Economics Part 3

Competitive Markets

Retrieval

1. State the meaning of opportunity cost
2. State the definition of a market
3. What is the role of markets in the economic problem?
4. State the three functions of price
5. What are the two different types of market?

Answers

1. The cost of missing out on the next best alternative when making a choice.
2. A place where buyers and sellers come together to exchange/determine the price of goods and services. (all the different ways that buyers & sellers interact)
3. One way of determining how finite resources get distributed.
4. Rationing, signalling & incentives.
5. Factor Market & Product Market

What is a Competitive Market?

- A market is where buyers and sellers meet. A competitive market is a market that has many buyers and sellers. In order for the market to work efficiently, producers should face no barriers to entry into the market and consumers should have perfect information.

Independent Task

- Write down as many possible barriers to entry for different markets that you can think of, if you are struggling to think of a market think about the car manufacturing industry, the pharmaceutical industry or the newspaper publishing industry.

Answers

- Possible barriers include... Patents, copyright, economies of scale, start-up costs, capital costs, advertising, low prices, skilled workers.

- There may be many others you have come up with.

Profit maximisation

- In a free market economy, it is assumed that all firms want to maximise their profits. Therefore, in order to be profitable in a competitive market, firms have to find ways of lowering their costs of production and this in turn means they can lower their prices.
- Remember that in an elastic market where there are many substitutes (which there should be in a competitive market) a firm would have to lower its price in order to increase revenue. By increasing revenue, they should be able to boost profits, assuming they can keep costs the same or lower them.

Competition

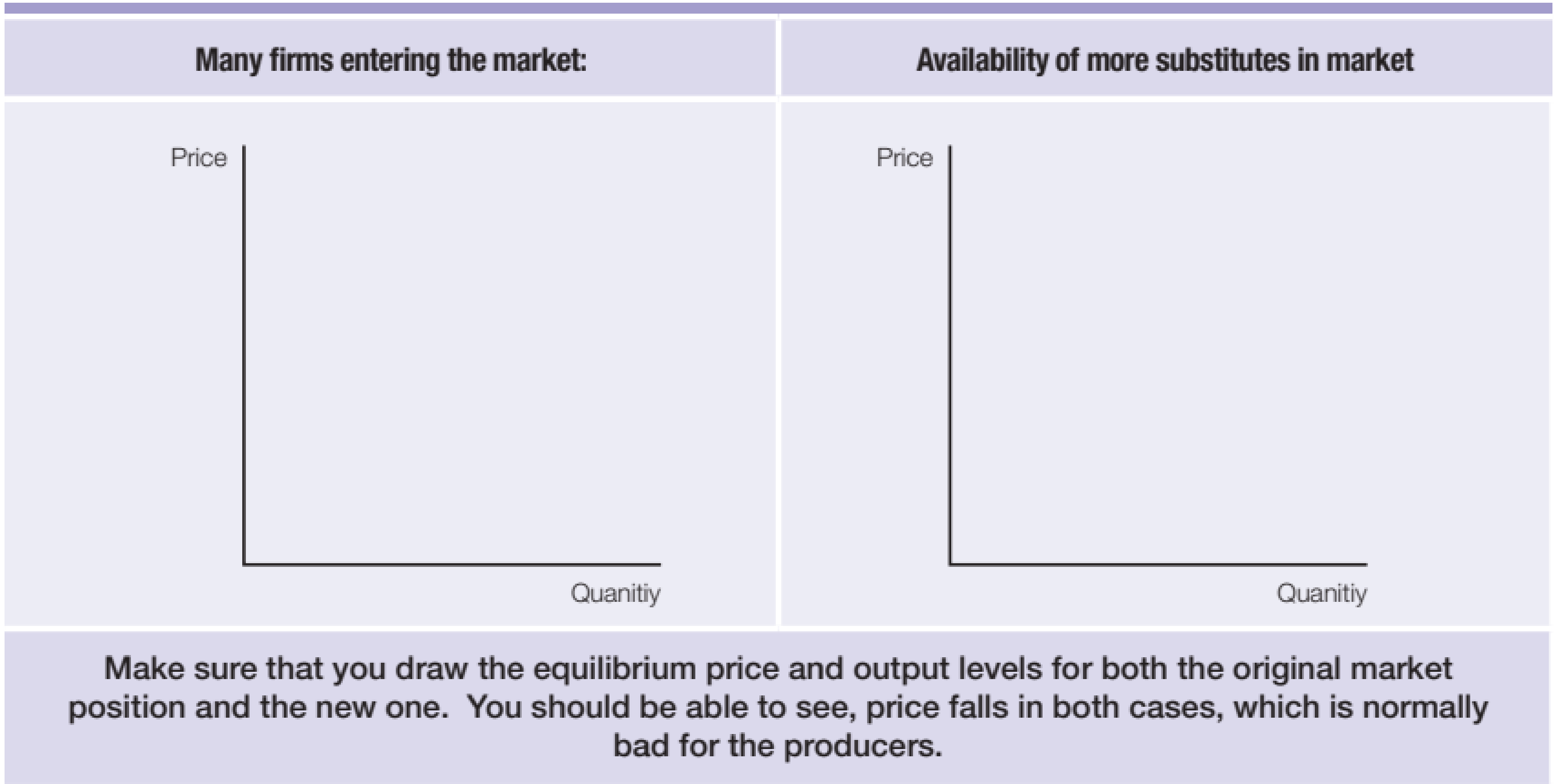
- The most obvious way that firms compete is through price competition. However, there is a limit to how low prices can go before producers start making a loss and therefore, they have to come up with other ways of enticing the consumer.

