Perfect Competition

- What conditions must exist for perfect competition?
- What are barriers to entry and how do they affect the marketplace?
- What are prices and output like in a perfectly competitive market?

The Four Conditions for Perfect Competition

Perfect competition is a market structure in which a large number of firms all produce the same product.

1. **Many Buyers and Sellers**
   There are many participants on both the buying and selling sides.
2. **Identical Products**
   There are no differences between the products sold by different suppliers.
3. **Informed Buyers and Sellers**
   The market provides the buyer with full information about the product and its price.
4. **Free Market Entry and Exit**
   Firms can enter the market when they can make money and leave it when they can't.

Barriers to Entry

Factors that make it difficult for new firms to enter a market are called barriers to entry.

Start-up Costs

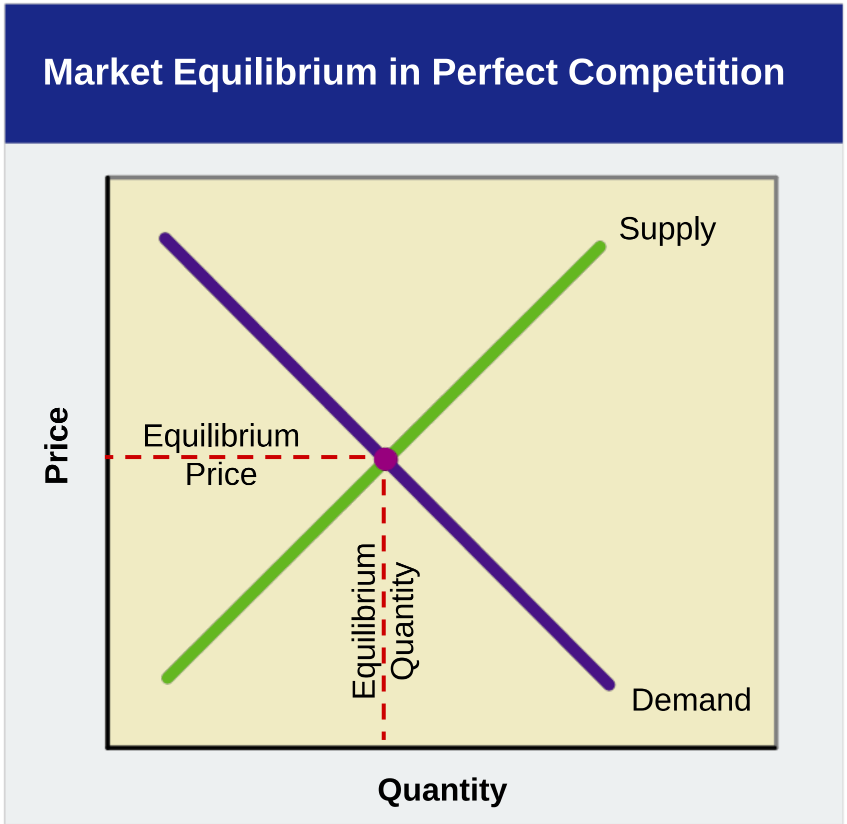
- **The expenses that a new business must pay before the first product reaches the customer are called start-up costs.**

Technology

- **Some markets require a high degree of technological know-how. As a result, new entrepreneurs cannot easily enter these markets.**

Price and Output

One of the primary characteristics of perfectly competitive markets is that they are efficient. In a perfectly competitive market, price and output reach their equilibrium levels.



Section 1 Assessment

1. Which of the following is NOT a condition for perfect competition?
   (a) many buyers and sellers participate
   (b) identical products are offered
   (c) market barriers are in place
   (d) buyers and sellers are well-informed about goods and services
2. How does a perfect market influence output?
   (a) Each firm adjusts its output so that it just covers all of its costs.
   (b) Each firm makes its output as large as possible even though some goods are not sold.
   (c) Different firms make different amounts of goods, but some make a profit and others do not.
   (d) Different firms each strive to make more goods to capture more of the market.

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Monopoly

- **How do economists define the word monopoly?**
- **How are monopolies formed?**
- **What is price discrimination?**
- **How do firms with monopoly set output?**

Defining Monopoly

- **A monopoly is a market dominated by a single seller.**
- **Monopolies form when barriers prevent firms from entering a market that has a single supplier.**
- **Monopolies can take advantage of their monopoly power and charge high prices.**

Forming a Monopoly

Different market conditions can create different types of monopolies.

