Monopolistic Competition

# Presentation 1 –Intro to Monopolistic Competition

Take notes. Your notes should cover the following questions:

* What is meant by Monopolistic Competition?
* What assumptions is the theory of Monopolistic Competition based on?
* What is the short run result of Monopolistic Competition?
* What is the Long run result of Monopolistic Competition?

# Article Task: The Impact of Competition in the Pizza Market

**Instructions:**

* Highlight the advantages and disadvantages of monopolistic competition
* Answer the Question.

**Article**

Back in 1990, Pizza Hut was in a truly privileged position on the high street. It was part of a small industry serving pizzas to take-away and eat-in customers. The only real competition facing Pizza Hut was from a small number of other restaurants such as Pizza Land and the Deep Pan Pizza Company. With such a low level of competition, prices were high. In 1990 a small 7 inch pizza was around £5.00 (equivalent to almost £7.00 today) as consumers who wanted pizza had very little choice and therefore had to pay the price. Furthermore, as consumers began to eat out more often, demand for pizzas increased, leading to yet higher prices (which reached around £6.00 for the same 7 inch pizza) and greater profits for the few pizza firms in the industry.

Not surprisingly, other entrepreneurs noticed the large profits being made by Pizza Hut and wanted to earn some of this too. However, local authorities were reluctant to give planning permission for so many new take-away shops: they believed the high street was better served by banks, building societies, post offices and other ‘essential’ services. Soon after 1990, however, banks and building societies began to close many of their branches as more of their customers decided to use ATM machines and telephone banking instead. And by the mid to late 1990s, the advent of internet banking and e-commerce meant that even more businesses could afford to close down their shops. Consequently, high streets were being left with too many empty shops, so local authorities started to give fast-food firms easier planning permission.

At the same time, the set-up costs of opening a new pizza shop (e.g. initial building works, capital equipment such as ovens, dough mixers, etc) began to fall, making it easier for new entrepreneurs to enter the industry. Accordingly, it didn’t take long before many new pizza shops appeared on the high street. *Existing* firms (like Pizza Hut and Pizza GoGo) began to open new branches, while other entrepreneurs from *outside* the industry began to set up new pizza companies (like TGF Pizza, as well as a large number of other single branch pizza businesses).

**Advantages**

As a result, consumers have had more choice than ever before. For example, between 1990 and 2000 in the Hackney area alone, the number of pizza shops increased from eight to a staggering 42. With this many pizza shops to choose from, consumers do not have to put up with high prices any more – if Pizza Hut is too expensive, it is easy to buy from Pizza GoGo, TGF, or any of the other firms instead. As a result, *price competition* has intensified to the point where some take-away shops are now offering £1 pizzas for takeaway customers.

But it didn’t end there. Keen to protect their profits, the larger pizza chains decided to focus on *non-price competition* in order to justify their higher prices. Firstly, Pizza Hut began offering its customers a service guarantee that their order would be delivered within a maximum of 30 minutes or it would be half-price. This meant the firm had to keep a few more scooters and hire a few more drivers. But the extra cost was worth it, as hungry customers who didn’t want to wait too long for their meal would feel more confident in buying from Pizza Hut. It didn’t take long, however, for other firms to follow suit and to offer their own 30 minute service guarantees.

Secondly, in 1998 Dominos launched the Heatwave – a hot bag using patented technology that kept the pizza oven-hot to the customer’s door. More recently, Pizza Hut introduced the Hot Dot – a sticker on each of their pizza boxes which turns red to indicate the pizza is hot. This assures customers that quality will always be high, without them having to check the product before the driver leaves.

