Chapter 11: Monopolistic Competition and Oligopoly

Now that we have explored the market structures at the extremes of market power—pure competition and monopoly—it is time to examine the market structures in which the vast majority of industries operate. Monopolistic competition is very similar to pure competition, except that the products are differentiated, affording the firm a small amount of market power. The oligopoly is very similar to the monopoly, though the firm does have a few competitors and the rivalry among those firms leads to interdependent relationships. Chapter 11 introduces these two models and explains the output and pricing decisions of firms in these industries.

The monopolistically competitive firm heavily advertises the differences in its product, hoping to build a brand loyalty that will allow the firm a little market power to raise the price of the product. The monopolistic competition model looks like the monopoly model, except that demand is more elastic and the marginal revenue curve is flatter (due to competition), and the average total cost curve is tangential to the demand curve at the point where price is set (representing zero economic profit in the long run). Prices are slightly higher and output slightly lower than pure competition, but the firm earns no long-run economic profit because of the easy entry of competitors. Firms do not achieve allocative or productive efficiency, resulting in excess capacity because the firms are producing less than optimal output.

An oligopoly occurs when a few firms dominate the industry, whether the products are homogeneous or differentiated. Significant barriers to entry prevent much competition, and the model looks like the monopoly model. Mutual interdependence among firms is unique to oligopolies, as firms' profits are directly tied to the actions of their rivals. An understanding of game theory is important, as multiple-choice and free-response questions have specifically tested this concept. Collusion is common among oligopolies, though such agreements are generally unstable due to each firm's incentive to cheat in order to increase profit. Because collusion is illegal in the United States, price leadership is the more common way American firms engage in oligopolistic behavior. Like the other forms of imperfect competition, oligopolies produce lower output at higher prices and do not achieve allocative or productive efficiency.

Material from Chapter 11 consistently appears on the AP Microeconomics Exam in a few multiple-choice questions and, in recent years, in free-response questions. It is very important to be able to illustrate the output and pricing decisions of firms in the market, as well as deadweight loss and excess capacity. It is also important to be able to determine the profit-maximizing strategies of oligopolistic firms using game theory. Though these two market structures are the dominant forms of industry, the AP exam focuses more questions on pure competition and monopolies.