How does this link to demand/supply

- A competitive market means that there are many buyers and sellers within the market.
- As new firms enter a market, supply shifts to the right and this causes a reduction in price due to the increased competition leading to increased efficiency, which lowers the cost of production.
- As there are more firms in the market, individual firms demand curves are likely to shift to the left as there are more substitutes

Independent task – 5 minutes

- Draw 2 demand and supply diagrams to illustrate the situations shown on the previous slide.



The economic impact of competition (how do competitive markets impact the three economic groups?)

- **Consumers** – those who demand goods and services should benefit from competitive markets, as they should pay lower prices and have more choice. Also, they may receive improved quality of products as firms innovate to survive. However, it's not all good news for consumers as sometimes the good or service might be of poor quality due to a producer trying to cut costs in order to compete. They might also be faced with higher prices as firms spend money advertising their goods and services and this is an additional cost that could increase the price.

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- **Producers** – those who supply goods and services will have to become more efficient to survive. If they do not, then they could easily go out of business. As a producer in a competitive market, it should be impossible to make large profits as firms would be incentivised to enter the market if they could see large profits were being made and this would compete away profit. A producer would also have to think carefully about how to spend their profit. Would they use it to advertise in order to boost market share in the short term or invest into research and development in order to create innovative products in the long run?

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- **Government** – the government normally encourages competitive markets as it leads to increased wellbeing for consumers through lower prices and greater choice. However, as producers receive lower profits, it means tax revenue will not be as high for the government.

Retrieval

1. What is the definition of a competitive market?
2. Explain one advantage of a competitive market for a consumer.
3. Explain one effect of competitive markets on producers.

Non-Competitive Markets

- A non-competitive market is a market that has few sellers. A market where there is only one seller is called a monopoly and where there are just a few sellers it is called an oligopoly
- As well as the number of sellers, a non-competitive market will have the following characteristics

Non-Competitive Markets

- **Barriers to entry** – there may be a number of reasons which prevent other businesses entering the market. The existing business may benefit from customer loyalty or economies of scale. It may be that the cost of setting a business in the market is so large many private individuals do not have (or even borrow) sufficient funds to start.
- **Product** - The firms will ensure that their products are slightly different (called differentiated) to set them aside from their competitors. These differences are more likely to be important than differences in prices. For example, petrol forecourts in any one town may charge very similar prices for their fuel but may use opening times, offers or availability of groceries as a means of attracting customers.
- **Prices** - Non-competitive firms have a much greater say over the price that they charge. A lack of competition means that the firms are not having to drive their prices down to attract customers.
- **Profits** – most non-competitive firms will attempt to profit maximise. They may be so large that they suffer from diseconomies of scale.

