Selected Topics in Business Administration:

Economics or the Art of Bringing Home the ~~Bacon~~ Avocado: Markets

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Excerpts from Economics or the Art of Bringing Home the ~~Bacon~~ Avocado *forthcoming*

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5 Passive markets

5.1 Features

Unlike a perfectly concurrent market, a *passively competitive* market is characterized by producers competing indirectly or non-voluntarily in the sense that if there is competition and not concurrence it is because producers cannot make significant changes in the price of their products in a way to be advantageous to them (price control), and thus are other factors at play.

The fact that producers cannot control price can be explained as follows. Since producers are attracted by *extraordinary profits*[1] i.e., additional revenue beyond that which covers the costs, they will tend to increase price. This is risky for two reasons. First, consumers being relatively price-sensitive can easily switch from one producer to another, because in this type of market there are a lot of producers offering similar products: it is easy for consumers to switch from one to the other without compromising satisfaction. Second, earning extraordinary profits in the long run will not go unchecked by potential competitors i.e., new market entrants, thereby reducing the market share with a tendency to push the price down to stay competitive.

Thus, since producers *cannot control the price even though they would like to*[2], they need to resort to other means to earn extraordinary profits. Advertising is not an option since there is very little product differentiation. Quality of products/offer/service can be an option that could help a producer demarcate itself locally, yet this is hardly noticeable in the vastness of the market.

What makes or breaks such a producer is location. If this is not chosen strategically, i.e., the producer has no option than to choose a location for the business that is to some extent imposed by circumstance; the business might or not work depending on traffic and proximity i.e., that location contributes to the functioning of the business.

For this reason, such producers are *passively competitive*[3] and are left with determining the quantity of production within the confines of location to maximize profit.

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[1] Also known as "supernormal profits" – but which are certainly not "abnormal" as some texts put them because there is nothing abnormal to seek to earn more than thy neighbour!
[2] Thus, labelled to be *price-takers*.
[3] The reason I have chosen to label them "passively" competitive is that the idea of passivity translates the frustration that some producers experience when they spend vast sums of money to differentiate themselves from their competitors for very little results: they are rendered passive and submissive by the market conditions and are not actively and dynamically competitive as they would have liked to – which is the case with dynamic competitors. As a case in point compare a local pizzeria – passive, with Domino's Pizza – dynamic.

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Passive competition does not imply the absence of competition because there are other factors at play over which the producer has no control and little to say.

5.2 Market conditions

From the above one can say that *passive competition* occurs where there are many passively competitive sellers producing standardized and similar products who *cannot individually affect the price in the market*.

In detail, the features of a passively competitive market are the following:

- Number of producers: many
- Number of consumers: many.
- Producer business size and operations scope relative to market size: small
- Knowledge of producers*: imperfect knowledge of what consumers despite marketing and consumer research*.
- Knowledge of consumers: *imperfect knowledge of what producers offer despite internet information, and this is because there many producers – in a sense, there are too many products to choose from*.
- Movement of factors of production: *labor and capital cannot freely move out of one given industry because labor skills are not transferable from that industry to another; capital is often directed by state policy in particular industries because for some economies they are the major employer – multiplier effects can be another reason.*
- Barriers to entry: these *are at play legal barriers relative to the legal structure the business will take, administrative barriers such as tax and employment formalities, and financial barriers because business operations need important capital investment*.
- Market exit: *because of the existing capital assets, there cannot be a simple liquidation of the business.*
- Product differentiation: *although the products and services are similar among producers, it is the choice on offer made by each producer that makes the difference because producers cannot offer all those consumers want, let alone produce it.*
- Market differentiation: *service-oriented marketing efforts make that one business is different from another despite synergies to make economies of scales on marketing budgets*.
- Market leadership strategies: ineffective as the price of products and services cannot be changed since producers are basically price-takers.

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6 Dynamic markets

6.1 Dynamically competitive markets

Dynamic competitors[4] are business enterprises that actively seek to control to some degree the output (Q) in the market and thus the price (P), and thus behave as *price makers*.

