Imperfect Competition

An imperfectly competitive market is a market with features of both monopoly and perfect competition. The products supplied are similar with slight differences. They are been sold by a large number of profit-maximizing sellers in a market where there is freedom of entry and exit. It follows that imperfect competition is a market structure which closely mirrors the conditions under which the vast majority of firms operate in a modern economy.

Assumptions underlying Imperfect Competition

The characteristics or assumptions underlying imperfect competition are identified below:

- **There are many buyers**
    - An individual buyer, by his/her own actions, cannot influence the market price of the goods.
- **There are many sellers in the industry**
    - An individual seller can influence the quantity sold by the price it charges for its output.
- **Product differentiation exists**
    - The goods supplied by the firm are not homogenous but are close substitutes. Firms use branding to distinguish their products from one another.
- **Freedom of entry and exit**
    - No barriers to entry exist within the industry. It is possible for firms to enter/leave the industry as they wish.
- **Reasonable knowledge**
    - Within the industry each firm has reasonable knowledge of profits made by other firms. Consumers have a reasonable knowledge of the prices being charged for different products.
- **Each firm attempts to maximise profits**
    - Firms produce where MC = MR. Each firm will attempt to minimise costs of production.

Imperfect Demand Curve versus Perfect Demand Curve

- The demand curve facing a firm in imperfect competition is downward-sloping. This is because each firm sells a differentiated product, which creates scope for brand loyalty. Each firm has a product that consumers view as somewhat distinct from the products of competing firms. If the firm increases the product price there will be a reduction in demand as some consumers will switch to rival firms' goods (close substitutes) that have become relatively cheaper.

- The demand curve facing a perfectly competitive firm is horizontal or perfectly elastic (D=AR=MR). This is because each firm is selling an identical (i.e. homogeneous) product and each firm's quantity sold is small relative to the total market size. Any attempt to undercut the market price will result in complete switching to identical products of competitors.

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Equilibrium Position Of A Firm In Imperfect Competition

- **Short-Run Equilibrium Position**

The Short-Run Equilibrium Position Of A Firm In A Imperfectly Competitive Market

- Equilibrium occurs in the long run at point *e* where MR=MC, and MC continues to rise.
- That is the quantity that ensures profit maximisation, Q1.
- P1 is the price charged.
- AR > AC therefore supernormal profits are made.
- The average cost of production of Q1 is at point B. The firm is not producing at the minimum AC in the long run.
- As the firm is not producing at the lowest point on the AC curve it is wasteful of resources.
- MC cuts/equals AC at the point W, the lowest point on the AC curve

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- **Long-Run Equilibrium Position**

The Long-Run Equilibrium Position Of A Firm In A Imperfectly Competitive Market

- **Long Run Equilibrium Position**
  - Existence of SNPs attracts new firms
  - D/AR shifts to the left

- Equilibrium occurs in the long run at point *e2* as follows:
- Q2 is produced where MR=MC, and MC continues to rise. That is the quantity that ensures profit maximisation.
- P2 is the price charged. This is the (now lower) price as set by the industry, and as the firm is a price taker it charges that price.
- At Q2, AR = AC. Normal profits are made. SNPs are eroded. (If AR falls below AC then firms will make a loss, causing some firms to leave the market until AR rises and normal profits are made.)
- The firm is not producing at the minimum AC in the long run. Q2 is supplied at the lowest point on the AC curve in the graph (point B2).
- MC cuts/equals AC at the point W, the lowest point on the AC curve

David

What are the Advantages of Imperfect Competition?

- **Contestable Markets**
  - There are few barriers to entry, making markets quite competitive and thus benefiting the consumer with lower price or better quality goods and services
- **Choice of goods**
  - Differentiation creates diversity of goods and services for consumers, although this may mean higher prices. Consumers like to have a wide variety of goods and services to choose from, e.g. many types of restaurants in a town
- **Normal Profit**
  - In the long run consumers are not being exploited, as the firm is earning normal profit (AR=AC)
- **Access to Information**
  - Consumers have more information available to them because of the extensive competitive advertising used within the industry

What are the Disadvantages of Imperfect Competition?

