Firms, costs, growth and competition

Pearson Edexcel · International A-Level · Economics

Supported transfer: Firms, costs, growth and competition

Scope and prerequisite teaching

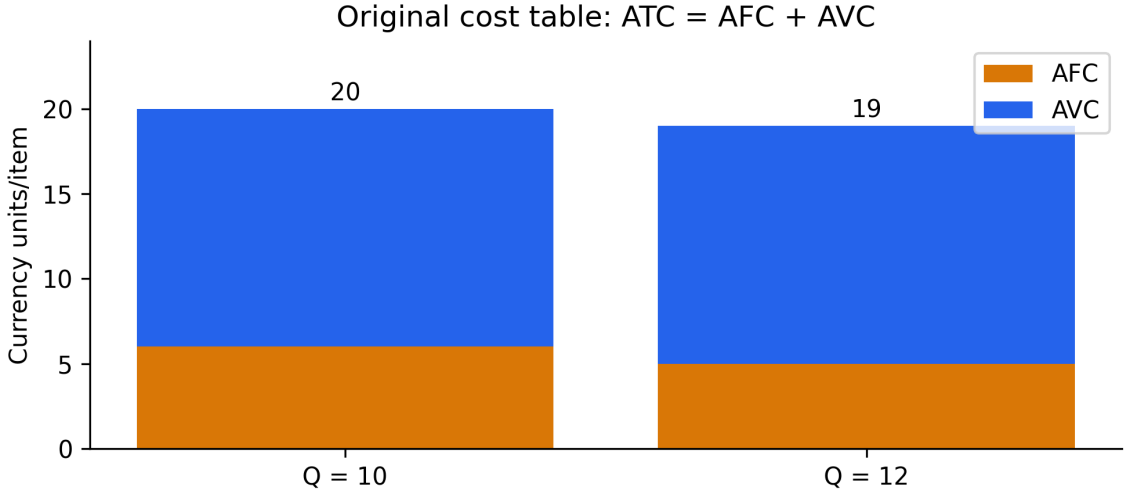
Issue 2, June 2018. All four units have a complete lettered objective map; IAS and IA2 target teaching authored; qualification rubric certified from recent WEC11–WEC14 schemes.

This focused rehearsal adopts the linked native explanations; it does not replace them or certify a whole qualification. Supported objective IDs: 3.3.1.1a, 3.3.1.2a, 3.3.1.2b, 3.3.1.2c, 3.3.1.2d, 3.3.1.2e, 3.3.1.2f, 3.3.1.2g, 3.3.1.3a, 3.3.1.3b, 3.3.1.3c, 3.3.2.1a, 3.3.2.1b, 3.3.2.2a, 3.3.2.2b, 3.3.2.2c, 3.3.2.2d, 3.3.2.3a, 3.3.2.3b, 3.3.2.3c, 3.3.2.3d, 3.3.2.3e, 3.3.2.3f, 3.3.2.4a, 3.3.2.4b, 3.3.3.1a, 3.3.3.2a, 3.3.3.2b, 3.3.3.3a, 3.3.3.3b, 3.3.3.3c, 3.3.3.3d, 3.3.3.4a, 3.3.3.4b, 3.3.3.4c, 3.3.3.4d, 3.3.3.5a, 3.3.3.5b, 3.3.3.5c, 3.3.3.5d, 3.3.3.5e, 3.3.3.5f, 3.3.3.5g, 3.3.3.6a, 3.3.3.6b, 3.3.3.6c, 3.3.3.6d, 3.3.3.6e, 3.3.3.6f, 3.3.3.6g, 3.3.3.6h, 3.3.3.7a, 3.3.3.7b, 3.3.3.8a, 3.3.3.8b, 3.3.3.8c, 3.3.3.8d.

Native prerequisites: 0502, 0503, 0504, 0505, 0506, 0507, 0508, 0509, 0510, 0511, 0512, 0513, 0514, 0515, 0516, 0517, 0518, 0519, 0520.

Key terms

fixed cost ; **variable cost** ; **average cost** ; **profit** ; **monopsony** ; **contestable market** ; **sunk cost** ; **limit pricing** ; **predatory pricing** .



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Firms, costs, growth and competition

Total, average and marginal measures answer different questions. Profit=total revenue−total cost. Additional output is justified in a profit-maximizing model by incremental revenue and cost, subject to relevant conditions; higher sales do not guarantee higher profit. Size, ownership and integration affect finance, control, risk and coordination. Market power and contestability require evidence about alternatives and entry, not firm size alone.

■ Worked case

In an original short-run table, fixed cost is 60 currency units. At Q=10 items, variable cost is 140; at Q=12, variable cost is 168. Calculate costs and interpret the change.