How do non-competitive markets impact the three economic groups?

- **Consumers** – a lack of competition will mean that the price charged to customers is likely to be higher than a competitive market. Alongside this, there is less of a drive for the businesses to ensure as high quality as possible or to innovate and improve the functionality of the product. There may also be very little choice for consumers. As such, consumers often lose out in markets with few competitors.

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- **Producers** – Businesses in non-competitive markets are able to make large profits. There is less drive for businesses to be highly efficient. However, those large profits may mean that the business has more funds to innovate. For example, Apple exist in a market for tablets with few genuine competitors. However, they use their huge profits to continually improve the quality of their Ipad. Likewise, whilst many competitors can produce cheaper, possibly better value tablets than Apple, brand loyalty means that the Ipad remains the most popular tablet on the market.

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- **Government** – because there is a potential for consumers to lose out in non-competitive markets, the government are more likely to intervene on their behalf. For example, the UK government has discussed the possibility of setting an upper price limit on energy suppliers so that consumers are not paying higher and higher amounts. The government may prevent two firms merging if it will make the market less competitive. In some cases, the government can even force businesses to break into two separate firms so that more competition is created. The large profits made by non-competitive firms may bring in large taxation revenues for government.

Independent task

The government has insisted that the arm of BT known as Openreach be legally separated from its parent company and should operate as an independent business. Openreach provides the cabling to almost every household and business in the UK allowing them access to data and the internet. They act as a 'monopoly' in the supply of cabling and have been accused of giving preferential treatment to businesses that use BT for other services (such as their telephone and mobile phone services). Another concern was that Openreach was not acting quickly enough to ensure that customers had the best quality of broadband fibre cables installed in their homes or offices.

Identify two issues that have arisen because Openreach operate in a non-competitive market:

Answer

- BT are a monopoly and want to maximise profits – they have allowed Openreach to operate to the benefit of BT rather than customers.
- Without competition, there are fewer forces making BT and Openreach operate differently. Without competition, there are few forces in place to make Openreach innovate their services and products.

Production

Business Objectives

- How a business manages its operations will depend on a number of internal and external factors. One such factor is its own objectives as a business. Although the obvious reason for a business to exist is to ‘make money’ there are several potential objectives that can be identified

Business Objectives

- **Profit (maximisation).** Many firms exist in order to maximise the return to the business owners. Starting and running a business is both risky (in terms of losing income) and hard work so many business owners seek to maximise the profit made as their reward. Profit can be defined as ‘sales revenue minus the cost of production (or running of the business)’.

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- **Sales growth.** Some firms may wish to maximise the number of units of their products or services that they sell. Some business owners and managers will gain personal satisfaction from having as large an operation as they can (without making a loss). This does not always mean that they are maximising profits – to achieve sales growth firms may have to reduce the price of their goods and services.

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- **Increasing market share.** A firm may also take the view that a short-term goal may be to improve the proportion of the market share that they have. This means that they will need to take customers off their competition or start to sell a higher proportion of goods than their competitors. The firm may hope that they gain more customer loyalty and maintain profits over an extended period of time.

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- **Social enterprises.** Some firms may not wish to make large profits at all but want their business to provide a social purpose. For example, supermarkets may sell Fair Trade foodstuffs at high prices and with low profit margins but will be content that they are supporting farmers in poorer communities.

Independent Task

ACTIVITY 1

Consider the table below on market share for supermarkets in the UK.

Grocery Market Shares April 2016	Market Share (%)
Tesco	28
Asda	17
Sainsburys	16
Morrisons	11
Co-Op	6
Aldi	6
Waitrose	5
Lidl	4
Iceland	2

Although they have been established since 1913 in Germany, the first **Aldi** store in the UK was only opened in 1990. Now it has over 300 stores nationwide and its market share continues to increase – over-taking the long-established UK brand Waitrose.

Suggest **two** possible advantages for Aldi from growing its market share in the UK:

Costs & Revenue

- To determine if a firm is meeting its objectives it will need to calculate the revenue that it brings in from sales and the costs of production or providing services.

