Lesson-30

Imperfect Competition

We have identified p-competition as an ideal, in the sense that the p-competitive structure encourages strong price competition. This, in turn, leads to price and output at the supply-and-demand equilibrium levels. In appropriate circumstances, the supply-and-demand equilibrium is efficient, as the Fundamental Principle of Microeconomics points out.

For an industry to have a p-competitive structure, it must have all four of these characteristics:

- Many buyers and sellers
- A homogenous product
- Sufficient knowledge
- Free entry

Some industries, such as financial service industries and many agricultural industries, seem to approximate the p-competitive structure nearly enough. So, there is little doubt that the p-competitive theory can be applied to them. A few industries are equally clearly exceptions to which the p-competitive theory cannot be applied like the monopolies. There seem to be a considerable number of industries that do not clearly fit either extreme. The discussion of these cases in the 1920's and 1930's led to a classification of industries and markets into four major types:

- Perfect Competition
- Monopoly
- Oligopoly
- Monopolistic Competition

"Oligopoly" and "monopolistic competition" are often lumped together as "imperfect competition."

The following table illustrates the four characteristics of "pure competition" and how the four market forms differ.

	Sellers	Product	Knowledge	Entry
Pure Competition	Many	Homogenous	Sufficient	Free
Monopoly	One	?	?	None
Oligopoly	Few	?	?	None or limited
Monopolistic Competition	Many	Differentiated	?	Free

Forms of Imperfect Competition

The two recognized forms of imperfect competition are defined by the ways in which they deviate from the four characteristics of p-competitive markets.

Oligopoly

The term "oligopoly" comes from Greek roots meaning "few sellers," and that is the way oligopoly differs both from p-competition and monopoly-- there is more than one seller, but not "very many." Of course, this is a vague conception-- the vagueness is unavoidable in the use of the relative term "few"-- and economists have debated on the exact boundaries between "few" and "many.” For the small number of sellers to be stable, there presumably must be some "barriers to entry" of new competitors.

Monopolistic Competition

In monopolistic competition, the products sold by the different firms in the industry group are not homogenous but differentiated. Thus, each firm has a "monopoly" of its own product. But it is not a true monopoly because the differentiated products are "close substitutes." Once again, we have a certain vagueness here-- how close is a "close substitute?" But once again, the vagueness is in the facts, and not in the discussion-- the products of real firms may be more or less close substitutes in different cases. For monopolistic competition, however, entry is free.

All of this vagueness is a bother. But it should be kept in mind that these are broad umbrella terms, each of which includes a range of possibilities, and that may overlap to some extent. For example, some oligopolies sell differentiated products.

Implications of Imperfect Competition

The main significance of the four characteristics of p-competitive structure is that they are conducive to price competition. When these characteristics are missing, we may see the following:

- Increased non-price competition
- Decreased price competition

Other Forms of Competition

In these other two market structures, which together are often called "imperfectly competitive" structures, there may just be less competition, or there may be other forms of competition, like "non-price competition."

Non-price competition includes the following:

- Competition in the characteristics of the good
    - Differentiation
    - Quality competition
- Advertising
    - Informational
    - Persuasive

Product Differentiation

Products are differentiated when the products of different companies are not perfect substitutes. Instead, “every company has a monopoly of its own product." Nevertheless, companies may compete by changing the characteristics of the product they sell. The idea is not necessarily to make a better product than the competitor, but a product which is just different-- to appeal to a different "market niche."

Again, economists (on the whole) regard this form of competition as a mixed bag. They give the following arguments:

1. It increases variety, thus increasing the range of consumer choice.
2. It divides up the market, leading to higher prices and costs.

According to the traditional ideas on "imperfect competition" developed in the first half of the twentieth century, this form of competition is especially common in "monopolistic competition." In fact, it is a part of the definition of monopolistic competition. But it is also observed in many oligopolies.

Competition in Quality

In some industries, there is cutthroat competition to introduce a product which is superior to rival products. This form of competition has a good reputation, but it can certainly be overdone and may be overrated.

Competition in quality lends itself to "horse races" in which only the winner gets any profit at all. Recent research indicates that these "winner take all" competitions tend to lead to over-investment and waste of resources. The constant upgrading of computer software may be an example. In any event, too much of a good thing, i.e. spending too much on a good thing, can always change it into a bad thing.

On the other hand, quality improvement makes consumers better off in an obvious and probably major way. So, competition in quality is at worst a mixed bag.

Informational Advertising

In a p-competitive market, there is no advertising. This is because there is no need to advertise. The firm can sell its profit-maximizing output at the market price, so why should it spend on advertising? But in the real world, advertising is a very important competitive strategy.

When the aim of advertising is to give people information about the availability, characteristics and prices of goods, we call it "informational advertising." This sort of advertising increases the consumer's range of choice and may improve the quality of the decisions consumers make. It can also contribute to the effectiveness of price competition, so (in some markets) it may complement price competition and bring the market closer to the supply-and-demand outcome than it otherwise would be.

The purpose of cutting your price is to attract more customers, after all. If nobody knows about the price cut, it will be less effective, so why bother? Conversely, an advertised price cut can be the most powerful form of price competition.

Some "professional ethics" laws have prohibited physicians and lawyers from advertising, on the grounds that such advertising would be inconsistent with professionalism. In recent years, as part of the trend toward increased reliance on markets in modern economies, those laws have been repealed in some jurisdictions. The repeal does seem to lead to increased price competition.

All the same, like other forms of non-price competition, economists regard informational advertising as something of a mixed bag. They say the following things:

1. It gives people information they might lack.
2. It can be overdone, spending too much on advertising and driving prices up.

Persuasive Advertising

The purpose of persuasive advertising is to shift the utility functions of the customers, and thus, to shift their demand curves in favor of the good being advertised. Since we judge consumers' benefits in terms of given consumer utility functions, it is hard to say if consumers benefit or lose. So, persuasive advertising looks like spending money without making consumers any better off, and many economists regard this as a negative.

We expect that both forms of advertising will be especially common in oligopolies and whenever products are differentiated, as in monopolistic competition. Monopolies too may find it profitable to advertise.

Summary

While the various forms of non-price competition seems to be a mixed bag-- some good, and some bad consequences-- many economists feel that, on the whole, more competition in all these categories tends to be better than less competition. This is especially likely where the competition results in an increased range of consumer choice. Common sense tells us that choices "keep the suppliers honest." On the other hand, economic theory tells us that even when the suppliers are as honest as they could be, more choices can make people better off, but never worse off. So, non-price competition, even though it has costs, can have pretty substantial benefits that more than balance them.

Let us go through a very interesting example of garbage pickup. Garbage pickup is a rather interesting industry, in the sense that we can find just about all forms of economic organization in this field.

1. Government organization-- In many localities, the garbage is hauled by public employees.

2. Privatization-- There are a considerable number of communities in which garbage is hauled by private monopolies under a contract with the government.

3. Free competition-- You must have seen some people picking up garbage from roadside.

4. Autarky-- Autarky means each person must provide the service for himself or herself, and there are rural areas in which there is indeed no garbage pickup service at all.