Thirdly, pizza firms have sought to differentiate themselves by offering more variety to their customers. Pizza Hut began by offering the stuffed crust. This was in response to market research showing consumers found the crust to be the most ‘tasteless and boring’ part of the product. So Pizza Hut tried to get 'one-up' on its rivals by turning this bland part of the pizza into a unique selling point. But then Dominos followed with their own version, the ‘Dominator’; now, virtually every pizza firm has stuffed crust on the menu and consumers have got used to having this as a choice. Yet the variety didn’t end there: from new flavours of pizza sauce (like BBQ base) to new toppings and fat-reduced mozzarella, to even whole new themes like the Chicken Tikka Curry Pizza at Dominos, consumers now have an unprecedented level of choice and variety. Furthermore, this would have been unimaginable in 1990 when so few firms dominated the pizza market and had no reason to fight for their customers. Indeed some firms have now gone as far as offering entire new product lines to keep their customers coming back. Pizza Hut is a prime example: not only did it diversify into newer varieties of pasta but the firm temporarily changed its name to Pasta Hut to ensure everybody heard about this.

**Disadvantages**

But it isn’t all benefits for consumers. Going back to the £1 pizzas served by the smaller shops, many of these are known to be produced with cheap ingredients that lead to a very low quality and soggy product. Furthermore, many of these pizzas are cooked with re-used oil that can have long-term health problems for customers who eat them frequently.

And for those pizza firms that advertise vigorously to win new customers, we might ask what effect this is having on their price. Namely, there are high profile TV adverts (e.g. Pizza Hut’s ad campaign starring Jessica Simpson) and expensive colour leaflets, which were not seen as necessary in the early 1990s when each pizza firm had so few competitors to fight. This could all mean that competition is adding an unnecessary cost to these firms that raises the price of their product.

Finally, it is worth reconsidering the increased number of firms now selling pizzas, as well as the fact that each one offers a large variety of different crusts and toppings. As a result, the whole industry may be depriving itself of the scale economies that are so vital in keeping average costs down. Again, we might question the extent to which consumers are really benefitting from competition in the pizza industry, as higher average costs often translate into higher prices for the consumer.

**Questions**

*Using an appropriate diagram(s) and the theory of monopolistic competition, fully explain and evaluate the short- to long-run adjustments in the pizza industry*

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# Presentation 2 – Evaluating Mono Comp

Take notes. Your notes should cover the following questions:

* What efficiency conditions are/are not met in Mono Comp?
* What other costs to Mono Comp exist?

# Resource allocation & efficiency in different market structures

**Instructions:** Complete the grid for the different market structures

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Perfect Competition** | **Monopolistic Competition** | **Monopoly** |
| **Productive efficiency***Cost minimization -Producing at the lowest point on lowest average cost curve* | * Not in the short run, unless by coincidence
* Yes in long run. **Proof:** Firms are profit maximisers; MR=MC. Firms are also price takers, meaning a perfectly elastic demand curve; AR=MR. Combining gives AR=MC. As firms can only make normal profit in long run (due to a lack of entry barriers), AC=AR. Combining gives AC=MC i.e. productive efficiency.
 |  |  |
| **Allocative efficiency***Where AR (P) = marginal cost so that firms are producing products that consumers want at a price they are willing to pay* |  |  |  |
| **Dynamic efficiency***Efficiency from innovation - developing & introducing new production techniques & new products* |  |  |  |
| **X – inefficiency***Difference between actual costs & attainable costs due to lack of competitive pressure* |  |  |  |

# Font, Logo, Text, Brand, Graphics, Trademark, Graphic design, Article task: Uber in the taxi market

**Instructions:**

* Read highlight and annotate the article
* Take notes for the discussion questions
* Discuss as a class

**Article:**

# *Uber-competitive: Uber risks a consumer backlash over its tough tactics*

# DESPITE its tender age of only five years, Uber, an American firm that links taxi passengers to drivers through a smartphone app, already has several records to its name. It has raised $1.5 billion in venture capital and reached a valuation of more than $17 billion. It has expanded to 229 cities in 46 countries. It is rumoured to be bringing in gross revenues of almost $1 billion a month. But it now seems, in record time, to have gone from hero to villain in the eyes of much of the technology press. Praised in its early days for disrupting unreliable, high-cost local taxi monopolies, Uber now stands accused of using unfair tactics against both rivals and critics.

