CHAPTER 17

MONOPOLISTIC COMPETITION

• Many firms
   There are many firms competing for the same group of customers. Each is small compared to the market. (Each firm has a monopoly for the product it makes, but, many other firms make similar products that compete for the same customers.)

• No barriers to entry
   Firms can enter (or exit) the market without restriction. Thus, the number of firms in the market adjusts until economic profits are driven to zero.

• Differentiated products (each firm makes a unique product)
   This means that rather than being a price taker, each firm faces a downward-sloping demand curve.

How do firms facing monopolistic competition behave?

Perfectly competitive firm faces a perfectly elastic (horizontal) demand curve.

Since everyone's product is the same, an individual firm can not raise price. MR curve is on top of D curve.

A monopolistically competitive firm faces a downward sloping demand curve since they are selling differentiated products. Thus faces a downward sloping MR curve that is below the D curve.
**Setting P and Q (we will draw a graph)**

1. Set MR = MC to determine profit-maximizing quantity, Q*.
2. Set highest price that allows firm to sell Q*. This is price P*.

   (same as monopoly so far)

**What about economic profits?**

We will start with a firm making economic profits.

\[ P^* > ATC^* \implies \text{firm is making economic profits (above average profits)} \]

   (same as monopoly so far)

**What differentiates a monopolistically competitive firm from a monopoly?**

The persistence of economic profits!

With monopolistic competition there are no barriers to entry to protect economic profits.

\[ \implies \text{in the long-run, economic profits will be zero} \]

   (same as firms in a perfectly competitive industry)

**Why?**

- New firms may enter market.
- The new firms steal some market share since they offer a substitute product to consumers.
- The demand curve for our firm shifts in (L).

Long-run situation for monopolistically competitive firm: \[ P^* = ATC^* \]
Because there are no barriers to entry, the firm can not protect its economic profits!

**Monopolistic versus perfect competition**

**Excess capacity**

- The monopolistically competitive firm does not operate at the quantity that minimizes average total cost.

- These firms produce on the downward sloping portion of their ATC curves.

- Stark difference from perfectly competitive firms.

  Firms in perfectly competitive markets are driven to produce at the quantity that minimizes ATC.

- The quantity that minimizes ATC is called the **efficient scale of the firm**.

  In the long-run, the perfectly competitive firm produces at the efficient scale.

  In the long-run, the monopolistically competitive firm produces below the efficient scale.

  It is said to have **excess capacity**.

  It could increase the quantity it produces and lower the ATC of production.
**Relationship between price and marginal cost**

Definition: **Markup** = P-MC

- For a perfectly competitive firm, P = MC.
- For a monopolistically competitive firm, P > MC.

How is this consistent with free entry and zero profit?

- Zero economic profit ensures only that P = ATC. It does not ensure that P = MC.
- Since in long-run, the monopolistically competitive firm produces on the downward sloping portion of ATC, MC is below ATC. Since P=ATC in long-run, MC < ATC = P and thus MC < P.

**Monopolistic competition and the welfare of society**

Is monopolistic competition desirable from the standpoint of society as a whole? Can policymakers improve on the market outcome?

There is no simple answer to these questions.

Why?

There is a tradeoff.

There is inefficiency since there is a markup of price over marginal cost (P >MC). So we get normal deadweight loss (DWL) of monopoly that we have already studied.

On the other hand, we have variety. People value variety.

Loss of efficiency due to monopolistic competition must be weighted against the gain of greater product differentiation.