HUM1033 Micro Economics Assignment | F1+TF1 | TT504 | Dr. ALLI P | Winter Semester 2021-22

by **Sharadindu Adhikari, 19BCE2105**

Problem Statement: How society benefits from product differentiation in a monopolistic competition.

Introduction:

One of the defining traits of a monopolistically competitive market is that there is a significant amount of non-price competition. This means that product differentiation is key for any monopolistically competitive firm. Product differentiation is the process of distinguishing a product or service from others to make it more attractive to a target market.

Review of Literature:

The authors of [1] have tried to elaborate on the spatial analogy to product differentiation in order to clarify some issues in monopolistic competition. The excess capacity theorem was reaffirmed. Consistency of the assumptions was shown to be somewhat uncertain. Some monopoly power is retained by firms as long as consumers have different tastes and there are fixed costs to developing new products.

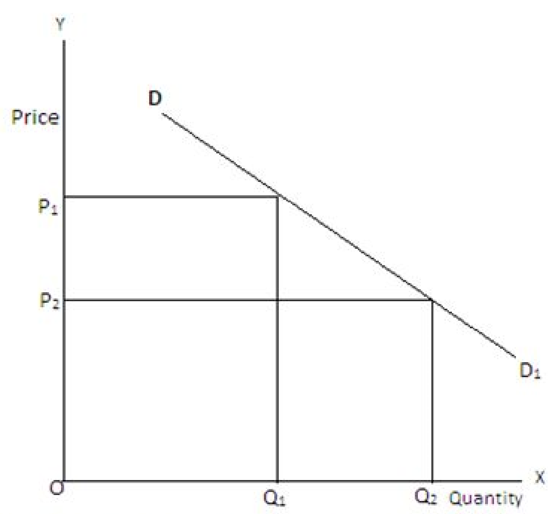
In paper [2], the authors argued that in in the neoclassical framework, product differentiation provides consumers with the benefit of more variety in exchange for higher cost, because firms produce above minimum average total cost. The only benefit that product differentiation provides is greater variety for consumers. In fact, firms do not differentiate their products to make them different from those of their rivals, they differentiate them to make them better. By so doing, product differentiation produces continually better products—as viewed by the people who buy and consume them—and in this way product differentiation is the engine of economic progress.

This paper [3] generalised a model of monopolistic competition attributable to Spence (1976)[4]. Firms produce symmetrically differentiated products with declining or U-shaped average costs. Free entry drives profits to zero in equilibrium. Spence finds that when firms behave "competitively," in a specific sense, the market equilibrium yields too little product diversity. However, when Spence's "competitive" behavioural assumption is relaxed, the authors find that the market may produce excessive diversity; this occurs when product differentiation is weak relative to scale economies of production. They also studied two second-best regulatory policies and characterize conditions under which they are potentially effective in improving the market outcome.

My viewpoints:

A differentiated product can increase brand loyalty and even survive a higher price point. If a product is perceived to be better in some way than its competitors, consumers will consider it worth the higher price. Differentiation marketing can help companies stand out when a product isn't perceived to be much different from a competitor's, such as bottled water. The strategy might be to focus on a lower price point or that it's a locally owned business. When functional aspects of the two products are identical, non-functional features can be highlighted. The strategy can be an appealing change in design or styling. A successful product differentiation campaign raises consumer interest and gives the consumer a reason to believe they need one product rather than another.

If we look from the brands’ point of view, it is important because it allows them to gain a competitive advantage in the market. If differentiation were unachievable, the bigger companies with economies of scale would always dominate the market because they can undercut smaller producers in terms of price. Product differentiation is also a way to control costs for the consumer by maintaining a competitive market. In fact, firms work hard to emphasize the non-price related differences between their products and their competitors’.



Also, the demand curve for an individual firm is downward sloping in monopolistic competition, in contrast to perfect competition where the firm’s individual demand curve is perfectly elastic. This is due to the fact that firms have market power: they can raise prices without losing all of their customers. In this type of market, these firms have a limited ability to dictate the price of its products; a firm is a price setter not a price taker (at least to some degree). The source of the market power is that there are comparatively fewer competitors than in a competitive market, so businesses focus on product differentiation, or differences unrelated to price. By differentiating its products, firms in a monopolistically competitive market ensure that its products are imperfect substitutes for each other. As a result, a business that works on its branding can increase its prices without risking its consumer base.

While a monopolistic competitive firm can make a profit in the short-run, the effect of its monopoly-like pricing will cause a decrease in demand in the long-run. This increases the need for firms to differentiate their products, as I’ve already mentioned, thereby leading to an increase in average total cost. The decrease in demand and increase in cost causes the long run average cost curve to become tangent to the demand curve at the good’s profit maximizing price.

Here, firms operate with excess capacity. The firm's profit maximizing output is less than the output associated with minimum average cost. All firms, regardless of the type of market it operates in, will produce to a point where demand or price equals average cost. In a perfectly competitive market, this occurs where the perfectly elastic demand curve equals minimum average cost. Again, in a monopolistic competitive market, the demand curve is downward sloping. In the long run, this leads to excess capacity. Thereby benefitting the consumers and thus the society at large.

Concluding remarks:

In economics, successful product differentiation is inconsistent with the conditions of perfect competition, which require products of competing firms to be perfect substitutes.

Consumers do not need to know everything about the product for differentiation to work. So long as the consumers perceive that there is a difference in the products, they do not need to know how or why one product might be of higher quality than another. For example, a generic brand of cereal might be exactly the same as a brand name in terms of quality. However, consumers might be willing to pay more for the brand name despite the fact that they cannot identify why the more expensive cereal is of higher "quality."

Product differentiation, thus, is a way for products and brands to command market share based on consumer preferences. Customers choose products for various reasons whether it be price, brand image, quality or durability, taste, colour, or a temporary trend. If a product can differentiate itself from its competitors in some unique way and appeal to consumers, it will have a competitive advantage and gain market share. Therefore, product differentiation is also a way for market forces to do their work and keep prices down for the consumer. Hence, the society benefits as it gets more diversity of product and continuous innovation in a particular domain.

References:

1. *Dennis R. Capozza and Robert Van Order*. The Journal of Industrial Economics Vol. 31, No. 1/2, Symposium on Spatial Competition and the Theory of Differentiated Markets (Sep. - Dec., 1982), pp. 27-39
2. *Randall G. Holcombe*. Product Differentiation And Economic Progress; The Quarterly Journal Of Austrian Economics 12, NO. 1 (2009): 17–35
3. *Roger W. Koenker and Martin K. Perry*; The Bell Journal of Economics Vol. 12, No. 1 (Spring, 1981), pp. 217-231
4. *Spence*, *A.M.* Product Selection, Fixed Costs, and Monopolistic Competition; Review of Economic Studies, Vol. 43, No. 2 (June 1976), pp. 217-236