D Examining business markets

Different market structures

There are several different types of market structure which dictate the degree of risk to business operations. For example, the market structure determines the amount of power and competition in the market. A business will need to understand its market structure in order to plan strategically and operationally.

Market structures

You will focus on two types of market structure – perfect competition and imperfect competition (although there are at least four main types, including a monopoly).

Perfect competition

This concept refers to those businesses which all supply exactly the same product at the same price, such as newspapers and possibly basic food products. However, in reality, where suppliers can manufacture their own brands they become more competitive. Where the cost of products cannot be increased by individual businesses to increase their profits, the business has to find other ways to ensure they maintain or increase their market share, such as customer service or location.

There are no barriers to entry as the number of suppliers, producers and customers are unlimited. In summary, these criteria define perfect competition.

1. All firms sell an identical product.
2. All firms are **price takers**.
3. All firms have a relatively small **market share**.
4. Buyers know the nature of the product being sold and the prices charged by each firm.
5. The industry is characterised by **freedom of entry** and exit.

Key terms

Price taker – this is when a company has to accept the prevailing price of a product in the wider market.

Freedom of entry – a business has freedom of choice to enter or leave the market due to an unlimited number of buyers and sellers.

Imperfect competition

This type of market structure faces less competition than businesses fitting the perfect competition structure. While there may be many sellers, such as clothing shops, cafes, jewellers, etc. their product lines are not identical. Therefore businesses can determine their own prices, as seen in jewellery stores including Ernest Jones, H Samuel and Goldsmiths.

The differences between perfect and imperfect competition are based on:

- number and size of the producers of the products being sold
- number of customers buying the product or service the business offers
- type of products or services
- the effectiveness of communicating or marketing the products and services.

Features of different market structures

Each different market structure has similar and different features (see Table 1.7).

Table 1.7: Features of different market structures

	Perfect competition	Imperfect competition
Number of sellers	Many	Variable, possibly not identical
Barriers to entry	None	Potentially significant
Type of substitute products	None	Many
Nature of competition	Price only	Price, quality, etc
Pricing power	None	Potentially significant

You will examine three main features which impact on business markets.

Number of firms

You have already considered how a business with a perfect competition structure can compete amongst other businesses offering the same product at a fixed price. Note how newspaper sellers can operate in a small locality yet still survive, although profits will be small. Yet they are not without risk and even the smallest retailer needs to understand their own strengths and weaknesses, and those of their competitors, to gain market share (albeit small in their sector).

Freedom of entry

You have looked at how perfect competition allows freedom of entry (and exit) to the market and the factors you have been learning about in this learning aim are crucial factors in making those decisions.

Freedom of entry differs when a business has an imperfect competition structure. The criteria for operating such a business are more flexible than perfect competition structures, for example there is flexibility in pricing. However, the business is unlikely to have unlimited customers and the cost to run the business will probably be quite high.

Nature of product

The product being offered determines the market structure. It also determines the freedom of entry, number of competitors offering similar products and whether the environment can sustain the market share or withstand further businesses entering the market.

For example, Currys, Comet and PC World all offered similar product lines with a few variances. Often they were situated in out-of-town retail parks competing against each other. When the businesses were no longer sustainable, Comet closed down and Currys merged with PC World. The nature of the products they offered was too similar for the demand – the products were not sufficiently different to remain competitively priced yet increase profits.

Key term

Venn diagram – a logical relationship diagram representing overlaps between categories.

Relationship between demand, supply and price

You have started to explore the relationship between demand and price. Business markets rely on examining the relationship between demand, price and supply, represented here in a **Venn diagram** (Figure 1.10):

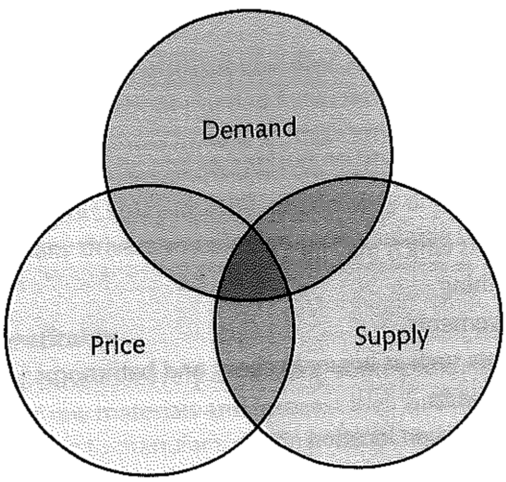

Figure 1.10: Venn diagram representing the relationship between demand, supply and price

Influences on demand

Five of the most common factors influencing demand for a product or service are explored here.

