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Monopolistic Competition and Advertising

Previously…

- Price discrimination
  - Occurs when a firm sells different output units at different prices
  - Will increase firm profitability
  - Can increase economic efficiency
- General rule for price discrimination
  - Charge a higher price to relatively inelastic consumer group
  - Charge a lower price to relatively elastic consumer group

Big Questions

1. What is monopolistic competition?
2. What are the differences among monopolistic competition, competitive markets, and monopoly?
3. Why is advertising prevalent in monopolistic competition?

What Is Monopolistic Competition?

- Monopolistic competition
  - A market structure characterized by
    - Free entry
    - Many different firms
    - Product differentiation
- Product differentiation
  - The process that firms use to make a product more attractive by contrasting its unique qualities with competing products

Comparing Market Structures

Perfectly Competitive Markets	Monopolistic Competition	Monopoly
Many sellers	Many sellers	One seller
Similar products	Differentiated products	A unique product without close substitutes
Free entry and exit	Free entry and exit	Barriers to entry and exit

Product Differentiation

- Style or type
  - Clothing stores
  - Food court at mall
- Location
  - Gas stations
  - Dry cleaners
  - Barber shops

Product Differentiation

- Quality
  - Low quality versus high quality
  - Taco Bell versus Baja Fresh
  - Subway versus Quiznos
  - McDonald's versus White Castle
- Trade-off:
  - Lower quality, lower prices, faster service
  - Higher quality, higher prices, slower service

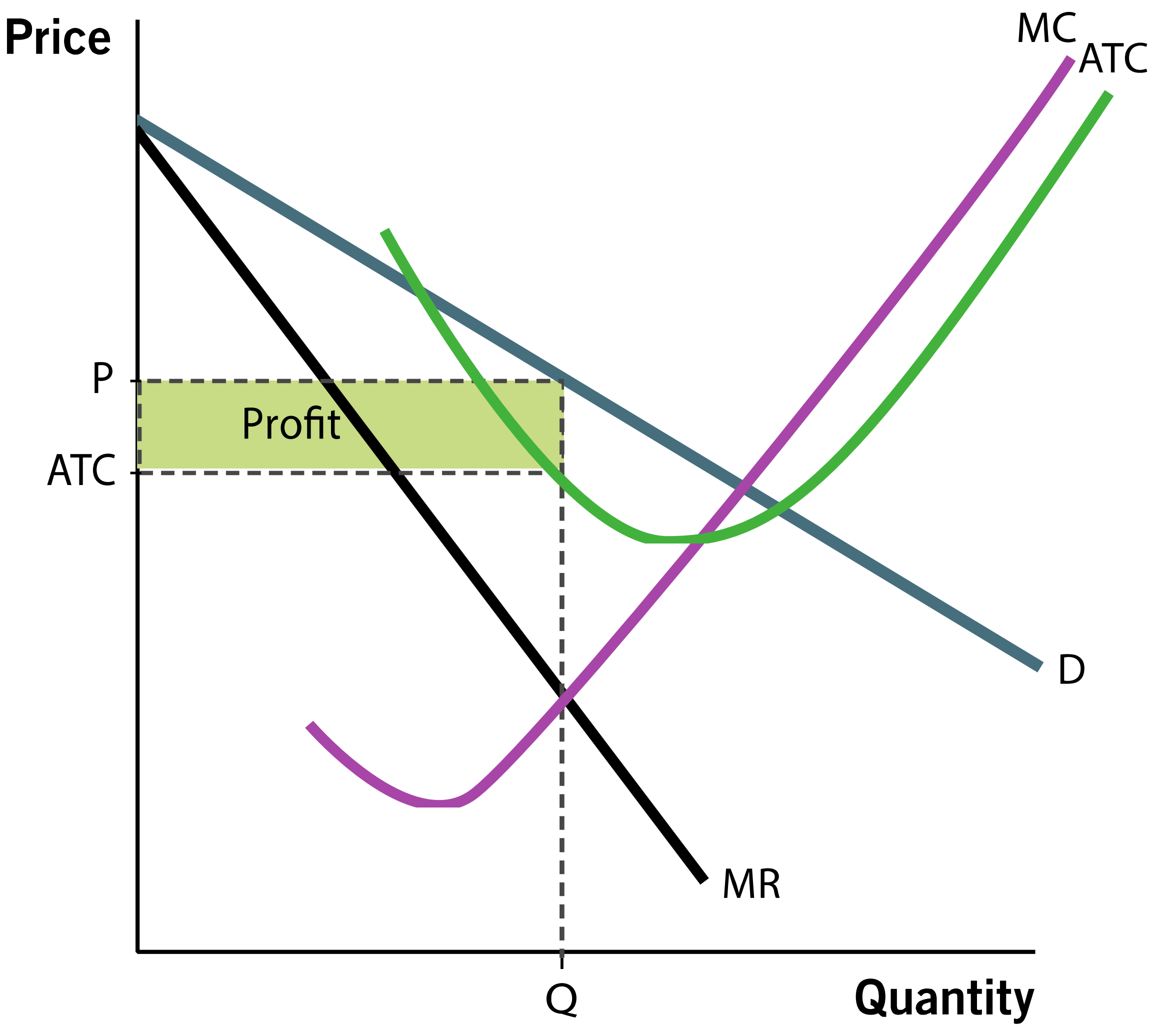
Economics in *Seinfeld*

- "The Cafe" (1991)
  - Jerry convinces Babu to serve Pakistani food—he'll be the only Pakistani restaurant in the neighborhood. When the restaurant fails, Jerry blames it on a bad location.

