

25 marker model answer | Economics A Level OCR style

Here is a response to a practice question:

Evaluate the view that consumers benefit from oligopolies. (25 marks)

Answer

An **oligopoly** is when a few large firms dominate the market. Key properties of an oligopoly include: firms are price makers, interdependence between firms - one firm's actions affect outcomes for other firms. This can lead to price wars and/or collusion. There are also high barriers to entry and non-price competition.

Consider the “**prisoner's dilemma**” game theory model. There are two firms, firm A and firm B. Each firm can either choose to raise its prices or lower its prices. This payoff matrix below shows the outcomes. The “Nash equilibrium” is the set of actions where both firms are playing their “**best responses**” to the action the other firm undertakes. The Nash equilibrium here is for both firms to drop their prices. Given firm A is dropping their price, then it is best for firm B to lower their price, as profit increases from 1 to 2 (£million, and vice versa). This means a **price war**, where firms keep reducing their prices. This means a movement along the demand curve, an extension. This increases consumer surplus. This may take place in the supermarket industry in the UK, where the five largest firms have a total market share of 66%. Supermarkets may use price match guarantees to engage in price wars.

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		Firm B	
		High price	Low price
Firm A	High price	(4,4)	(1,5)
	Low price	(5,1)	(2,2)

(1,5) means firm A earns £1 million in profits while firm B gets £5 million in profits.

However this assumes firms cannot communicate or trust each other. If firms can **communicate and trust** one another, they can work together. Firm A and B both raise prices and have higher total profits compared to if one of them lowered their price. This would be **collusion**, which is illegal in many advanced economies. But higher prices would lead to a contraction in consumer demand, **reducing consumer surplus**. In 2019, there was an accusation that 20 pharmaceutical firms colluding to increase prices of certain drugs by over 1000%. So collusion seems

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more likely than a price war in an industry like pharmaceuticals, leading to higher consumer prices.

While collusion increases profits for firms, these profits may be reinvested into **research and development**. More generally in an oligopoly there are likely to be high supernormal profits because of high barriers to entry. In other words, there can be “**dynamic efficiency**”. One can view two colluding firms as one firm with market power. In other words, colluding firms behave like a monopoly. This means the firms together can raise prices above the perfectly competitive price. This leads to higher supernormal profits. If profits are reinvested in improving product quality, then consumers benefit from improved products. If profits are reinvested in cutting the cost of production, then this may be passed on to consumers in the form of lower prices. Overall high market concentration can lead to greater reinvestment of profits. For example, the pharmaceutical market has 9 key suppliers selling over 60% of all global vaccines - while there is high market concentration, pharmaceutical companies typically invest heavily in research and development for new drugs. This could include new vaccines or discovery of new drugs, such as new drugs for Alzheimer’s disease. This benefits consumers that are less likely to be ill and more likely to recover as a result.

This depends on the **allocation of profits**. Firms may instead allocate profits instead to shareholder dividends or payouts to top CEOs. This could be because of myopia (short termism) by investors or CEOs, who forgo the long-term success of the company in favour of higher payouts today. There have been allegations of excessive CEO pay, including in the pharmaceutical industry - Martin Shkreli, a former pharmaceutical