Additionally, unlike passively competitive markets, dynamically competitive markets are characterized by a few enterprises (Online 1) virtually at war (Online 2). The digital games industry (e.g., Nintendo etc.) is a prime example. Additionally, business enterprises which are chiefly found in passively competitive markets given the sheer number of them, can display dynamic features (e.g., fast food producers).

6.2 Dynamic competition

Dynamic competition refers to the market situation wherein enterprises vie for *advantages chiefly through voluntary product and market differentiation*, which means that they have the financial means to achieve this purpose.

Product differentiation is achieved through advertising whose aim is to single out the product. In cases where product differentiation is unlikely to happen in the production process, advertising may change a product from being a mass produced one to becoming a symbolic product, which is branded, as is the case of luxury products.

Another way of maintaining product differentiation is through innovation, hence the importance of research development with innovative producers (e.g., top restaurants, movie production).

6.3 Maintaining advantages through advertising

Advertising informs potential consumers of existing and new products thus acting as an important tool for the market to function.

Since advertising is used to build up loyalty of consumers to a product by associating that product with unique characteristics which are found to be pleasing, it creates wants to consumers (demonstration effect): technically, it affects the demand for such

[4] I have chosen this label because "monopolistic competitors", to use the typical denomination, are producers that spend sums of money on product research – tope restaurants, and advertising – fast food outlets, for the sole purpose of staying ahead of their competitors; they are literally "competitors" in the sense of seeking to maintain any leadership they have. Yet, they cannot claim any monopoly position as this involves having ousted competitors all together. The notion "dynamic" captures the rapid evolution of such markets in the Schumpeterian tradition.

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products rendering it less elastic i.e., less prone to price changes. In this way, with a price that is above market, advertising increases the extraordinary profits of the dynamic competitor.

6.4 Losing advantages to competitors

Such profits are only made in the short run and so long as innovation and advertising can keep the producer in its advantageous position.

In the long run however, new competitors could be lured to enter the market while the existing ones will resort to new advertising campaigns or develop innovative products: in both cases the above-normal profits will dwindle. If some may think a reversion to a passive situation, such innovative producers may have set aside sufficient funds for their next coup!

6.5 Gaining advantages

Dynamic competitors can gain advantages by acquiring access to new markets (Online 3), which is the ends result of marketing efforts and market sharing by raising high entry barriers, either financial (investments) or administrative (deals with local governments).

6.6 Market conditions

Dynamic competition can be the result of structural and strategic barriers that include the systematic control of resources, whether capital or labor or even raw materials to keep low costs. It may seek to make economies of scale by streamlining production. If mergers and acquisitions happen with hotels, with fast-food outlets franchising enables producers to do economies of scope.

In detail, the features of a dynamically competitive market are the following:

- Number of producers: *few.*
- Number of consumers: *many, but consumption is at times clustered by brands.*
- Producer business size and operations scope relative to market size: *still small compared to other industries but different market penetration techniques enable the multiplication of operations and a constant presence in various markets.*
- Knowledge of producers*: efforts to know what consumers desire through research.*
- Knowledge of consumers: *good knowledge of product range and prices for a given dynamic outlet but imperfect knowledge across the industry.*
- Movement of factors of production: *labor and capital cannot freely move out of a specific industry because labor skills are not transferable from one industry to another; capital is often directed by state policy in particular industries.*

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- Barriers to entry: *legal barriers are at play according to the legal structure the business takes, administrative barriers such as tax and employment formalities, and financial barriers because business operations need important capital investment*.
- Market exit: *because of the existing capital assets, there cannot be a simple liquidation of the business.*
- Product differentiation: *actively sought and most inventions are patent protected.*
- Market differentiation: *actively sought with important marketing efforts.*
- Market leadership strategies: *effective since such producers are price-makers and brand-makers.*

6.7 Spotting the dynamic competitors:

A common way to spot dynamic competitors is the *Herfindahl-Hirschman Index* (HHI). This is a measure of market concentration (Online 4).

