Chapter 3 – Market Structures

3.1 Perfect Competition

➢ **Market Structure – Characteristics of a market that determines firm behaviour**

Perfect Competition Characteristics

1) There are **many (infinite) buyers and sellers** in a perfectly competitive market. The concentration ratio is 0 where firms must compete with each other in order to survive in the market place.

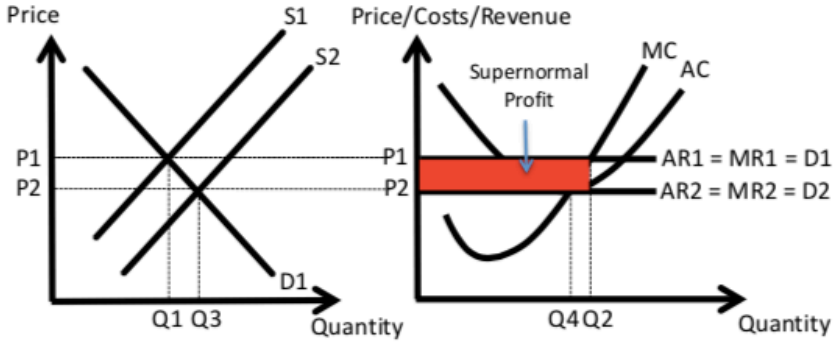
2) The goods and services produced are **homogenous** (identical). The makes firms **price takers**, taking the price set by the market, they have no influence at all in setting prices with no differentiation between products. If firms raised their price, they would lose all their customers and if firms reduce their price, either all firms would follow immediately reducing revenues or revenues will not cover costs leading to losses that can't be sustained.

3) There are **no barriers to entry or exit for firms**, meaning entry and exit is completely costless. If firms are attracted by supernormal profits they can enter straight away and if firms want to leave due to losses being made, they can do so immediately. This implies that short run supernormal or subnormal profit will not be sustained in the long run.

4) There is **perfect information/knowledge of market conditions** for both consumers and producers. For consumers they have perfect information over prices being charged and producers have perfect information over costs and technology in the industry as well as prices being charged.

5) **Firms are profit maximisers** producing where marginal cost = marginal revenue at all times and **consumers are utility maximisers** consuming only up until price equals their marginal utility.

Perfect Competition – Firm Behaviour, Short Run Supernormal Profit



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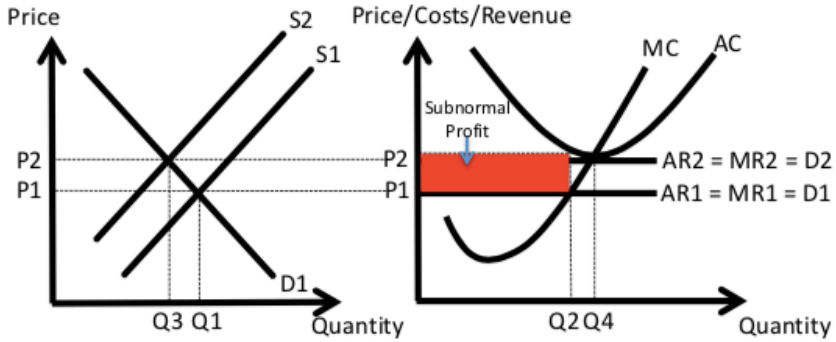
The market equilibrium price is at P1. Taking this price, firms will profit maximise where MC=MR producing Q2 units of output. At this level of production, AR>AC, thus the firm is making supernormal profits indicated by the shaded rectangle. Firms are attracted into the industry by the supernormal profits and with no barriers to entry, the supply curve shifts to the right from S1 to S2 thus the market equilibrium price falls. This process continues from P1 to P2 until the demand (AR) curve, for an individual firm, is tangential to the AC curve, where normal profit is being made and the firm has returned to a long run stable equilibrium at Q4.

Perfect Competition – Firm Behaviour, Short Run Subnormal Profit (Loss)



The market equilibrium price is at P1. Taking this price, firms will profit maximise where MC=MR producing Q2 units of output. At this level of production, AR<AC, thus the firm is making subnormal profits (economic losses) indicated by the shaded rectangle. Firms who are not covering their average variable costs of production will shutdown and leave the industry to minimise their losses immediately given no barriers to exit, thus the supply curve shifts to the left from S1 to S2 increasing market equilibrium price. This process continues from P1 to P2 until the demand (AR) curve, for an individual firm, is tangential to the AC curve, where normal profit is being made and the firm has returned to a long run stable equilibrium at Q4.

Long run equilibrium in perfectly competitive markets is defined by normal profit (AR=AC) and allocative efficiency, where P=MC at Q4.

