# CHAPTER 12: Distortions to Market Forces

## Key Revision Points

### Introduction

Perfectly competitive markets may be ideal for consumers because they have a tendency to minimise prices paid for any given goods and services. However, lower prices are not attractive to suppliers because, for any given level of output, lower prices mean lower revenue and therefore lower profit. It is not surprising, therefore, that firms seek to limit the workings of market forces. This chapter looks at **imperfect competition**. In practice, firms can create imperfections in markets that give them limited monopoly power over their customers.

- **The development of brands**

The process of branding is at the heart of organisations' efforts to remove themselves from fierce competition between generic products.

Branding simplifies the decision-making process by providing buyers with a sense of security and consistency which distinguishes a brand from a generic commodity.

The traditional role of branding has been to differentiate products, but brands have been increasingly applied to organisational images too.

There have been many conceptualisations of the unique attributes of a brand and how these affect buying decision processes. These usually distinguish between elements that can be objectively measured (such as the reported reliability of an airline) and the subjective values that can only be defined in the minds of consumers (such as the perceived personality of the Virgin airline brand).

- **Brand strategy**

Given the importance of brands for reducing the effects on a company of fierce generic competition, the question needs to be asked how the company should develop a brand strategy. Indeed, how many brands should it develop?

The branding literature has identified a number of branding strategies but we will focus here on just two important strategies:

- Individual brands linked to specific products, or groups of products are more likely to be used by companies who have separate operating units serving quite distinct market segments
- Single, strong brand strategies allow companies to diversify into new product areas relatively easily. In doing so, companies have used their brand reputation to overcome buyers' perception of risk, enabling them to deepen the trusting relationship that they have already developed with buyers.

**Oligopoly**

Oligopoly lies somewhere between imperfect competition and pure monopoly. An oligopoly market is dominated by a small number of sellers who provide a large share of the total market output. All suppliers in the market are interdependent. One company cannot take price or output decisions without considering the specific possible responses of other companies.

Oligopoly is a particularly important market structure in industries with economies of scale.

**Monopolistic markets**

In its purest extreme, monopoly in a market occurs where there is only one supplier to the market, perhaps because of regulatory, technical or economic barriers to entry. However, this rarely occurs in practice. Sometimes, monopoly control over supply comes about through a group of suppliers acting in collusion together in a 'cartel'.

Government definition of a monopoly is less rigorous than pure economic definitions. In the United Kingdom, two types of monopoly can occur:
- A scale monopoly occurs where one firm controls 25 per cent of the value of a market.
- A complex monopoly occurs where a number of firms in a market together account for over 25 cent of the value of the market and their actions have the effect of limiting competition.

- **Effects on prices and output of monopoly**

A monopolist can determine the market price for its product and can be described as a 'price maker' rather than a 'price taker'.

In a pure monopoly market, consumers would face prices that are higher than would have occurred in a perfectly competitive market.

- **Implications of monopoly power for a firm's marketing activities**

In a pure monopoly, a firm's output decisions would be influenced by the elasticity of demand for its products. As long as demand remained elastic, it could continue raising prices, and thereby, its total revenue.

Organisations that think strategically will be reluctant to fully exploit their monopoly power. By charging high prices in the short-term, a monopolist could give signals to companies in related product fields to develop substitutes that would eventually provide effective competition.

- **Porter's Five Forces model of industry competitiveness**

The competition environment of most organisations is dynamic, with new organisations and technologies emerging to challenge a company's position. A widely used framework for analysing the dynamism of the competitive environment is Porter's Five Forces model. This model helps to identify the factors that affect the intensity of competition within a particular industry, and illustrates the relationship between different players and potential players in the industry. The five forces requiring evaluation are: the power of suppliers, the power of buyers, the threat of

new entrants, the threat of substitute products and the intensity of rivalry between competing firms (Figure 12.4).

**Competition policy**

The vision of competitive markets that bring maximum benefit to consumers is often not achieved. The imperfections described above can be summarised as resulting from:
- The presence of large firms able to exert undue influence over participants in a market.
- Collusion between sellers (and sometimes buyers)
- Barriers to market entry and restraints on trade
- Rigidity in resource input markets

Because of the presumed superiority of competitive markets, the law of most developed countries has been used to try and remove market imperfections where these are deemed to be against the public interest. A growing body of legislation based on statute law is now available to governments and organisations seeking to curb anti-competitive practices.

- **Common law approaches to improving market competitiveness**

There is case law that holds that agreements between parties that have the effect of restraining free trade are unlawful.

The 'public interest' is important in deciding whether a restrictive agreement is reasonable.

A claim of restraint of trade can also be made against a company buying a business that restricts the future business activity of the person from whom they have bought the business.

If a clause in an agreement is deemed by a court to be unreasonable, it may remove it from the contract. It can however, be difficult to know what a court will consider to be 'reasonable' in the circumstances of a particular case.

- **Statutory intervention to create competitive markets**

Common law has been supplemented by statutory legislation, that is, laws passed by government as an act of policy. One outcome of statutory intervention has been the creation of a regulatory infrastructure, which in the United Kingdom includes the Office of Fair Trading, the Competition Commission and regulatory bodies to control specific industries.

- **Articles 85 and 86 of the Treaty of Rome**

Article 85 of the Treaty of Rome prohibits agreements between organisations and arrangements between organisations that affect trade between member states of the European Union and in general prohibits anti-competitive practices.

Article 86 prohibits the abuse of a dominant market position within the European Community insofar as it may affect trade between member states.

The EU often has difficulty in reconciling the need for firms to operate globally at a large scale, and the resultant domination of the EU market by that firm.

- **UK Competition legislation**

In the UK, the 1998 Competition Act reformed and strengthened competition law by prohibiting anti-competitive behaviour.

A number of agencies have responsibility for preserving the competitiveness of markets in the UK, the most important being:
- The Director General for Fair Trading
- The Competition Commission
- Public utility regulators

- **Evaluating claims of anti-competitive practices**

A fine balance often exists between the co-operation among firms which leads to lower prices / better products for consumers, and co-operation which leads to collusion and a reduction in consumers' choice. There is diversity in interpretation of the notion of the 'public interest', which may be explained partly by cultural/ political factors, and developments in our understanding of the consequences of market imperfection.

Regulatory bodies are increasingly recognising that co-operative relationships between companies can become anti-competitive.

- **Control on price representations**

One of the assumptions of a perfectly competitive market is that participants in it have complete information about competing goods and services. In reality, buyers may find it very difficult to judge between competing suppliers because prices are disclosed in a deceptive or non-comparable manner. Legislation, such as the Consumer Protection Act 1987, makes it illegal for a company to give misleading statements about the price of goods or services.

- **Regulation of public utilities**

To protect the users of these services from exploitation, the government response has been twofold:
- Government has sought to increase competition, in the hope that the invisible forces of competition will bring about lower prices and greater consumer choice.
- Where competition alone has not been sufficient to protect the consumers' interest, government has created a series of regulatory bodies which can determine the level and structure of charges made by these utilities.

In utility markets where competition is absent, regulators have to balance what is desirable from the public's point of view with the companies' need to make profits, which will in turn provide new capital for investment in improvements.

- **Control of government monopolies**

There are still many services that cannot be sensibly privatised or deregulated. Therefore, where it is impractical to privatise publicly provided services, government has taken a number of measures to try and protect consumers from exploitation. These are some of the methods that have been used:

- Arms length organisations
- Market testing
- Customers’ charters