Monopolistic Competition
Monopolistic Competition

• Imperfect competition
  – Between perfect competition and monopoly
  – Oligopoly
  – Monopolistic competition

• Oligopoly
  – Few sellers
  – Offer similar or identical products
Monopolistic Competition

- **Concentration ratio**
  - Percentage of total output in the market supplied by the four largest firms
- **Highly-concentrated industries**
  - Electric lamp bulbs (75%)
  - Breakfast cereal (80%)
  - Aircraft manufacturing (81%)
  - Household laundry equipment (98%)
  - Cigarettes (98%)
Monopolistic Competition

- Monopolistic competition
  - Many sellers
  - Product differentiation
    - Not price takers
    - Downward sloping demand curve
  - Free entry and exit
    - Zero economic profit in the long run
The Four Types of Market Structure

Economists who study industrial organization divide markets into four types—monopoly, oligopoly, monopolistic competition, and perfect competition.
Short Run Equilibrium

- **Profit maximization**
  - Produce the quantity where marginal revenue = marginal cost
  - Price: on the demand curve
  - If $P > ATC$: profit
  - If $P < ATC$: loss
  - Similar to monopoly
Monopolistic competitors, like monopolists, maximize profit by producing the quantity at which marginal revenue equals marginal cost. The firm in panel (a) makes a profit because, at this quantity, price is above average total cost. The firm in panel (b) makes losses because, at this quantity, price is less than average total cost.
Long Run Equilibrium

• If firms are making profit in short run
  – New firms - incentive to enter the market
  – Increase number of products
  – Reduces demand faced by each firm
    • Demand curve shifts left
  – Each firm’s profit declines until: zero economic profit
In a monopolistically competitive market, if firms are making profit, new firms enter, and the demand curves for the incumbent firms shift to the left. Similarly, if firms are making losses, some of the firms in the market exit, and the demand curves of the remaining firms shift to the right. Because of these shifts in demand, monopolistically competitive firms eventually find themselves in the long-run equilibrium shown here. In this long-run equilibrium, price equals average total cost, and each firm earns zero profit.
Long Run Equilibrium

• Zero economic profit
  – Demand curve
    • Tangent to average total cost curve
    • At quantity where marginal revenue = marginal cost
  – Price = average total cost
  – Price exceeds marginal cost
Long Run Equilibrium

- Monopolistic versus perfect competition
  - Monopolistic competition
    - Quantity: not at minimum ATC
      - Excess capacity
    - $P > MC$, markup over marginal cost
  - Perfect competition
    - Quantity: at minimum ATC
      - Efficient scale
    - $P = MC$
Monopolistic versus Perfect Competition

Panel (a) shows the long-run equilibrium in a monopolistically competitive market, and panel (b) shows the long-run equilibrium in a perfectly competitive market. Two differences are notable. (1) The perfectly competitive firm produces at the efficient scale, where average total cost is minimized. By contrast, the monopolistically competitive firm produces at less than the efficient scale. (2) Price equals marginal cost under perfect competition, but price is above marginal cost under monopolistic competition.

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Welfare of Society

• Sources of inefficiency
  – Markup of price over marginal cost
    • Deadweight loss of monopoly pricing
  – Too much or too little entry
    • Product-variety externality
      – Positive externality on consumers
    • Business-stealing externality
      – Negative externality on producers
Advertising

• Incentive to advertise
  – When firms sell differentiated products and charge prices above marginal cost
  – Advertise to attract more buyers

• Advertising spending
  – Highly differentiated goods: 10-20% of revenue
  – Industrial products: Little advertising
  – Homogenous products: No advertising
Advertising

• Debate over advertising
  – Wasting resources?
  – Valuable purpose?

• The critique of advertising
  – Firms advertise to manipulate people’s tastes
    • Psychological rather than informational
    • Creates a desire that otherwise might not exist
Advertising

• The critique of advertising
  – Impedes competition
  – Increase perception of product differentiation
    • Foster brand loyalty
  – Makes buyers less concerned with price differences among similar goods
Advertising

- The defense of advertising
  - Provide information to customers
    - Customers - make better choices
    - Enhances the ability of markets to allocate resources efficiently
  - Fosters competition
    - Customers - take advantage of price differences
  - Allows new firms to enter more easily
Advertising and the price of eyeglasses

• What effect does advertising have on the price of a good?
  – Consumers – view products as being more different than they otherwise would
    • Markets less competitive
    • Firms’ demand curves less elastic
    • Higher prices
Advertising and the price of eyeglasses

• What effect does advertising have on the price of a good?
  – Consumers – easier to find firms with the best prices
    • Markets – more competitive
    • Firms’ demand curves more elastic
    • Lower prices
Advertising and the price of eyeglasses

• 1972, economist Lee Benham
• States that prohibited advertising
  – Average price = $33 ($248 in 2012 dollars)
• States that did not restrict advertising
  – Average price = $26 ($196 in 2012 dollars)
• Advertising
  – Reduced average prices
  – Fosters competition
Advertising

• Advertising as a signal of quality
  – Little apparent information
  – Real information offered – a signal
    • Willingness to spend large amount of money
      • = signal about quality of the product
  – Content of advertising = irrelevant

*Is it rational for consumers to be impressed that Ellen DeGeneres is endorsing this product?*
Advertising

• Brand names
  – Spend more on advertising and charge higher prices than generic substitutes

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Advertising

• Critics of brand names
  – Products – not differentiated
  – Irrationality: consumers are willing to pay more for brand names

• Defenders of brand names
  – Consumers – information about quality
  – Firms – incentive to maintain high quality
### Table 1
Monopolistic Competition: Between Perfect Competition and Monopoly

<table>
<thead>
<tr>
<th>Features that all three market structures share</th>
<th>Market Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goal of firms</td>
<td>Perfect Competition</td>
</tr>
<tr>
<td>Maximize profits</td>
<td>Maximize profits</td>
</tr>
<tr>
<td>$MR = MC$</td>
<td>$MR = MC$</td>
</tr>
<tr>
<td>Can earn economic profits in the short run?</td>
<td>Yes</td>
</tr>
<tr>
<td>Features that monopolistic competition shares with monopoly</td>
<td></td>
</tr>
<tr>
<td>Price taker?</td>
<td>Yes</td>
</tr>
<tr>
<td>$P = MC$</td>
<td>$P &gt; MC$</td>
</tr>
<tr>
<td>Price</td>
<td>Yes</td>
</tr>
<tr>
<td>Produces welfare-maximizing level of output?</td>
<td>Yes</td>
</tr>
<tr>
<td>Features that monopolistic competition shares with competition</td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>Many</td>
</tr>
<tr>
<td>Entry in long run?</td>
<td>Yes</td>
</tr>
<tr>
<td>Can earn economic profits in long run?</td>
<td>No</td>
</tr>
</tbody>
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