Costs

- There are a variety of costs we must consider:
  1. **Fixed Cost:** Any cost that does not change with output, e.g. rent
  2. **Variable Cost:** Any cost that does change with output, e.g. raw materials
  3. **Total Cost:** The total cost of all goods/services produced (fixed costs plus variable costs)
  4. **Average Cost:** Total cost of goods and services divided by the number of units produced

Independent Task – 5 minutes

ACTIVITY 2

The list below shows some costs for a T-shirt manufacturer. Separate the costs into those that you think are fixed and those that are variable.

Delivery charges, lighting, rolls of fabric, trade magazine advertising, fabric dye, sewing machines

Fixed Costs	Variable Costs

Calculating Costs

- Look at this cost table for a market stall which is selling cakes.

Fixed costs	£2,500
Variable cost per cake	£0.50
Current output of cakes	1,000

- What is the average cost per cake?

Independent Task – 5 minutes

ACTIVITY 3	
Look at this table for a small business selling printer cartridges:	
Fixed costs	£8,000
Variable cost per cartridge	£2.50
Current output of cartridges	2,000
What is the average cost per cartridge?	

Revenues

- Revenue is the amount of money generated from sales

Total Revenue	All revenues generated by sales of goods
Average Revenue	Total revenue divided by the number of units sold
Profit	Total revenue – total costs

Revenues

- Remember, from your demand and supply analysis, sometimes the only way that a business can increase sales is by reducing prices. This means that as output and sales increases the business is likely to see a decrease in average revenue – what they receive in sales receipts will fall per item sold.

Revenues

- Look at this table for a small business manufacturing and selling boxes of gloves to retailers (figures in £):

Output	Total fixed cost	Total variable cost	Total cost	Average cost	Total Revenue	Average Revenue
0	70	0	70	-	-	-
1	70	15	85	85	100	100
2	70	30	100	50	180	90

- Total cost = Total Fixed Cost + Total Variable Cost
- Average Cost = Total cost/Output
- Average Revenue = Total Revenue/Output

Guided Task

Complete the table for a small business manufacturing and selling boxes of gloves to retailers (figures in £):						
Output	Total fixed cost	Total variable cost	Total cost	Average cost	Total Revenue	Average Revenue
0	70	0	70	-	-	-
1	70	15	85	85	100	100
2	70	30	100	50	180	90
3					240	
4					280	
5					300	

Profit

- Profit is the difference between our costs and sales revenues.

- Profit = Total Sales Revenue – Total Costs

Independent Task

Complete the table for a small business manufacturing and selling boxes of lettuces at local markets (figures in £):							
Output	**Total fixed cost**	**Total variable cost**	**Total cost**	**Average cost**	**Total Revenue**	**Average Revenue**	**Profit**
0	100	0		-	-	-	-
1		20			180		
2		40			320		
3					420		
4					480		
5					500		

The importance of cost/revenue/profit for producers

- If profit is the most likely objective for many businesses, the ability to calculate and predict a figure is very important. In order to do this, the businesses must be aware of their costs and potential revenue – including being aware that average revenue is likely to decrease as sales increase. Often the easiest costs to alter are the variables ones – although all costs can be altered over a period of time, including such things as rent on factory space.

Ethical and Moral Considerations

- ‘Ethics’ is the concept that someone or an organisation should do the ‘right thing’ by society’s standards. ‘Moral considerations’ are referring to actions that contravene an individual’s or a group of people’s principles. Although profit will often be the most significant objective, businesses may still be under considerable pressure to ensure that they operate in an ethical or moral way, even if this may mean increasing average costs. Such issues may include:

Ethical and Moral Considerations

- **Ensuring sufficient business taxes are paid to central governments**. Some firms are able to reduce their tax payments by operating under favourable international conditions (e.g. Starbucks only paid £8.4m in corporation tax to the UK between 1998 and 2012). If a business pays low levels of tax compared to individuals paying income tax, some people will argue that the company is not fulfilling its moral obligations.

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- **Environmental impact.** The impact on the environment either from production processes or from use of manufactured products needs to be considered.
- **Exploitation of workers living in relative poverty.** Some businesses reduce costs by using relatively cheap labour from developing nations. The business needs to be seen to pay such workers a fair pay and ensure that they work in a safe environment.