Perfect Competition – Long Run Performance Pros

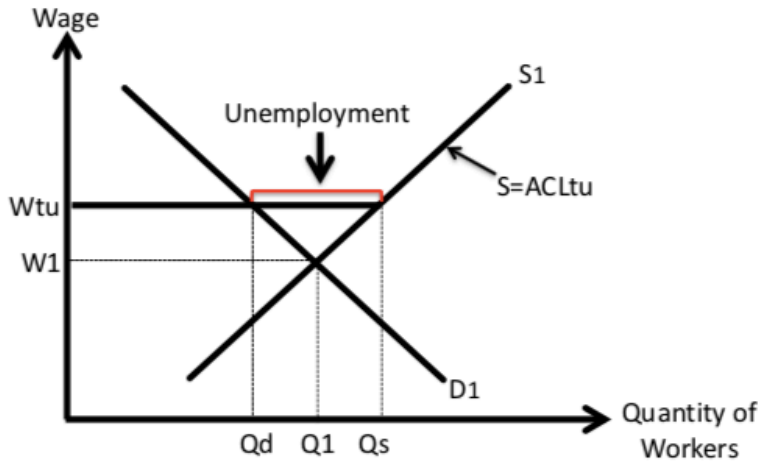
1) **Allocative efficiency is achieved in the long run.** This is because firms in perfect competition produce where P=MC at the long run equilibrium point of production. This is where demand equals supply maximising the sum of both consumer and producer surplus a key feature of a highly competitive industry. At this point of production, resources are allocated according to consumer demand with consumers getting what they demand at the exact quantity they desire. Consumer choice is high and prices are low maximising consumer surplus in the market. The quality of the product being sold is excellent too given the drive to meet the needs and wants of the consumer.

5.5 Trade Unions

➢ **Trade Union – An organisation of workers who group together to further their interests in terms of pay, working hours, holidays and working conditions.**

Trade Unions – Labour Market Outcomes

Trade unions use collective bargaining, where the pay of a large group of workers is determined through one negotiation thus providing workers more strength and market power. An assumption is made that there is a closed shop agreement whereby all workers in a profession are members of one trade union giving that one union maximum market power where it essentially becomes a monopoly supplier of labour, able to control the labour supply at given wage rates.



The labour market above is operating efficiently at competitive levels, W1 and Q1. If workers through their trade union are unsatisfied with pay and conditions, the union can bargain for a higher wage of Wtu, controlling the labour supply at that wage rate up until the existing labour supply curve at Qs. Firms are very likely to accept this given the number of workers they can lose if they reject the settlement and the threat of strike action with no production and negative publicity that comes with it. The firm therefore becomes a wage taker at the trade union wage rate Wtu with the new supply curve equal to the wage up until Qs. The union cannot control labour supply beyond this point as those workers require a higher wage to enter the profession therefore the new supply curve with trade union involvement possesses a kink reverting back to the original supply curve beyond Qs.

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With new market conditions, where demand equals supply is now at employment Qtu at the wage rate Wtu. Although the wage rate is higher than competitive levels, employment levels are lower, with the trade union creating an excess supply of labour, i.e. unemployment between Qs and Qd hence improving pay and living standards for some but worsening outcomes significantly for others who are left without a job distorting efficient competitive labour market outcomes.

Trade Unions Evaluation

1) The impact of trade unions depends on their strength and power **i.e. the union density.** The union density measures the percentage number of workers in a profession that are members of a union. The higher the percentage density is, the greater the power of the union to bargain collectively and increase wages/improve working conditions. Workers in professions where union density is weak are unlikely to benefit from higher than competitive wages.

2) The success of the union fighting for higher wages is determined by the **union mark up.** This is the difference in wage between workers who are members of a trade union and those who aren't. The bigger the difference in favour of union workers, the more successful the union is in bargaining for better pay and conditions, however the impact on unemployment is greater as well.

3) Trade unions are more likely to be successful when the **economy is in a period of strength not when there is economic turmoil in a recession** for example. This is because in a boom period, firms are more willing to increase wages when revenues and profits are strong and labour is scarce, improving the bargaining power of unions. In a recession however, unions have less power as firms are struggling for revenue and profit and are therefore much less likely to increase costs by allowing wages to rise. Furthermore there is usually an abundant supply of labour available where firms will sack workers if necessary and hire new employees to avoid succumbing to the wage bargaining of unions.

4) Union power is significantly weakened with **regulation that reduces their power**. Governments can use regulation as a supply side policy to improve the efficiency of labour, making the economy more competitive and increasing potential output. Trade unions increase costs in various ways for businesses; wage increases, longer maternity/paternity leave, longer holidays and breaks, extra perks to the job, increasing health and safety standards etc. The government is also a significant employer where successful unions increase their costs and thus borrowing or taxation requirements. Regulations to reduce trade union power include, making closed shop unions illegal, making strike action legal only if a certain percentage of the union workforce agree when voting in secret and only allowing workers to strike against their own employer rather than allowing any workers in a profession to partake in a strike. Union density and the threat to strike are the biggest weapons a union possesses therefore reducing their impact significantly lowers the union's power to increase wages and improve working conditions.

5) Trade unions can have a significantly **negative long run impact on firms**. This is because unions increase costs in various ways for businesses; wage increases, longer maternity/paternity leave, longer holidays and breaks, extra perks to the job, increasing health and safety standards etc. As a consequence firms may shut down if they become too unprofitable or leave the country to work in countries where unions are not as prevalent hurting the long run growth potential of the country and employment prospects. The government is also a significant employer where successful and powerful unions increase their costs and thus borrowing or taxation requirements impacting both current and future generations.