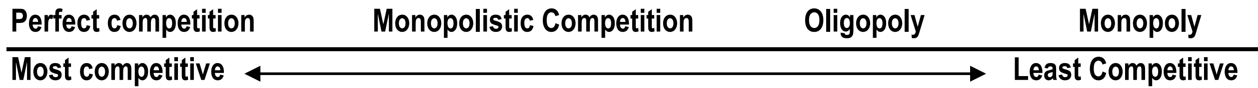
Market Structures

The classification of market structures can be arranged along a continuum, ranging from perfect competition, the most competitive market, to monopoly, the lease competitive:



Perfect Competition

Also called "pure competition," this is the simplest market structure. There are four conditions to perfect competition:

1. Many buyers and sellers participate in the market.
2. Sellers offer identical products.
3. Buyers and sellers are well informed about the product.
4. Sellers are able to enter and exit the market freely.

1. Many Buyers and Sellers. Perfectly competitive markets require many participants on both the buying and selling sides. No individual or firm can be powerful enough to buy or sell enough goods to influence the total market quantity or the market price. Everyone in the market accepts the price as given, and as determined by the interaction of the supply and demand curves. The participants are known as "price takers" because they have to "take" the price determined by the market, and they have no power to influence the market price.

2. Identical products. In a perfectly competitive market products are not differentiated; one is the same as the others. A rancher buying corn to feed his livestock won't care which farmer grew the corn, as long as every farm is willing to deliver the corn for the same price. A stock market participant doesn't care which share of stock he buys; they're all the same. A product that is considered the same regardless of who sells it is called a "commodity." Commodities are sometimes described as "fungible" goods. Fungible means that one unit is interchangeable for any other unit. Think of twenty-dollar bills, for example. If you go to the bank and cash a check for $100, you don't care which $20 bills you get, so long as you get five of them. The bills are said to be fungible.

3. Informed Buyers and Sellers. This condition requires that buyers and sellers alike must know enough information about the market to find the best price they can get. The market must provide this information for those willing to search for it.

In most markets, a buyer's willingness to find information about prices and availability represents a trade-off. The time spent gathering information must be worth the amount of money

that will be saved. For example, most buyers wouldn't scour internet ads and shop multiple grocery stores to find the best deal on a dozen eggs, but it would be worth their time to do so if they were buying a refrigerator to store the eggs.

4. Free market entry and exit. The final condition is that firms must be able to enter a market easily when prices are high enough to make it profitable for them, and must be able to leave easily when they can't earn enough at the market price. The factors which restrict this free movement are called **barriers to entry.** While there are many factors that can make it difficult for a new firm to move into a market, two broad categories of common barriers to entry are (1) high start-up costs and (2) high thresholds of expertise, knowledge, or technological know-how. In either of these cases, there will be fewer entrepreneurs and firms available to move into the market even if market prices are attractively high.

Price and output under perfect competition. In perfect competition, the market will be at equilibrium, and the market will be efficient. This means that competition in the market will keep both prices and production costs low. Producers must use all inputs – land, labor, and capital – efficiently, in order to remain competitive. As a result, the prices consumers pay and the revenue that sellers receive accurately reflect how much the market values the resources that have gone into the product.

Thus, prices in a perfectly competitive market are the lowest sustainable prices possible, and they accurately reflect the opportunity costs of each product.

Monopolistic Competition

Much, if not most, of what we buy on an everyday basis, we buy from a monopolistic competitive firm. The primary distinction between pure competition and monopolistic competition is that the products are slightly differentiated, and each seller has a monopoly over its own product. Firms have slight control over their price, but they tend to compete using what economists call **nonprice competition**, emphasizing features *other than price* which set their products apart from their competitors' products. There are four conditions of monopolistic competition:

1. Many firms.
2. Few artificial barriers to entry.
3. Slight control over price.
4. Differentiated products.

1. Many Firms. Sellers in a monopolistically competitive market can be thought of as being arranged in "product groups," collections of similar products. There are many firms in each

product group and many firms on the sidelines prepared to enter the market. Factors such as fixed costs, economies of scale and the degree of product differentiation determine how many firms will enter a market.

2. Few artificial barriers to entry. A monopolistically competitive market has relatively few barriers to entry (but, generally, somewhat more barriers than a purely competitive market), and there are so many firms in a market that producers cannot work together to keep competitors out of a market.

3. Slight control over price. Firms in a monopolistically competitive market have some freedom to raise or lower their prices because each firm's products are a little different from everyone else's, and some people are willing to pay more for the difference. This control is limited, however, because beyond a point buyers will select a competitor's product if prices rise too high. (Remember? – this is the *substitution effect*)

4. Differentiated products. Again, this is the main difference from perfect competition; products are not homogeneous, they are differentiated, and sellers compete based on the differentiation. This type of competition – nonprice competition – falls into four broad categories:

(1) *Physical characteristics*. This could mean color, size, shape, texture, shape, or even packaging.

(2) *Location*. Some products can be differentiated by *where* they are sold. You might choose a gasoline station or a grocery store because it is convenient to where you live or work or the route you travel each day, when there is otherwise very little difference between that business and others. Many small businesses succeed or fail based on their location.

(3) *Service level*. Some sellers differentiate based on service level. Think of the difference between fast-food restaurants and more upscale restaurants that bring the food to your table. Customers at the latter are willing to pay more for the service and the atmosphere.

