Determinants and effects of an oligopoly economics essay

What is an oligopoly?

In the harsh, unsympathetic world of business, businessmen and women everywhere seek to maximize his or her profits. Thus, it would be very much of their interest to have greater control over the goods or services which they produce. Bigger and more established companies would often weigh a much broader spectrum of influence to control market prices, driving other new or upcoming companies to leave the industry all together and discouraging other interested ones. Competition is restricted only between those few large companies. This is an economic reality existing in our world today called oligopoly.

The online Oxford dictionary defines oligopoly as a state of limited competition, in which a market is shared by a small number of producers or sellers. Oligopolistic firms offer identical or homogenous products, such as petrol; but these companies may also produce differentiated products that may be similar in nature but differ in physical as well as qualitative aspects, like sneakers. These many products can be identified in the market by an ingenious idea called branding. For instance, the market for petrol in Malaysia is controlled by Petroliam Nasional Berhad (National Petroleum Ltd. – PETRONAS), as well as other foreign companies like Shell and Caltex; while Nike, Adidas and the likes control the market for sneakers. In reality, because of the limited number of producers, their actions would bring substantial effect to the balance of the market. These companies may act together as an entity in a whole to form a monopoly – lowering their productions while raising the prices above marginal cost, or they make decisions independent of each other (acting as a competitive market).

Therefore, a key feature of oligopoly is the tension between cooperation and self-interest.

Factors of success for a collusion

The many individualistic elements of an oligopolistic market may or may not make an agreement, whether open or tacit, about the quantities to produce or prices to change. When this arrangement is made, it is called a collusion; and the group of companies colluding amongst each other may be called a cartel. Once the agreement is made, the cartel effectively functions as a monopoly, and would then need to decide on two important factors – efficiency and equality, regarding to the nature of their cooperation; in order to ensure their success. In general, there are many factors that would determine the outcome of a collusion. There must be limited number of firms; firms must also be equally efficient; and the colluding firms must successfully dominate a defined market.

The ability to regulate prices among the various members of the cartel depends on the number of firms in participation. Technically speaking, coordination is more difficult among larger number of individual components. Successful price fixing depends on the synchronization between the firms to effectively adjust and allocate only desirable levels of resources to their output, and this can be done successfully when the number of firms is small. Besides that, it is much more difficult to detect a defector among the ranks when the number of firms rises. For instance, if ever Northrop, Boeing and Lockheed formed a cartel to monopolize the aviation industry in the US, a significant increase in one company’s production level would in turn increase substantially the cartel wide output too. Therefore, the ‘ traitor’ is easily identified. Compare this to say a collusion of clothe companies (there are probably hundreds, or even thousands in the US alone) – even a significant rise in one firm's production level would hardly make a bulge in the cartel wide output. On the other hand, successful collusion requires a noteworthy amount of communication between the various administrative members of each firm. A larger number of firms would make this increasingly difficult and risky (especially for a tacit collusion) as the probability of being detected by a third party rises too. In a theoretical aspect too, the price of goods would fall further with an increase of producers. Therefore, prices would cease to be of oligopolistic nature – that is lower than the monopolistic but above the marginal cost – and approach the competitive market's level.

For a collusion to be successful, it would be better for all the members of a cartel to be of equal quality, efficiency and size. Other things being equal, firms with lower efficiency – that is with a higher production cost – would certainly want to lower production and raise prices as to maximize profit. Therefore, even if there is a commitment in place, the inequalities experienced by firms in a cartel would definitely induce some of them to cheat. The same concept applies in relation to the companies' size. Generally, if the firms colluding with one another are of equal size, they would generally like to allocate resources on an identical scale; and same to for a larger firm. However, smaller firms prefer a pro rata concept, which is an unconditional reduction for the larger firms' part. This would generate an opportunity for a dispute to arise.

