

5.2 Monopsony and contestable markets

Name: _____ Class: _____ Date: _____

Total: 34 marks

KEY WORDS

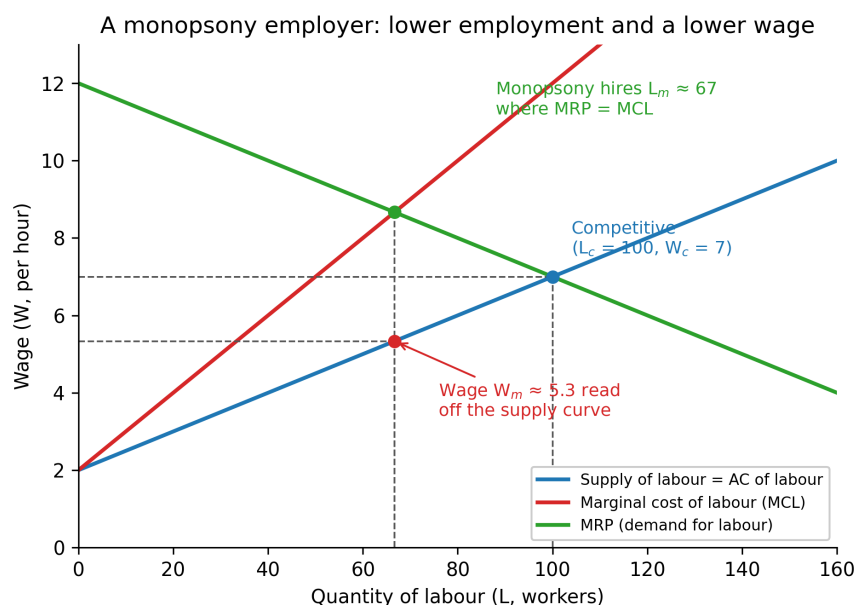
- monopsony
- contestable market
- predatory pricing
- monopsony power
- sunk cost
- limit pricing

Objective

Analyse monopsony and contestable markets with diagrams, and evaluate their effects on named groups at full IA2 essay standard (knowledge, application and analysis 12 marks; evaluation 8).

1 Key knowledge and worked examples

A **monopsony** is a market with a single buyer; **monopsony power** means one buyer is large enough to influence the price it pays. A monopsony employer faces the market supply of labour as its average cost of labour, so its marginal cost of labour (MCL) lies above supply: hiring one more worker means paying the higher wage to every worker. It hires where $MRP = MCL$ and pays the wage on the supply curve, giving lower employment and a lower wage than a competitive labour market.



Worked example (model numbers from the diagram). Supply of labour: $W = 2 + 0.05L$, so $MCL = 2 + 0.10L$ (doubling the slope, because the rise applies to all workers). Demand for labour (MRP): $W = 12 - 0.05L$.

Competitive hiring sets supply equal to demand: $2 + 0.05L = 12 - 0.05L$, so $0.10L = 10$ and $L_c = 100$ workers; $W_c = 2 + 0.05 \times 100 = 7$ per hour. The monopsonist sets $MRP = MCL$: $12 - 0.05L = 2 + 0.10L$, so $0.15L = 10$ and $L_m \approx 67$ workers; the wage is read off supply, $W_m = 2 + 0.05 \times 66.7 \approx 5.3$ per hour. Check: $67 < 100$ and $5.3 < 7$, matching the diagram.

A **contestable market** has easy, cheap entry and exit, low **sunk costs**, shared technology and no retaliation, so potential competition disciplines incumbents. **Limit pricing** sets price below the short-run profit-maximising level to make entry unprofitable; **predatory pricing** instead prices below average variable cost to force existing rivals out.

2 Practice

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

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]

2.3 Explain two differences between limit pricing and predatory pricing. [4]

3 Exam-style questions

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]

Solutions

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.

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.

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.

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–revenue diagram shows the input price cut shifting MC and AC down ($MC_1 \rightarrow MC_2$), raising supernormal profit.

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.

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. ($\approx$ 340 words; allow supported alternative judgements with conditions.)