1. Details of Module and its structure

Module Detail	
Subject Name	Economics
Course Name	Economics 03 (Class XII, Semester - 1)
Module Name/Title	Monopolistic Competition: Part – 1
Module Id	leec_10601
Pre-requisites	Knowledge about Producer Behaviour
Objectives	After going through this lesson, the learners will be able to understand the following: 1. Meaning of Monopolistic Competition, 2. Why firms advertise, promote, build brands 3. Non-price Competition
Keywords	Product Differentiation, Selling Costs, Advertisement, Monopolistic Market

2. Development Team

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1. Introduction

While trying to learn about newer forms of market structures it is worthwhile to recall our understanding of Perfect Competition and Monopoly. Both these market structures are a rarity, barely observed in the real world. Such simplification however, helps one to theorize about market structures which are more realistic, and resemble our everyday observations. Under perfect competition, firms have no control over market prices: they are price takers. Under Monopoly, the firm has complete control over prices.

In reality however, we often find firms exercising *some* control over prices of their products. Unlike perfect competition, this control over price is not entirely absent and unlike monopoly, the control over price is not perfect too.

Why do we observe this difference in the ability to influence market prices? Under perfect competition, firms sell homogeneous products which are perfect substitutes of each other. If one firm raises prices, consumers will shift completely to some other firm selling the same good at the original (lower) price. In monopoly, there is a single firm selling a product that has no close substitutes and there is very weak threat of entry of other firms.

Similarly, you will notice that the Monopolist sets prices and corresponding quantities, given they are the single seller of a commodity and the product has no substitute. It should become clear that availability of substitutes affects the degree of control that firms have over their product's price. Now remember your visit to your nearby grocery shop or the superstore. You would have come across different varieties of a particular product sold, e. g: rice, toothpastes, fruit juices, cheese etc that are sold under various brand names.

Source: https://goo.gl/CqDYgX

You must understand here that these different varieties of one product sold, reduces an individual seller's command over its price because one brand of fruit juice is a good substitute for another brand of fruit juice and so on.

Source: https://goo.gl/FvMA5s

Given there are many brands of fruit juice sold in the market, an individual seller of a particular brand can't set prices which are very different from its competitors. At the same time, he can exercise *some* control over its product price given that his brand of fruit juice is unique in some ways and hence, it does not have a perfect substitute.

So while **Substitutability of products** restricts seller's ability to command prices, at the same time product differentiation gives the seller *some* ability to influence prices because no two

brands of fruit juices are exactly the same. Clearly, this is a market structure which draws from both Perfect Competition and Pure Monopoly and this is why such a market structure is referred to as Monopolistic Competition, as it has elements of both Monopoly and Perfect Competition.

2. Features of Monopolistic Competition

Let us explore the features of Monopolistic Competition.

1. Product Differentiation: The products sold in the market are differentiated within a category. It refers to the variety of goods sold within a product category.

Source: https://goo.gl/xiEuEd

For example, within toothbrushes, one observes variety of brands for sale. Some offer coloured bristles as opposed to transparent bristles; some offer criss-cross bristles as opposed to straight bristles. Each brand or variety differs from the other in packaging, appearance, taste or some aspect. Since these products are within a broad product category, for instance in our example, we had different brands with different features but all of them were toothbrushes, they are often substitutes for one another.

Product Differentiation can be "Real" or "Fancied". The former refers to actual difference in the two goods while later refers to consumer's perception that products are varied and distinct. Look at various brands of cooking oils sold in your nearby grocery store. There might be products with

actual differences arising out of inputs, chemical content of the product while there might be products differentiated simply because the consumer has a perception of the same. Consumers prefer one brand over other brands of the same product. So other brands are close substitutes for consumers but not perfect substitutes. This brings in the concept of brand loyalty. If the price of a product increases, consumers may choose not shift to the substitute completely, because they prefer this product and do not consider any other product a perfect substitute. Thus, product differentiation, whether real or fancied, gives the producer the ability to command prices for his product given his product is distinct to the consumer with no perfect substitutes.

2. Large number of Sellers and Buyers of a Particular Product Category: There are large number of buyers and sellers for a product category. Each firm competes with other firms to attract consumers and with a large number of firms, each ends up with a small share in the market of that product category. Firms compete among themselves through a mix of price setting and product differentiation to lure the consumers. With this pull of competition, In the long run the monopolistic market reaches its equilibrium with optimal number of firms such that a firm earns only normal profits.

3. Free entry of new firms and exit of existing firms: There are no barriers to entry or exit, As a result, if the existing firms earn positive economic profits, new firms are attracted to enter into the market and market supply goes up. Hence, market price of product comes down and makes it unprofitable for some firms to operate. They exit from the market. Eventually existing firms earn normal profits. On the other hand, if due to some reason, the existing firms make losses, then some of the firms would leave the market. As a result of this exit, industry's output falls and price rises. This continues till remaining firms in the industry are once again able to earn just the normal profit in the *long* run. It may me mentioned here that the freedom of entry of new firms is to be seen only in a restricted sense that while the new firms may enter and manufacture the product, they cannot produce the product by the existing brand names.

4. Selling Cost: The notion of 'Selling Costs' is unique to monopolistic market structures.

Selling Costs actually refers to those expenditures made by firms to effectively raise its product's demand. It typically involves expenditures on marketing, sales promotion, publicity and advertisements. Selling Costs can be fixed or variable.