Collusion among firms is also easier when there is product homogeneity. When the goods or services produced by those companies are similar, competition is only limited to these firms and therefore, would benefit them directly. As an example, compare a cartel between Nike and Adidas with a cartel between the former with Calvin Klein. While the first group is a collusion between sports footwear producers, the latter is between a sports footwear with a formal footwear producer. In these cases, evidence would point that the first collusion would be more successful than the second one. There is more coordination between producers of homogenous products because the demand for these goods are unique to that specific industry. On the other hand, collusions between producers of heterogeneous would not work out that well because there are different demands for the goods sold. Hence, the target market is dissimilar and coordination is rather difficult to occur in two separate and unique audiences.

The elasticity of the goods or services produced can also determine the outcome of a collusion. In general, the goods or services provided by the firms in a cartel must be inelastic. When there are no close substitutes for a particular product, and consumers cannot easily change their buying preferences, the effect would be that the oligopolistic firms can benefit substantially when a collusion is made and the goods' prices rise above the competitive level. This can be reflected in the $150 million investment of Microsoft in non-voting shares of Apple in 1997. Although this is seen as a legitimate business deal between the two giant computer operating system producing companies, this factual account can explain why inelastic goods would lead to a successful collusion. Operating systems for computers are relatively very inelastic, contributed by the fact that there is a boom in the number of computer users in the US (and indeed, the world) but only a handful of operating systems to choose from. Therefore, when Microsoft ' helped' Apple, computer users cannot easily change their choice even when the prices rose. In reporting its fiscal 1998 first-quarter financial results, Apple clocked in a profit of $45 million and its stocks rose 20%, while Microsoft, already the most popular and preferred choice of operating system, got a huge boost in public relations.

Effects of oligopolies on public interests

Generally speaking, a cartel of oligopolistic firms has many negative impacts towards the consumers. This happens because as a cartel, the firms effectively behave much like a monopolistic entity and therefore, retain much of the undesirable elements of a monopoly.

Firstly, prices are overcharged beyond the market level whenever a collusion is formed. The price would normally be above the marginal cost, but below the monopolistic level. Therefore, firms usually would receive supernormal profits compared with the zero economic profits they would have earned if they remained perfectly competitive. Look at the graph below:

oligopoly. jpg

The oligopolistic firms would choose an output level where their combined marginal revenue equals their combined marginal cost. The price is then determined by the market demand of the same output level. The profit received by the companies is the area of the rectangular box ' abcd'. Therefore, like a monopolistic firm, the prices concurred would actually be a burden to the general public. Wages of the public, where most would be in the middle-income group, are usually stagnant in the short-run. Thereby, the public would sometimes need to make uncomfortable adjustments to their lives to make do with the rise in price of a usually inelastic need; as what we can and frequently see whenever OPEC (Organization of the Petroleum Exporting Countries) raises the price of oil.

In addition, whilst the price rises, the quantity produced would dwindle instead. This would definitely produce a shortage in the market, creating a conducive environment for market discrimination to happen. When this happens, the goods may not be bought by customers who value them the most. Thus, the market surplus as a whole becomes a lopsided affair. While producer surplus is outrageously maximized; the same cannot be said about consumer surplus. Questions of efficiency and equality are without doubt being subjugated. This is definitely not in the best welfare of the public. This is one reason why antitrust measures, such as the 1890 US Sherman Antitrust Act and the position of the Competition Commissioner of the European Union are created.

Besides that, there are many other adverse effects of oligopolies on the public. High prices in the market do not guarantee quality. Once again, the public is cheated of their right for prices corresponding to the quality of the goods or services. High entry barriers prevent smaller enterprises to compete on the scene – preventing the prices to fall further towards the more ethically fair level of the perfectly competitive one. Freedom of choice is also being restrained, as consumers are forced between choices of goods only provided by the colluding firms. There, is no questioning the rationality of policymakers (who had, in the US and Europe, recognized this problem since before the 19th century) that curtailing collusion would be for the best interest of not only the public, but the welfare of the nation involved.