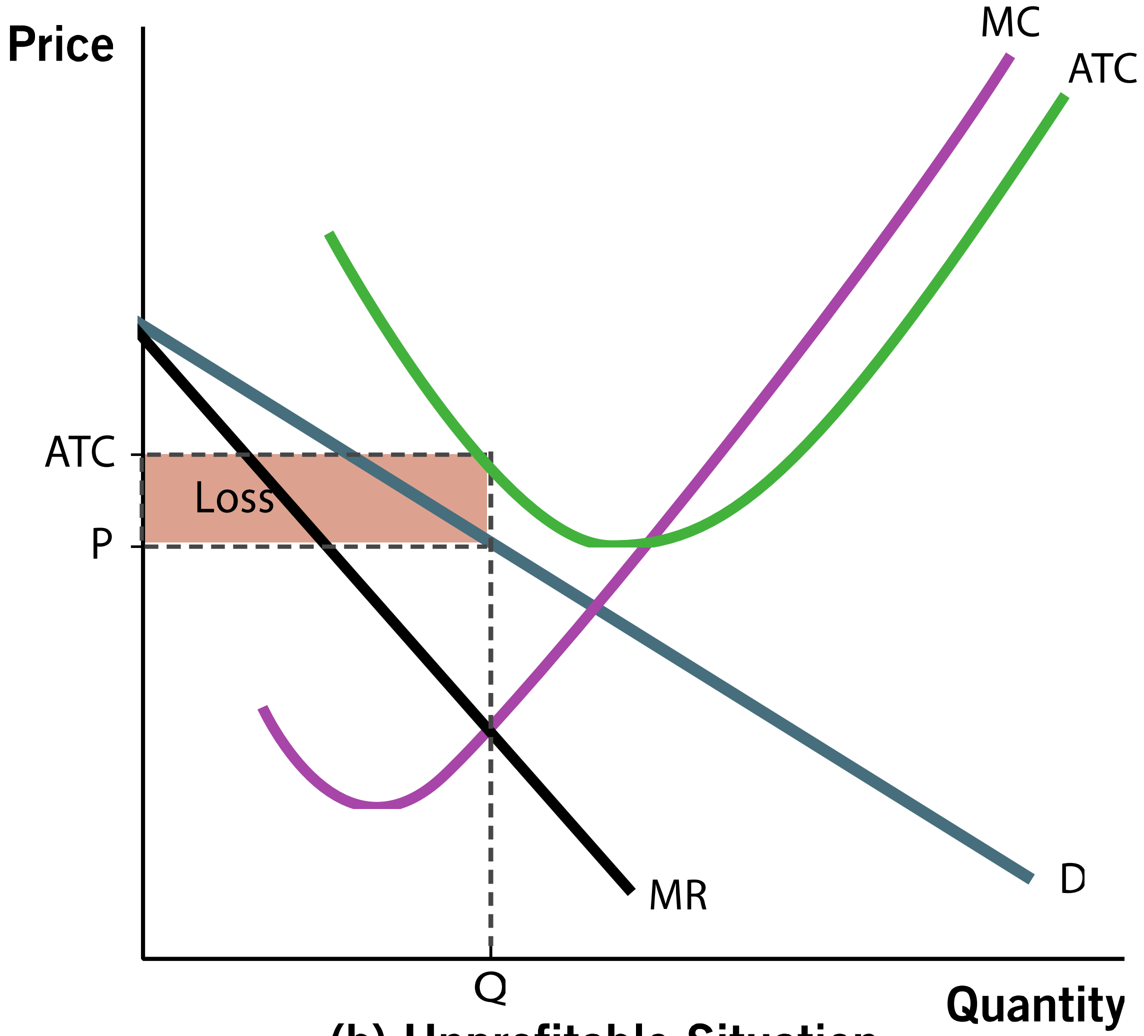
Monopolistic Competition in the Short Run and Long Run

- Monopolistically Competitive Firm
  - Sells a differentiated product
  - Has market power
  - Uses profit-maximizing rule of MR = MC
  - Charges a price on the demand curve corresponding to this point, and P > MC
  - Long run profits will depend on firm entry and exit. Generally, there is free entry and exit.