1. **Economies of Scale**
   If a firm's start-up costs are high, and its average costs fall for each additional unit it produces, then it enjoys what economists call **economies of scale**. An industry that enjoys economies of scale can easily become a natural monopoly.
2. **Natural Monopolies**
   A **natural monopoly** is a market that runs most efficiently when one large firm provides all of the output.
3. **Technology and Change**
   Sometimes the development of a new technology can destroy a natural monopoly.

Government Monopolies

A government monopoly is a monopoly created by the government.

- Technological Monopolies
  - The government grants patents, licenses that give the inventor of a new product the exclusive right to sell it for a certain period of time.
- Franchises and Licenses
  - A franchise is a contract that gives a single firm the right to sell its goods within an exclusive market. A license is a government-issued right to operate a business.
- Industrial Organizations
  - In rare cases, such as sports leagues, the government allows companies in an industry to restrict the number of firms in the market.

Price Discrimination

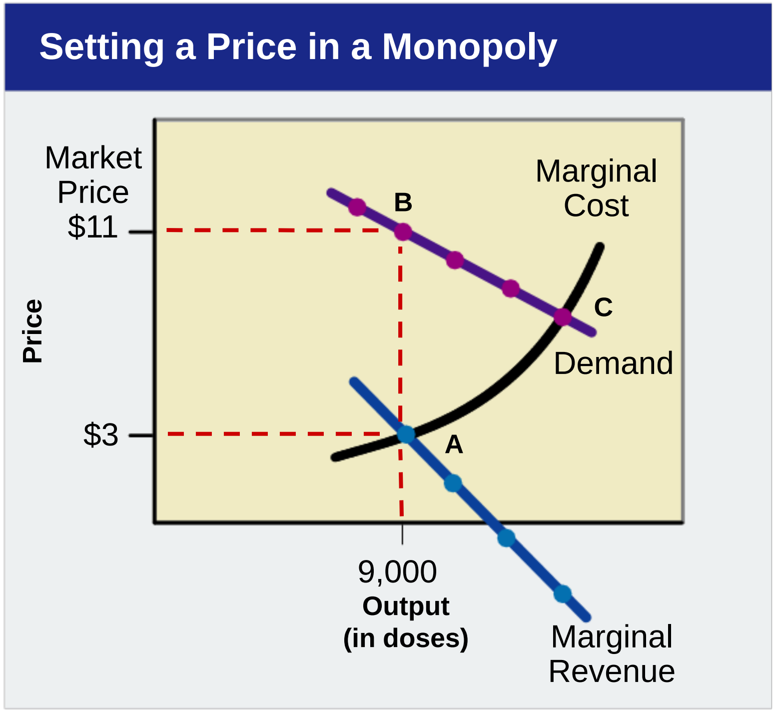
Price discrimination is the division of customers into groups based on how much they will pay for a good.

- Although price discrimination is a feature of monopoly, it can be practiced by any company with **market power**. Market power is the ability to control prices and total market output.
- Targeted discounts, like student discounts and manufacturers' rebate offers, are one form of price discrimination.
- Price discrimination requires some market power, distinct customer groups, and difficult resale.

Output Decisions

- **Even a monopolist faces a limited choice – it can choose to set either output or price, but not both.**
- **Monopolists will try to maximize profits; therefore, compared with a perfectly competitive market, the monopolist produces fewer goods at a higher price.**

A monopolist sets output at a point where marginal revenue is equal to marginal cost.



Section 2 Assessment

1. A monopoly is
   (a) a market dominated by a single seller.
   (b) a license that gives the inventor of a new product the exclusive right to sell it for a certain amount of time.
   (c) an industry that runs best when one firm produces all the output.
   (d) an industry where the government provides all the output.
2. Price discrimination is
   (a) a factor that causes a producer's average cost per unit to fall as output rises.
   (b) the right to sell a good or service within an exclusive market.
   (c) division of customers into groups based on how much they will pay for a good.
   (d) the ability of a company to change prices and output like a monopolist.

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Monopolistic Competition and Oligopoly

- How does monopolistic competition compare to a monopoly and to perfect competition?
- How can firms compete without lowering prices?
- How do firms in a monopolistically competitive market set output?
- What is an oligopoly?

Four Conditions of Monopolistic Competition

In monopolistic competition, many companies compete in an open market to sell products which are similar, but not identical.

