Monopolistic Competition

Microeconomics for Students of Accounting, Finance, and Digital Applications

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Between Monopoly and Perfect Competition

Introduction

YOU have already learned a lot about

- how in a competitive market the growing demand does not result in growing revenues and abnormal profits for an individual firm in the long run
- how a firm with market power can sustain abnormal profits in both the long run and the short run as long as it is protected by barriers to entry
- why owning stock of a firm with significant market power and/or employment by such firm may be very lucrative

Now YOU are going to learn about the profitability and output decisions in industries where firms have some market power but are not protected by any significant barriers to entry.

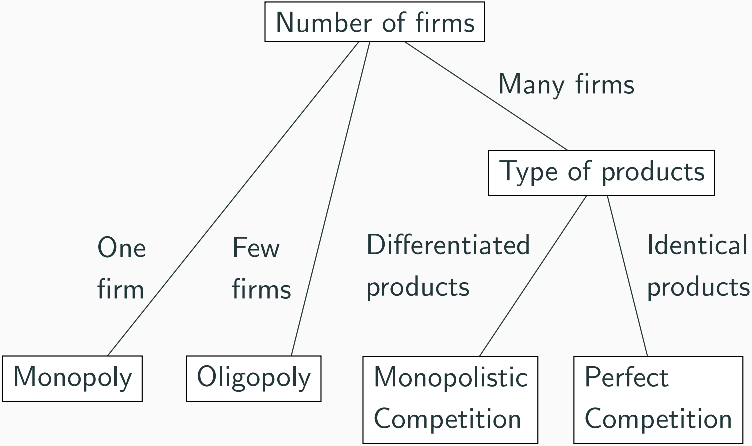
Monopolistic Competition

monopolistic competition a market structure in which many firms sell products that are similar but not identical

🌎 dental practices, lawyer services, books, computer games, restaurants, piano lessons, cookies, clothing

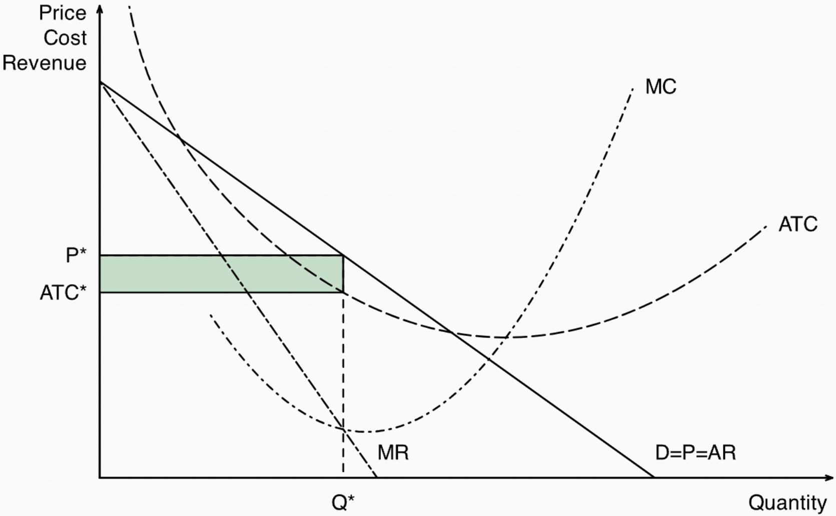
⚖ the licensing/educational requirements for lawyers and dentists may appear as barriers to entry but the huge number of practices in these industries imply that these requirements hardly deter new firms from entering the market and competing with existing firms in the long run if abnormal profits are present

Key Characteristics of Monopolistic Competition



Competition with Differentiated Products

The Monopolistically Competitive Firm in the Short Run



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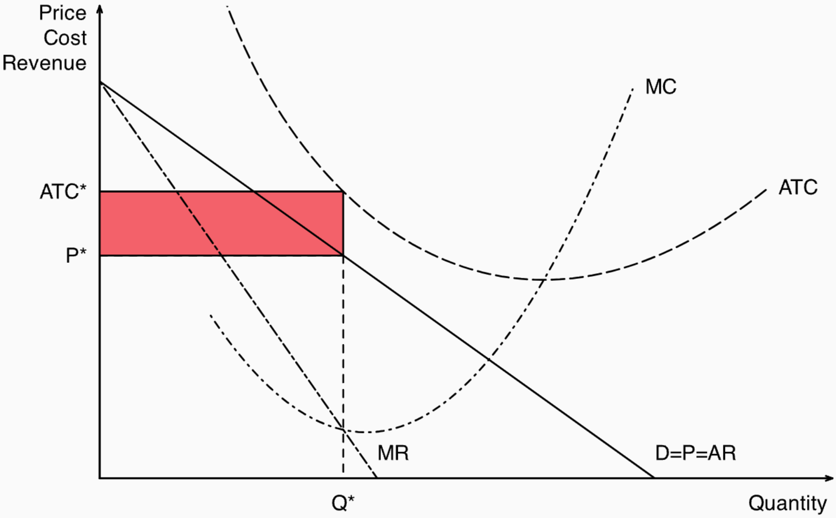
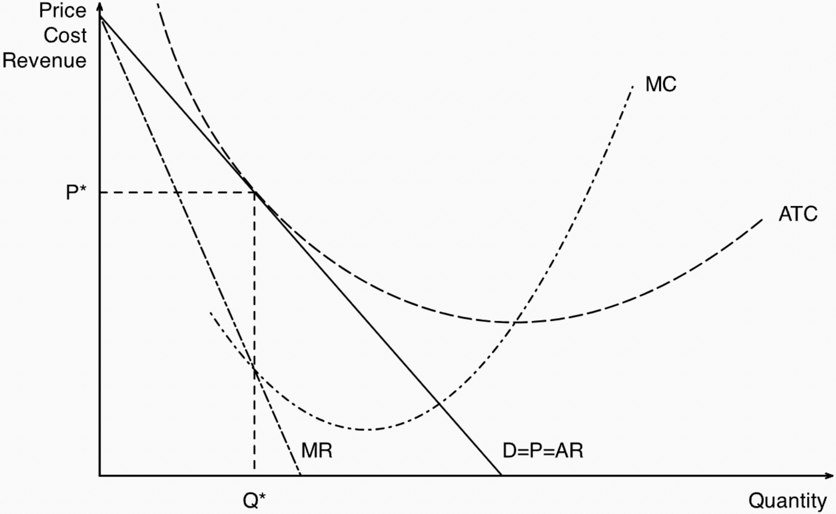


