

# Market failure

In this centrespread, **David Horner** outlines market power and how it may lead to market failure

## What is market power?

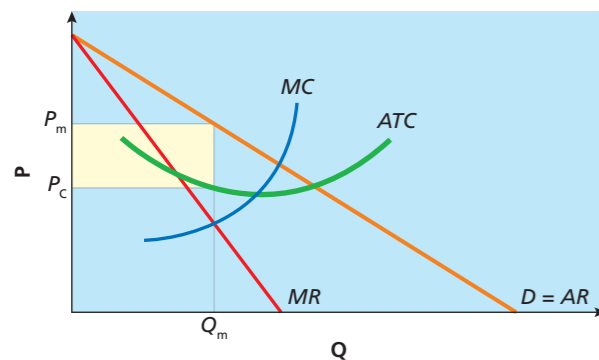
- Market power is where a firm can increase and maintain a selling price above what would exist if the market was a competitive market.
- Market power is also known as monopoly power.
- Market power is normally exercised by firms that are monopolies but can also be exercised by firms in an oligopoly and monopolistic competition (though not in the long run in this case).
- Market power is the result of barriers to entry and exit.
- Market power can lead to market failure through an inefficient allocation of resources and possibly through the effects that high prices have on consumers who may face an inequitable distribution of income.

## Efficiency and market power

- Without market power, firms in a perfectly competitive market can be both allocatively and productively efficient.
- Firms in a perfectly competitive market operate at the lowest part of their average cost curve – making them productively efficient.
- They also set price equal to marginal cost – making them allocatively efficient.
- Firms with market power are not productively or allocatively efficient – price is set above marginal cost and the output level produced is not where average cost is minimised.
- However, firms with market power may be dynamically efficient.

## Market power and profits

- Market power allows firms to have control over the selling price – they are said to be ‘price makers’.
- This allows them to set the price higher than the level they would set if they had no market power.
- Market power means they can earn supernormal profits, which lead to the market failure caused by inequities where those on lower incomes struggle to access a product at a high price.



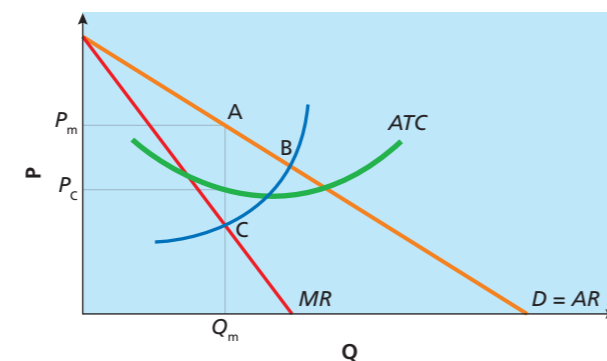
**Figure 1** Market power can lead to high prices and rising inequality

## Barriers to entry and exit

- Barriers to entry are factors that hinder new firms from entering a market. These barriers can be natural (e.g. high startup costs or economies of scale) or artificial (e.g. predatory pricing or exclusive contracts imposed by incumbents).
- Low barriers to entry make a market more contestable.
- Barriers to exit are factors that make it difficult for a firm to leave a market, such as the inability to recoup the investment into the industry once a firm exits.

## Natural barriers

- Natural (or innocent) barriers to entry are obstacles that arise from the inherent characteristics of a market or industry. These barriers are not created by the intentional actions of existing firms but are instead the result of natural circumstances.
- Access to a raw material that is limited in supply can create barriers to entry (e.g. access to copper supplies or diamonds).
- Particular climatic conditions may create an entry barrier – e.g. grapes for certain types of wine may only be grown in a particular climate.
- Economies of scale – where existing firms benefit over new entrants by lower average costs – especially where the minimum efficient scale is at a high level of output, it is particularly difficult for new firms to get established in a market.



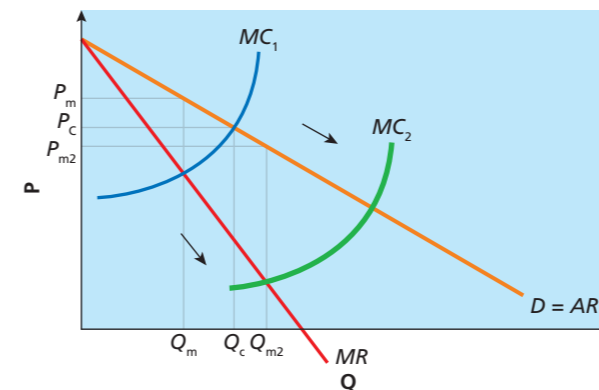
**Figure 2** Where firms have no market power, prices are lower and there is reduced inefficiency

## Artificial barriers

- Artificial or strategic barriers are created by a firm to make it harder for other firms to enter the market.
- Examples of artificial barriers include:
  - Advertising – Firms spending high amounts on marketing and advertising can make it difficult for a new firm to establish itself in a market.
  - Branding – Similar to the above, a strong brand image or name can make it very hard for new entrants to become established.
  - Limit/predatory pricing – Existing firms can set their prices so that they only make natural profits, which will be difficult for new entrants to match (without making losses) as they are not as efficient as the existing firms.

## Static and dynamic efficiency

- Firms in perfectly competitive markets are statically efficient – they are productively and allocatively efficient at a point in time.
- Firms with market power earn supernormal profits and can reinvest these profits in order to reduce their costs (e.g. through investment in cost-saving new technologies).
- This cost-saving can lead to dynamic efficiency. On Figure 3, the original monopoly price ( $P_m$ ) is above the price in a competitive market ( $P_c$ ). However, by reinvesting the supernormal profits, the monopolist may be able to reduce costs so that the price eventually falls below  $P_c$  to  $P_{m2}$ .

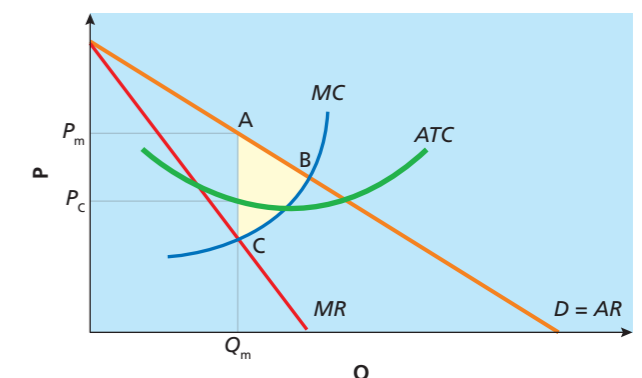


**Figure 3** Even with market power it is possible that consumers may not face higher prices

- This means that with costs reduced significantly, selling prices may fall for a monopoly to a level lower than what would be achieved under perfect competition.

## Market power and market failure

- Prices are higher where firms have more market power than they would otherwise.
- Output levels are lower where firms have market power.
- Competition is generally good for consumers.
- Market power creates welfare losses.
- On Figure 4, the welfare loss is shown by the shaded area ABC.



**Figure 4** Market power can lead to welfare losses and market failure

- In all types of market structure, market failure can appear regardless of market power through creation of externalities.

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