Monopolistic Competition in the Short Run



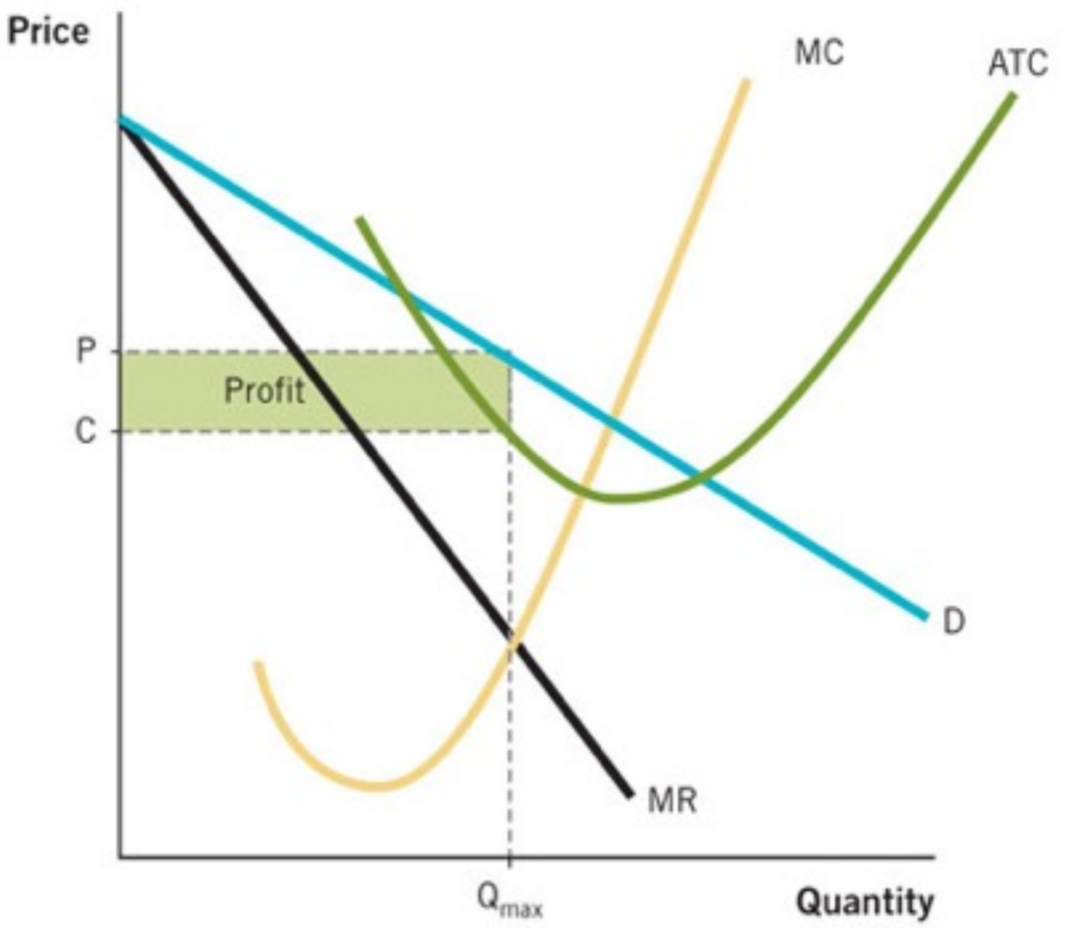
(a) Profitable Situation



(b) Unprofitable Situation

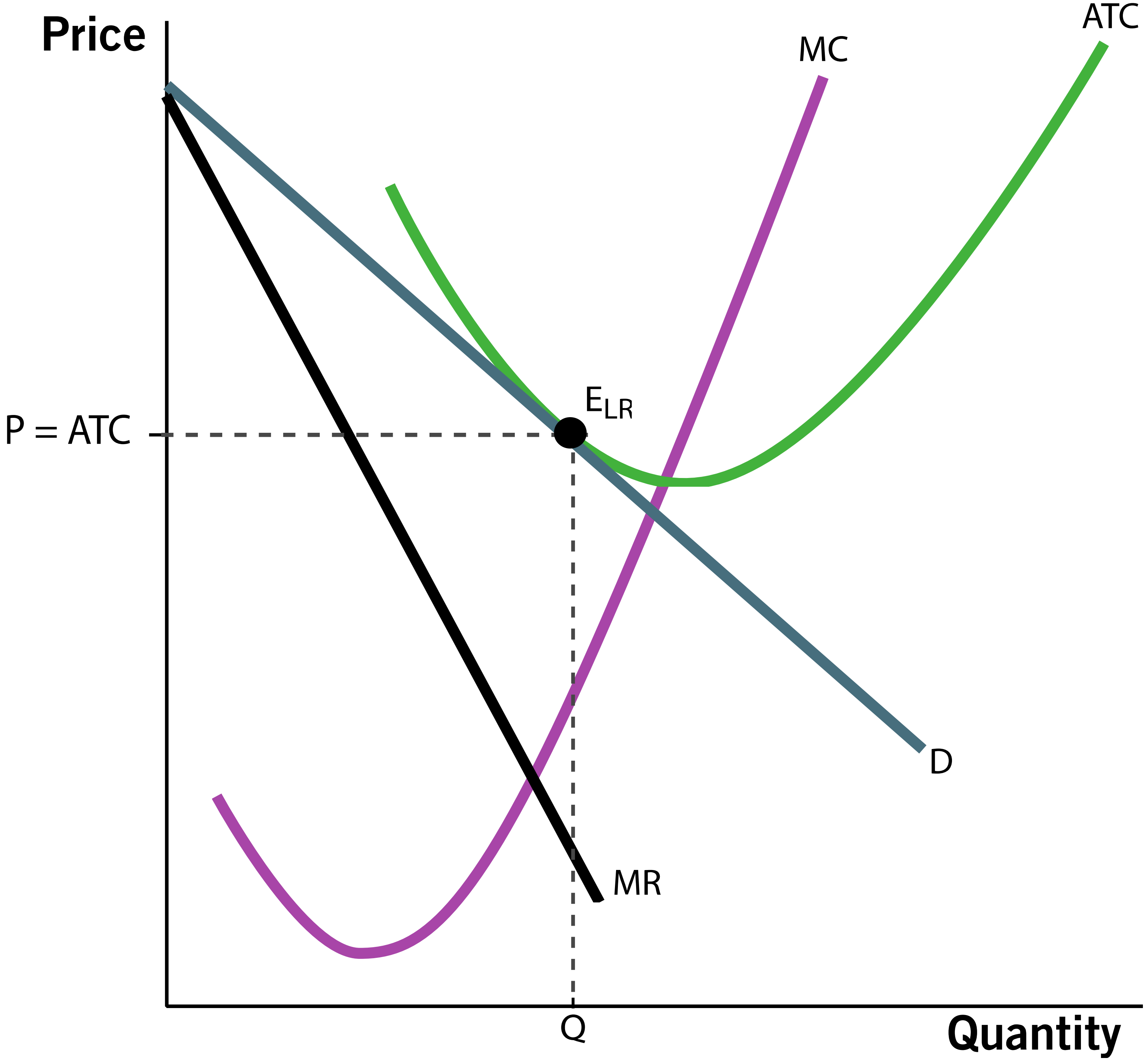
Monopolistic Competition in the Short Run

- Graph summary
  - Firm chooses output level where MR = MC
  - The price is determined by the height of the demand curve at this level of output
  - Firm could make a profit or loss. This depends on whether price is greater than or less than the ATC of production at the profit-maximizing output level.