The Monopolistically Competitive Firm in the Long Run



Key Characteristics of Monopolistic Competition

The application of the profit-maximization model to the market structure of monopolistic competition reveals a number of key characteristics of this market structure:

- as with monopoly, in the short run price may exceed marginal cost (P $>$ MC) and average total cost (P $>$ ATC), resulting in abnormal profits
- however, it is more likely than in a monopoly market that the price would be less than the average cost (P$<$ATC) in the short run, resulting in economic losses
- as with perfect competition, in the long run the price per unit equals the production cost per unit (P$=$ATC), resulting in the inability of the typical monopolistically competitive firm to earn abnormal profit

Key Characteristics of Monopolistic Competition

The application of the profit-maximization model to the market structure of monopolistic competition reveals a number of key characteristics of this market structure:

- as with monopoly, in both the short run and the long run, the profit-maximizing firm would produce below the *efficient scale* quantity where the cost of production per unit (ATC) is at its minimum, resulting in *excess capacity*
- as with monopoly, the firm charges a *mark-up* above the marginal cost of production (MC), necessarily increasing its profit if it can somehow sell an extra unit at its posted price

Evaluation of Monopolistic Competition

The review of the key characteristics of monopolistic competition results in the following conclusions about the market outcome of profit-maximizing firms in this market structure:

- since, at equilibrium, price (marginal benefit expressed in dollars) exceeds marginal cost (P $>$ MC), there are units of the product that, if produced, would bring more benefit to society than the cost of resources employed, but these units are not produced, resulting in welfare loss for the particular period of time
- over the long run, being in a monopolistic competition is much less profitable than being in a monopoly market — the strategies to differentiate its product and attract more customers are often self-defeating because costs rise too

Evaluation of Monopolistic Competition

The entry of new firms which introduce differentiated products to the market leads to the following outcomes:

- consumers enjoy more variety and attention, possibly increasing their welfare
- existing producers lose market share, decreasing their profits and, therefore, the welfare of the firm owners

Regulation of Monopolistic Competition

The fact that for any given period the monopolistically competitive firm does not maximize the social welfare may imply that the governments should regulate these firms to improve social welfare (as with monopolies). However, this is not the case because:

- regulating so many firms, industries and products would cause enormous burden on the government, hence wasting scarce resources (incurring opportunity costs)
- forcing monopolistically competitive firms to produce more (necessarily dropping their prices), would likely result in losses for all firms that would otherwise make normal profit, forcing them to leave the market and resulting in less product variety and less employment

Product Differentiation Through Advertising and Branding

The Debate Over Advertising

There are two important (and somewhat related) questions with regard to advertising in a market economy

- ? Is advertising causing a waste of society's scarce resources?
- ? Or does advertising serve a positive social purpose?

Critique of Advertising

The critics of advertising usually provide the following arguments against using scarce resources for advertising:

- advertising manipulates people into buying stuff they don't really need or want (related to the idea of *consumerism*);
- advertising prevents competition on prices by focusing consumers' attention to other, less important or tangible, features of the product.

Defense of Advertising

The proponents of advertising usually provide the following arguments for using scarce resources for advertising:

- advertising provides to consumers information about pricing, product quality, retail locations, new products, etc.;
- advertising fosters competition by allowing new entrants to attract customers from established firms by letting consumers know that a better and/or cheaper product is available;
- advertising serves as a *signal* of quality, decreasing the problems resulting from asymmetric information.

