Section 3

# Monopolistic Competition and Oligopoly

**Objectives** You may wish to call students' attention to the objectives in the Section Preview. The objectives are reflected in the main headings of the section.

**Bellringer** Display the following terms: *bread*, *soft drinks*, *athletic shoes*. Have students list their favorite brands of each of these products. Explain that in this section they will learn that most of these items are produced by firms that are monopolistically competitive.

**Vocabulary Builder** Have students find the definition of each key term listed in the Section Preview in the margins. Then ask groups of three to four students to act out the terms *price war*, *price fixing*, and *cartel*.

## Lesson Plan

### Teaching the Main Concepts L3

**1. Focus** Point out to students that the monopolistic competition market structure is closest to the perfect competition market structure while the oligopoly is closest to the monopolistic market structure.

**2. Instruct** Discuss with students the characteristics of monopolistic competition and oligopoly. Ask them to think of examples of firms in these types of market structures.

**3. Close/Reteach** Refer students to the chart on p. 170 that summarizes the characteristics of market structures. Have them create another row that explains how each type of market structure affects consumers.

**Guided Reading and Review**
Unit 2 folder, p. 39 asks students to identify the main ideas of the section and to define or identify key terms.



Section 3

# Monopolistic Competition and Oligopoly

## Preview

### Objectives

**After studying this section you will be able to:**

1. **Describe** characteristics and give examples of monopolistic competition.
2. **Explain** how firms compete without lowering prices.
3. **Understand** how firms in a monopolistically competitive market set output.
4. **Describe** characteristics and give examples of oligopoly.

### Section Focus

Monopolistic competition is similar to perfect competition, except that companies sell slightly different goods. Oligopoly, which is closer to monopoly, describes a market with only a few large producers.

### Key Terms

**monopolistic competition**
**differentiation**
**nonprice competition**
**oligopoly**
**price war**
**collusion**
**price fixing**
**cartel**

**monopolistic competition** *a market structure in which many companies sell products that are similar but not identical*

So far, you have studied the two extremes of the range of market structures: perfect competition and monopoly. Very few markets fall into either of these categories. Instead, most fall into two additional categories that economists call monopolistic competition and oligopoly.

## Monopolistic Competition

In **monopolistic competition,** many companies compete in an open market to sell products that are similar but not identical. Each firm holds a monopoly over its own particular product. You can think of monopolistic competition as a modified version of perfect competition with minor differences in products.

The differences between perfect competition and monopolistic competition arise because monopolistically competitive firms sell goods that are similar enough to be substituted for one another but are not identical. Monopolistic competition does not involve identical commodities. An example of a monopolistically competitive market is the market for jeans. All jeans can be described as denim pants, but in the shops, buyers can choose from a variety of colors, brand names, styles, and sizes.

Unlike perfect competition, monopolistic competition is a fact of everyday life. You

▶ **The market for denim jeans is monopolistically competitive because jeans can vary by size, color, style, and designer.**

BUILDING KEY CONCEPTS

## Graphing the Main Idea

**Markets and Prices** To build understanding of the concepts of **markets and prices,** have students use a double web graphic organizer like the one below to record details about the elements of monopolistic competition and oligopoly. Remind students that a double web organizer can be used to compare and contrast information about two topics.

**Section Reading Support Transparencies** A template and the answers for this graphic organizer can be found in Chapter 7, Section 3 of the Section Reading Support Transparency System.