# On November 17th it emerged that an Uber executive, Emil Michael, had said at a private dinner that the firm should consider spending $1m to dig up dirt on its critics in the media, in particular Sarah Lacy, the editor of Pando, a tech-news site. Mr Michael has since apologised. Travis Kalanick, Uber’s boss, said on Twitter that his remarks showed “a lack of humanity and a departure from our values and ideals”, but brushed off calls for Mr Michael to resign.

# Although it is hardly an excuse, the remarks were a reaction to a series of highly critical articles on Uber, in particular by Ms Lacy and her publication. She has argued that Mr Kalanick, known for his libertarian views and combativeness, is an example of Silicon Valley’s “asshole problem”, meaning that venture capitalists increasingly invest in entrepreneurs who know neither scruples nor social graces. Most recently, she accused the firm of “sexism and misogyny” because its branch in Lyon, France, had offered to pair passengers with “hot chick” drivers. She says she has deleted the Uber app from her smartphone.

# Uber has never feared controversy. In its drive to disrupt taxi markets it has often ignored local regulations, leading to court-ordered bans on its services. It has emerged that the firm has sent “brand ambassadors” to hire cabs through Lyft, a rival app, who would then either cancel them, or press their drivers to defect to Uber. Mr Kalanick has also admitted to having intervened in its rival’s fund-raising attempts by telling potential investors that his firm was also about to raise large amounts of capital.

# The network effects in the taxi-app business are strong: as a firm recruits more drivers, this reduces pickup times, which attracts more passengers; this in turn attracts more drivers, since they get more fares on each shift. That winners and losers emerge so quickly explains the need for a degree of ruthlessness. Uber’s hardball tactics have helped it pull well ahead of its rivals: by some estimates its revenues are now 12 times those of Lyft, and are growing at ten times the rate.

Technology firms like to say that in their business one must “move fast and break things”. Whether it is Uber’s attempt to get one over its rivals, Facebook’s tinkering with users’ privacy settings or Amazon’s tough negotiating tactics in its now-resolved price dispute with Hachette, a publisher, ambitious tech firms often seem quite purposefully to be testing the conventions of acceptability. They all risk turning customers, and regulators, against them. But perhaps they have taken note of how the most thick-skinned of low-cost airlines—such as Spirit Airlines and Ryanair—are constantly cursed by customers and media commentators, and yet are highly successful. People may say they are outraged but if the service on offer is cheap and convenient, it will be hard to resist.

**Discussion Questions:**

1. To what extent is the taxi market a monopolistically competitive market

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1. Assess the impacts of Uber’s entrance into the taxi market

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# Assignment

**SECTION A**

1. A small profit maximising café faces the following cost and revenue curves. It is noted that the café is never full.



Which one of the following is most likely to apply to this café?

[1]

**A** It is productively inefficient in the long run

**B** It is making supernormal profits

**C** There is evidence of collusion

**D** It operates in a perfectly competitive market

**E** It is allocatively efficient in the long run

1. A firm in long run equilibrium under monopolistic competition will be

[1]

**A** allocatively but not productively efficient

**B** productively but not allocatively efficient

**C** productively and allocatively inefficient

**D** making supernormal profits

**E** allocatively and productively efficient

1. Which of the following characteristics is shared by a monopolist and a firm operating under conditions of monopolistic competition?

[1]

**A** Low or no barriers to entry to the industry

**B** Productive efficiency in the long run

**C** Some degree of price setting power

**D** Supernormal profits in the long run

**E** Allocative efficiency in the long run

1. The diagram shows a firm in monopolistic competition in the short run.



* 1. Which of the following statements is true?

[1]

**A** New firms will enter the industry in the long run

**B** Demand for this firm’s products will increase in the long run

**C** Collusion will occur

**D** The supernormal profit level is NKLM

**E** The firm is producing where demand is price inelastic

* 1. Explain your answer to part (a) above.

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**SECTION C**

1. To what extent would a monopolistically competitive market be more beneficial to firms and consumers than a perfectly competitive market?

[25]

1. To what extent might a monopolistically competitive market be more beneficial to consumers than a monopoly market?

[25]