# Monopolistic competition

*Detailed notes for Edexcel Economics A, unit 3.4.3: Monopolistic competition.*
*Written by Tom Furber, [tfurber.com/edexcel-economics](tfurber.com/edexcel-economics)*

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## Characteristics of monopolistically competitive markets

A monopolistically competitive market has the following properties:

- **A large number of small firms**.
  - Small firms may not be able to realise economies of scale.
  - However this means firms can avoid diseconomies of scale.
- **Low barriers to entry and exit**.
  - One possible consequence of low barriers to entry is that firms can enter over time to take a share of any supernormal profits in the market.
  - This could lead to firm entry and exit until **supernormal profits are zero** in the long run.
- **Products are similar but differentiated**. This is the key difference between perfect competition and monopolistic competition.
  - As a result of product differentiation, firms have some **price-making power** in their particular variety of the good.
  - This makes the demand curve for the firm's product downward-sloping.
- **Large number of substitutes**.
  - Because of this, demand (average revenue) is more **price-elastic** compared to a monopoly.
- **Firms invest in product differentiation (non-price competition).**

- This could include advertising or branding, quality differences, customer service, add-on services, loyalty bonuses and so on.
- Some argue this may mean an over-investment in advertising. Too much advertising could also overwhelm or mislead consumers. This could create an imperfect information market failure.
- However the increase in variety and quality may benefit consumers.

Examples of monopolistically competitive markets include hairdressers, coffee shops and restaurants. For more on the hairdressing industry, see the practice question near the end of this document.

**Please turn over for the section on diagrams for monopolistic competition.**

**Diagram for monopolistic competition (short run)**

In monopolistic competition Revenue curves are downward-sloping. As products are differentiated, firms are price makers for their own variety of the good. However because there are many substitutes, the revenue curves will be more price-elastic compared to monopoly revenue curves.

So in the short run, the diagram is similar to a monopoly. In the diagram below, the monopolistically competitive firm chooses the level of output where MR = MC in order to maximise profit. This is at output level q.

At output level q, the price is p and the average cost is c. Therefore the supernormal profit made is (p-c)q. In the short run in monopolistic competition, supernormal profits are possible.