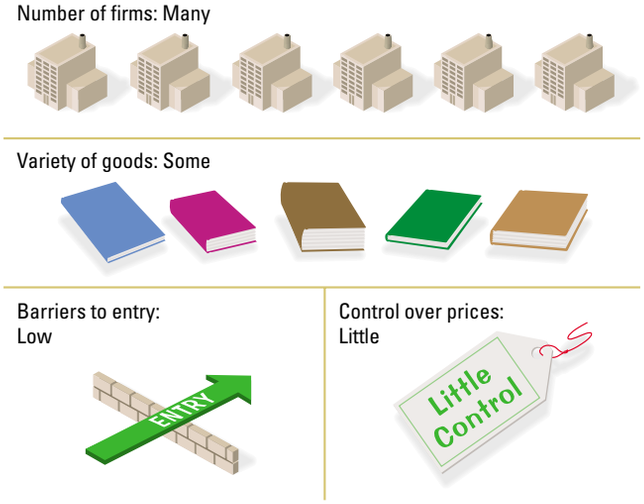
and your friends probably buy from monopolistically competitive firms several times a week. Common examples include bagel shops, ice cream stands, gas stations, and retail stores.

## Four Conditions of Monopolistic Competition

Monopolistic competition develops from four conditions. As you read about the types of markets that favor monopolistic competition, note how similar they are to the rules that define perfect competition.

1. *Many firms* As a rule, monopolistically competitive markets are not marked by economies of scale or high start-up costs. Because firms can start selling goods and earning money after a small initial investment, new firms spring up quickly to join the market.
2. *Few artificial barriers to entry* Firms in a monopolistically competitive market do not face the high barriers to entry discussed in Section 1. Patents do not protect anyone from competition, either because they have expired or because each firm sells a product that is distinct enough to fall outside the zone of patent protection. Just like a perfectly competitive market, a monopolistically competitive market includes so many competing firms that producers cannot work together to keep out new competitors.
3. *Slight control over price* Firms in a monopolistically competitive market structure have some freedom to raise or lower their prices because each firm's goods are a little different from everyone else's, and some people are willing to pay more for the difference. However, unlike a monopoly, a monopolistically competitive firm has only limited control over price. This is because consumers will substitute a rival's product if the price rises too high. For example, many customers will choose a can of brand-name cola over a generic cola even if it costs a quarter more per can. If the brand-name cola cost $5 more per can, however, most people would buy the cheaper cola or drink something else.
4. *Differentiated products* Firms have some control over their selling price because they can differentiate, or distinguish, their goods from the other products in the market. The main difference between perfect competition and monopolistic competition is that **differentiation** enables a monopolistically competitive seller to profit from the differences between his or her products and competitors' products.

*Figure 7.8* **Monopolistic Competition**




BUILDING KEY CONCEPTS

Many firms provide a variety of goods in a monopolistically competitive market.

**Competition** **Why do firms in monopolistic competition have some control over prices?**

## Nonprice Competition

Firms try not to compete on price alone. The alternative is **nonprice competition**, or competition through ways other than lower prices. Nonprice competition takes several different forms.

1. *Physical characteristics* The simplest way for a firm to distinguish its products is to offer a new size, color, shape,

**differentiation** *making a product different from other similar products*

**nonprice competition** *a way to attract customers through style, service, or location, but not a lower price*

## Econ 101: Key Concepts Made Easy

**Competition** Two of the key concepts in this section are **differentiation** and **nonprice competition.** The presence of differentiated products is a defining characteristic of a monopolistically competitive market. Differentiation results in nonprice competition, in which firms try to compete not through price alone but through other factors that set their products apart from the competitors' products.

Ask students to read the section titled "Nonprice Competition." Then have them look at magazine ads and television commercials to find examples of the various forms of nonprice competition. Have students share their examples with the class.

**Differentiated Instruction** L2

Work with students to help them change the section's main headings and subheadings into questions. Then organize the class into small groups. Assign each group one of the main headings. Ask group members to work together to answer the questions related to it. Have the groups share their answers. ELL

**Differentiated Instruction** L3

*(Reteaching)* Have students choose a product category (such as pain relievers, shampoos, or cosmetics) that is sold by monopolistically competitive firms. Ask students to create posters that use product pictures and text to explain elements of monopolistic competition (nonprice competition, the relationship between price and output, profit).