Affordability

Whether or not customers can afford or are willing to pay for the offer.

Competition

Demand can reduce significantly if the competition reduces its prices for like products, quality and service (think about Comet, Woolworths and the problems being faced by HMV and Jessops).

Availability of substitutes

If businesses are struggling to make sufficient profit to remain operating, they will seek alternative products or suppliers to keep their costs down and profits up. A business may resort to a substitute which is inferior or superior or seek out alternative and more competitively priced suppliers. Therefore alternatives depend on supply and demand from all sides of the operation. A business must consider all the external factors and undertake a situational analysis before taking the risk of bringing in a superior substitute product at a higher price.

Level of Gross Domestic Product (GDP)

The GDP is one of the most important indicators used by economists to calculate the state of the economy. The ONS (Office for National Statistics) produces these figures and relies on quarterly data gathered from:

- output – the value of goods and services produced from a sample of every type of business and sector
- expenditure – the value of all goods and services purchased by businesses, government and individuals, including all exported sales
- income – the value of money generated primarily through wages and profits.

Needs and aspirations of consumers

Consumers influence demand by their needs and aspirations. Our needs include basic requirements such as food, warmth, water and safety. These are common to everyone. Consumers also have other and varying needs which are those products and services they are used to and believe they cannot, or do not want to, live without. These might include:

- mobile phones
- technology and multimedia
- entertainment
- beauty treatments
- own transport.

> **Link**
>
> You will learn more about Maslow's hierarchy of needs in *Unit 14: Investigating Customer Service.*

These examples increase demand on businesses and also influence price, which may go up as well as down.

We also have aspirations which may include:

- latest trends in clothing
- technology improvements
- home improvements such as luxury kitchens and bathrooms
- home or garden projects
- larger housing or improved location
- newer, faster or bigger transport
- holidays (more frequent and luxurious).

Influences on supply

Whether supply can meet demand relies on being able to anticipate current and future demands based on GDP data and other statistical information such as UK consumer spending and Consumer Price Index, both available from the ONS. Crucial to meeting demand is the ability of the business to meet supply needs. For example, if an unexpected spell of hot weather increases consumer demand for BBQ charcoal, business is lost if the supplies are not available. Other influences on supply are outlined below.

Availability of raw materials and labour

Raw materials and labour influence supply, and raw materials also impact on the availability of products. Unseasonable weather conditions impact on food and livestock – in a particularly harsh winter when fewer live lambs are born than expected, the availability of lamb will be reduced and the price will therefore increase. Likewise, a very wet winter can ruin winter crops we rely on, especially around times of festivities when we traditionally eat particular foods. Ultimately, products made from these and other food stuffs will also be affected.

Key term

Raw materials – any material from which a product is made.

Examples of raw materials in short supply globally include:

- graphite
- platinum
- iron ore
- coal
- scrap iron
- Colombian emeralds.

Of course, a surplus of a raw material can also influence supply, for example the price suppliers can charge to manufacturers. The effects of availability are also reflected in the stock market.

Even if supplies of raw materials are readily available, labour availability influences supply. Businesses all rely on labour to supply their products or services – so if a supplier does not have enough labour to transport the raw materials to the manufacturer, the manufacturing process will be significantly interrupted. If this happens, the raw materials may be sourced from another supplier or an alternative means might be found for the logistics of obtaining the raw materials. Either way, there are likely to be cost implications.

Logistics

The process of ensuring smooth logistics is complex. As you learned, supply is influenced by logistics and the labour needed for a smooth operation. Imagine if the logistics company Eddie Stobart was unable to make any of its European deliveries which they claim occur every 20 seconds; consider the impact on the businesses involved. During the transport strike in 2008, the delivery of petrol to garages was heavily disrupted and many drivers were left stranded, unable to refill their vehicles with fuel.

Ability to produce profitably

As you have learned, all businesses rely on making some profit. Suppliers are controlled by the cost of raw materials and forecast their business plans based on the costs they are likely to incur to manufacture the product and then sell it to customers. Their customers will also have anticipated the cost of supply when they are forecasting their business needs to ensure they make sufficient profit to continue operating.

Competition for raw materials

When raw materials become scarce, for example some metals and fuel, prices will increase and this impacts on suppliers and their market share. Likewise, when raw materials become more readily available, there is competition between suppliers to maintain their profits and to keep their customers, who can choose where to take their business.