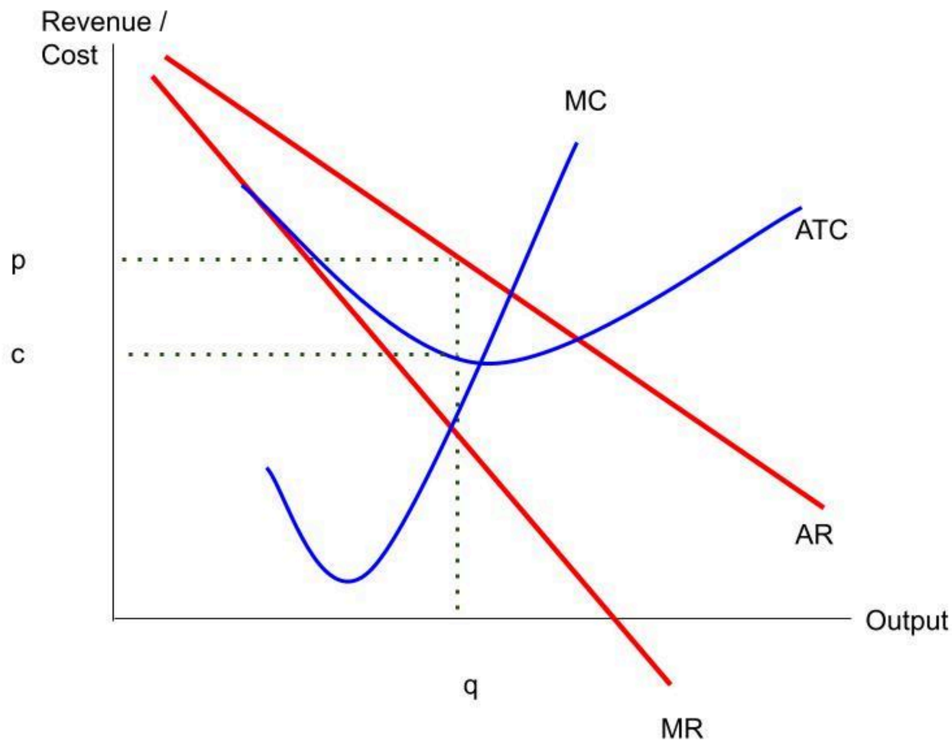
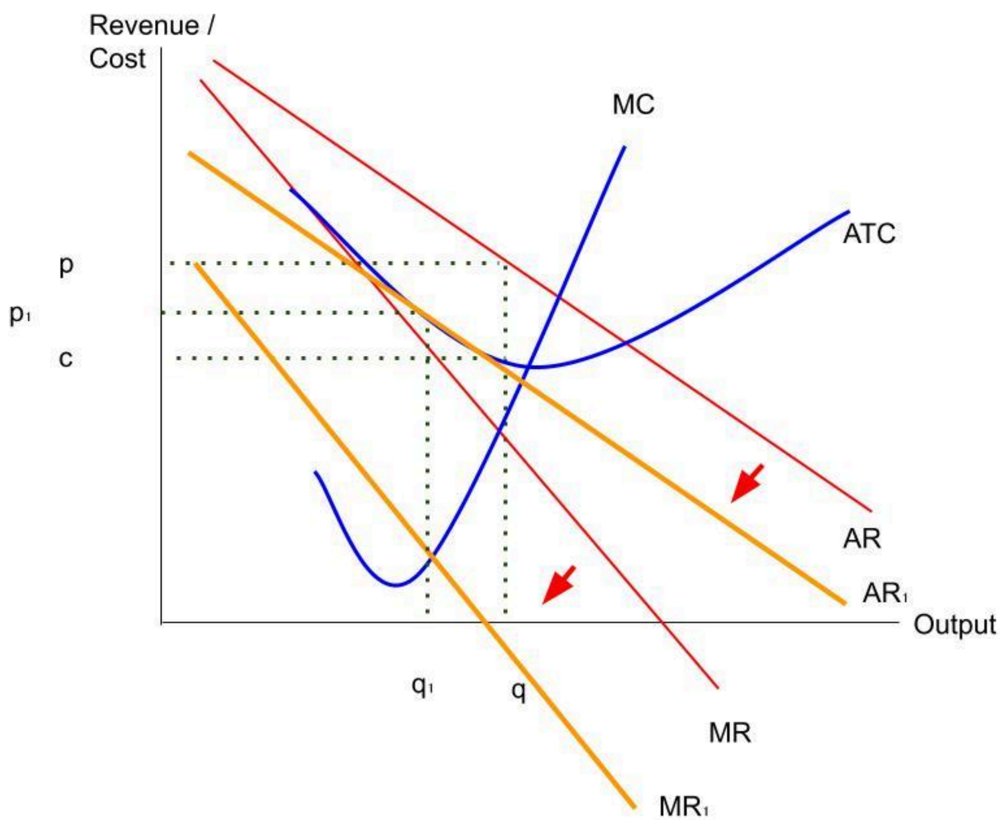