**Transparency Resource Package**
Economics Concepts, 7F: Monopolistic Competition

**Differentiated Instruction** L1

Explain that monopolistic competition includes many forms of nonprice competition, such as product differentiation, branding, and advertising. Ask students to name products that they would buy, even at a higher price because of one or more of these factors. SN

***Answer to . . .***

**Building Key Concepts** The firms have some control because each firm's goods are slightly different from the rest, and some people are willing to pay more for the difference.

**Differentiated Instruction** L4

Have students find examples of businesses in their community that are in monopolistic competition, such as restaurants, hardware stores, and so on. Ask students to examine local advertising and visit locations to find out what each business does to differentiate its product or service from that of the competition. Have students present their findings in oral reports to the class. GT

**Differentiated Instruction** L3

Have students choose a product they use that is manufactured by a variety of firms, such as a hair care product. Ask them to identify the reasons why they choose one brand over other available brands. Have students present their reasons in an advertisement for the product. Encourage them to evaluate whether the differences between the product they use and other, similar products are more a matter of perception than of reality.

texture, or taste. Running shoes, pens, cars, and toothpaste are good examples of products that can be easily differentiated by their physical characteristics. A pen is always a writing tool that uses ink, but many people will pay extra for a pen that looks or writes differently. Similarly, you can probably describe a "car" in only a few words, but factories around the world manufacture thousands of car models to fit a range of personalities, jobs, families, and incomes.

2. *Location* Real estate agents say that the three most important factors when buying property are "location, location, location." Some goods can be differentiated by *where* they are sold. Gas stations, movie theaters, and grocery stores succeed or fail based on their locations. A convenience store in the middle of a desert differentiates its product simply by selling it hundreds of miles away from the nearest competitor. Such a location allows the seller to charge a lot more for a quart of water.
3. *Service level* Some sellers can charge higher prices because they offer their customers a high level of service. Conventional restaurants and fast-food restaurants both offer meals to customers. However, conventional restaurants provide servers who bring the food to your table, whereas fast-food restaurants offer a more barebones, do-it-yourself atmosphere. Conventional restaurants and fast-food chains sell many of the same food items, but fast-food chains sell their meals for less. Customers at conventional restaurants pay more for the service and the relaxing atmosphere.
4. *Advertising, image, or status* Some firms use advertising to create apparent differences between their own offerings and other products in the marketplace. These product differences are often more a matter of perception than reality. For example, a designer can apply his or her name to a plain white T-shirt and charge a higher price, even if the quality of fabric and stitching is no different than what generic T-shirts offer. Customers who pay extra for a designer T-shirt do so because the image and status that go with the designer's name are worth the extra money to them.

## Price, Output, and Profits

When economists look at price, output, and profits under monopolistic competition, they find the market looks very much as it would under perfect competition.

### Prices

Prices under monopolistic competition will be higher than they would be in perfect competition, because firms have some power to raise prices. However, the number of firms and ease of entry prevent companies

▼ **A gas station built in the right location can charge more for gasoline.**

## Block Scheduling Strategies

Consider these suggestions to take advantage of extended class time:

- Extend the Vocabulary Builder activity by discussing the presentations. Then form small groups, and have each group write a story that uses at least three key terms. Ask a representative from each group to read the completed story aloud.
- Have students complete the Learning Styles activity on this page. Then ask students to identify the brand of a favorite food. Have them work with partners to set up blind taste tests. Have students compare their final choices with their stated preferences.

from raising prices as high as they would if they were a true monopoly. As you have read, if a monopolistically competitive firm raised prices too high, most customers would ignore any differences and buy the cheaper product. Because customers can choose among many substitute products, monopolistically competitive firms face more elastic demand curves than true monopolists do.

### Output

The law of demand says that output and price are negatively related. As one rises, the other falls. Because monopolistically competitive firms sell their products at higher prices than do perfectly competitive firms, but at lower prices than a monopoly, total output under monopolistic competition falls somewhere between that of monopoly and that of perfect competition.

