

# Monopolistic Competition

IB Economics: Theory of the Firm & Market Structures



# Basics of Monopolistic Competition

- Monopolistic competition is a form of **imperfect competition** and can be found in many real world markets ranging from sandwich bars and coffee stores in a busy town centre to pizza delivery businesses in a city or hairdressers in a local area.
- Care homes for older people might also fit into the market structure known as monopolistic competition
- Monopolistic competition is similar to perfect competition, indeed some economists regard it as more realistic, because the products are differentiated
- Product differentiation means that businesses have some control over their products, it implies that firms have some price-setting power, AR slopes downwards

# Examples of Monopolistic Competition



Shoe repairs and  
key makers



Taxi and minibus  
companies



Sandwich bars  
and coffee stores



Hairdressing  
salons



Dry-cleaners and  
laundrerettes

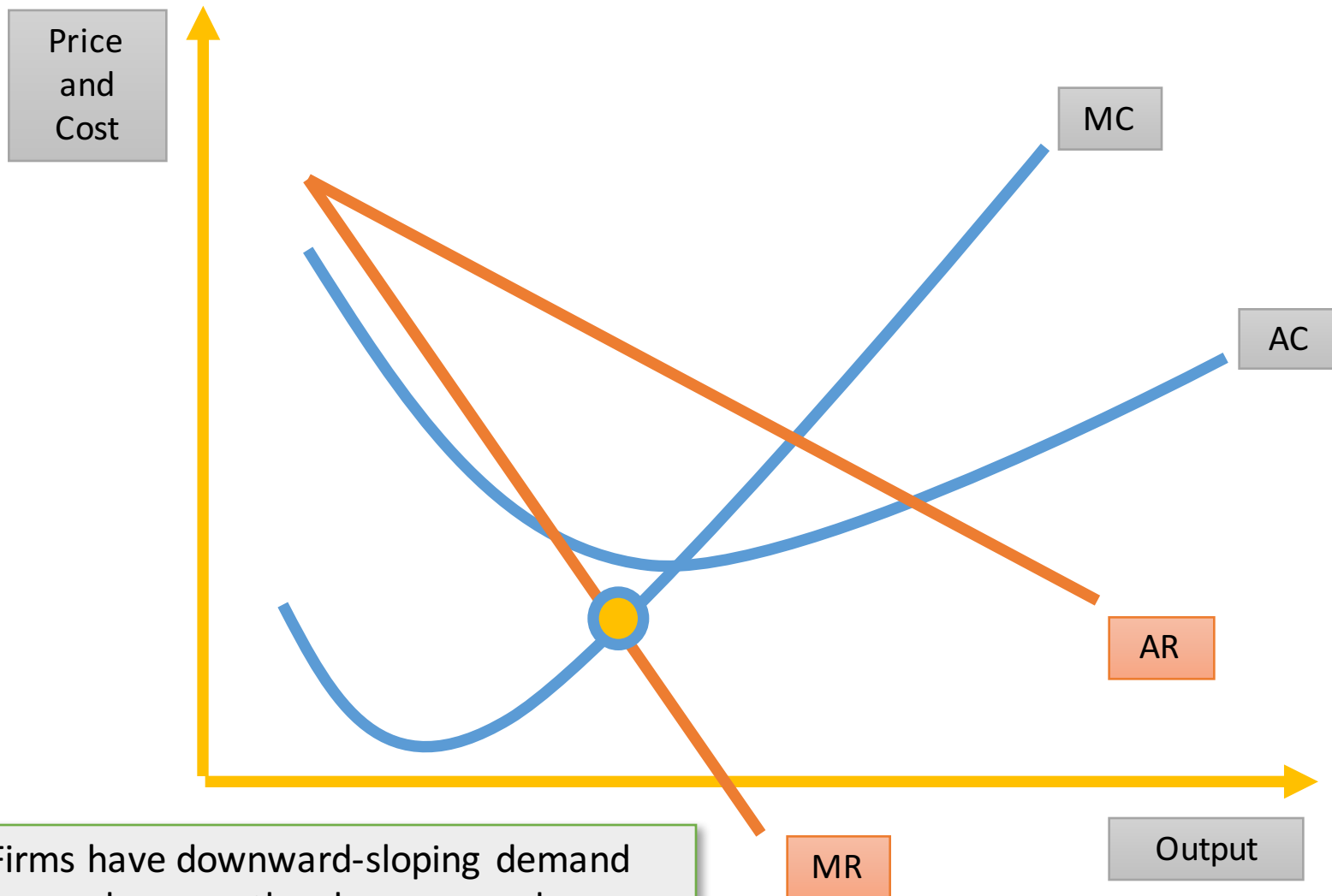


Bars and  
Nightclubs

# Assumptions: Monopolistic Competition

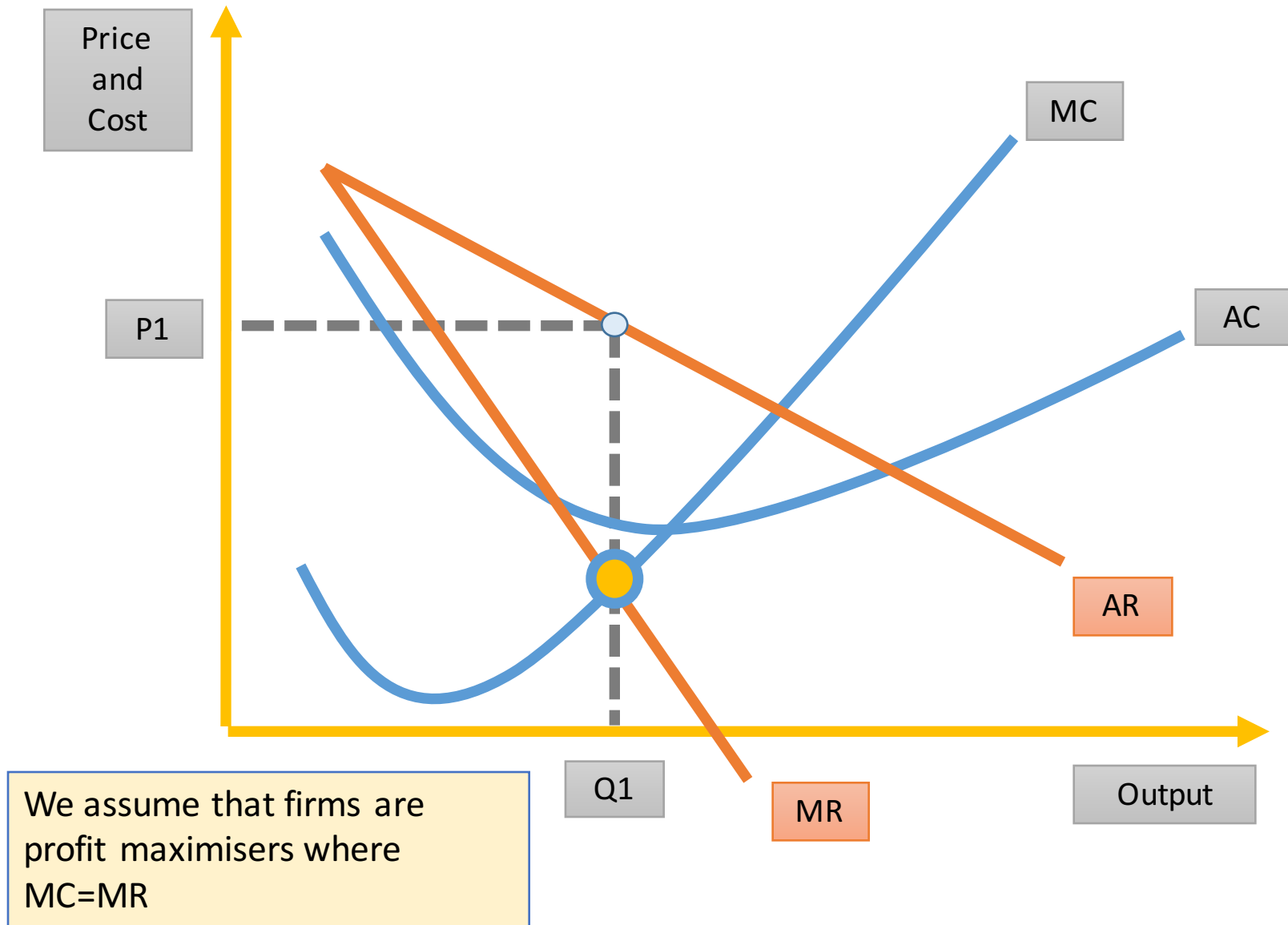
1. There are **many producers** and **many consumers** - the industry concentration ratio is low
2. Consumers are aware that there are non-price differences among products i.e. there is slight **product differentiation** – **non-price competition** is strong and plenty of consumer switching takes place
3. **Producers have some control over price** - they are “price makers” not “price takers” but the price elasticity of demand is higher than it would be under monopoly (the cross-price elasticity is high)
4. **Barriers to entry and exit are low** – this allows producers respond to changing profit signals and means profits are competed away in the long run