TC=TFC+TVC; TC at 10=60+140=200 units. ATC=TC/Q; ATC at 10=200/10=20 units/item. At 12, TC=60+168=228 units and ATC=228/12=19 units/item. Interval MC=ΔTC/ΔQ=(228−200)/(12−10)=14 units/item. AVC=TVC/Q=140/10=168/12=14 units/item. AFC falls from 60/10=6 to 60/12=5 units/item, lowering ATC. These are table intervals, not a claim about a smooth derivative or all output levels. Productivity and profit need their own measures.

■ Independent transfer

A firm expands through acquisition and lowers unit costs but loses customers after quality problems. Evaluate growth rather than assuming economies of scale guarantee success.

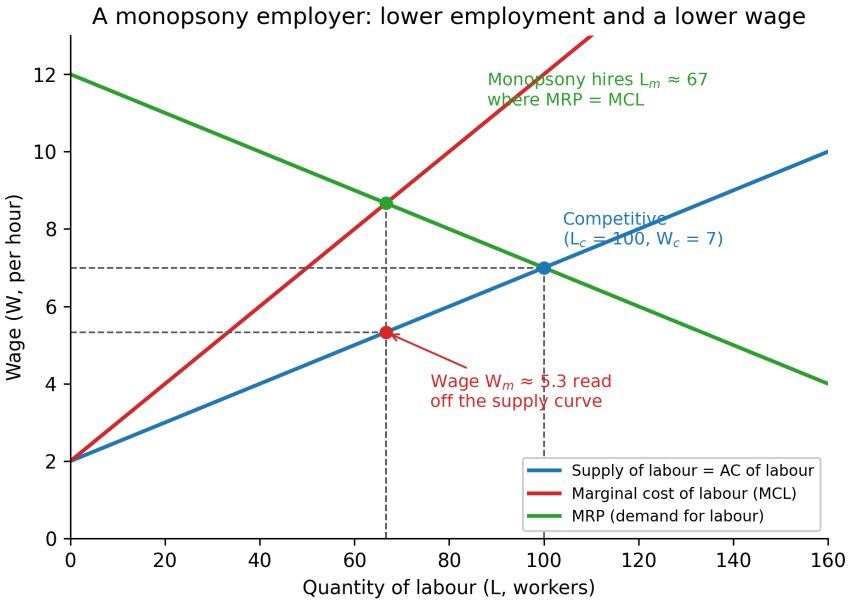
■ Checked original model

Lower long-run average cost can improve competitiveness, but revenue depends on demand and quality. Acquisition can add finance, capacity and coordination risks; integration does not automatically improve management. Compare margins, quality, customer response, entry barriers and alternative organic growth. A small niche firm may rationally remain small. Supported IAL WEC13 targets in this topic are reused; the monopsony and contestability objectives below are taught in full, and the 3.3.4–3.3.5 and Unit 4 targets in the topic 6–8 supplements.

Monopsony: one dominant buyer

A **monopsony** is a market with a single buyer. **Monopsony power** exists whenever one buyer is large enough to influence the price it pays, even if smaller buyers exist. The conditions are: suppliers have no alternative buyer of similar size; sellers face barriers to reaching other customers (distance, contracts, product specificity); and in a labour market, workers face geographical or occupational **immobility** , so one employer dominates local hiring.

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In the labour-market model, the supply curve of labour is the firm's average cost of labour. Because the single employer must raise the wage for all workers to attract one more, the marginal cost of labour (MCL) lies above supply. A profit-maximising monopsonist hires where MRP = MCL (L_m), then pays the wage shown by the supply curve at that employment (W_m). Compared with a competitive outcome (L_c, W_c), employment and the wage are both lower. With supply $W = 2 + 0.05L$ and MRP $= 12 - 0.05L$, the competitive outcome is $L_c = 100$ workers at $W_c = 7$ per hour; with $MCL = 2 + 0.10L$, the monopsonist hires $L_m \approx 67$ at $W_m \approx 5.3$ per hour.

Costs and benefits must be argued per group, then weighed. The monopsonist firm gains: lower input prices reduce marginal and average cost ($MC_1 \rightarrow MC_2$, $AC_1 \rightarrow AC_2$ on a standard cost–revenue diagram), raising supernormal profit; bulk buying can add purchasing economies of scale; and bargaining power lets it set terms on price, quality and delivery. Supplier firms lose: a lower price cuts revenue and profit, dependence on one customer is risky, and weak bargaining power can block investment – although a guaranteed, stable demand can help suppliers plan. Employees typically face a lower wage and lower employment than in a competitive labour market, and possibly poorer conditions; against this, a large secure employer can offer job security, and a socially responsible or non-profit-maximising buyer (many monopsony employers are governments) may pay fairly. Consumers may gain lower prices **if** the cost saving is passed on – but if the firm also has selling (monopoly) power it may keep the saving as profit, and squeezed suppliers may cut quality, reducing choice.

