2014 Y6 H2 Prelims Essay Q2

The degree of market dominance is often associated with the size of a firm.

(a) Explain how the degree of market dominance affects the amount of profits earned by a firm. [10]

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- A firm with market dominance will have a downward sloping demand curve.
- Higher market dominance a firm has, the higher its price setting ability and this results in the form of a more price inelastic demand curve.
- Higher the ability of the firm to increase total revenue (TR) since an increase in price would lead to a less than proportionate fall in its quantity demanded, this would in turn indicate more profits for the firm, assuming no change in the total cost (TC).
- Barriers to entry refer to any man-made or natural which are strong enough to prevent new rival firms from competing on an equal basis with the existing firms.
- A perfectly competitive and monopolistically competitive market structure have no and low barriers to entry and exit respectively. Thus, a perfectly competitive firm possesses no market dominance and a monopolistically competitive firm possesses low market dominance.
- There are substantial barriers to entry and exit in an oligopolistic market and for a monopoly it has the highest level of barriers to entry and exit. Thus, an oligopoly and monopoly possess a high degree of market dominance.
- Due to the varying degrees of barriers to entry, the different market structures will see a different impact on the amount of profits earned in the long run. The amount of profits can take the form of supernormal profits (TR>TC), normal profits (TR=TC) or subnormal profits (TR<TC).

- In a perfectly competitive market, there are no barriers to entry. This implies that firms are free to enter and exit the market.
- Explain using diagrams, how the PC firm eventually makes normal profits
- In contrast, should a perfectly competitive firm be earning subnormal profits initially, this will cause some firms to leave the industry and decrease the market supply. This will in turn increase the market price and diminish the magnitude of subnormal profits. Firms will continue to leave the industry until the remaining firms earn normal profits in the long run.

- Similarly, in a monopolistically competitive market, there are low barriers to entry in reality.

- Explain using diagrams, how the MC firm eventually makes normal profits

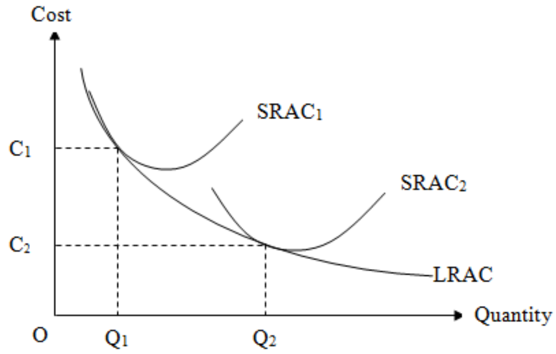
- In contrast, a monopoly faces high barriers to entry. If the monopolist is making supernormal profit initially, new firms cannot easily enter the market even when there are supernormal profits to be made. There will be no change to the firm's demand and it can continue to retain its supernormal profits. Likewise for a firm in an oligopolistic market, it also faces considerable barriers to entry. As it is difficult for firms to enter or exit easily, an oligopolistic firm's supernormal profits will not be whittled away and can continue to retain its supernormal profits in the long run.

Knowledge, Application, Understanding and Analysis		
L3	**Developed** explanation of how market dominance, which is determined by the level of barriers to entry, affects the amount of profits for the different market structures.	8 - 10
L2	**Undeveloped** explanation of how market dominance, which is determined by the level of barriers to entry, affects the amount of profits for the different market structures.	4 - 7
L1	Smattering of valid points	1 - 3

(b) Discuss whether economic analysis favours large firms over smaller ones. [15]

Economic analysis favours large firms

- Firstly, internal economies of scale are those cost saving that accrue directly to the firm from the expansion of the firm's output, independent of what is happening to other firms. The falling portion of the firm's LRAC reflects internal economies of scale. With reference to Figure 3, a large firm producing at Q_2 will be able to benefit in the form of enjoying a lower average cost at C_2 as compared to a small firm producing at Q_1 with an average cost of C_1.



- The lower average cost that a large firm enjoys can be derived from various sources.
- Explain with examples the various sources of IEOS. (E.g. marketing, managerial, technical)
- When a large firm is able to reap more internal economies of scale, consumers may benefit in the form of lower prices if firms pass on their cost savings. Firms may also use the cost savings to carry out research and development (R&D) to improve on their production processes, which can bring down the cost of production and eventually be passed on to consumers in the form of lower prices, or improve on the quality of the goods sold, improving the welfare of consumers.

- Large firms are able to earn supernormal profits in the long run as compared to small firms like that of a monopolistically competitive firm as explained in part (a). The large firms' supernormal profits are protected by high barriers to entry, making it difficult for potential firms to enter the industry. This means that large firms will have a higher financial ability to carry out R&D that can benefit consumers as explained previously. And in contrast, small firms don't have the financial ability to do so since they can only earn normal profits in the long run.

Economic analysis do not always favour large firms / Economic analysis favours small firms

- One reason could be due to internal diseconomies of scale. This happens when a firm expands beyond its optimum size. (Explain with reference to diagram)
- This is mainly due to managerial diseconomies. As the size of the firm increases, it becomes increasingly difficult to carry out the management functions of co-ordination, control, and the maintenance of morale → Elaborate with examples
- Large firms may then pass on this higher average cost in the form of higher prices, and this would not be advantageous to consumers.

- In some industries, diseconomies of scale set in early, meaning that the minimum efficient scale (MES) is low and internal economies of scale is exhausted quickly. As such, costs rise sharply as output increases. Any advantage to large-scale production is more than offset by the disadvantage. The optimum size of firms in such industries is small. → Give example.

- The total demand, both domestic and foreign, for the firm's output may be small because the firm is selling a niche product. Such a market may be limited by price. This is true for distinctive products like luxury sports cars, exclusive clothing and high quality jewellery, where only a small group of customers are willing and able to pay for the element of uniqueness and prestige.

- Furthermore, if the product has great bulk in relation to its value or requires special transport arrangement, the transport cost will be high relative to the unit price. Under such circumstances, the market for such products is likely to be local rather than national.

- Another reason for firms remaining small could be the need to cater to consumer's specific or individual requests. In this case, due to the varying nature of such requests, the size of production unit tends to be small. Thus, firms providing services in the area of law or repair services tend to be small. For instance, as cars do not break down in exactly the same way, the 'non-standardised' services make mass production of repair services impossible.

- Explain with diagram how large firms tend to be allocatively inefficient while small firms are allocatively efficient.

- Explain how large firms also tend to be productive inefficient.

- Since large firms' supernormal profits are protected by high barriers to entry, this lowers the firm's incentive to engage in R&D since there is little chance for new firms to enter the industry to erode away its supernormal profits earned, as previously explained in part (a). This will in turn have implications on consumers as there will be little improvements to the quality of goods. As such, large firms may not always be favoured. On the contrary, small firms like a monopolistically competitive firm may have the incentive to engage in R&D since firms making subnormal profits will be the first to leave the industry. Hence, in order to ensure long-term survival and the possibility to earn supernormal profits in the short run, they will have the incentive to innovate.

Knowledge, Application, Understanding and Analysis		
L3	For a **developed discussion** of how economic analysis favours large <u>and</u> small firms.	10 - 13
L2	For a **developed explanation** of how economic analysis favours large <u>or</u> small firms. OR For an **undeveloped discussion** of how economic analysis favours large <u>and</u> small firms.	5 – 9
L1	Smattering of valid points	1 - 4
Evaluation		
E2	For an evaluative assessment based on economic analysis.	3 – 4
E1	For an unexplained assessment, or one that is not supported by economic analysis.	1 - 2