# Short Run Price, Output and Profit

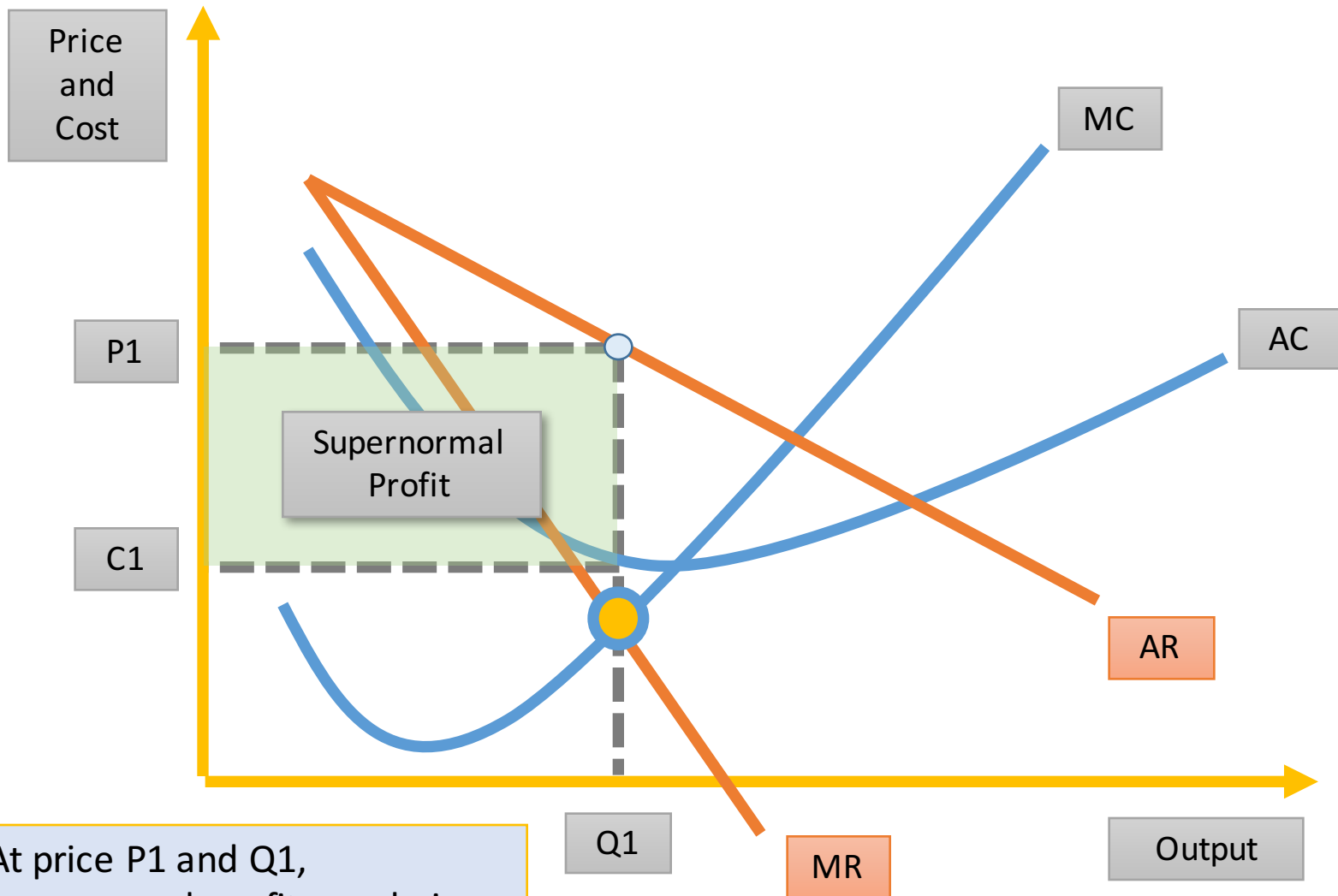


Firms have downward-sloping demand curves because they have some degree of price-setting power