**Diagram for monopolistic competition (long run)**

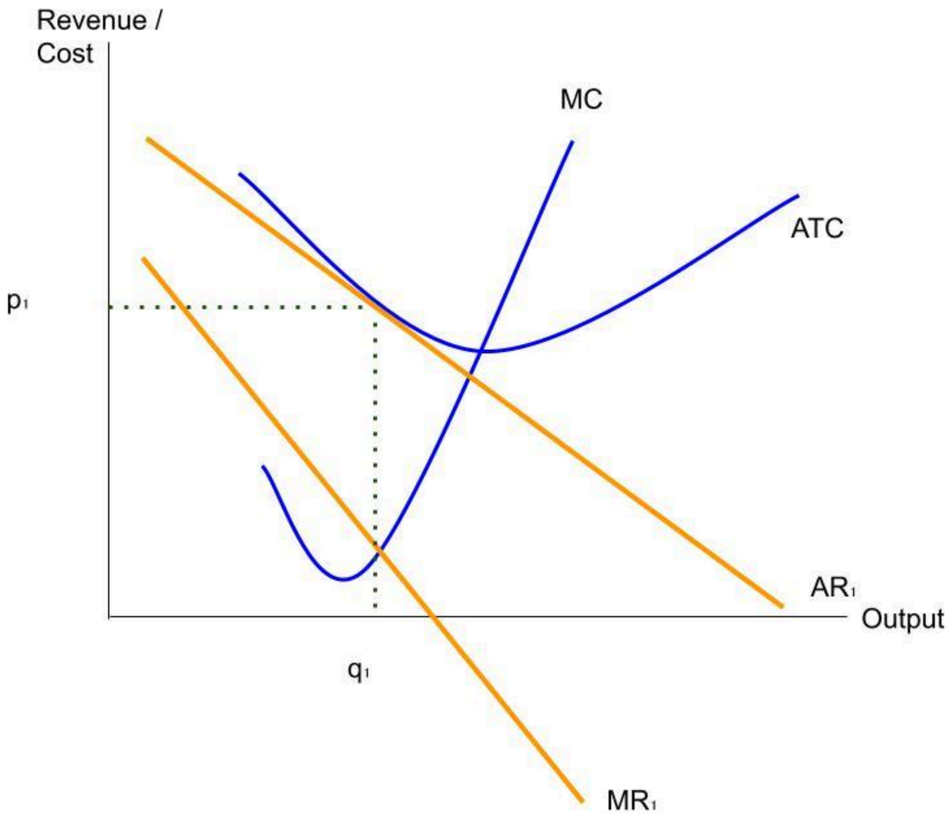
Low barriers to entry means firms can enter the market in the long run. Observing supernormal profits in the short run, firms may enter to grab a slice of these profits.

This reduces the market share of each firm, reducing the individual demand that the firm faces. This means in the long run, AR and MR shift left until there is zero supernormal profit.




Monopolistic competition diagram: transition from short run to the long run

This means that in the long run, AR=ATC (zero supernormal profit).




Monopolistic competition long run: final position – zero supernormal profits, so AR=ATC.

Note when drawing the long run diagram, MR=MC at the same output level where AR=ATC. Make sure you get this right when drawing – I recommend drawing the cost curves first, then each revenue curve.

**Are monopolistically competitive firms efficient?**

(Links with theme 3.4.1 on efficiencies)

- **Allocative inefficiency**
    - In monopolistic competition, generally average revenue is not equal to marginal cost. So there is allocative inefficiency.
    - Monopolistically competitive firms have some price making power, as shown by their downward sloping AR / demand curve.
    - This incentivises firms to cut back output, below the allocatively efficient level, in order to raise the price and profits.
- **Productive inefficiency**
    - Monopolistically competitive firms are generally not producing at the minimum point of their average cost curve (see the diagrams above).
- **Dynamic inefficiency in the long run**
    - In the long run supernormal profits are eliminated through firm entry.
    - This leaves firms without supernormal profits to reinvest into lowering the cost of production or improving product quality.
    - However in the short run, firms can achieve supernormal profits. So we could argue that there is dynamic efficiency in the short run in monopolistic competition.

A key advantage of monopolistic competition is consumers are offered a larger variety of products.

Moreover, although firms are not allocatively nor productively efficient, there is some pressure to reduce costs and prices due to the large number of substitutes. As a result, firms can only make normal profit in the long run.

