

Lecture 7: Market Structure

I. Perfect Competition

1. A "perfectly competitive" market has the following characteristics:
 - * each business sells the exact same product
 - * each business is relatively small and can't affect the price of the product
 - * each business is a "price taker", meaning the price is set in the "big" market of all the businesses interacting with demand
 - * new businesses can easily enter and existing businesses can easily exit the market
 - * each business generally makes only "normal" profits - "above normal" or "below normal" profits can only be earned for a short period of time
2. Easy entry and exit keep profits "normal": if profits are higher than normal, new businesses enter the market, supply is increased, and price falls, restoring normal profits. If profits are lower than normal, some existing businesses leave the market, supply is decreased, and the price rises, restoring normal profits.
3. If there are any differences in price, they will reflect cost differences (e.g., extra cost of dry- cleaning women's blouses by hand vs. by machine for men's shirts).
4. Individual business in perfect competition will take product price as "given" and then determine output that will maximize profits. Will produce more the higher the price.
5. In perfect competition, business people are constantly trying to "find an edge" - to make the product cheaper. If they can, they will be able to earn "above normal" profits for at least a short period of time, until others copy.
6. Policy Impact: If businesses in the market are temporarily making above-normal profits, they will be motivated to try to get laws passed to keep out new businesses from entering the market.

II. Monopolistic Competition

1. Businesses in a perfectly competitive market will try to "tweak" their product so it is perceived by consumers as not being interchangeable with similar products.

Examples: Fast-food restaurants don't just sell hamburgers, but sell burgers with "special sauce", or "flame broiled" burgers, or burgers with beef bought from the "high plains". Auto manufacturers don't just make cars, but make cars having different images and features. Mr. Pizza emphasizes that his sauce is made "from scratch" and his cheese and meat are fresh, not processed.

Some of this "tweaking" may be real; some may be contrived - it's up to the consumer to judge

One "real" feature is location - businesses at the "best" locations know these sites can't be copied

Advertising and brand loyalty are used to cement these differences.

2. The point is, if a businesses can create "uniqueness" for its product, then the business will be able to set its own price ("price setter"), and this price will be higher than the comparable price in a perfectly competitive market. Also, any above-normal profits won't be eaten away by new businesses producing the same product - because no one sells exactly the "same" product.
3. All firms in perfectly competitive markets strive to move away from that market into monopolistic competition, where they hope to make permanently above-normal profits.
4. But monopolistic competitive businesses walk a fine line. They constantly must determine if the higher price they can charge (compared to a perfectly competitive business) can be sustained by the unique features of the product - or will consumers refuse to pay and go for the lower priced alternative (are pizza customers willing to continue to pay for Mr. Pizza's fresh ingredients?)
5. Monopolistic competitive businesses will try to find the combination of price and output that will maximize their profits. But must worry about price elasticity of demand - that is, when increase price, lose customers.

III. Monopoly

- a. a single seller with total control over price setting
- b. price will be higher than in perfect competition, but monopoly must still worry about elasticity of demand curve.
- c. makes permanent above-average profits
- d. how to get to be a monopoly?
 - exclusive control over a resource
 - constantly declining marginal cost as output increases - means only the largest company will survive (power plants) - called "natural" monopoly
 - government granted monopoly (local cable TV, patents for inventions)
- e. monopolies usually don't last - there's a strong incentive for substitutes to be developed (satellite as a substitute to local cable)
- f. "natural" monopolies will be regulated by the government
- g. like monopolistic competition, try to find combination of price and output that will maximize profit

IV. Oligopoly

- a. a relatively small number of businesses in the industry
- b. collusive oligopoly: the businesses get together (collude) to collectively agree on price and output that will maximize their collective profits; then must decide on a way to distribute the profits; examples: OPEC, professional sports leagues
- c. collusive oligopolies are illegal in the US, except in the case of professional sports leagues
- d. problem with collusive oligopolies - incentive for member businesses to "cheat" - produce more than their allocated output to make more profit - if this happens, price will fall and agreement will come apart

V. Market Segmentation

- a. practiced by monopolists, oligopolists, and monopolistic competitors
- b. also called price discrimination
- c. means selling the same product to different buyer groups at different prices
- d. motivation: increase profit
- e. rule: higher price is sold to buyer groups with inelastic demand; lower price is sold to buyer groups with elastic demand
- f. numerous examples
 - airlines: leisure vs. business travelers
 - resorts: peak season vs. off-peak season
 - senior citizen discounts
 - bulk buying