AQA Economics A-level
Microeconomics

Topic 5: Perfect Competition, Imperfectly Competitive Markets and Monopoly

5.8 The dynamics of competition and competitive market processes

Notes

Short-run and long-run benefits which are likely to result from competition

- In the long run, firms are likely to be more productively and allocatively efficient. This is because they provide the goods and services that consumers want, and competitive pressure forces them to lower their costs of production.
- In the short run, firms might make supernormal profits, which can be reinvested back into the firm. This can increase dynamic efficiency and lower LRAC.
- Consumers get a wide variety of choice due to the number of firms in the market. Goods and services are likely to be of a higher quality, since firms are trying to gain consumer loyalty.

- Firms do not just compete on price. Firms can try and distinguish their products and gain market share using **non-price competition.**

- Firms might also aim to:
  - **Improve products:** Improving the quality of the product, or innovating to keep it up to date with the latest technologies, will mean the product remains competitive in the market.
  - **Reduce costs:** By reducing costs, new firms will not be able to compete on price terms with existing firms, so there will be less competition in the market. This also means the firm is being more productively efficient.
  - **Improve the quality of the service provided:** This is particularly important in the service industry, such as with banking. Consumers are likely to leave banks which do not provide them with good customer service. Now, many employers have customer service as one of their areas of focus.

- Firms might compete vigorously with each other, but monopoly power could lead to consumers being exploited.

- They could be charged high prices, because consumers have little choice where to purchase their goods and services, since there are so few firms in the market. Consumer surplus falls.

The process of creative destruction

- If firms have monopoly power and they are making large profits, new firms have an incentive to enter the market and innovate, to overcome barriers to entry. This process of creative destruction is a fundamental feature of the way competition operates in a market economy.
- The process of creative destruction is linked to technological change.
- Schumpeter, an economist, proposed the idea of 'creative destruction'. This is the idea that new entrepreneurs are innovative, which challenges existing firms in the market. The more productive firms then grow, whilst the least productive are forced to leave the market. This results in an expansion of the economy's productive potential.
- Creative destruction leads to more innovation and the production of new goods and services.
- Netflix and Blockbuster provide a good example of creative destruction. Netflix innovated and adapted their DVD subscription service to the advancing technology of the internet. This has resulted in them becoming one of the biggest video distribution networks.
- Technological change can lead to the development of new products, the development of new markets and the destruction of existing markets. For example, the development of DVDs, then Blu-rays, and now the rise of Netflix, has essentially destroyed the market for VHS video tapes. Blockbuster was driven out of business by changing consumer tastes towards Netflix, and similar services, as well as the technological advancement of internet services.