Monopolistic Competition

Assessment Objectives

Specific Expectations	
AO2	Explain that monopolistic competition has less market power due to many substitutes compared to monopoly and illustrate with a diagram showing a more elastic demand curve compared with monopoly.
AO2	Explain profit maximization in the short-run and long-run, with diagrams showing abnormal profit, normal profit, and loss.
AO2	Explain allocative inefficiency and market failure in monopolistic competition.
AO2	Explain that monopolistic competition has more product variety in exchange for less efficiency.
AO3	Discuss the advantages and disadvantages of monopolistic competition.

Monopolistic Competition: Assumptions

- **Monopolistic Competition** is a market type in which a large number of firms compete with each other by making similar but slightly different goods and services.
  - There is a fairly large number of small or medium-sized firms in the industry.
  - There are no barriers to entry; any new firm can enter the industry.
  - There is product differentiation; each firm tries to make its product different from those of the other firms in the industry in terms of various characteristics like the quality, servicing or packaging.
  - These firms use product differentiation to gain some control over the price of their products. However, the existence of other similar products limits the degree of its power to control the market prices.
  - **Example(s):** Shoe, clothing, detergent, computer, and restaurant industries.

Product Differentiation

- **Product Differentiation** occurs when each firm in an industry tries to make its product different from those of its competitors; usually in order to create market power (monopoly power).
  - Product differentiation can be achieved by:

  1. **Physical differences**
     - Products may differ in size, shape, material, texture, taste, packaging, etc.
  2. **Quality differences**
     - Products can differ in quality.
  3. **Location**
     - Some firms attempt to differentiate their product by locating themselves in areas that allow easy access for customers.
     - **Example(s):** Hotels near airports and convenience stores in residential areas.

Product Differentiation

4. **Services**
    - Some firms offer specific services to make their products more attractive.
    - **Example(s):** Home delivery, product demonstrations, free support, warranties and purchase terms.
5. **Product image**
    - Some firms attempt to create a favourable image by use of celebrity advertising or endorsements, by brand names, or attractive packaging.

Monopolistic Competition: Demand curve

- Monopolistic competition resembles perfect competition because there are many firms in the industry and there is freedom on entry.
- It is like monopoly because of product differentiation.
- Firms in monopolistic competition face a demand curve that is less elastic than in perfect competition, but more elastic than monopoly.
  - Firms face a downward-sloping demand curve for their product.
  - However, because each of these products is at the same time a substitute for the other, this demand curve is relatively elastic.
- In monopolistic competition, if a firm raises its price, it will lose more sales than the monopolist, because consumers now do have substitutes they can switch to.
  - However, it will lose fewer sales than the perfectly competitive firm because of product differentiation – the available substitutes are not perfect substitutes, as they are in perfect competition.

Price and Non-Price Competition

- **Price Competition**
  - Occurs when a firm lowers its price to attract consumers away fro rival firms thus increasing sales at the expense of other firms.
    - May occur in the case of monopolistic competition or oligopoly, but not in perfect competition (or monopoly).
- **Product Differentiation**
  - Occurs when firms compete with each other on the basis of methods other than price (such as product differentiation, advertising and branding).
    - Non-price competition occurs in oligopoly and monopolistic competition.
    - The more differentiated the product is from its substitutes and the more successful the advertising and branding as methods of convincing consumers about the superiority of a product, the less elastic will be the demand curve facing the firm, the greater the market power (the ability to control price), and the larger the firm's potential to increase short-run profits.

Price and Non-Price Competition

- By contrast, firms that are less able to achieve consumer loyalty for their product, and whose product is less differentiated from substitutes, may have to rely more on price competition to increase their sales.

- Monopolistically competitive firms compete with each other on the basis of both price and non-price competition.
  - They engage heavily in product differentiation through R&D in product development, as well as in advertising and branding.
  - Firms that can attract customers by use of these methods increase their market power and their ability to charge a higher price without risking loss of buyers to rival firms.

Monopolistic Competition: Profit Maximization

- There are there possible cases when determining the profit maximizing output for a monopolistically competitive firm in the short-run.

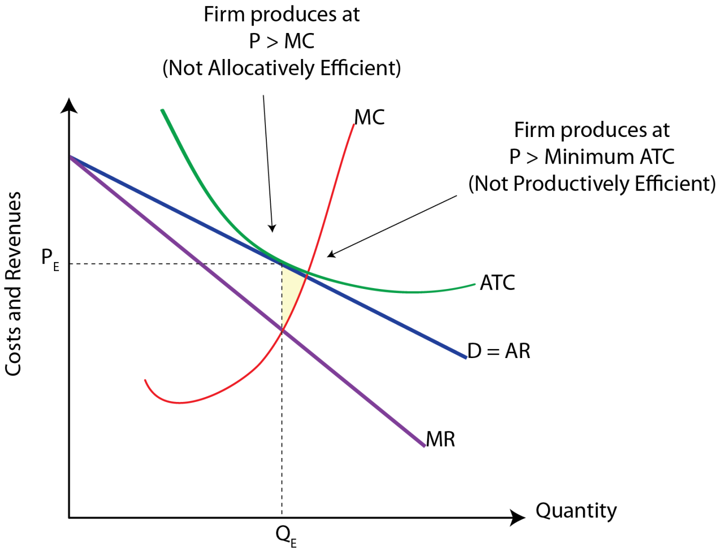
  1. **Abnormal (Supernormal) profit:** Profit $>$ 0 & P $>$ ATC (TR $>$ TC)
  2. **Normal profit:** Profit $=$ 0 & P $=$ ATC (TR $=$ TC)
  3. **Loss:** Profit $<$ 0 & P $<$ ATC (TR $<$ TC)

- In monopolistic competition, in the long-run, profit-making industries attract new entrants; on loss-making industries, some firms shut down and exit the industry.
  - The process of entry and exit of firms in the long-run ensures that economic profit or loss is zero and all firms earn normal profit.
  - If firms are making abnormal profits then new firms will enter and they will attract customers away from existing firms.
  - The result will be to decrease demand facing existing firms, so that it shifts left until it is just tangent to the ATC curve and the firms earn normal profit since P $=$ ATC.