- **Production is not at the minimum point on the AC**
  - In equilibrium the firm is not producing at a level where costs are at their lowest. This is because money is spent on advertising, differentiated packaging, etc, which increases the cost of production and is inevitably passed on to the consumer.
- **Excess capacity**
  - Production is not where average costs are at a minimum and this is considered to be wasteful of scarce resources. The firm could produce greater output than it does, meaning that is has overcapacity.
- **Price is greater than MC**
  - The price charged by a firm in imperfect competition will exceed marginal cost, as opposed to perfect competition where price equals MC.

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Price vs Non-Price Competition

- **Why consumers may prefer price competition**
  - **Lower prices / value for money**
    - Consumers will benefit from availability of commodities at lower prices. Consumers will be able to get better value for their limited income.
  - **Higher disposable income**
    - With lower prices consumers will now have a higher disposable income, resulting in a better standard of living.
  - **More choice**
    - As consumers have a greater disposable income they can now choose how to spend this additional income.
  - **Preferable to non-price competitive measure because:**

        - Consumers pay for non-price competitive measures e.g. advertising; Offers may be unwanted / of little value; tokens may go unused etc.

- **Benefits of non-price competition to consumers**
    - **Consumer loyalty rewarded**
        - Consumers can, by shopping in selected stores, receive loyalty points which can be used as they wish.
    - **Stability in prices**
        - Non-price competition means prices will not be constantly changing and so consumers do not have to worry that they are losing out on bargains / may be better able to budget.
    - **Better quality commodities / services**
        - Firms may improve the quality of their commodities; offer better service and/ or after sales service to consumers.
    - **Allows consumers to save and / or avail of 'free' gifts**
        - With regular shopping consumers can 'save' their loyalty points for those time periods when they incur additional expenses e.g. Christmas; Easter etc. Consumers may benefit from 'free' gifts from retailers e.g. free turkeys at Christmas.
    - **More informed consumers**
        - Through advertising consumers may acquire more information about products and services and so can make more informed choices.

Advertising

- **What is competitive advertising?**
    - This is advertising which stresses the advantages of one firm's products/services over its rivals.
- **How advertising can be used to prevent small firms entering an industry**
    - **Prohibitive costs of advertising**: If a small firm has to advertise in order to compete with rival firms its costs will increase disproportionately to a larger firm, therefore advertising may be used as a barrier to a small firm entering an industry.
- **Disadvantages of Advertising for the Consumer?**
    - **Increased prices**
        - The firm may have to increase prices to cover the increased costs.
    - **False / Misleading information**
        - Consumers may be presented with inaccurate/incomplete information leading to confusion / mis-information.
    - **Impulse buying / creates unsustainable wants**
        - The advertising may lead customers to impulse buy and so 'waste' part of their income. Advertising may create a desire in consumers for a life style which is not attainable.
    - **Harmful commodities**
        - Advertising may encourage the consumption of harmful commodities e.g. cigarettes; alcohol which may damage the health of the consumer.
    - **Unnecessary pollution**
        - Consumers may have to pay for the removal of litter caused by advertising such as leaflets discarded etc.

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Wasting Resources

- **Why are firms in Imperfect Competition considered to be wasteful or resources?**
  - An imperfectly competitive firm does not produce at the socially efficient lowest point on its AC curve, point W.
  - They are not producing at the lowest point of AC due to product differentiation. Product differentiation makes a firm's product appear different through additional costs such as advertising and branding.
  - Price exceeds the marginal cost of production. The extent of the difference between P and MC represents the degree of monopoly power the firm is able to exert in the market for its differentiated product.
  - Because it is not producing at the lowest point of the average cost curve, there is spare/excess capacity in its operations and society does not benefit from maximum utilisation of resources. Consumers gain variety at the expense of social efficiency.

Features common to perfect and imperfect competition

- In the short run, firms in both markets earn supernormal profits, i.e. the quantity is produced where AR>AC.
- The absence of barriers to entry and perfect knowledge of profits in both markets ensure that new suppliers are attracted and supernormal profits are eroded until only normal profits are to be made in the long run. That means that Q is produced where AR= AC in the long run in both markets.

Features common to monopoly and imperfect competition

- Both are inefficient in the use of resources - Firms in both markets produce at a point that is above the minimum possible point on the AC curve.
- Firms in both industries are subject to the law of demand and therefore face downward sloping demand curves.

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