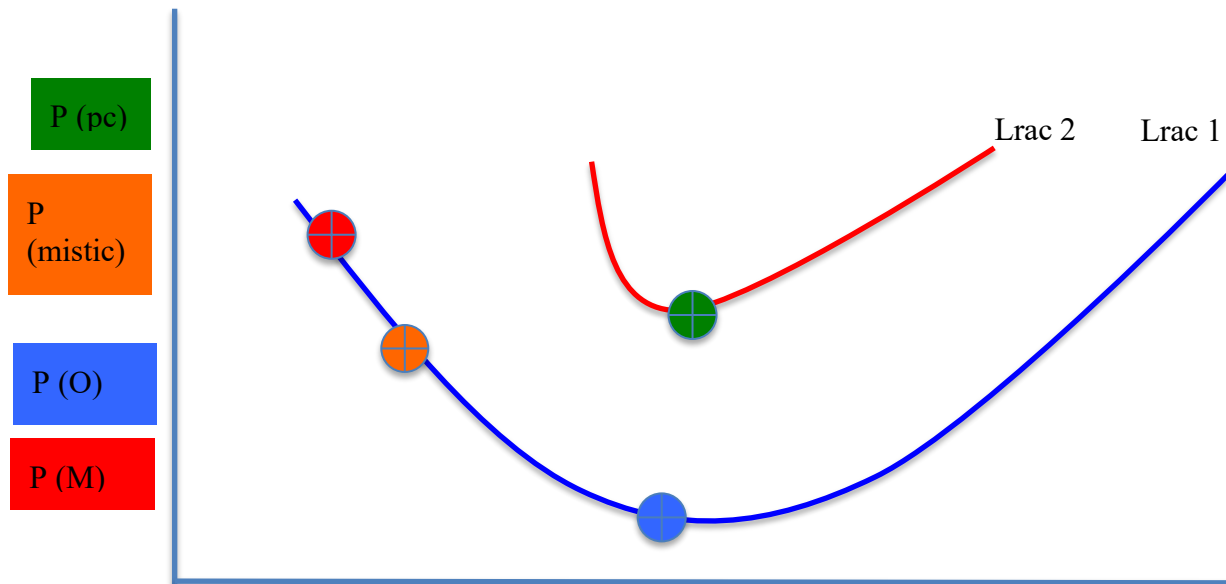
Does the firm have power to set up barriers to entry? (if a firm has price power it can earn S/N profits in the long run. Barriers can be uncompetitive and governments regulate.

6 Key formulas:

1. $mc = ac$ at lowest point (productively efficient)
2. $mc = ar$ (allocatively efficient)
3. $mc = mr$ (profit maximisation)
4. $ar = ac$ (normal profit)
5. $ar > ac =$ supernormal/abnormal profit
6. $ar < ac =$ losses (in long run firm must cover its ac . It can stay open in the short run as long as it covers its variable costs.

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Fig 1: Long Run Average Cost for a Firm (LRAC) (= total costs of firm / total output)



Notes:

Efficiency and Economies of Scale

- The blue line (LRAC1) is more likely for oligopoly and monopoly. Monopolistic is likely to have higher prices also because it is inefficient but monopoly and oligopoly may be inefficient due to various factors such as diseconomies of scale
- The red line (LRAC 2) is a likely situation for perfect competition. Notice that costs are higher here even if the firm is producing at the lowest point on the AC curve because there are no economies of scale.

Fig 2 The Price Taker and the Price Maker (Leader) in Microeconomics