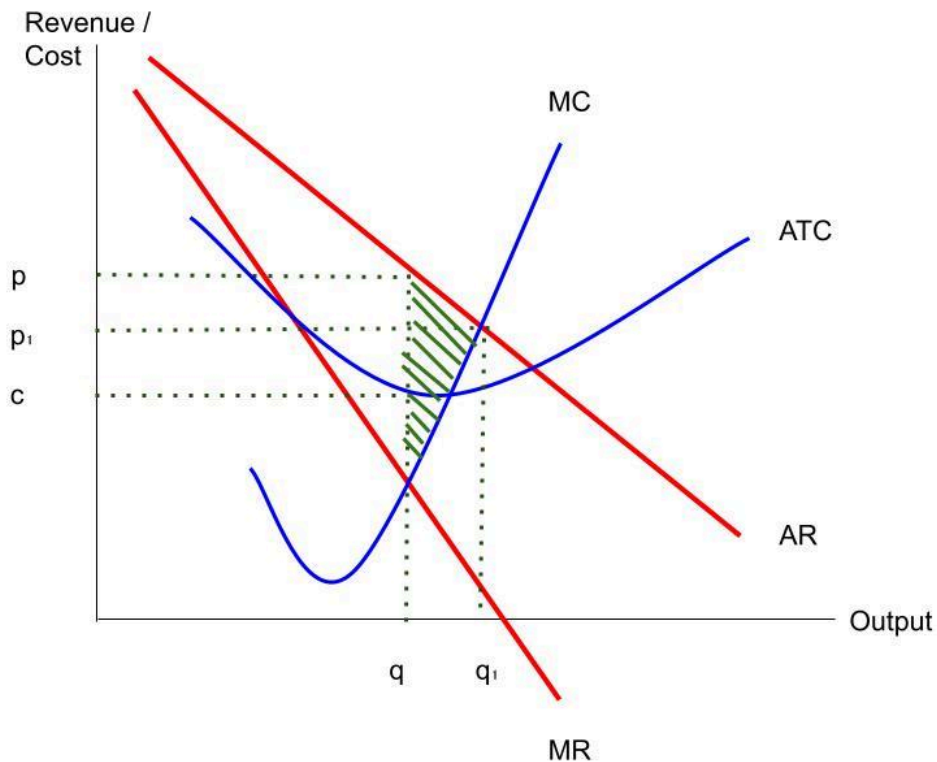
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CEO, was ordered by a judge to return £64 million in excess profits due to a price hike from selling a drug Daraprim. So there is less funding for reinvestment. So product quality does not improve over time, nor do firm costs (and hence prices) fall over time. This reduces the extent of consumer benefit from oligopoly.

An oligopolistic firm is likely to be **allocatively inefficient**. Particularly when colluding, an oligopoly is likely to operate like a monopoly, restricting the quantity to raise prices. Vp and MGF, construction supplier companies, were found to be colluding by sharing information on future pricing strategies. Collusion increases the oligopoly firm's profits. The allocatively efficient outcome occurs where $AR=MC$ at (q_1, p_1) , which maximises social welfare. But the oligopoly firms, acting as a monopoly, restrict the quantity supplied to q and raise the price to p to maximise profit, which occurs at the output level where $MR=MC$. This **reduces consumer surplus** as consumers now experience higher prices and reduced quantity. Specifically there is a welfare loss as shown by the shaded area. Moreover oligopolies, colluding, are likely to be **X-inefficient** - the lack of competition reduces incentives to cut costs. So average costs increase relative to a perfectly competitive market, which are likely passed on to the consumer in the form of higher prices. This further worsens consumer surplus.



This depends on whether the oligopoly is regulated. For example a **price cap** at the allocatively efficient price p_1 would restore allocative efficiency, increasing consumer surplus and maximising social welfare. Energy firms in the UK face a price cap that is updated every three months by Ofgem. This can prevent energy companies from colluding and provide “**surrogate competition**” as a means to incentivise firms to cut costs. **Cutting costs** is the main way in which firms can increase their supernormal profits, when there is a price cap. So an oligopoly is inefficient only in some circumstances.

Overall oligopolies, when unregulated, are likely to harm consumers. With regulation to prevent and disincentivise collusion, such as large

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fines, oligopolies are likely to benefit, not harm, consumers in terms of **price wars** and **R&D investment**, such as Astrazeneca's £30bn over 5 years. Whether consumers benefit from oligopolies depends on the effectiveness of any regulation to manage oligopolies. Regulation, done poorly, can lead to **government failure**. For example, regulatory capture means regulators are too close to the interests of firms, leading to the watering down of regulation, such as setting light fines or generous price caps. But if the CMA is actively intervening, it can prevent excessively high prices.

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