# Short Run Price, Output and Profit



# Short Run Price, Output and Profit



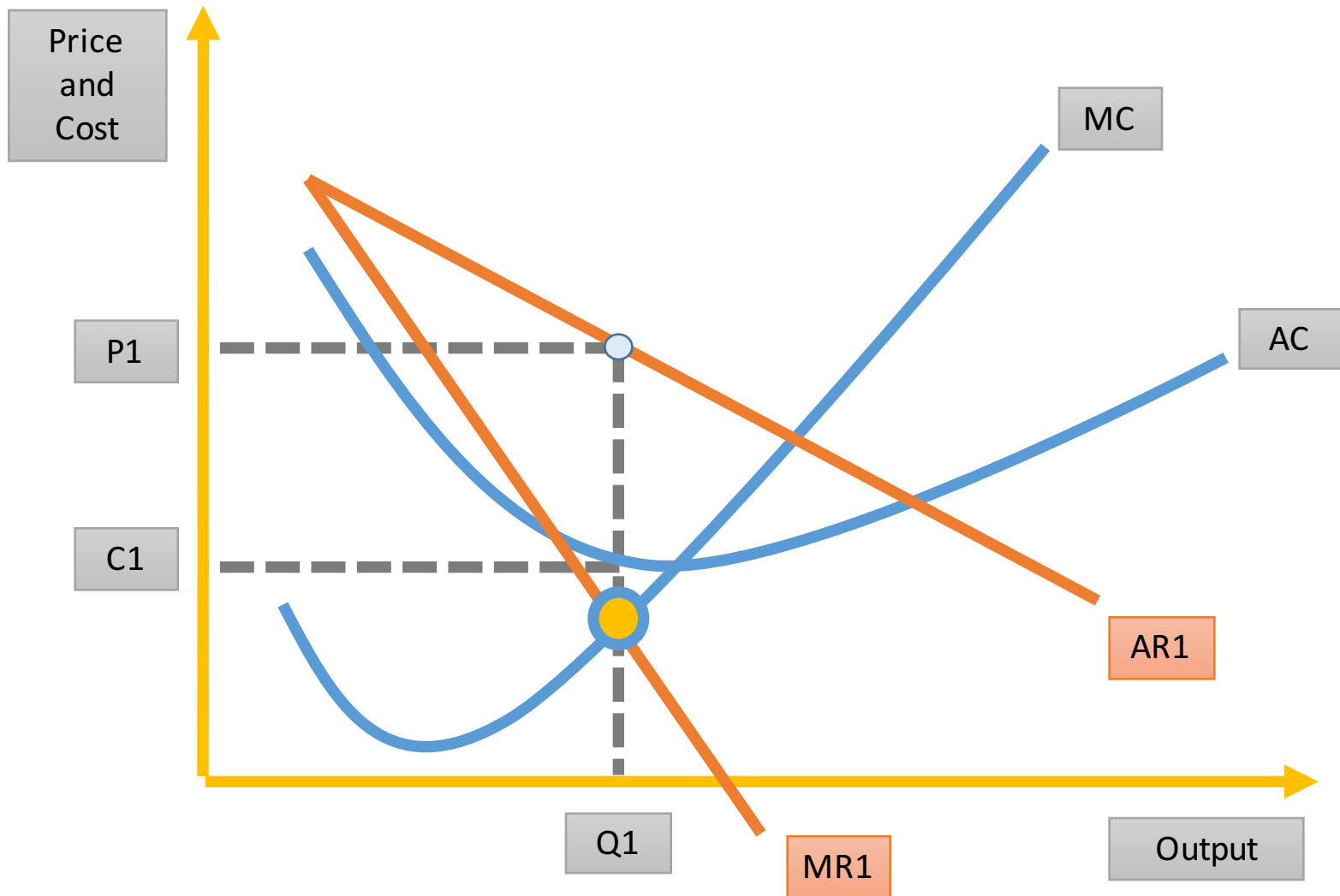
At price P1 and Q1, supernormal profits are being made because Price > AC