### Profit

Like perfectly competitive firms, monopolistically competitive firms earn just enough to cover all of their costs, including salaries for the workers. If a monopolistically competitive firm started to earn profits well above its costs, two market trends would work to take those profits away.

First, fierce competition would encourage rivals to think of new ways to differentiate their products and lure customers back. If one company hires a basketball star to promote its soft drink, a rival might hire a popular singer, while another rival could invest in an advertising blitz on television. The rivalries among firms prevent any one firm from earning excessive profits for long.

Secondly, new firms will enter the market with slightly different products that cost a lot less than the market leaders. If the original good costs too much, consumers will switch to these substitutes. You've seen this happen when a brand-name line of clothing, video games, or stuffed animals becomes popular. Competitors quickly flood the market with cheap imitations for people who can't afford the original or don't know or care about the difference.

**Figure 7.9 Oligopoly**

In an oligopoly, a few large firms dominate a market. **Competition Why are high barriers to entry an important part of oligopoly?**

While monopolistically competitive firms can earn profits in the short run, they have to work hard to keep their product distinct to stay ahead of their rivals. Often, they don't succeed.

### Production Costs and Variety

Some economists note that firms in monopolistic competition may not be able to produce their goods at the lowest possible average cost. Monopolistically competitive markets have many firms, each producing too little output to minimize costs and use resources efficiently. On the other hand, consumers in these markets enjoy a wide variety of goods to choose from.

## Oligopoly

**Oligopoly** describes a market dominated by a few large, profitable firms. Oligopoly looks like an imperfect form of monopoly. Economists usually call an industry an oligopoly if the four largest firms produce at least 70 to 80 percent of the output.

**oligopoly** *a market structure in which a few large firms dominate a market*

**Differentiated Instruction** L3

To help students create a product on a contemporary economic issue or topic using critical methods of inquiry, have them choose one of the following industries: domestic automobiles, air travel, soft drinks, breakfast cereals, or household appliances. Ask students to research the industry and explain why it can be considered an oligopoly. Students should specify how characteristics of the industry reflect those of an oligopoly. Ask them to present their findings in an annotated poster.

**Differentiated Instruction** L3

**Time:** 90 minutes

**Activity:** Create an infomercial comparing monopolistic competition to monopoly, perfect competition, and oligopoly.

**Grouping:** Groups of four to six students

**Purpose:** To create an infomercial that can be used as a teaching tool for other students of economics. Students work together to create script with illustrations and graphics that would provide instruction about and comparisons of the market structures discussed in Chapter 7.

**Roles:** Illustrator, writer, narrator

**Outcome:** Students will understand the major characteristics of each of the market structures.

## Preparing for Standardized Tests

**Have students read the section titled "Price, Output, and Profits" and then answer the question below.**

Which of the following best describes prices in a monopolistically competitive market?

**A** Prices can be raised as high as in a true monopoly.

**B** Prices are higher when output increases.

**C** Prices are lower than in a perfectly competitive market.

**D** Prices are higher than in a perfectly competitive market.

***Answer to . . .***

**Building Key Concepts** If it were easy for firms to enter the market, more firms would enter, so an oligopoly would not exist.

## Background

### Economics in History

In 1993 the three major producers of baby formula paid $200 million to retailers and wholesalers of their products. The money was part of a settlement of lawsuits that had been brought against the three firms, claiming that they had conspired to fix prices.

**Learning Styles Activity**
Learning Styles Lesson Plans folder, p. 19 asks students to compare and contrast characteristics of three market structures—perfect competition, monopolistic competition, and oligopoly—using Venn diagrams.

**Transparency Resource Package**
Economics Concepts, 7G: Oligopoly
Economics Concepts, 7H: Comparison of Market Structures

Go Online PHSchool.com Typing in the Web Code when prompted will bring students directly to the article.