Monopolistic Competition: Efficiency

- Monopolistically competitive firms achieve neither productive efficiency (P = Minimum ATC) nor allocative efficiency (P = MC).
  - In monopolistic competition $P > MC$ or alternatively $MB > MC$, indicating there is market failure.
  - The market underallocates resources to the production of the good and too little of it is produced relative to the social optimum level.
  - Economists argue that some inefficiency in monopolistic competition is justified by the presence of product differentiation, which leads to greater product variety.
  - In other words consumers enjoy product variety and gain this while giving up some efficiency.

Monopolistic Competition: Efficiency



Monopolistic Competition versus Perfect Competition

- **Similarities**
  - Large number of firm
  - Free entry of firms into an industry (no barriers to entry).
  - Normal profit in the long-run, abnormal profit or loss in the short-run (due to no entry barriers).
- **Differences**
  1. **Market power and the demand curve**
     - Firms in perfect competition have not market power; they are price-takers facing a perfectly elastic (horizontal) demand curve they face.
     - Firms in monopolistic competition do have some market power (ability to influence price), reflected in their downward-sloping demand curve.

Monopolistic Competition versus Perfect Competition

2. **Allocative efficiency**
   - Whereas the perfectly competitive firm achieves allocative efficiency in long-run equilibrium, the monopolistically competitive firm does not.
   - Fewer than optimal resources are allocated to the production of the good. Monopolistic competition is therefore a type of market failure.
   - Since P $>$ MC, consumers pay a higher price for the good than in perfect competition.
3. **Product variety**
   - Whereas all firms in perfect competition produce the identical product, under monopolistic competition firms go to great lengths to differentiate their products.
   - From the consumer's perspective, product variety is usually an advantage; perfect competition cannot offer this advantage.

Monopolistic Competition versus Perfect Competition

4. **Economies of scale**
   - Firms in perfect competition cannot achieve economies of scale because they are very small.
   - Firms in monopolistic competition may have some small room for achieving economies of scale but only to a relatively small degree as these firms also tend to be relatively small.

Monopolistic Competition versus Monopoly

- **Similarities**

  1. **No allocative efficiency therefore a form of market failure**

     - Both these market structures face downward-sloping demand curves, and therefore have MR curves that lie below the demand curve.
     - This means at the profit-maximizing level of output (found by $MR = MC$), we have $P > MC$ (no allocative efficiency).

- **Differences**

  1. **Number of producers**

     - While in monopolistic competition there is a large number of firms, in monopoly there is a single firm, or else the industry is dominated b one large firm.

  2. **Size of firms**

     - In monopolistic competition firms are usually small, whereas in monopoly the fact that there is a single or dominant firm suggests a very large size.

Monopolistic Competition versus Monopoly

3. **Barriers to entry**
   - Monopolistic competition is characterized by free entry whereas in monopoly there are high barriers to entry.
4. **Normal and abnormal profits**
   - Whereas the firm under monopolistic competition earns normal profit in the long run, the monopoly can earn abnormal profits due to high barriers to entry.
5. **Competition and prices**
   - Free entry and exit under monopolistic competition drive abnormal profits down to zero in the long-run, and allow prices to be lower for the consumer than is possible under monopoly, where barriers to entry allow the firm to maintain abnormal profits over the long-run.
   - Therefore prices under monopolistic competition are likely to be lower and the quantity larger than in monopoly and more in the interests of consumers.

Monopolistic Competition versus Monopoly

6. **Market power**
   - While both monopolies and firms in monopolistic competition have market power, a monopoly is likely to have more market power because there are no substitutes for the good it produces.
   - The availability of substitutes means that consumers can switch to substitute goods, thus reducing the firm's market power.
7. **Competition and costs**
   - Competition between firms in monopolistic competition put a downward pressure on costs as firms compete with each other.
   - These competitive pressures may force less efficient firms to leave the industry.
   - The absence of competition in monopoly dies not exert such downward pressure on costs.

Monopolistic Competition versus Monopoly

8. **Research and development**
   - The abnormal profits that monopolies can earn over the long-run puts them in a better position than monopolistically competitive firms with respect to financing R&D.
   - However, the pressures of competition faced by monopolistically competitive firms may induce them to pursue R&D for product development in order to maintain or increase their sales.
9. **Economies of scale**
   - Some small economies of scale may be achieved by firms under monopolistic competition, but the potential for this is much greater under monopoly, which can benefit consumers through lower prices.
10. **Product variety**
    - Whereas many monopolies sell more than one product, there is likely to be far greater product variety in monopolistic competition which is characterized by many firms producing products that are substitutes for each other.