Production & Productivity

- Production’ refers to the process of manufacturing a product. ‘Productivity’ refers to the level of efficiency throughout the production process.
- Productivity is often quoted as ‘output per person’ or ‘output per hour’. For many businesses, a key method of reducing costs is to improve the level of productivity.
- For example, if a firm pays one worker a fixed wage of £200 a week and that worker produces 10 products the fixed cost per unit is (200/10) £20. However, if the same worker could produce 12 units per week for the same wage then the fixed cost per unit reduces to (200/12) £16.67. This would be classed as an ‘increase in productivity’.

Production & Productivity

- Let’s say a worker for a business produces 100 units per week. The business purchases a machine for the same worker and they now produce 200 units per week thanks to the machine. In this instance, the productivity of the worker has clearly improved (in fact, its doubled!) but the cost of the machine has to be taken into account. Machinery can be very expensive and whilst it may improve productivity it may take months or years before the cost of the machine starts to bring improved profits for the business.

Methods of improving Productivity

- Division of Labour
- Use of technology/machinery
- Training of Workers
- Improving employee morale
- More effective management

Independent task – 5 minutes

Google have several offices around the world to house their employees and have plans to build a new one in London. A common theme throughout their offices are a series of resources to help its workers. These include swimming pools and saunas, 'nap' rooms for staff to have short sleep breaks, games rooms and zones that resemble children's play areas.

Why would Google include these types of resources for their workers when they come at such a large cost?

Write a short "explanation" to answer the above question (2 marks)

What are the benefits of increased productivity?

What are the benefits of increased productivity?

- It should increase output leading to higher sales
- It can lower costs leading to higher possible profit levels
- Lowering costs could be passed on to a reduction in price, making the business more competitive
- It could improve the quality of the products which, again, improves competitiveness.
- Higher productivity could lead to higher wages for workers (particularly if they are paid commission or by output).

Guided Task

A factory making golf balls employs 5 people and produces 1,000 golf balls a week.
The factory purchases a new machine to help the manufacturing process and the number of golf balls produced increases to 1,500 per week. What is the increase in output per worker?

Economies of Scale

- One way a firm may be able to reduce unit costs is if it can benefit from economies of scale.
- ‘Economies of scale’ is any financial advantage that comes from increasing output or production, and which leads to a fall in average unit costs. Mass production of goods should start to reduce the average cost of production per unit.

Types of Economies of Scale

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- **Marketing economies** – a firm which is selling on a large scale may be able to afford more effective advertising. For example, a TV advert will have a much wider reach than a magazine advert. However, the business can only afford the cost of TV advertising if producing and selling in large enough numbers.

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- **Financial economies** – businesses making larger loans can often do so at a reduced interest rate (reducing the cost of repayments). Larger firms may be able to raise more money through other methods such as selling shares.

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- **Managerial economies** – larger firms can afford to employ more managers which can lead to an increase in efficiency of workers.
- **Risk-bearing economies** – larger firms are more able to increase the range of different products that they produce. In this way, the business is more able to cope with a fall in demand for one or more of its products.

Economies of Scale

- The existence of economies of scale means that businesses are more likely to want to grow and increase their output. The reduction in average cost should lead to an increase in profits and improve the potential for gaining market share from competitors
- However, business growth does not come without some costs. Any factor which starts to lead to an increase in average cost is called a '**diseconomy of scale**'.

Types of diseconomies of scale

- **Communication problems** – with an increase in the number of managers and workers, effective communication between them can become more difficult. Some staff may not know all the information that they need or it may take a longer time to inform everyone. This will make the workers less effective and increase average costs.

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- **Morale** – workers in organisations with a large number of people may start to feel as if they are less important as their view will count for less. This can lead to lower morale and less efficient work practices.

Independent Task – 5 minutes

Identify the types of economies of scale occurring in these case studies:	
	Type of economy of scale:
Paperworks paper manufacturing company was set up to offer good employment to people with registered disabilities and has just opened a much larger factory with state-of-the-art machinery. They now hope to supply paper to newspaper companies as well as stationery firms.	
Gordon Construction have grown so large they have been floated on the stock market. Now that they are completing massive building projects they are able to buy raw materials in large quantities at a discount.	