# Explaining Adjustment to the Long Run

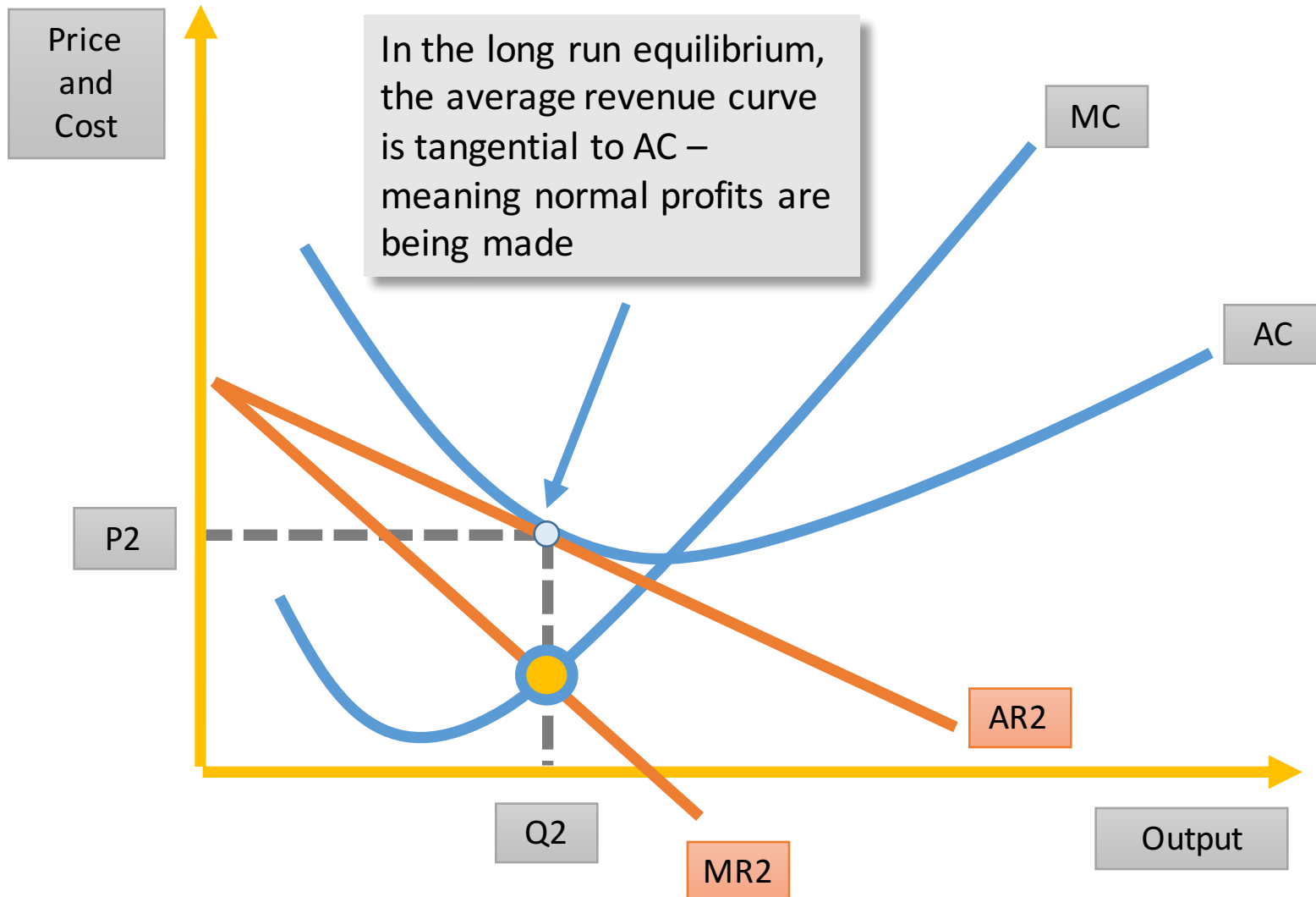
- In the short run, profits competing in monopolistic competitive markets can be at any level
- Unlike monopoly, **there are no barriers to entry**
- So the presence of supernormal profits **acts as a signal**
- This means that short-run **supernormal profit attracts new producers with new products** and so **normal profits** only are made in the long run equilibrium i.e. **where  $AR = AC$**
- As more firms enter the market, the demand curve for any existing firm shifts to the left as consumers opt to buy products offered by new or alternative companies.
- The demand curve continues to move to the left until it is **tangential to the AC curve**.
- At this point, the monopolistically competitive firm is at its profit-maximising level of output (because  $MR = MC$ ) but is also making only normal profit (because  $AR = AC$ )