Key term

Supply chain – the stages that goods pass through between the producer that makes them and the retailer that sells them.

Government support

The government provides support for businesses if they feel there is a significant need to boost the UK economy. For example, in 2012 the Prime Minister announced considerable financial support for the UK **supply chain** to generate growth into the economy. Some of the businesses benefiting included:

- British Airways
- Jaguar Land Rover
- Sainsbury's
- Marks and Spencer
- O2
- Rolls Royce, and many others.

While this support directly affects these businesses, government grants, for example for central heating and insulation, also support other businesses indirectly by increasing demand and generating a need for supply.

Elasticity: price elasticity of demand

Economists use the term 'price **elasticity**' to measure the relationship between quantity in demand and change in pricing. The formula for this calculation is:

$$\text{price elasticity of demand} = \frac{\text{\% change in quantity demanded}}{\text{\% change in price}}$$

Key term

Elasticity – responsive to price changes.

If a small change in price is accompanied by a large change in the quantity demanded, the product is said to be elastic (or responsive to price changes). Alternatively, a product is inelastic if a large change in price is accompanied by a small amount of change in the quantity demanded.

Key term

Output decisions – an economist term relating to maximising profit.

Pricing and output decisions

You have been learning about how market structures and pricing and **output decisions** relate to perfect and imperfect competition businesses in different ways.

Perfect competition businesses are usually so small that they are unable to affect price because the prices for the products they sell are predetermined and therefore the price they pay to suppliers is also unlikely to be negotiable.

However, imperfect competitive businesses may have more influence over both pricing and output decision making. Businesses can use a range of strategies to increase their profits based on either the price they charge for their products and services or the price they are willing to pay for output such as goods, services and labour. Depending on the type of business, what is output to one can be input to another depending on whether goods are coming in or out. Some of the strategies businesses use are outlined below.

Key term

Loss leader – a product or service offered at a knock down price, possibly even at a loss to the business. This is done to attract additional sales and increase profits and market share.

Loss leaders

Businesses may introduce **loss leaders**, for example:

- estate agents, especially those selling large numbers of new housing for developers, may offer one house as a loss leader, especially if house sales have been slow or non-existent

- retailers may offer bargains on product lines which are slow to move
- the travel industry, for example, airlines will sell cheap flights or train companies may promote bargain prices for first class seats rather than run empty carriages
- restaurants and bars promote happy hour to attract customers at quiet times or to shift excess stock.

As you know, businesses need to keep their eye on the competition to make informed decisions.

Responses by business to pricing and output decisions of competitors in different market structures

Businesses with a perfect competition structure are too small to influence changes to prices as they hold a small share of the market.

Imperfect competitive structures can influence pricing by forcing suppliers to reduce costs when demand increases or the cost of raw materials decreases. Factors which contribute to their ability to influence output decisions include the:

- cost of production
- environment
- market power.

Assessment practice 1.2

C.P4 C.P5 C.M3 D.P6 D.M4 C.D2 D.D3

You are progressing towards realising your business idea. For future success you need to convince people who have shown an interest that you have considered your business environment and market. Provide a report that shows that you understand the effects of internal and external environments and how a large business can respond to change.

Your report should begin with an overview of the environment in which your chosen business operates. Consider the internal, external and competitive environment. Complete a situational analysis for your chosen business, using several techniques. Ensure that you choose appropriate techniques. Using this research, provide an analysis of how and how much the business environment has affected your chosen business.

You should then explore the business market in which your chosen business operates. Evaluate how the market structures influence supply and demand, which subsequently affect the pricing and output decisions for one business. While examining the operations of this business, evaluate how the business has reacted to changes and how they may react to future changes, for example, if demand changes or legislation restrictions develop further. Take into account any ethical or environmental issues.

Plan

- How will I structure my report so it is interesting and informative?
- Where will I undertake my research?
- How will I check if the information is accurate? How will I ensure I can find the information again?
- How will I ensure that I have chosen the most appropriate situational analysis techniques?

Do

- Produce a draft of my report and self-critique it for accuracy and content, improving where relevant.
- Ask someone I trust for critical feedback.
- Reflect and learn from the feedback given to me and amend my report as necessary.

Review

- I can identify what I have learned from this activity.
- I can explain how I would tackle a similar exercise differently next time and why.
- I can explain why I chose the situational analysis techniques I did and how they were successful.
- I am confident that the research I have conducted justifies my conclusions.