

Study Guide: Market Structures

Directions: In this reading, you will be introduced to the four major broad types of market structures in a market economy: perfect competition, monopolistic competition, oligopoly, and monopoly.

Perfect competition is a market structure made up of many small firms with full market information. They also have equal access to the same production technology, and each one is selling identical products to many buyers. In perfect competition, no seller is large enough to set the price of a product. Also, the behavior of individual buyers and sellers doesn't have a significant effect on the market price. If it sounds a little too perfect, you're right! Perfect competition rarely happens. It's considered an ideal.

Some markets do come close to it, however. One current example would be a large farmers' market where numerous local producers (truck farmers) come to sell their produce and numerous consumers come to buy it.

Imagine a busy Saturday with lots of local farmers trying to sell their fruits and veggies to a large crowd of shoppers. Each vendor's table would be stocked with nearly identical items (it's difficult to distinguish one ripe red tomato from another two stalls over). Farmers choose to grow crops that they believe will bring the highest profit. So they might grow sweet peppers one season and carrots the next, responding to market demand. Sellers and buyers all act independently and the interaction of supply and demand determines the price equilibrium. Finally, since all sellers post their prices for everyone to see, buyers and sellers all work with enough pricing information for consumers to make the best and most efficient purchasing decisions, and for sellers to make efficient decisions as to what to bring to the market next time and what to plant and harvest in the next growing season.

To sum up, a **perfect (or close-to-perfect) market generally displays** all the following characteristics:

- Large number of buyers and sellers
- Identical or nearly identical products
- All buyers and sellers acting independently
- Perfect and equal (or nearly perfect and equal) information on prices and products
- Easy entry into and exit from the industry
- The seller does not set the price. No matter what an individual seller's cost of production, the market determines the price (the seller and the consumer are therefore called *price takers* since neither party can decide the price alone).

Monopolistic competition is a very common market structure today. It shares many characteristics with perfect competition. The difference is that the products sold by competing suppliers are not identical. Two things make monopolistic competition different from perfect competition: product differentiation and competition that is not wholly based on price (and where competitors try to gain or protect market share by other means).

Product differentiation boils down to attempts by companies to make products stand out even when they are nearly identical to the competition. Non-price competition simply means competition through ways other than price. For example, one way would be discounted tickets for amusement parks that

can only be redeemed by submitting specially marked cans of soda. The toothpaste market is a good example of monopolistic competition. While Crest and Colgate do taste a little different, the distinction seen by consumers reflects the companies' efforts to differentiate their products through branding and marketing. That's why companies pay huge sums for television ads. In the end, these non-price competitive practices do give the brands some pricing power. However, it is limited. If one player in the market attempts to push the price up beyond a certain point, consumers will respond to the price difference by switching to a competitor.

To recap, a **monopolistic competitive market generally displays** all of the following characteristics:

- There are large numbers of buyers and sellers.
- Differentiated products are present.
- All buyers and sellers act independently.
- Information on prices and products is extensive and equal for all consumers.
- There are low or no barriers to entry.
- There is non-price competition (advertising, promotions, cross-marketing, etc.).
- Marketing, product differentiation, and other techniques of non-price competition enable suppliers to influence the market price of their product, but only over a limited range.

An **oligopoly** is a market structure where a small number of companies own or control the production of a specific good or service. It is less common than monopolistic competition, but it is a substantial part of all modern economies. Unlike the two market structures already discussed, oligopolies have a limited number of sellers but many buyers. A very high cost of entry is usually why there are so few sellers. But other barriers to entry can be significant too. To enter the market, new companies must spend a great deal of money before they can begin to compete effectively.

In oligopolies, there is interdependent behavior among the competing firms. In the fast-food industry, for example, you'll notice that once one company introduces a value menu, most of the competitors will follow. This interdependence cuts both ways for the consumer. Just as all the companies in the industry will follow their competitors' prices down, they will also follow them up. The problem is that consumers do not know if prices went up because of additional costs or because of collusion (a formal or informal agreement to cooperate in product pricing). Generally, consumers pay more in oligopolistic markets than in other, more competitive, market structures.

Some examples of oligopolies include oil (Shell, ExxonMobil, BP), soft drinks (Coca-Cola, Pepsi), airlines (United, Southwest, American Airlines), and computer operating systems (Microsoft, Apple).

To recap, an **oligopoly generally displays** all of the following characteristics:

- Few sellers (when four firms own more than 40% of the market)
- Differentiated products that are functionally identical or very similar
- High barriers to entry
- Parallel pricing structures (a pattern of behavior of setting prices to match those of competitors)
- Non-price competition (advertising, promotions, cross-marketing, etc.)
- Tendency toward price fixing and collusion
- Pricing is generally higher than that found in perfect or monopolistic competition

Monopolies are rare (as is perfect competition). Governments in most well-developed market

economies have adopted laws against them. A monopoly happens when a single producer dominates a market. In that case, it has substantial market power. Market power is the ability of a company to alter the market price of a good or service.

This market structure gives the producers a great deal of power over price. This is true because there is typically little opportunity for new businesses to enter the market or because the cost of joining the industry is too high. Since there is only one producer, consumers typically see little or no product differentiation and experience limited choices.

Even though monopolies are generally frowned upon in the United States, there are cases in which they are either welcomed or unavoidable. For example, the provision of water to a city is what is called a **natural monopoly**. This is a situation in which extreme economies of scale exist (the average cost of goods decreases dramatically the larger a firm becomes). Once a water system is in place, it costs relatively little to connect one additional house or apartment. By contrast, building a second competing water system would be cost prohibitive. Therefore, the government allows these types of monopolies but imposes service obligations (water must be available to everybody) and often regulates the price charged. When prices are regulated, the regulator must also allow the company to make a return on its investment that is sufficient to ensure continued investment in the water system.

To recap, a **monopoly generally displays** all of the following characteristics:

- One seller dominates
- No product differentiation
- Extremely high barriers to market entry
- Price maker (the monopolist's own actions affect the price of its goods or services)