Monopolistic Competition

If we think of competition as quantifiable in some way, we can create a spectrum of competition with perfect or pure competition at one end and monopoly at the other end. In between these two extremes lie many different industrial structures. This chapter is concerned with looking at a mixture of pure competition with monopoly. It is therefore called monopolistic competition. Sometimes it is also called imperfect competition, but that includes a broader class of models.

Monopolistic competition shares something with pure competition — they both assume there are many buyers and sellers and there is free entry and exit of firms in the long run. Monopolistic competition also shares something with monopoly — each monopolistically competitive firm faces its own downward sloping demand curve. Note however that this downward sloping demand curve is *not* the industry demand. It is a demand special to the firm itself. Indeed, the demand can be influenced by the behavior of other firms in the industry. Therefore, a monopolistically competitive firm is not protected by barriers to entry.

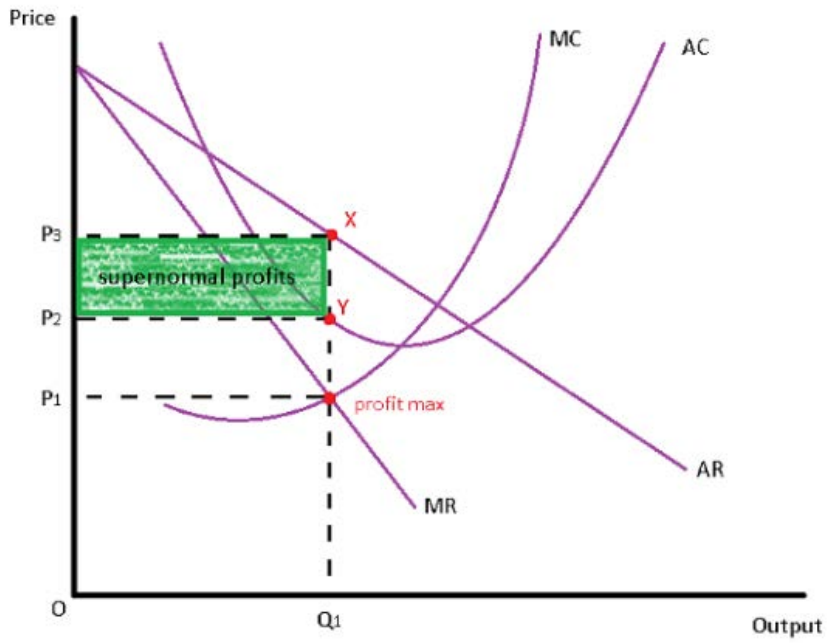
One way to motivate the concept of monopolistic competition is to say that the firms sell the same type of product, but these products have different qualities such as color, size, shape, or packaging. This means that they differ in some significant way. Because of this, firms will advertise to let the public know about their product and will try to influence the demand for their product. Advertising is useful in the short run, but such advertising cannot force people to buy a good they do not like. Once the consumer knows about the product or has tried it, it is useless for the company to use advertising to drive the consumer back to the store to buy it again. People will not be fooled. If the product being advertised as "new and improved" is not really new and is not really improved, then the consumer will not continue to buy the good. If they like the product, then they will buy it, if the price is acceptable. In the long run, price becomes the main motivation for attracting consumers. This is why we make another important assumption that monopolistic competition shares with pure competition — free entry and exit from the industry. If monopolistically competitive firms make short run above normal profits, then in the long run firms will enter the industry, sell new goods *very much like* the profitable firms, and will therefore drive economic or above normal profits to zero. Like competitive firms, monopolistically competitive firms will earn only a normal level of profits.

Here is how the theory of monopolistic competition works. (you can see a nice video here).

The current theory of monopolistic competition was created independently by Edward Chamberlain and Joan Robinson during the 1930s. It can be split into a short run and long equilibrium. In this case, the short term refers to a period where entry is not possible – it takes time to design and manufacture new products to compete with those currently earning above normal profits. In the short run, there is no entry of firms, so it is possible for existing firms in the industry to earn above normal profits. The graphical exposition is very much like that of monopoly. However, it must be understood that the firm is acting like a monopolist because the good being produced is well differentiated from others in the industry. This is why the firm faces a downward sloping demand curve. One way to think of this is to posit that consumers care about color and therefore each firm has a single color to its product. this makes each firm's product slightly different and dives the firm a downward sloping demand for its product. Of course, price remains an important consideration to the consumer and firms still compete using price, but color

distinguishes the goods in a significant way and makes each firm appear to be a monopoly for the good *having that color*. The fact that the goods differ means that each firm can have a brand name and can advertise. This makes monopolistic competition different from both monopoly and pure competition. Figure 1 below shows the familiar short run equilibrium for the firm and the above normal profits (sometimes called super normal profits). Remember that a normal profit has been added to cost so that a zero profit condition actually means the firm is earning a normal profit. Think of the normal profit as an average level of profit needed to even motivate the firm to produce.