**Further evaluation points for monopolistic competition**

When asking whether an industry is monopolistically competitive, consider whether the characteristics of monopolistic competition apply to that particular industry. For example:

- **The extent of barriers to entry.**
    - If there is a lot of advertising in an industry, this may itself be a barrier to entry. New entrants would have to spend a lot on advertising to attract consumers from better established brand names.
    - More generally, barriers to entry are more likely to exist in real markets such as brand loyalty or economies of scale.
    - As a result, some markets may no longer be monopolistically competitive. It may be possible to make supernormal profits in the long run if there are barriers to entry.
- **There may be some large firms.**
    - Some large firms do emerge in markets traditionally considered to be "monopolistically competitive".
    - For example, in the restaurant industry, McDonald's and Nando's examples of large chains in the UK.
    - This could be because of the existence of economies of scale and brand loyalty (as well as other barriers to entry). This leads to the minimum efficient scale at a high level of output, disincentivising firm entry and leading to the growth of incumbent firms.
- You could also consider the level of supernormal profits in the industry or the number of substitutes.

When evaluating whether monopolistically competitive markets are desirable or even efficient, consider these additional evaluation points:

- **Short run versus long run.**
    - In the short run supernormal profits are possible.
    - This allows firms to reinvest the profits e.g. in R&D.
    - We could even say a monopolistically competitive firm can be dynamically efficient in the short run.

- **Firms are closer to allocative efficiency in monopolistic competition than monopoly.**
    - We previously argued that in monopolistic competition, firms are allocatively inefficient.
    - Yet the only market structure which achieves allocative efficiency consistently is perfect competition. Perfect competition may be an unrealistic market structure even as a benchmark.
    - Instead, suppose we compare monopolistic competition with monopoly.
    - In monopolistic competition, there is a high number of substitutes in monopolistic competition and firms have limited price-making power.
    - So firms cannot raise their prices too far above the allocatively efficient price. Consumers are more willing to switch away to other substitutes.
    - Therefore the outcomes in monopolistic competition may be closer to allocative efficiency than in a monopoly.
- **The benefits from variety may outweigh the traditional inefficiencies.**
    - While monopolistic competition exhibits productive inefficiency, it also enables consumers to enjoy a greater variety of products.
    - Consumers may be willing to pay a little more in exchange for access to a greater variety of goods.
- **The importance of information**
    - In monopolistic competition firms only make normal profit in the long run. As well as assuming low barriers to entry and exit, this also requires that firms have perfect information.
    - For instance, potential entrants need to know the production process of incumbent firms (firms already in the market). This is so new entrants can perfectly copy a production process, so they cannot be outcompeted on cost.
    - However, firms may not have this information in practice.
    - This may occur particularly where there are many different varieties of the good being produced, with each having its own production process.
    - Consumers may also not be aware of which variety of the product is cheapest, which may allow supernormal profits to remain over time.
- **What is the socially optimal level of advertising?**
    - We previously mentioned that there may be “too much” advertising in monopolistic competition.
    - However it is difficult to assess the “socially optimal” level of advertising.
    - Indeed some level of advertising can be informative to consumers, helping them to decide which variety of the good to consume.

**Practice question on monopolistic competition**

Below is a practice question written in the style of Edexcel Economics A.

There is a short extract followed by the practice question.

***Extract A: Hairdressing in the UK***

*There are 46,000 hair and beauty businesses in the UK in 2021. Hairdressing contributes up to £6.6 billion to the UK economy per year.*

*Hairdressers sell similar services. Yet the services may be differentiated e.g. depending on the quality of the haircut, the interior or comfort in the salon or upsells such as a particular shampoo or hair product. The UK hairdressing industry has a mix of independent stores, as well as chains such as Toni and Guy.*

*Should hairdressers need a licence to cut customers' hair? The British Barbers Association states this would improve quality of service. This would also increase barriers to entry.*

**Question:** Evaluate the view that hairdressing is a monopolistically competitive market. Refer to Extract A in your answer. (15 marks)

**Related resources for Edexcel Economics A**

Edexcel Economics A notes, model answers and practice questions:
https://tfurber.com/edexcel-economics

Edexcel Economics A Theme 3 notes, model answers and practice questions:
https://tfurber.com/theme-3-edexcel-economics/

Related topics:

- Costs.
- Revenues.
- Business objectives.