**ECO 2306 – Principles of Microeconomics**

Week 16

**Hello and Welcome to the weekly resources for ECO 2306 – Principles of Microeconomics!**

**This week is Week 16 of class, and typically in this week of the semester, your professors are covering these topics below.**  If you do not see the topics your particular section of class is learning this week, please take a look at other weekly resources listed on our website for additional topics throughout of the semester.

We also invite you to **look at the group tutoring chart on our website to see if this course has a group tutoring session offered this semester**.

If you have any questions about these study guides, group tutoring sessions, private 30 minute tutoring appointments, the Baylor Tutoring YouTube channel or any tutoring services we offer, please visit our website [www.baylor.edu/tutoring](http://www.baylor.edu/tutoring) or call our drop in center during open business hours. M-Th 9am-8pm on class days 254-710-4135.

Our main resource is going to be Principles of Microeconomics by N. Gregory Mankiw.

**Topic of the week**

**Monopolistic Competition**

**Keywords:** oligopoly, monopolistic competition.

**Concepts:**

Sometimes there are many firms competing in the market, but the products they offer are not identical. In this case, we have a market that is neither a monopoly nor perfect competition. This market is what we study here.

**Between Monopoly and Perfect Competition**



Figure 1 The four types of market structure (source: Mankiw)

There are four different market structures. We’ve already discussed monopoly and perfect competition. If a market has many firms with differentiated products, we have **monopolistic competition**. When we have a few firms in a market, we have an **oligopoly**. In this chapter we study monopolistic competition.

Consider the market for movies. There are many companies that produce movies and anyone can enter the movie business. However, movies are not identical and there are some movies that you prefer to watch. Therefore, movie makers, theaters, and streamers have some price making power. The same argument is true about restaurants and clothing companies.

In the short run, monopolistic competition is just like monopoly. Companies produce the quantity where total revenue equals marginal cost and set the price on the demand curve. If P>ATC they make a profit and if P<ATC they lose money.



Figure 2 Monopolistic Competition in the short run (source: Mankiw)

What happens in the long run? If firms are making profit in short run, new firms will have an incentive to enter the market and increase the number of products. This reduces demand faced by each firm and demand curve shifts left. Each firm’s profit declines until there’s zero economic profit. This process is why you can watch an old movie or play an old video game pretty much for free.

Zero economic profit means price will equal average total cost, which is still higher than marginal cost. Therefore, price will be higher than a what we saw in perfect competition. This difference in price is known as the monopolist’s markup.



Figure 3 Monopolistic vs Perfect Competition (source: Mankiw)

There is some deadweight loss involved in monopolistic competition due to the monopolist’s markup, so the general welfare of society is lower. In the long run, new firms entering the market creates two forms of externalities. Since new firms add to the quantity of products in the market, they have a positive externality for consumers, and since they reduce other firms’ business, they have a negative externality on producers. Depending on which externality is larger, a monopolistically competitive market could have either too few or too many products.

**Advertising**

The amount of advertising depends on the kind of product a firm is selling. Firms that sell highly differentiated products (movies, perfume, soft drinks) spend 10-20% of their revenue on advertising. Firms that sell industrial products (communication satellites) spend very little on advertising. Firms that sell homogeneous products (crude oil, wheat) spend no money on advertising.

There is a debate about the value of advertising and whether or not society is wasting its resources by spending money on it. Critics believe advertising is a form of psychological manipulation and creates fake desires in consumers. Advertising also impedes competition, increases perception of product differentiation, and makes buyers less concerned with price differences among similar goods.

Defenders of advertising argue that ads provide information to customers and help them make better choices. Therefore, the market allocates resources more efficiently. Advertising also allows customers to take advantage of price differences which leads to more competition. It also allows new firms enter more easily.

Advertising can be a signal of quality. A producer who reveals real information about a product signals a very high quality. Also, a producer’s willingness to spend a large amount of money on an ad, shows its confidence in the quality of its product. This is why company’s hire famous actors to star in their ad campaigns. Consumers are not necessarily impressed by seeing a good looking actor, but rather by knowing how much the company is willing to spend (invest) in a product.

Brand names (Coke, Tide) spend more money on advertising and charge higher prices than generic substitutes (Great Value, HEB). Critics of brand names argue that products are not really differentiated and consumers are being irrational by paying more for these brands. Proponents of brand names consumers receive information about quality by seeing a brand name, and firms have an incentive to maintain quality in order to protect their brand’s reputation.

**What you might struggle with**

We’ve talked about many similar concepts in these last chapters. This table will help you remember the key ideas.



Figure 4 Monopolistic competition: between perfect competition and monopoly (source: Mankiw)

**Check your learning**

1. Among monopoly, oligopoly, monopolistic competition, and perfect competition, how would you classify the markets for each of the following drinks? (source: Mankiw)

a. tap water

b. bottled water

c. cola

d. beer

2. Classify the following markets as perfectly competitive, monopolistic, or monopolistically competitive, and explain your answers. (source: Mankiw)

a. wooden no. 2 pencils

b. copper

c. local electricity service

d. peanut butter

e. lipstick

3. For each of the following characteristics, say whether it describes a perfectly competitive firm, a monopolistically competitive firm, both, or neither. (source: Mankiw)

a. sells a product differentiated from that of its competitors

b. has marginal revenue less than price

c. earns economic profit in the long run

d. produces at the minimum of average total cost in the long run

e. equates marginal revenue and marginal cost

f. charges a price above marginal cost

4. For each of the following pairs of firms, explain which firm would be more likely to engage in advertising.

a. a family-owned farm or a family-owned restaurant

b. a manufacturer of forklifts or a manufacturer of cars

c. a company that invented a very comfortable razor or a company that invented a less comfortable razor

**Answers**

These are my answers. You should be able to come up with your own arguments that may or may not differ from mine.

1. a. Monopoly, b. perfect competition, c. monopolistic competition, d. monopolistic competition

2. a. perfectly competitive (production is relatively simple, cheap, and unregulated, so there’s a small barrier to entry. Products are exactly the same.)

b. monopolistic (barrier to entry is extremely high, product is homogeneous, it’s a natural monopoly)

c. perfectly competitive (there are many companies to choose from, product is identical)

d. perfectly competitive (product is generic and easy to make, there’s free entry)

e. monopolistic competition (products are differentiated, there’s free entry and competition)

3. a. monopolistically competitive

b. monopolistically competitive

c. neither

d. monopolistically competitive

e. perfectly competitive

f. monopolistically competitive

4. a. a family owned restaurant; a farm produces homogeneous products such as wheat that need no advertising. A restaurant has to show the customers that it’s different from other restaurants.

b. a manufacturer of cars will advertise a lot to a broad market, a manufacturer of forklifts will advertise a little to a specific market.

c. a company with a very comfortable razor is more confident in the success of its product, so it would invest much more money in advertising.

Thanks for checking out these weekly resources!

Don’t forget to check out our website for group tutoring times, video tutorials and lots of other resources: [www.baylor.edu/tutoring](http://www.baylor.edu/tutoring) ! Answers to check your learning questions are below!