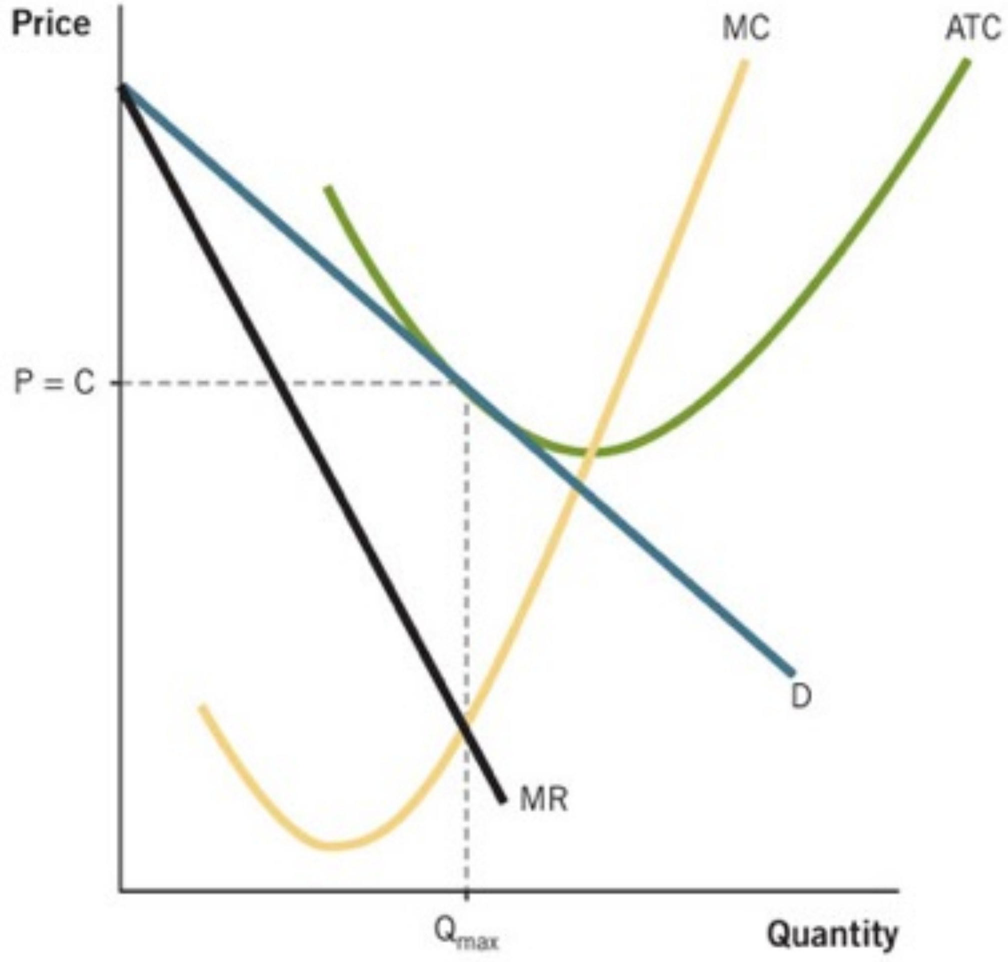
(a) Profitable

Monopolistic Competition in the Long Run



Monopolistic Competition in the Long Run

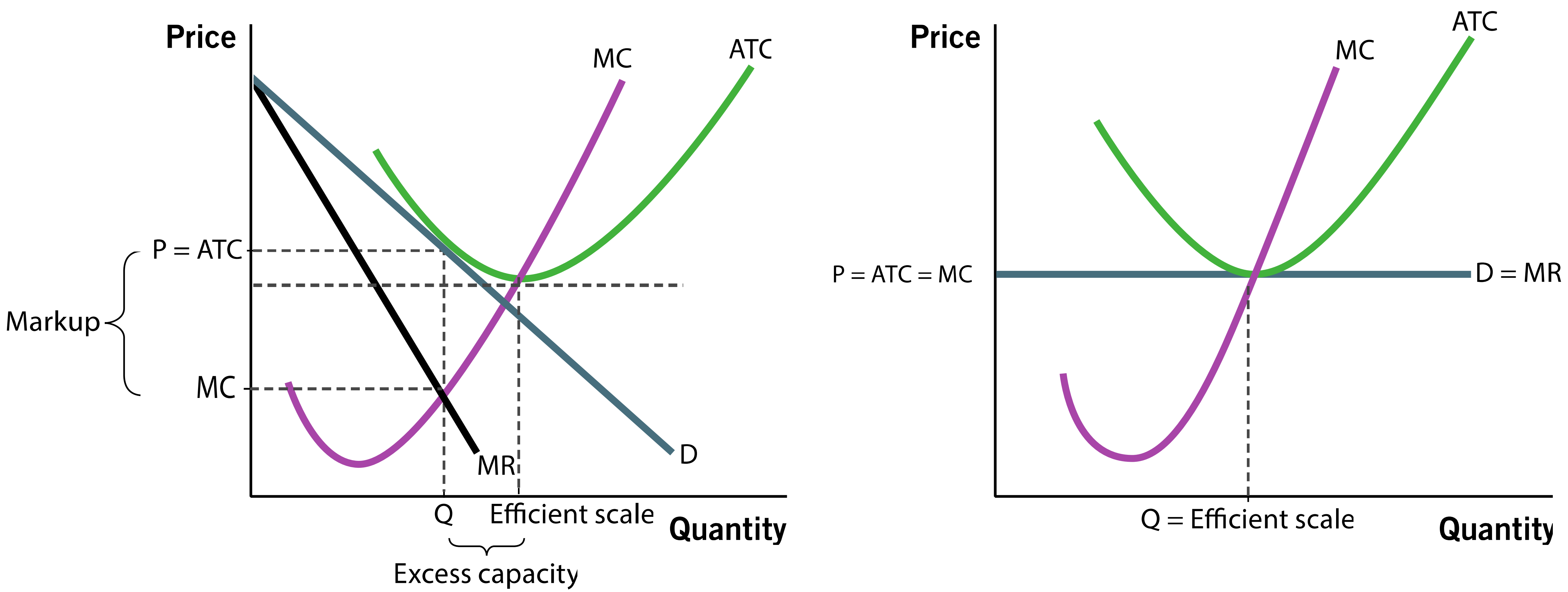
- Graph summary
  - A key idea is *free entry and exit*.
  - If the industry is profitable, other firms will enter, causing the deman[d] for existing firms' products to decrease
  - If the industry is experiencing losses, firms will exit, causing demand for remaining firms' products to increase
  - Entry and exit will stop when profit[s] are zero. This occurs when P = ATC.



Relationship between Price, Marginal Cost, and LRAC

- Markup
  - The difference between P and MC
  - Markups are possible when a firm has market power and sells a differentiated product
  - Results in consumers paying more

LR Equilibrium in Two Market Structures



(a) Monopolistic Competition

(b) Competitive Market

Scale and Output

- Excess capacity
  - Firms are relatively small, so they are not at the output level where ATC is minimized
- Why not produce more?
  - To sell more, the firm would have to lower the price of output. It is more profitable to produce at excess capacity.
- Compare to perfect competition
  - Perfectly competitive firms operate at capacity at the minimum of ATC. Overall output is higher in perfect competition.