Empirical Research on Advertising

Economists have studied advertising empirically to see which side of the debate is closer to the truth. Two important empirical studies have demonstrated that:

- in the 1960s in the United States, in states where advertising by optometrists was allowed, on average price a pair of eyeglasses was more than 20% cheaper compared to states where advertising by optometrists was prohibited;
- in the 1990s in the United States, the removal of restrictions on advertising alcohol in Rhode Island decreased the price of some liquors by more than 20% compared to prices in the neighbouring Massachusets.

The Debate Over Brand Names

Since brand names are closely related to advertising, the arguments in the debate for and against advertising can be extended for brands as well:

- ⊖ critics of brand names argue that products with brand names are no better than similar generic products and any spending on brand building is either waste of money or a way to mislead the consumer to overpay for a product that is not superior;

- ⊕ proponents of brand names argue that branding decreases the problems of asymmetric information by serving as a *signal* of quality for consumers and an *incentive* to maintain quality for firms.

Summary

	Market Structure		
	Perfect Competition	Monopolistic Competition	Monopoly
Features that all three market structures share			
Goal of firms	Maximize profits	Maximize profits	Maximize profits
Rule for maximizing profit	MR=MC	MR=MC	MR=MC
Can earn economic profits in the short run?	Yes	Yes	Yes
Common features of monopoly and monopolistic competition			
Price taker?	Yes	No	No
Price markup?	No (P=MC)	Yes (P>MC)	Yes (P>MC)
Produces welfare-maximizing level of output?	Yes	No	No
Common features of monopolistic competition and perfect competition			
Number of firms	Many	Many	One
Entry in the long run?	Yes	Yes	No
Economic profits in the long run?	No	No	Yes

Conclusion

Key Takeaways

- The lack of barriers to entry in a monopolistically competitive market prevents monopolistically competitive firms from earning economic (abnormal) profit in the long run.
- Managing such firm is a difficult job because attempts to increase profitability are self-defeating — product differentiation by R&D, advertising and branding do attract customers but also raises costs, allowing for only normal profit to be earned over the long run.
- Therefore, owning a firm not protected by significant barriers to entry and/or employment by such firm may not be very lucrative.

Quick Quiz

Quick Question 1

Which of the following conditions does NOT describe a firm in a monopolistically competitive market?

A. It has the freedom to enter or exit in the long run.
B. It maximizes profit both in the short run and in the long run.
C. It takes its price as given by market conditions.
D. It sells a product different from its competitors.

Quick Question 1

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C. **It takes its price as given by market conditions.**
D. It sells a product different from its competitors.

Quick Question 2

Which of the following markets best fits the definition of monopolistic competition?

A. haircuts
B. tap water
C. corn
D. crude oil

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A. **haircuts**

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C. corn

D. crude oil

Quick Question 3

A monopolistically competitive firm will increase its production if

A. marginal revenue is greater than marginal cost.
B. marginal revenue is greater than average total cost.
C. price is greater than marginal cost.
D. price is greater than average total cost.

Quick Question 3

A monopolistically competitive firm will increase its production if

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Quick Question 4

New firms will enter a monopolistically competitive market if

A. marginal revenue is greater than marginal cost.
B. marginal revenue is greater than average total cost.
C. price is greater than marginal cost.
D. price is greater than average total cost.

Quick Question 4

New firms will enter a monopolistically competitive market if

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B. marginal revenue is greater than average total cost.
C. price is greater than marginal cost.
D. **price is greater than average total cost.**

Quick Question 5

What is true of a monopolistically competitive market in long-run equilibrium?

A. Price is greater than marginal cost.
B. Price is equal to marginal revenue.
C. Firms make positive economic profits.
D. Firms produce at the minimum of average total cost.

Quick Question 6

What is true of a monopolistically competitive market in long-run equilibrium?

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Quick Question 7

If advertising makes consumers more loyal to particular brands, it could . . . . . . the elasticity of demand and . . . . . . the markup of price over marginal cost.

A. increase; increase
B. increase; decrease
C. decrease; increase
D. decrease; decrease

Quick Question 7

If advertising makes consumers more loyal to particular brands, it could ...... the elasticity of demand and ...... the markup of price over marginal cost.

A. increase; increase
B. increase; decrease
C. **decrease; increase**
D. decrease; decrease

Quick Question 8

If advertising makes consumers more aware of alternative products, it could . . . . . . the elasticity of demand and . . . . . . the markup of price over marginal cost.

A. increase; increase
B. increase; decrease
C. decrease; increase
D. decrease; decrease

Quick Question 8

If advertising makes consumers more aware of alternative products, it could . . . . . . the elasticity of demand and . . . . . . the markup of price over marginal cost.

A. increase; increase
B. **increase; decrease**
C. decrease; increase
D. decrease; decrease

Quick Question 9

Advertising can be a signal of quality

A. if advertising is freely available to all firms.
B. if the benefit of attracting customers is greater for firms with better products.
C. only if consumers are irrationally attracted to products they see advertised.
D. only if the content of the ads contains credible information about the products.

Quick Question 9

Advertising can be a signal of quality

A. if advertising is freely available to all firms.

B. **if the benefit of attracting customers is greater for firms with better products.**

C. only if consumers are irrationally attracted to products they see advertised.

D. only if the content of the ads contains credible information about the products.

Q&A Session!

Thank You!