Exercise walk-through

5.2
Monopsony and contestable markets

Pearson Edexcel · International A-Level · Economics

Business objectives (2)

- **satisficing** : in Herbert Simon's theory, managers aim for a result that is "good enough" for all the groups they must keep happy, not the maximum.
- The firm's demand (average revenue) is $P = 70 - Q/2$, so $TR = 70Q - Q^2/2$ and $MR = 70 - Q$. For a straight-line demand curve, MR is twice as steep as AR.
- At $Q = 40$: $P = 50$, $TR = 2000$ and $MR = 30$, still positive.
- Revenue is greatest where $MR = 0$: $Q = 70$, $P = 35$, $TR = 2450$ — the point where PED is -1, as in Unit 1.

Monopsony and contestability

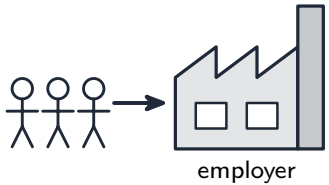
- A **monopsony** is a single buyer facing many sellers, such as the only large employer in a town, or the UK's National Health Service as the main employer of nurses.
- A **monopsony** can push the price it pays below the competitive level.
- The firm gains from lower costs and higher profits; suppliers and workers lose from lower prices and wages, and fewer of them are hired.
- Consumers may gain if the cost savings are passed on in lower prices.

Data-response practice (Section B style)

- (a) Using the table, calculate the three-firm **concentration ratio** and identify the market structure it suggests. [2]
- (b) Explain why Microsoft's purchase of Activision could be described as vertical integration. [4]
- (c) With the help of a diagram, explain why less competition could lead to higher prices for consumers. [6]

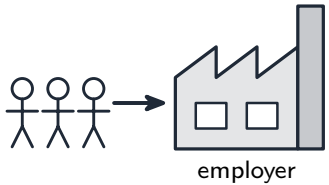
Exercise 2.1

2.1 Define monopsony and state two conditions that allow monopsony power to operate in a labour market. [4]



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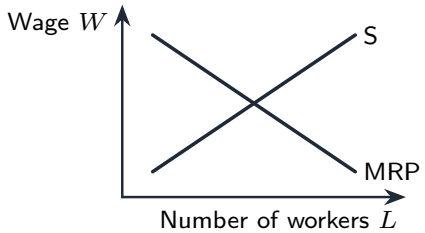
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2.1 A monopsony is a market with a single buyer. Conditions (any two, B1 each, plus B1 for development up to the total): workers cannot easily move to other towns or occupations (immobility); no other employer of similar size exists locally; the buyer can set the wage or price it pays because sellers have no alternative customer. Authored marking guidance (original, not an official scheme): B1 definition, B1 each condition, B1 development.

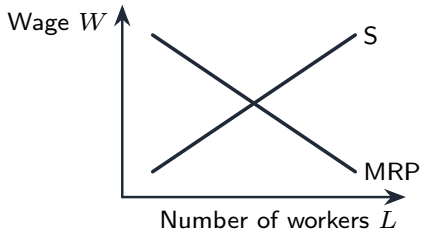
Exercise 2.2

2.2 A town's only large employer faces labour supply W = 4 + 0.02L and MRP W = 16 − 0.04L. Calculate the competitive wage and employment, then the monopsony wage and employment, and state which group loses. [6]



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2.2 Competitive: supply = MRP, 4 + 0.02L = 16 − 0.04L, so 0.06L = 12 and $L_c = 200$ workers; $W_c = 4 + 0.02 \times 200 = 8$ per hour. Monopsony: MCL = 4 + 0.04L; set MRP = MCL, 16 − 0.04L = 4 + 0.04L, so 0.08L = 12 and $L_m = 150$ workers; wage from supply, $W_m = 4 + 0.02 \times 150 = 7$ per hour. Employees lose: 50 fewer jobs and a wage 1 per hour lower. Check: $L_m < L_c$ and $W_m < W_c$, as the model requires. Authored marking guidance (original): M1 method, A1 answers, B1 identification.

Exercise 2.3

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limit pricing predatory pricing

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2.3 Limit pricing targets potential entrants: the incumbent holds price below the short-run profit maximum but above its own average cost, so entry is unprofitable. Predatory pricing targets existing rivals: price is set below average variable cost so rivals make losses and exit. Authored marking guidance (original): one mark per identified difference and one per development.

Exercise 3.1

3.1 GreenHarvest, a supermarket chain, is the only buyer of organic vegetables from 400 small farms in its region. Evaluate the likely costs and benefits of GreenHarvest's monopsony power for suppliers and consumers. Illustrate your answer with an appropriate diagram(s). [20]



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3.1 Model response (original; official WEC13 essays are marked 12 for knowledge, application and analysis plus 8 for evaluation, with Level 3 caps when the diagram or a named agent group is missing).

Definition and diagram: GreenHarvest is a monopsonist – the single buyer of the farms' vegetables. Draw the labour/input-market diagram with supply (average cost) below marginal cost of the input, and MRP falling: the monopsonist buys where MRP = MCL and pays the price on the supply curve, below the competitive price. An equivalent cost–

Full solution on next slide

Full solution 3.1 (1/2)

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Analysis – suppliers: the 400 farms receive a lower price because no alternative buyer exists, cutting revenue and supernormal profit; some high-cost farms may leave the industry. Weak bargaining power also lets GreenHarvest impose contract terms, and dependence on one customer makes farms vulnerable if its demand changes. Farm workers share the loss: a monopsonist employer hires fewer workers and pays a lower wage than a competitive labour market. Analysis – consumers: if GreenHarvest passes the lower input costs on, retail prices fall and consumer surplus rises; higher profit could also fund investment, improving quality and dynamic efficiency.

Full solution 3.1 (2/2)

Evaluation – suppliers: the damage depends on the strength of the buying power. Farms might form a cooperative to bargain jointly or sell through other channels (farm shops, direct delivery), and a large secure buyer guarantees demand, which can support planning and investment. Evaluation – consumers: the benefit appears only if cost savings are passed on; if GreenHarvest also has local monopoly power it may keep the gain as profit, and squeezed farms may cut quality, reducing choice. In the long run, farm exits could shrink supply so far that retail prices rise, reversing the early consumer gain.

Judgement: monopsony power here probably hurts suppliers more than it helps consumers, because 400 small farms have no organised counterweight; the consumer case rests on a pass-through the firm has no pressure to make. Regulation or supplier organisation would shift the balance. (≈340 words; allow supported alternative judgements with conditions.)