(4) *Advertising, image, or status*. This is where advertising comes in. Firms attempt to differentiate by building a brand identity and brand loyalty. Nikes or Reeboks? Apple or Samsung? What about designer jeans, or designer handbags? Buyers who pay extra for a brand name or a designer item often do so because the image and status that go with the designer name are worth the extra money to them.

Oligopoly

Industries dominated by just a few firms are called oligopolies. Examples in the United States include automobile manufacturers, airlines, household appliance manufacturers, wireless carriers, healthcare insurers, broadcasting companies, beer brewers and cola manufacturers. Four important characteristics of oligopolies are:

1. Few firms.
2. Significant barriers to entry
3. Ability to set prices.
4. Interdependence.

1. Few Firms. There's no hard and fast rule for how many firms there may be, but one rule of thumb is that it's an oligopoly if the four largest firms in an industry produce at least 70 percent of market output.

2. Significant barriers to entry. Oligopolies tend to emerge when significant barriers to entry keep new companies from entering the market to compete with existing firms. The most important barriers are economies of scale, patents, access to expensive and complex technology, and strategic actions by existing firms designed to discourage or destroy new firms. Sometimes, government regulation favoring existing firms (crony capitalism?) makes it difficult for new firms to enter the market.

3. Ability to set prices. Oligopolies are price setters rather than price takers, and they have a great deal of control over market pricing compared to perfect competitors and monopolistic competitors. But they don't have the degree of price control that monopolies have.

4. Interdependence. The distinctive feature of an oligopoly is interdependence. Each firm is so large that its actions affect market conditions. Therefore the competing firms will be aware of a firm's market actions and will respond appropriately. This means that in contemplating a market action, a firm must take into consideration the possible reactions of all competing firms and the firm's countermoves. It is very much like a game of chess or pool in which a player must anticipate a whole sequence of moves and countermoves in determining how to achieve his objectives. For example, an oligopoly considering a price reduction may wish to estimate the likelihood that competing firms would also lower their prices and possibly trigger a price war. Or if the firm is considering a price increase, it may want to know whether other firms will also

increase prices or hold existing prices constant. In this way, oligopolies often *seem* to be working together even when they're not.

But other times, they actually *are* working together. This falls into two categories, both of which governments try to prohibit.

(1) Collusion is an agreement among oligopolies to set prices and production levels. This is sometime called "price fixing." Collusion among oligopolies is illegal in the United States.

(2) Taking it a step further, some firms go so far as to maintain a formal organization of producers to set prices and limit production. Their goal is to maximize profits for all of their members. But there is always an incentive to cheat, since each member will be tempted to raise production in order to capture a higher share of the over-priced market, and thereby generate additional profits. The cartel can only survive if every member keeps to its agreed output levels.

Perhaps the most well-known cartel is OPEC, the Organization of Petroleum Exporting Countries, which meets regularly for its members to set production quotas in order to maintain or achieve the organization's targets for market pricing of crude oil.

Monopoly

All monopolies have one thing in common – a single dominant seller in a market. One problem with monopolies is that they can take advantage of their market power and charge high prices. This means the quantity of goods supplied to a market is usually less than you'd fina if the market were more competitive.

A monopoly forms when significant barriers to entry prevent more than one firm from entering a market. Monopolistic markets are often ones where there are huge economies of scale. **Monopolies can form naturally, or be established by government action.**

Contrasted with the other market structures discussed above, in monopolies we see these features:

Price Maker: The seller decides the price of the good or product to be sold.
High Barriers to Entry: Other sellers are unable to enter the market of the monopoly.
Single seller: In a monopoly there is one seller of the good which produces all the output. Therefore, the whole market is being served by a single company, and for practical purposes, the company is the same as the industry.

Price Discrimination: A monopoly can change the price and quality of the product. It sells more quantities charging a lower price for the product in a very elastic market and sells less quantities charging high price in a less elastic market.

Natural Monopolies

A natural monopoly is one that runs more efficiently when one large firm provides all of the product. It would be inefficient for more than one supplier to operate. Utilities are often natural monopolies. In industries with a standardized product and economies of scale, a natural monopoly often arises. In the case of electricity, all companies provide the same product, the infrastructure required is immense, and the cost of adding one more customer is negligible, up to a point. Adding one more customer may increase the company's revenue and lowers the average cost of providing products for the company's customer base. So long as the average cost of serving customers is decreasing, the larger firm more efficiently serves the entire customer base.

As with all monopolies, a natural monopoly may engage in behavior that abuses its market position, which often leads to calls from consumers for government regulation. Common arguments in favor of regulation include the desire to control market power, facilitate competition, promote investment or system expansion, or stabilize markets. In general, though, regulation occurs when the government believes that the monopoly, left to its own devices, would behave in a way that is contrary to the public interest.

Legal Monopolies

Monopolies created by government action are called legal monopolies. This happens when government itself creates barriers to entry in markets. One way government can do this is by issuing a **patent**, which gives a company an exclusive right to sell a new product for a limited period of time. The argument for granting such a monopoly is that the patent provides incentives for firms to make the investments in research and innovation to bring new products to market.

Another form of legal monopoly is a **franchise**, which is a contract issued by a local authority that gives a single firm the right to sell its goods within an exclusive market. This would include, for example, firms that are given an exclusive market to sell products at an airport. On a larger scale, governments can issue a **license** granting firms the right to operate a business. This would include granting radio or television stations access to a broadcasting frequency.

The United States Post Office has a legal monopoly on delivering letters to mailboxes. The Georgia Lottery has a legal monopoly on gambling in Georgia.