



Oligopoly

What Is an Oligopoly?

An oligopoly is a type of market structure in which a small number of firms control the market. Where oligopolies exist, producers can indirectly or directly restrict output or prices to achieve higher returns. A key characteristic of an oligopoly is that no one firm can keep the others from having significant influence over the market. An oligopoly differs from a monopoly, in which one firm dominates a market.

- An oligopoly is a market structure wherein a small number of producers work to restrict output or fix prices so they can achieve above-normal market returns.
- Economic, legal, and technological factors can contribute to the formation and maintenance, or dissolution, of oligopolies.
- The major difficulty that oligopolies face is the prisoner's dilemma that each member faces, which encourages each member to cheat.
- Government policy can discourage or encourage oligopolistic behavior, and firms in mixed economies often seek government blessing for ways to limit competition.
- Market structures come in different forms and sizes. The term is used to describe the distinctions between industries, which are made up of different companies that sell their products and services. Most market structures aim for perfect competition, which is a theoretical construct that doesn't actually exist.
- These market structures are made up of a small number of companies within an industry that controls the market. Firms in an oligopoly set prices, whether collectively—in a cartel—or under the leadership of one firm, rather than taking prices from the market. Profit margins are thus higher than they would be in a more competitive market.
- Some of the barriers to entry (that prevent new players from entering the market) in an oligopoly include economies of scale, regulatory barriers, accessing supply and distribution channels, capital requirements, and brand loyalty.
- Oligopolies in history include steel manufacturers, oil companies, railroads, tire manufacturing, grocery store chains, and wireless carriers. The economic and legal concern is that an oligopoly can block new entrants, slow innovation, and increase prices, all of which harm consumers.
- Governments sometimes respond to oligopolies with laws against price-fixing and collusion. Yet, a cartel can price fix if they operate beyond the reach or with the blessing of governments. Oligopolies that exist in mixed economies often seek out and lobby for favourable government policy to operate under the regulation or even direct supervision of government agencies.
- The main problem that firms in an oligopoly face is that each firm has an incentive to cheat. If all firms in the oligopoly agree to jointly restrict supply and keep prices high, then each firm stands to capture substantial business from the others by breaking the agreement and undercutting the others. Such competition can be waged through prices, or through simply the individual company expanding its own output brought to market.



- Companies in an oligopoly benefit from price-fixing, setting prices collectively, or under the direction of one firm in the bunch, rather than relying on free-market forces to do so.

Oligopoly Characteristics

Oligopolies are considered stable. One of the main reasons why they are is because participating firms need to see the benefits of collaboration over the costs of economic competition, then agree to not compete and instead agree on the benefits of cooperation.

The firms sometimes find creative ways to avoid the appearance of price-fixing, such as using phases of the moon. Price-fixing is the act of setting prices, rather than letting them be determined by the free-market forces. Another approach is for firms to follow a recognized price leader so that when the leader raises prices, the others will follow.

The conditions that enable oligopolies to exist include high entry costs in capital expenditures, legal privilege (license to use wireless spectrum or land for railroads), and a platform that gains value with more customers, such as social media.

The global tech and trade transformation has changed some of these conditions. For instance, offshore production and the rise of mini-mills have affected the steel industry. In the office software application space, Microsoft (MSFT) was targeted by Google Docs, which Google funded using cash from its web search business.

Oligopolies and Game Theory

Game theorists have developed models for these scenarios, which form a sort of prisoner's dilemma. When costs and benefits are balanced so that no firm wants to break from the group, it is considered the Nash equilibrium state for oligopolies. This can be achieved by contractual or market conditions, legal restrictions, or strategic relationships between members of the oligopoly that enable the punishment of cheaters.

Maintaining an oligopoly and coordinating action among buyers and sellers in general on the market involves shaping the payoffs to various prisoner's dilemmas and related coordination games that repeat over time.

As a result, many of the same institutional factors that facilitate the development of market economies by reducing prisoner's dilemma problems among market participants, such as secure enforcement of contracts, cultural conditions of high trust and reciprocity, and laissez-faire economic policy, might also potentially help encourage and sustain oligopolies.

Advantages and Disadvantages of an Oligopoly

Advantages

One of the main benefits of having an oligopoly is that competition is very limited. That's because there are very few players in the market. Since there are few competitors, an oligopoly allows those who participate to net a higher



amount of profits.

Disadvantages

Oligopolies come with higher barriers to entry for new participants. This means that it can be difficult to enter the market because of the high costs associated with doing business, the regulatory environment, and the problems that arise when it comes to accessing supply and distribution channels.

Because of the lack of competition, there may be very little incentive to innovate product and service offerings. With no diversity in offerings, consumers remain loyal to what they know best.

Pros

- Limited competition
- Higher profits for companies
- Greater consumer demand

Cons

- High barriers to entry for new participants
- Lack of innovation
- Very little choice for consumers

Example of an Oligopoly

There are many examples of oligopolies in the market. But one of the major examples of a global oligopoly is the Organization of the Petroleum Exporting Countries (OPEC). The organization was founded in Baghdad in 1960 with five countries but expanded to 13 oil-producing countries in 1975

One of the main reasons why OPEC is considered an oligopoly is because it has no overarching authority. Every member nation within the group also has a substantial portion of the group's market share. These countries also have a great deal of power together (not separately) when it comes to supply and demand issues and pricing. So when the group lowers its supply as demand drops, prices rise. The opposite is true when demand rises.

What Are Some Negative Effects of an Oligopoly?

An oligopoly is when a few companies exert significant control over a given market. Together, these companies may control prices by colluding with each other, ultimately providing uncompetitive prices in the market. Among other detrimental effects of an oligopoly include limiting new entrants in the market and decreased innovation. Oligopolies have been found in the oil industry, railroad companies, wireless carriers, and big tech.