Inefficiency and Social Welfare

- Sources of inefficiency in monopolistic competition
  - ATC is higher compared to perfect competition
    - Firm could lower the price it charges and sell more
  - Markup
    - P > MC
    - If the firm tried to set P = MC, the level of output sold would occur where ATC > P, and the firm would lose profits

Inefficiency and Social Welfare

- Could government intervention be helpful?
  - Due to free entry, firms are not able to earn long run profits like monopolists.
  - Regulation may put many firms out of business
    - Less firms may mean more inconvenience and fewer choices for consumers
    - Already have seen problems of marginal cost pricing regulation
  - Inefficiency not large enough to warrant government intervention

Is the Inefficiency So Bad?

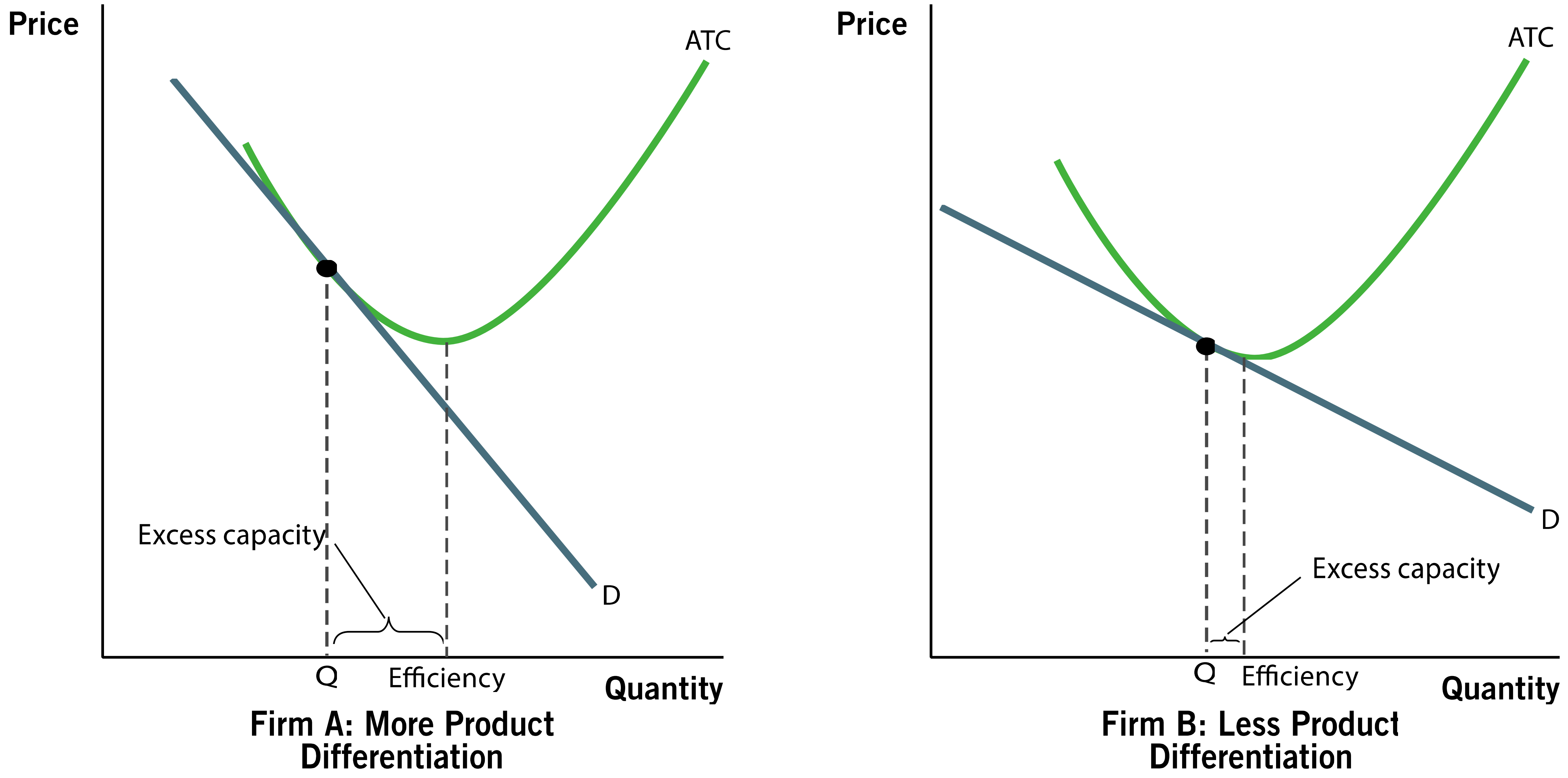
- Perfect competition
  - Lower prices
  - Higher quantities
  - Efficiency (P = MC, minimum ATC)
  - Homogenous products (no variety)
- Monopolistic competition
  - Slightly higher prices
  - Slightly lower quantities
  - Inefficiency (P > MC, not at minimum ATC)
  - Differentiated products (variety and choice)

Varying Degrees of Product Differentiation

- A highly differentiated product means
  - Higher markups
  - Larger excess capacity
  - Higher price

- A less-differentiated product means
  - Lower markups
  - Less excess capacity
  - Lower price