# (1) Short Run Price, Output and Profit



## (2) Long Run Price, Output and Profit



# A Stable LR Equilibrium is Unlikely

- In the long run equilibrium in monopolistic competition, the representative firm in the market is making **normal profits**.
- In reality, a stable equilibrium may not be reached since new products come and go, and some naturally do better than others. The market may be in a state of **constant flux**.
- Existing products within a market will typically go through a **product life cycle** that affects the volume and growth of sales
- The length of the product life cycle varies from market to market. Many businesses spend heavily on marketing / innovation to extend the life of profitable brands

# Monopolistic Competition & Efficiency

1. **Prices are above marginal cost** – meaning that the equilibrium is **not allocatively efficient**
2. Saturation of the market may lead to businesses being **unable to exploit fully economies of scale** - causing average cost to be higher – therefore **not productively efficient**
3. Critics of heavy spending on marketing and advertising argue that much of this spending is **wasteful** and an inefficient use of scarce resources.
4. Debate over the social costs of packaging and **negative externalities** is linked to monopolistic competition
5. Monopolistic competition associated with extensive consumer choice and innovation – **good for dynamic efficiency**

# Case Study: UK Taxi Industry

A fragmented market; There are an estimated 78,000 taxis and 153,000 licensed private hire vehicles in England and Wales. 80% of UK taxis are relatively small owner-operator businesses. The industry as a whole generates revenues of nearly £9 billion per year



**Addison Lee** Founded by minicab driver John Griffin in 1975 with just one car, Addison Lee has become a major competitor to London's black cabs and now carries more than 10m passengers a year. Bought by Carlyle, the US hedge fund manager in July 2013