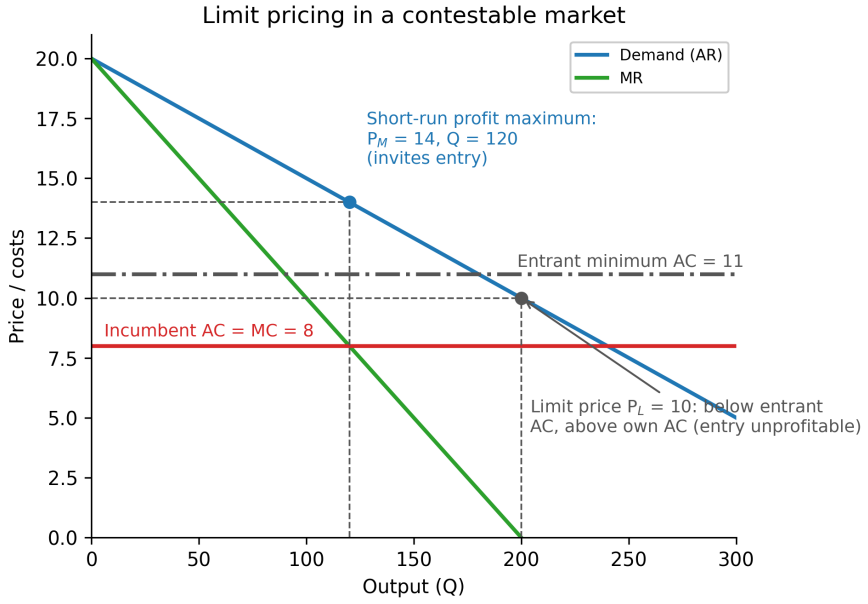
Evaluation hinges on conditions: the strength of buying power, whether suppliers can organise (cooperatives) or workers unionise, whether government restricts monopsony power, and the time horizon.

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Contestable markets and limit pricing

A **contestable market** is one where entry and exit are easy and cheap. Characteristics: no significant barriers to entry or exit, low **sunk costs** (spending that cannot be recovered on exit, such as industry-specific equipment or advertising), access to the same technology as incumbents, and no fear of aggressive retaliation. The key idea is that **potential competition** disciplines incumbent firms: the threat of "hit-and-run" entry can force even a single seller to behave competitively.

Implications for behaviour: incumbents hold profits closer to normal and may choose **limit pricing** – setting the price below the short-run profit-maximising level, low enough that entry at an entrant's higher cost is unprofitable, yet still above the incumbent's own average cost.



With demand $P = 20 - 0.05Q$, marginal revenue $P = 20 - 0.10Q$ and constant incumbent AC = MC = 8, the short-run profit maximum is MR = MC at Q = 120, $P_M = 14$. If an entrant's minimum average cost is 11, a limit price of $P_L = 10$ (selling Q = 200 where demand equals 10) keeps entry unprofitable while the incumbent still earns $(10 - 8) \times 200 = 400$ per period. Limit pricing deters *potential* entrants; **predatory pricing** is different – pricing below average variable cost to drive *existing* rivals out, which is illegal in many jurisdictions.

Sunk costs are decisive because they decide whether the threat of entry is credible. With low sunk costs an entrant can enter, take profits, and exit at little loss, so incumbents must behave as if competition were real. High sunk costs make exit expensive, entry risky, and the market less contestable whatever the concentration ratio says.

Costs and benefits: consumers gain from prices held near competitive levels, wider choice and pressure for quality; firms face lower supernormal profit but a spur to efficiency (X-inefficiency falls). Evaluation: contestability is a spectrum, not a yes/no

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property; incumbents may raise barriers deliberately (advertising, capacity expansion); and governments can raise contestability directly – subsidies and low-cost loans for small firms, tax incentives, deregulation, privatisation, competitive tendering for public contracts and trade liberalisation – though each measure carries opportunity cost, takes time, and can misfire (privatisation may create a private monopoly; foreign entrants may force domestic firms out).

WEC13 assessment demand for this topic

Recent WEC13 papers assess these outcomes as 20-mark Section C essays (two chosen from three) and 1-mark Section A multiple choice. Each 20-mark essay is marked as 12 marks for knowledge, application and analysis (four levels: accurate precise knowledge, fully integrated context, and logical multi-stage chains of reasoning reach Level 4, 10–12) plus 8 marks for evaluation (three levels: recognised different viewpoints or critical use of evidence leading to an informed judgement reach Level 3, 7–8). The January 2025 scheme caps answers at Level 3 when no appropriate diagram is offered or when only one economic agent is discussed, and the January 2023 scheme caps at Level 3 when the answer never refers to a firm with monopsony power. Diagrams, both agent groups named in the question, and the given context are therefore requirements, not extras.

Evidence and assessment limits

The tasks and marking points here are original, not official questions or mark schemes. The WEC13 essay rubric and caps cited above are read from the January 2023 and January 2025 WEC13 mark schemes; the monopsony and contestability teaching is grounded in those papers and specification page 36 (PDF page 40). The 3.3.4–3.3.5 labour-market and intervention targets are taught in topic 6's supplement; the Unit 4 targets in topics 7 and 8.

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