Differentiation, Excess Capacity, and Efficiency



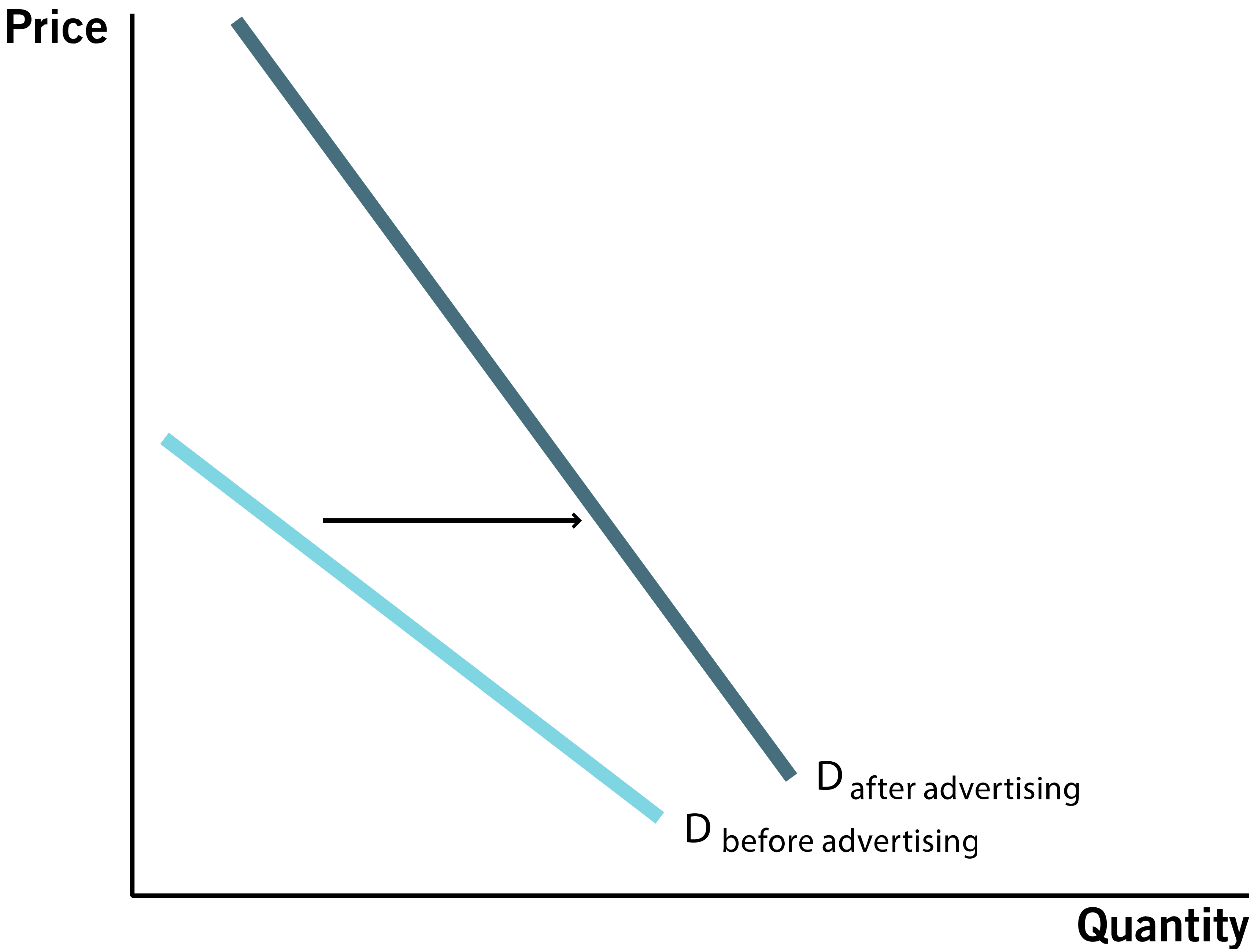
Economics in *South Park*

- “Gnomes” (1998)
  – A new, higher quality coffee shop opens up in South Park and threatens to put an existing coffee shop out of business

Advertising

- Advertising
  - A method of nonprice competition
  - Represents 2% of U.S. annual economic output
- Why advertise?
  - Provide information for consumers
  - Further differentiate the product
  - Increase demand for the product

Advertising and Demand



Who Advertises?

- Perfect competition
  - Homogenous products means that advertising won't help an individual firm
  - A single firm that advertises would be at a cost disadvantage
  - However, the *industry* can still benefit from advertising
- Examples:
  - Beef
  - Milk
  - Orange juice

Who Advertises?