## Private hire vehicles

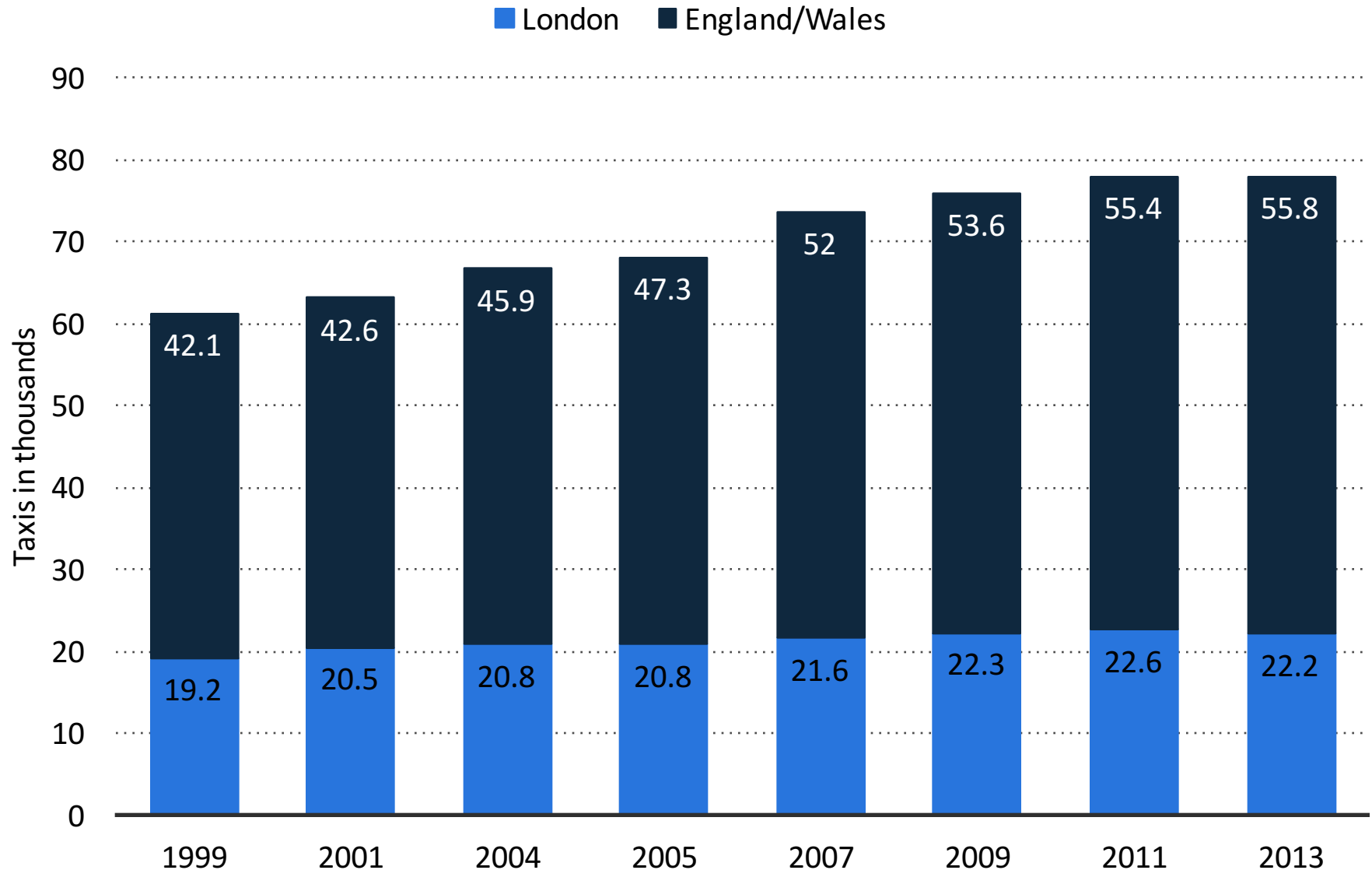
Mini cabs cannot be hailed from the street and must rely on telephone and internet bookings and walk-in reservations. Most private hire vehicles are licensed but there are also some un-licensed operators



## London Black Taxis

There are over 23,000 black cab drivers. Entry is restricted to those with licence and drivers who have passed "the Knowledge"

# Case Study: UK Taxi Industry



# Creative Destruction? The Rise of Uber

- The taxi market in London and many other cities has been disrupted by the arrival of Uber – a smartphone based cab service that allows users to hail a cab using their mobile device and which is significantly cheaper than traditional black cabs.
- Remember that technology acts as a disruptive force overcoming barriers to entry. In some cities Uber has been banned, not least in places where established taxi operators have political influence.
- Uber uses a **surge-pricing model** – the fares charged are higher when demand is rising at peak times. This is an example of price discrimination in order to maximise revenue.

# Price & Non-Price Competition in Gym Market

- The UK gym / health club industry generates >£2 billion of revenues annually with over 1,500 businesses employing nearly 40,000 people
- Gyms and fitness centres are concentrated in **urban areas** where **high population density** makes businesses more commercially viable
- The market position of **mid-market gyms** has come under pressure in recent years.
- Consumers are switching towards **budget gyms**, which do not require long-term contracts and charge less because they only offer basic services



# Price & Non-Price Competition in Gym Market

## Budget Gyms



Pay as you go

Basic equipment

Often out of town

Many open 24 hours

Dry facilities only –  
gym, classes

## Mid-Range Gyms



- Membership subscriptions
- Wet (spa, pool) and dry facilities
- Car parking
- Restaurants
- Tailored instruction

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