1. **Many Firms**
   As a rule, monopolistically competitive markets are not marked by economies of scale or high start-up costs, allowing more firms.
2. **Few Artificial Barriers to Entry**
   Firms in a monopolistically competitive market do not face high barriers to entry.
3. **Slight Control over Price**
   Firms in a monopolistically competitive market have some freedom to raise prices because each firm's goods are a little different from everyone else's.
4. **Differentiated Products**
   Firms have some control over their selling price because they can differentiate, or distinguish, their goods from other products in the market.

Nonprice Competition

Nonprice competition is a way to attract customers through style, service, or location, but not a lower price.

1. Characteristics of Goods
The simplest way for a firm to distinguish its products is to offer a new size, color, shape, texture, or taste.

2. Location of Sale
A convenience store in the middle of the desert differentiates its product simply by selling it hundreds of miles away from the nearest competitor.

3. Service Level
Some sellers can charge higher prices because they offer customers a higher level of service.

4. Advertising Image
Firms also use advertising to create apparent differences between their own offerings and other products in the marketplace.

Prices, Profits, and Output

- Prices
  - Prices will be higher than they would be in perfect competition, because firms have a small amount of power to raise prices.
- Profits
  - While monopolistically competitive firms can earn profits in the short run, they have to work hard to keep their product distinct enough to stay ahead of their rivals.
- Costs and Variety
  - Monopolistically competitive firms cannot produce at the lowest average price due to the number of firms in the market. They do, however, offer a wide array of goods and services to consumers.

Oligopoly

Oligopoly describes a market dominated by a few large, profitable firms.

Collusion

- **Collusion** is an agreement among members of an oligopoly to set prices and production levels. **Price-fixing** is an agreement among firms to sell at the same or similar prices.

Cartels

- A **cartel** is an association by producers established to coordinate prices and production.

Comparison of Market Structures

- **Markets can be grouped into four basic structures: perfect competition, monopolistic competition, oligopoly, and monopoly**

Comparison of Market Structures

	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Number of firms	Many	Many	Two to four dominate	One
Variety of goods	None	Some	Some	None
Control over prices	None	Little	Some	Complete
Barriers to entry and exit	None	Low	High	Complete
Examples	Wheat, shares of stock	Jeans, books	Cars, movie studios	Public water

Section 3 Assessment

1. The differences between perfect competition and monopolistic competition arise because
   (a) in perfect competition the prices are set by the government.
   (b) in perfect competition the buyer is free to buy from any seller he or she chooses.
   (c) in monopolistic competition there are fewer sellers and more buyers.
   (d) in monopolistic competition competitive firms sell goods that are similar enough to be substituted for one another.
2. An oligopoly is
   (a) an agreement among firms to charge one price for the same good.
   (b) a formal organization of producers that agree to coordinate price and output.
   (c) a way to attract customers without lowering price.
   (d) a market structure in which a few large firms dominate a market.

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Regulation and Deregulation

- **How do firms use market power?**
- **What market practices does the government regulate or ban to protect competition?**
- **What is deregulation?**

Market Power

Market power is the ability of a company to control prices and output.

- Markets dominated by a few large firms tend to have higher prices and lower output than markets with many sellers.
- To control prices and output like a monopoly, firms sometimes use predatory pricing. **Predatory pricing** sets the market price below cost levels for the short term to drive out competitors.

Government and Competition

Government policies keep firms from controlling the prices and supply of important goods. Antitrust laws are laws that encourage competition in the marketplace.

1. Regulating Business Practices

The government has the power to regulate business practices if these practices give too much power to a company that already has few competitors.

2. Breaking Up Monopolies

The government has used anti-trust legislation to break up existing monopolies, such as the Standard Oil Trust and AT&T.

3. Blocking Mergers

A merger is a combination of two or more companies into a single firm. The government can block mergers that would decrease competition.

4. Preserving Incentives

In 1997, new guidelines were introduced for proposed mergers, giving companies an opportunity to show that their merging benefits consumers.

Deregulation

Deregulation is the removal of some government controls over a market.

- Deregulation is used to promote competition.
- Many new competitors enter a market that has been deregulated. This is followed by an economically healthy weeding out of some firms from that market, which can be hard on workers in the short term.

Section 4 Assessment

1. Antitrust laws allow the U.S. government to do all of the following EXCEPT
   (a) regulate business practices
   (b) stop firms from forming monopolies
   (c) prevent firms from selling new experimental products
   (d) break up existing monopolies
2. The purpose of both deregulation and antitrust laws is to
   (a) promote competition
   (b) promote government control
   (c) promote inefficient commerce
   (d) prevent monopolies

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