When Selling Costs are fixed : When Selling Costs are fixed and determined in advance by the firm as a lump sum expenditure, independent of the volume of output,, then as the firm increases its output, the average selling cost declines and the curve looks like a rectangular hyperbola.

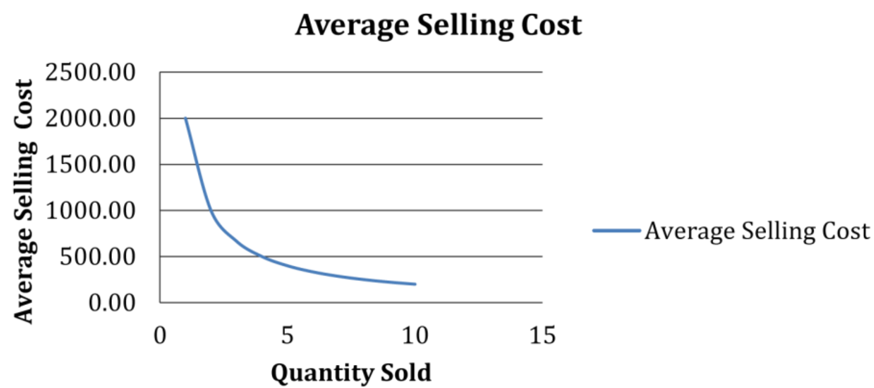

Figure 1

In this graph, you can notice that as the quantity sold increases for a fixed amount of selling cost, the average selling costs decline and behaves like a rectangular hyperbola.

When Selling Costs are variable: The shape of the Average Selling Cost curve is like other Average Cost Curves, resembling the U shape.

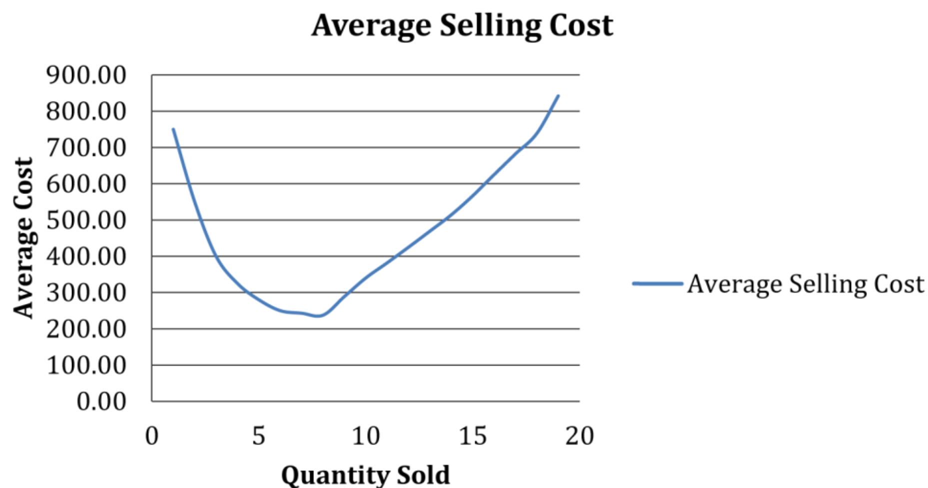

Figure 2

Average selling cost curve declines initially because an initial expenditure by firms towards selling costs raises more than proportionately the amount of output sold. Eventually, to sell additional amount of output the firm needs to incur more expenditure on selling costs. Ultimately the Average Selling Cost (ASC) curve could become vertical as increasing the expenditure on selling costs will not increase sales of the firm any more.

5. Nature of Demand Curve: Recall that each firm has a unique product for sale in the market and hence each firm faces a downward sloping demand curve for its product. The demand curve for a monopolistic firm is less elastic than the demand curve faced by a firm selling in a perfectly competitive environment. It is more elastic than the demand curve for a monopoly firm. This is so because for a monopolistic firm's products, there are substitutes unlike a monopoly, but not as many sellers as in a perfectly competitive market.

6. Non-Price Competition: Firms in a monopolistic competition do not compete with other firms only over prices. They also indulge in other forms of competition. For example, they incur expenditure on selling costs such as advertisement, branding, and sales tactics, in order to attract more consumers. They may offer better quality or more quantity for the same price. Selling Costs are a special feature of Monopolistic Competition. This is because various brands of a product type are broadly substitutable and every firm fears the loss of its customers.

In a perfectly competitive set up a firm can sell as much as it wants at the market price, so there is no point in spending money to attract customers, while in a Monopoly, such expenditures are minimal for the firm doesn't face any threat of competition.

The above features of Monopolistic competition unravel its similarities and differences with Markets having perfect Competition and Monopoly.

Summary

Monopolistic competition is an intermediate form of market between the Monopoly and Perfect Competition. Monopolistic Competition represents a market situation, in which there are Many sellers of a particular product type, but the product of each seller is in some way differentiated

from the product of every other seller. Product Differentiation gives monopoly-like power to firms to charge higher prices but these products being substitutable also reduces firms' control over the price.. It's for this reason that Monopolistic Competition is said to be a blend of Perfectly Competitive set up and Monopoly. Firms compete with each other through non-price discriminatory measures like advertisements, sales tactics, etc. Eventually In the long run, the existing firms earn normal profits.