Competition

What has happened to Hollywood Video?

- Why has a company that once owned thousands of video rental stores now gone bankrupt?
  - It failed to change its service, marketing, prices in the face of completion from the web.
  - How has Tsutaya stayed competitive?

Why do firms compete?

Firms compete to:

- increase their customer base
- increase their sales
- expand their market share
- achieve product superiority
- enhance their image and the image of their products

and ultimately to:

- increase profits

Competition between firms is good for the consumer. Competition encourages profit-seeking firms to use their resources efficiently to compete on prices and products, so that consumers buy from them

Types of competition

Price competition

Competing with rival suppliers on product price

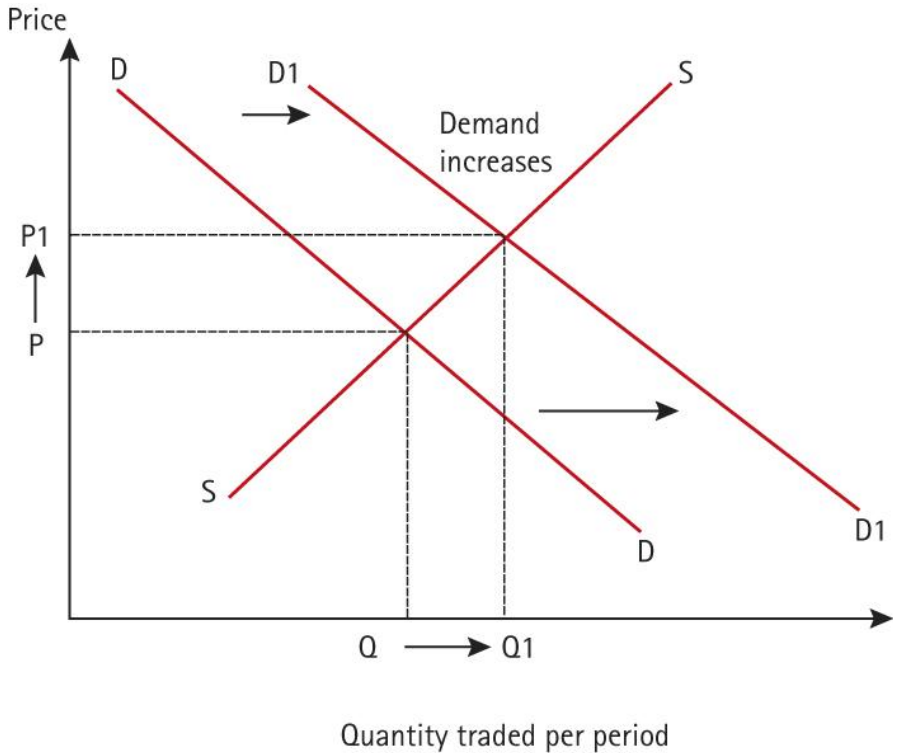
But if demand is price inelastic, revenue will fall; if price is cut below average cost, each unit will be sold at a loss

Non-price competition

Competing on all other product features other than price

For example, new product development, after-sales care, and promotions including advertising, in-store displays, competitions, etc.

The power of advertising



- It can create and increase consumer wants for a product
- It can create a powerful brand image for a product and increase customer loyalty

Brand loyalty has the following benefits:

- ✓ **It leads to repeat purchases**
- ✓ **It protects sales and market share**
- ✓ **Customers are willing to pay more for the brand**
- ✓ **Customers continue to buy the brand if the producer increases its price over rival products**

- It can reduce competition

Smaller firms will be unable to spend as heavily on advertising as larger rivals

Pricing strategies

Demand-based pricing

Price skimming: setting the price if there is little competition

Penetration pricing: setting a low price for a new product to boost its sales and increase market share

Competition-based pricing

Predatory pricing: undercutting the prices of rival firms in an attempt to drive them out of business

Price leadership: rivals setting their prices at or near the price charged by the market leader to avoid a price war

Cost-based pricing

Cost-plus pricing: setting price equal to average cost plus a fixed or percentage mark-up for profit

But this takes no account of what consumers may be willing to pay or how much competition there is to supply the market

But predatory pricing (also called destruction pricing) can result in damaging price wars

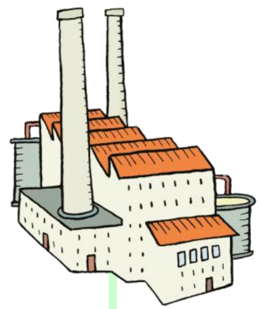
Competition

Some markets are more competitive than others. Competition between firms encourages them to make the best use of scarce resources, because in order to maximize profits they must produce outputs that gives consumers the best value for money to satisfy their wants. Any restriction on competition may therefore result in a mis-allocation of resources with costs and prices higher than they otherwise would be.