THE WALL STREET JOURNAL. CLASSROOM EDITION

For an additional article from *The Wall Street Journal Classroom Edition*, see the Source Articles folder in the **Teaching Resources**, pp. 21–23.

BUILDING KEY CONCEPTS

Markets can be grouped into four basic structures: perfect competition, monopolistic competition, oligopoly, and monopoly.
**Competition**
**How does a monopolistic competition differ from monopoly?**

*Figure 7.10* **Comparison of Market Structures**

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

Acting on their own or as a team, the biggest firms in an oligopoly may well set prices higher and output lower than in a perfectly competitive market. Examples of oligopolies in the United States include the markets for air travel, breakfast cereals, and household appliances.

### Barriers to Entry

An oligopoly can form when significant barriers to entry keep new companies from entering the market to compete with existing firms. Sometimes these barriers are created by a system of government licenses or patents.

In other cases, the economic realities of the market lead to an oligopoly. High start-up costs, such as expensive machinery or a large advertising campaign, can scare firms away from the market. Many small airlines have had trouble competing with larger, better-financed rivals because airplanes are very expensive to buy and maintain. The biggest airlines compound the problem because they often own the most desirable gates at the airport, and already enjoy name recognition and the trust of the consumer. As another example, the two big cola manufacturers have invested so much money in their brand names and sales networks over the last century that few companies think they can successfully challenge their grip on the market.

Some oligopolies occur because of economies of scale. As you have read, when a firm experiences economies of scale, the average cost of production decreases as output increases. In a monopoly market, only one company can produce enough goods to earn a profit. In an oligopoly, perhaps three or four companies can reach a profitable level of output before the market becomes too crowded and revenue falls below costs.

### Cooperation and Collusion

Oligopoly presents a big challenge to government, because oligopolistic firms often *seem* to work together to form a monopoly, even when they are not actually doing so. Many government regulations try to make oligopolistic firms act more like competitive firms. When determined oligopolists work together illegally to set prices and bar competing firms from the market, they can become as damaging to the consumer as a monopoly.

The three practices that concern government the most are price leadership, collusion, and cartels. While these three practices represent ways that firms in an oligopoly can try to control a market, they don't always work. Each tactic includes an incentive for firms to cheat and undo any benefits.

THE WALL STREET JOURNAL. CLASSROOM EDITION

*In the News* *Read more about oligopoly in "Bottom of the Food Chain," an article in* The Wall Street Journal Classroom Edition.

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## Interdisciplinary Connections: Geography

**The Organization of Petroleum Exporting Countries (OPEC)** A primary reason for the formation of OPEC was to increase the individual revenues of the member nations, thereby benefiting their economies. The oil reserves in these nations make up about three-fourths of the world's reserves, and oil from these countries makes up about 40 percent of the world's oil trade.

**Making the Connection** First have students locate the members of OPEC on a world map. Then ask them to research economic development in the OPEC countries. Have them find out to what extent oil revenue has affected those nations' economies and the reasons for these effects. Have students present their findings in oral reports.

***Answer to . . .***

**Building Key Concepts** Monopolistic competition consists of many firms, has a variety of goods, little control over prices, and low barriers to entry. A monopoly consists of one firm, no variety in goods, complete control over prices, and complete barriers.

Sometimes the market leader in an oligopoly can start a round of price increases and cuts by making its plans clear to other firms. Price leaders can set prices and output for entire industries as long as other member firms go along with the leader's policy. But disagreements among member firms can spark a **price war,** when competitors cut their prices very low to win business. A price war is harmful to producers but good for consumers.

**◀ A computer manufacturer can distinguish its computers with bright colors or a sleek design.**

**Collusion** refers to an agreement among members of an oligopoly to set prices and production levels. One outcome of collusion is called **price fixing,** an agreement among firms to sell at the same or very similar prices. Collusive agreements set prices and output at the levels that would be chosen by a monopolist. Collusion is illegal in the United States, but the lure of monopolistic profits can tempt businesses to make such agreements despite the illegality and risks.

