

Overview of the Specification

Introduction

This section of the web guide seeks to offer additional guidance to the unit 4 specification. It is assumed that teachers already have the “Teacher’s guide” which contains a gloss on many of the terms in the original specification. However, my experience at conferences has been that further clarification would be useful.

It is probably helpful both for revision and for teaching to think of the unit 4 specification as containing three main sections.

1. Introductory Material. This includes descriptive material on the growth of small firms, the motives for the growth of firms, forms of integration and the increasing importance of multinationals. Candidates should understand the different ways of achieving growth: marketing success and consequent reinvestment of profits, mergers or acquisitions, bond or equity finance.

2. Theory of the Firm. This section contains the standard theory of the firm that made up a large part of the old A level. The main market structures need to be covered – perfect competition, monopolistic competition (ignore the specification’s rather loose “imperfect competition”), oligopoly and monopoly. The assumptions of these models need to be evaluated. The framework of contestable markets also needs to be considered as a critique of the “market structure” approach – this is looked at in some detail in the next section of this guide.

3. Industrial Policy. The analysis and evaluation of UK Competition Policy and the effects of regulating the privatised industries. Although this section occupies two rather narrow rows in the specification it should be given considerable weight in teaching as it is likely to form a major component of the data response questions.

Additional Guidance on Theory of the Firm

There should be good basic understanding of cost and revenue concepts and how these inform profit maximising decisions. The specification states that an understanding of the law of diminishing returns is not required although teaching this concept is probably helpful to give pupils a good grounding in cost curves. An understanding of the relationship between average and marginal costs (and revenues) *is* required, e.g. why MC cuts the minimum of AC. This is probably best introduced with numerical examples and spreadsheet simulations.

Within the standard theory of perfect competition, monopolistic competition and monopoly candidates should be able to present long-run equilibrium diagrams for each. They should be able to point to the profit and efficiency consequences, and be in a position to analyse shifts in demand and the return to long run equilibrium. They should have available some criticisms of each of these models in terms of their assumptions. It is important that candidates can identify market structures from real life data, e.g. through concentration ratios and the nature of the product.

Within the theory of monopoly some attention to the various kinds of monopoly is required. In particular, candidates should be able to draw natural monopoly diagrams and illustrate the outcome of various objectives (e.g. that being allocatively efficient involves making a loss in such cases). Candidates should be familiar with price discrimination and be able to draw the standard diagram of a firm splitting its sales into two markets, each with different elasticities of demand. They should also understand the concept of perfect (first order) price discrimination. A welfare analysis of the likely effects of price discrimination in terms of producer and consumer surplus is also required. These concepts are illustrated in the revision notes (the 'definitions list') that form part of this guide.

It has always been difficult to know what to teach under the heading of oligopoly. No particular model will be required in unit 4 questions. Candidates may use the kinked demand curve if they must. However, in this examiner's opinion, a basic game theory framework is a more than perfect substitute for dealing with issues of collusion, price wars, and non-price competition. Candidates should certainly be able to distinguish between overt, covert and tacit collusion. Tacit collusion is understood to mean where firms decision making falls into line with rivals in the absence of written *or verbal* agreements.

Some importance should be attached to a consideration of alternative motives of firms. These should include revenue maximising (where marginal revenue is zero) and sales maximising (where average revenue equals average cost). Explanations of alternative objectives in terms of principal-agent problems, growth maximisation, long-run profit maximisation should also be covered. The term *satisficing* does not appear in the specification but can certainly be used by candidates to good effect in this area.

There is a certain amount of more applied material in this section of the specification. Candidates should be able to discuss pricing and non-pricing strategies of firms with plenty of real life examples. The distinction between the various forms of pricing (cost-plus, predatory, limit, collusive) should all be understood, as should methods of non-price competition such as advertising and sales promotion.

Additional Guidance on Industrial Policy

This web guide contains extensive discussion of both UK competition policy and the effects of the regulation of privatised industries in separate sections. Their aim is to show the level of detail required and the main emphasis of discussion. The main emphasis is on analysis and evaluation rather than detailed knowledge of legislation. It is important that candidates cover case studies in both of these areas.