Another way is to construct an *advertising index* (AI) which is about measuring the effectiveness of promotional campaigns for either one enterprise of various enterprises across the industry. To construct the index two elements are necessary, namely, the frequency of advertising, and the effect of advertising (e.g., UBS's Danone's or McDonald's advertising are frequent not only to make themselves present but also to launch new or seasonal products).

7 Non-competitive markets

7.1 Non-competitive markets

Unlike passively and dynamically competitive firms, *non-competitors* are business organizations that do not actively and dynamically seek to be competitive because they have no reason to do so.

The following points highlight

- Partial or associative controllers[5]
- Exclusive controllers[6]

[5] Usually referred to as oligopolies with an emphasis in the presence of few firms in a market; the emphasis here is the strategic willingness and financial ability to control the market in terms of the output produced and the price consumers will have to pay

[6] Usually referred to as monopolies with an emphasis on sales, whereas the label suggested here emphasises power

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7.2 Explaining the associative behavior of producers

Non-competition in the business industry is mainly the result of a structural barrier, that is, the clustering of producers in associations.

To explain the associative tendency in a few industries (cartelization) one can resort to *game theory*, that is, *a descriptive analysis of available strategies of producers, and in particular, the so-called "prisoner's dilemma"*.

Under unusual business conditions, firms set their own strategies which are *strictly dominant*, and it is highly unlikely that they be brought to work in association. Thus, for firms to choose to cooperate in an association, there have to be advantages:

- That there is a guarantee that no firm will decide to opt out of the association easily and without a cost.
- That the selling price be higher than that under passive competition to allow earn above-normal profits. This is a situation where prices are 'sticky' (Sweezy. in Wilkinson, 2005: 319) in the sense that firms operate at a level of production that is mutually advantageous. A case in point are cantonal hotel and catering associations in Switzerland: they fix the price for set menus.

7.3 Market conditions

The following features:

- Number of producers: *grouped in associations, chains, societies (cartels)*
- Number of consumers: *many, but consumption is at times clustered by brands.*
- Producer business size and operations scope relative to market size: *either large or small; associations allow them to have a bigger control over prices.*
- Knowledge of producers*: the standardization of offers resulting from associative control brings consumers to consume what is on offer, often the result of some consumer research or experience.*
- Knowledge of consumers: *good knowledge of the association's price and product range, which stays overall local.*
- Movement of factors of production: *labor and capital are not meant to freely move in and out the association – it can happen so long as the association has benefits.*
- Barriers to entry: *the conditions for being a member of an association and thus benefit from it, are at a charge.*
- Market exit: *because of the existing capital assets, there cannot be a simple liquidation of the business.*
- Product differentiation: *actively sought if an association is to compete with another one.*

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- Market differentiation: *actively sought if an association is to compete with another one.*
- Market leadership strategies: *collaborative.*

7.4 Exclusive Controllers

Exclusive controllers as non-competitive firms include:

- *Pure controllers*: firms controlling the entire output in a particular market (e.g., nationalized oil company, cement companies).
- *Natural controllers*: when the type of market only permits the presence of one firm (e.g., water, electricity, rail in Switzerland).

7.5 Characterizing non-competitors

- *Stagnation*: output control implies that the firm decides to supply a quantity that is lower that its production optimum or what the market would require; such restrictions have knock-out effects on the economy as a whole because at a lower output the firm employs less personnel putting pressure on people's incomes and consumption which can result in stagnation.
- *Price discrimination*: the controller can sell different units of output at different prices since there is no benchmark in the market.
- *Innovation*: extraordinary profits that are generated in the long run enable firms to invest in innovative processes that reduce costs thus further maximising profits and investor dividend.
- *Stability*: non-competitor power brings about some degree of protection from prospective competitors; however, following Schumpeter who developed a dynamic perspective on competition, non-competitor power is temporary since new firms may appear attracted by the extraordinary profits made by the existing firm; the reality is different: no prospective firm can become a competitor of exclusive controllers as they do not have the financial might to so.

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