- Monopolistic competition
  - Advertising is widespread and beneficial to individual firms with differentiated products
  - Advertising can increase demand for single firm's product
- Examples:
  - Fast-food restaurants
  - Clothing stores

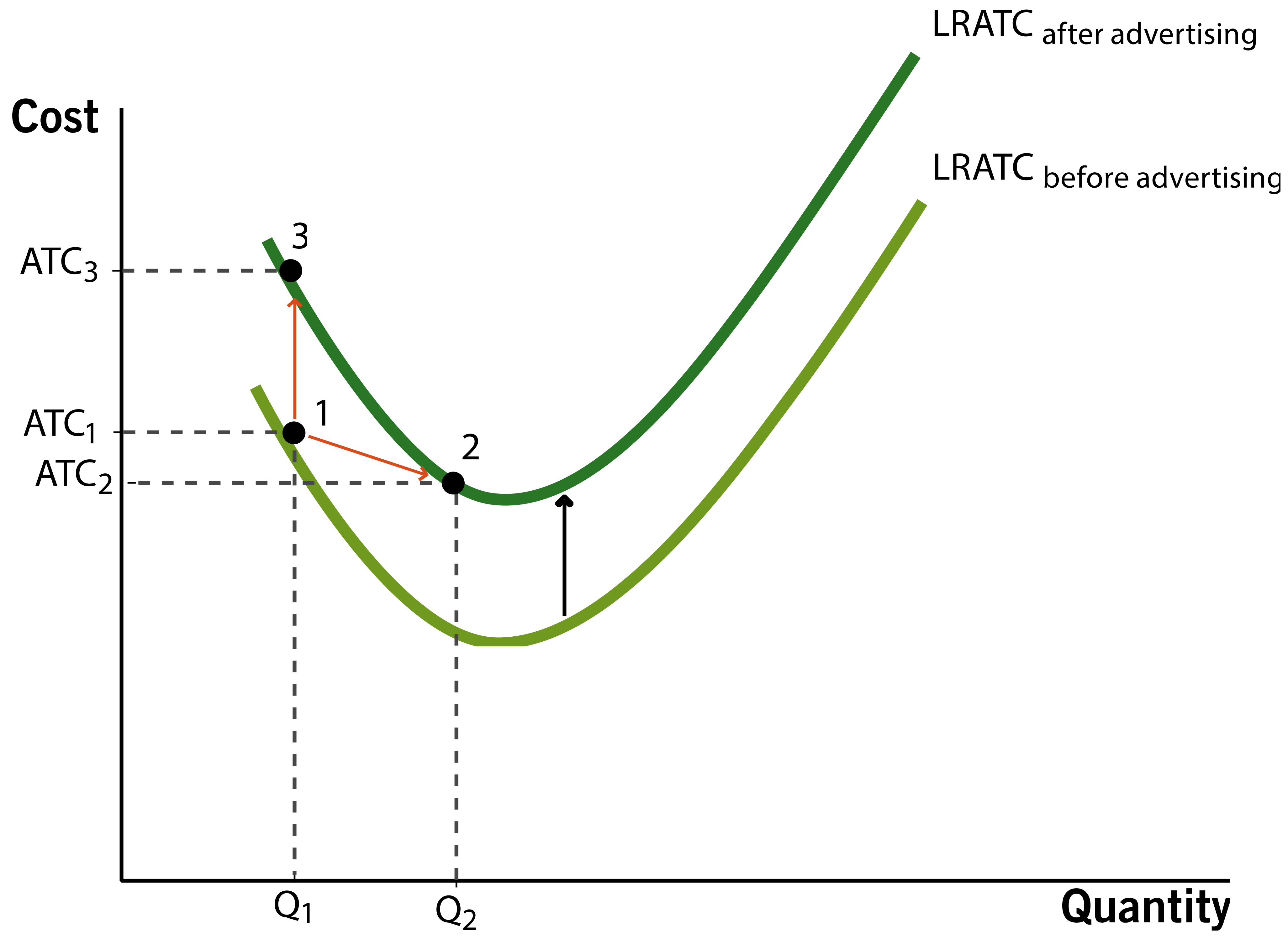
Who Advertises?

- Monopoly
  - Not as necessary to advertise since the product has no close substitutes and consumer choice is limited
  - May advertise simply to inform consumer about the product and stimulate demand
- Example:
  - De Beers (diamond monopoly)

Negative Effects of Advertising

- Advertising raises costs
  - One firm advertises, others follow suit
    - When all firms advertise, the demand-increasing effects may cancel each other out
    - No overall demand change, but higher costs still exist
    - Business stealing externality
  - Inspiring brand loyalty
    - Creates more inelastic demand, which raises prices

Advertising Increases Cost



Negative Effects of Advertising

- Many advertisements are persuasive rather than informative
  - May cross the line from beneficial to manipulative
  - Creates an incentive to lie about a product
- Advertising regulations
  - FTC regulates advertising
  - Goal: enforce truth-in-advertising laws
  - Special attention paid to food, drugs, supplements, alcohol, and tobacco
  - Internet has increased unsubstantiated claims

Conclusion

- Monopolistic competition
  - Exists when many competing firms produce differentiated products
  - Has features of both perfect competition and monopoly
  - Is closer to perfect competition than monopoly in terms of prices, output, and efficiency
  - Is prevalent throughout our economy