Collusion is not, however, the only reason for identical pricing in oligopolistic industries. Such pricing may actually result from intense competition, especially if advertising is vigorous and new lines of products are being introduced.

## Cartels

Stronger than a collusive agreement, a **cartel** is an agreement by a formal organization of producers to coordinate prices and production. Although other countries and international organizations permit them, cartels are illegal in the United States. Cartels can only survive if every member keeps to its agreed output levels and no more. Otherwise, prices will fall, and firms will lose profits. However, each member has a strong incentive to cheat and produce more than its quota. If every cartel member cheats, too much product reaches the market, and prices fall. Cartels can also collapse if some producers are left out of the group and decide to lower their prices below the cartel's levels. Therefore, cartels usually do not last very long.

**price war** *a series of competitive price cuts that lowers the market price below the cost of production*

**collusion** *an agreement among firms to divide the market, set prices, or limit production*

**price fixing** *an agreement among firms to charge one price for the same good*

**cartel** *a formal organization of producers that agree to coordinate prices and production*

## Section 3 Assessment

**Progress Monitoring *Online***
**For:** Self-quiz with vocabulary practice
**Web Code:** mna-2076

### Key Terms and Main Ideas

1. What are the four conditions of **monopolistic competition?**
2. How do economists determine whether a market is an **oligopoly?**
3. Give three examples of **nonprice competition.**
4. How would **price fixing** and **collusion** help producers?

### Applying Economic Concepts

5. ***Using the Databank*** The map on page 545 indicates which countries are members of OPEC, a cartel made up of oil-exporting countries. In the 1970s, OPEC successfully raised oil prices by cutting production. Based on what you have read in this section, explain how this situation illustrates **(a)** how cartels operate **(b)** why cartels can be dangerous.
6. ***Decision Making*** Would you describe the following markets as monopolistic competition or oligopoly? **(a)** refrigerators **(b)** video game systems **(c)** gourmet ice cream **(d)** sunscreen **(e)** cable sports channels
7. ***Critical Thinking*** Which of the four forms of nonprice competition described on pp. 167–168 would you emphasize for the following products? Explain your reasoning. **(a)** a new brand of bottled water **(b)** in-home computer repair **(c)** protein bars

Go Online PHSchool.com
**For:** Research Activity
**Visit:** PHSchool.com
**Web Code:** mnd-2073

**Progress Monitoring *Online***
For additional assessment, have students access Progress Monitoring Online at **Web Code:** mna-2076

Go Online PHSchool.com Typing in the Web Code when prompted will bring students directly to detailed instructions for this activity.

**Guide to the Essentials**
Chapter 7, Section 3, p. 30 provides support for students who need additional review of the section content. Spanish support is available in the Spanish edition of the guide on p. 30.

**Quiz Unit 2 folder,** p. 40 includes questions to check students' understanding of Section 3 content.

**Presentation Pro CD-ROM**
Quiz provides multiple-choice questions to check students' understanding of Section 3 content.

## Answers to . . .

## Section 3 Assessment

1. many firms, few artificial barriers to entry, slight control over price, differentiated products
2. An industry is usually called an oligopoly if the four largest firms produce at least 70 to 80 percent of the market's output.
3. Students may mention any three of the following: physical characteristics; location; service level; advertising, image, or status.
4. Price fixing aids producers by inflating prices unnaturally. Collusion occurs when sellers group together, set higher prices for goods and services, and then earn greater revenues as a result.
5. (a) Cartels set prices and production levels for entire industries as long as other member firms go along with the leader's policy, in effect monopolizing the industry and accruing significant profit from the consumer. (b) Cartels can control the market and significantly raise prices, requiring consumers to pay unnecessarily high prices.
6. (a) monopolistic competition (b) oligopoly (c) monopolistic competition (d) monopolistic competition (e) oligopoly
7. (a) advertising, image, or status (b) service level (c) physical characteristics