Market structure

The characteristics of a market include how many firms compete to supply it, the degree of competition between them, the extent of their product differentiation, and the ease with which new firms can enter the market to compete with them

PERFECT COMPETITION



PURE MONOPOLY

Number of firms supplying market

rising : falling

Many suppliers with identical products

Single large supplier

Individual firms have no control over market price

The monopoly firm can determine market price

Competitive markets

A **competitive market** will display many of the following features:

- There will be vigorous price competition and non-price competition between firms
- Firms will pursue different pricing strategies
- Product features and brand images will be highly differentiated
- The range of product designs available and the quality of after-sales services will tend to change frequently
- Market shares and profits of competing businesses will vary over time
- New firms will be able to enter the market and less efficient firms that are unable to compete will be forced to close

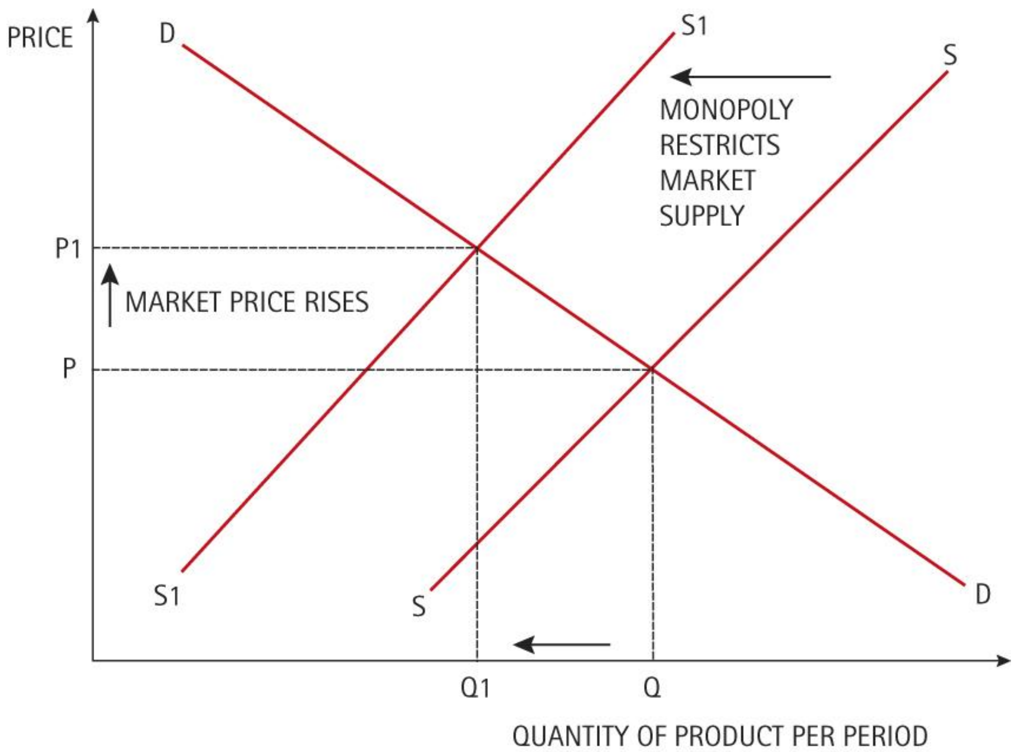
Monopoly

A single firm or group of firms acting together with sufficient market power to restrict competition and set the market price is a **monopoly**

A **pure monopoly** controls the total supply of a product to a market

A monopoly may restrict supply to force up the market price and earn **abnormal profits**

i.e. excess profits above what they would be if there was competition



Problems with monopolies

A monopoly may abuse its market power to:

- restrict market supply to force up market price
- restrict competition and consumer choice
- cut product quality to save costs

In addition, there may be:

- **x-inefficiency**

A monopoly may be poorly managed and inefficient because it does not face any competition

- a need for **regulation**

Governments may have to use resources to investigate and punish abuses of market power

Swisscom may be fined for overcharging customers

Regulator promises to end energy suppliers monopoly

EU investigates IBM over 'abuse' of market power

How monopolies can restrict competition

Artificial barriers to entry may be used by a monopoly to restrict competition unfairly by:

- using predatory or destruction pricing to force rivals out of business
- threatening major suppliers that it will stop buying from them if they supply rival firms
- threatening retailers to stop supplying them with their product if they stock rival products

But:

Natural barriers to entry are not necessarily bad. They occur because large-scale production is often more efficient.

Smaller firms may be unable to compete with larger firms on costs and revenues because:

- large firms may enjoy significant economies of scale that give them a **natural monopoly**
- small firms cannot match the capital investment needed for large-scale production
- large firms may have built up significant customer loyalty over time
- some large firms may have a **legal monopoly** because they have **patents** to protect their innovative products and technologies from being copied

Regulating competition

Competition policy refers to measures governments use to control the behaviour of firms acting anti-competitively and against the interests of consumers

(1) Regulating the prices and service levels of monopolies

(2) Imposing fines on firms that abuse their market power

(3) Forcing monopolies to break up into smaller, competing firms

Consumer protection laws protect consumers from exploitation and harmful business activities, e.g. it is an offence to sell goods or services which are unsafe or in an unsatisfactory condition or to mislead consumers about prices and products

Not all monopolies are bad

A firm that is a monopoly may still act competitively and be good for consumers if:

▲Some revolutionary products, like the jumbo jet and photocopier, may never have been developed if the business organizations that invented them were unable to enjoy monopoly profits. Abnormal profits were a reward for their significant investment risks.

- It is a more efficient producer with lower costs than smaller firms
- It faces competition from firms overseas and consumers are able to choose products that are close substitutes
- Its market is **contestable**, i.e. there are few or no barriers to entry
- It invests its profits in new product developments