Figure 1 Short Run Equilibrium for a Monopolistically Competititive Firm



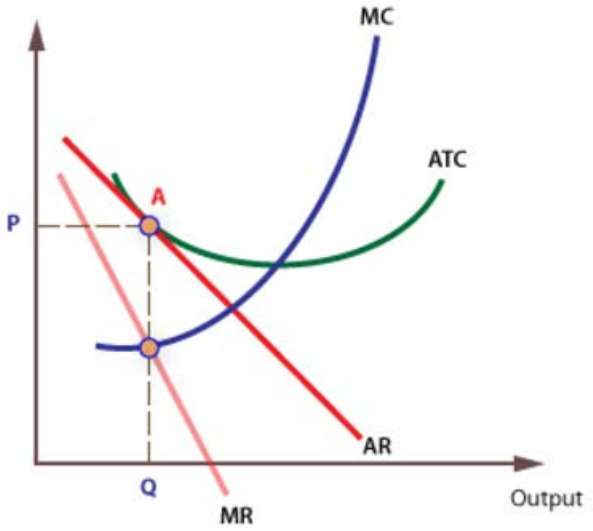
In the figure, we see that maximum above normal profit occurs at output Q_1. This is where MR = MC. Total profits are equal to $(X-Y)Q_1$ (note that in the figure we have called the demand curve the average revenue, AR, curve, which is perfectly correct). These profits will attract new firms into the industry.

In the long run, two important adjustments to the industry occur.[1] The above normal profits encourage new firms to enter the market producing and selling goods that are very close in quality to those already on the market. This steals away the demand for the goods of the existing firms. It shifts the existing demand inwards and then tilts the demand to make it flatter. The second adjustment is the rise of total average costs as entry of new firms raises factor prices, like wages. The confluence of these two effects results in a zero long run above normal profit. Thus, there

[1] In fact, the long run means that the scale of the firm can also change to an optimal size, and technology can change in such a way that costs are driven down. These are complicating factors, but they do not really change the end result in Figure 2.

remains competitive pressure in the industry to drive prices down, so as to equal long run ATC and no above normal profits are possible.

Figure 2 Long Run Equilibrium for a Monopolistically Competititive Firm



Note that in the long run, the firm is still inefficient (wasting societies resources) since households are paying a price for an extra unit of output greater than the marginal cost of producing an extra unit of output. The price is higher and the quantity is lower under monopolistic competition than under pure competition.

There are some economists that feel the monopolistically competitive firm may still be efficient. Their reasoning goes as follows. People like variety of goods, even within an industry and are willing to pay more for this variety. Therefore, it may not be true that the long run equilibrium price in Figure 2 is too high (i.e. greater than MC). People may be willing to pay the extra amount of the price to ensure there is a satisfying level of variety of goods in the market. Remember that if we eliminate variety of goods in the market, we will be back to pure competition and thus MR = MC. Hence, we have to ask why do people want varying qualities of goods in monopolistically competitive industries. It must be that they value this variety and that is causing the divergence between P and MC. The firms may be efficient after all.

The theory of monopolistic competition lays open the concept of competition. We now see that competition operates through many channels, not just through the obvious price channel. Competition can also be waged using diverse qualities introduced into the market. These qualities separate, or perhaps specialize, the goods of an industry, but there nevetheless remains unifying features of the products that allow them to continue to compete. Whatever the channel through which competition operates, above normal profits are eliminated in monopolistically competitive industries in the long run, and this keeps the market closer to efficiency.

Problems

(P1) What does it mean to say goods are differentiated in a monopolistically competitive industry?

(P2) Why do monopolistically firms advertise their products?

(P3) Why do monopolistically competitive firms face a downward sloping demand curve?

(P4) In the long run, the demands of monopolistically competitive firms experiencing above normal profits fall and tilt. How and why?

(P5) Why do some people say monopolistically competitive firms are inefficient?

(P6) Why do some people say monopolistically competitive firms are efficient?

(P7) Show graphically the short run and long run equilibria for a monopolistically competitive firms.