COMPETITION AND THE MARKETPLACE

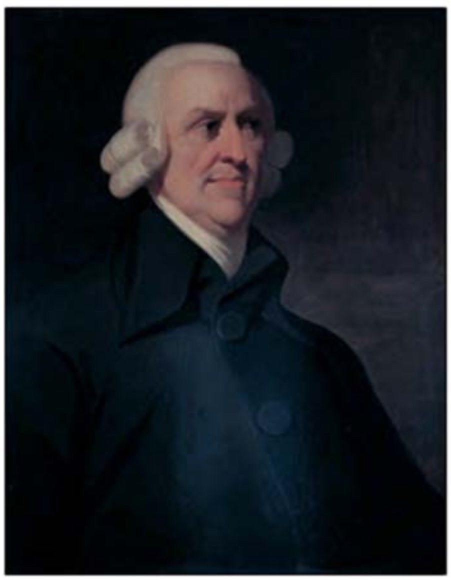
The Mall: One of the markets where buyers meet sellers

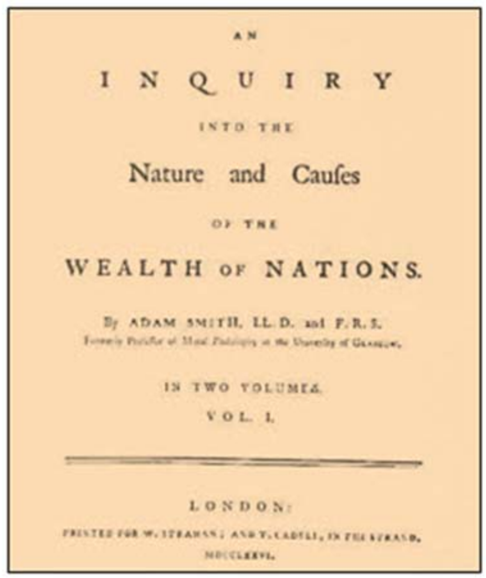
Unit Overview

One of the most important characteristics of a market economy is competition. In markets, producers compete with each other to meet demand and to make profits. At the same time, consumers compete for goods and services at prices that they are willing and able to pay. The degree of competition among rival firms has led economists to divide market structures into four major categories: perfect competition, monopoly, oligopoly and monopolistic competition. Let's see how it all works.

The Invisible Hand

According to most economists, one of the key elements in keeping a market economy functioning smoothly is **competition**. One of the first people to explain the importance of this characteristic was **Adam Smith**, a Scottish philosophy professor. In his book titled ***The Wealth of Nations***, Smith emphasizes that a country's economy works best and acquires its greatest wealth when individuals are free to pursue their own self-interests without government interference. While he notes that government should protect private property and enforce contracts, Smith stresses that it should not attempt to control prices or to bailout failing businesses. This philosophy is called ***laissez-faire***, a French term which means *let them do as they please*.





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By ADAM SMITH, LL.D. and F.R.S.

IN TWO VOLUMES.

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LONDON:

Adam Smith and the opening page from The Wealth of Nations: 1776

According to Adam Smith, self-interest acts as an **invisible hand** that guides the decision-making process of producers and consumers. This leads to choices which make the best use of scarce resources. With the goal of making a profit, producers become rivals and challenge one another to meet consumer demand. The competition heats up when sellers employ tactics, such as advertising, offering promotions and producing more efficiently. As profits convince sellers to create more of what buyers are willing and able to purchase, competition among sellers encourages new businesses to enter the market. This increases supply, improves quality and eventually lowers prices. Consumers also compete against each other in the marketplace. Competition among buyers impacts demand and, in turn, prices. It also allocates goods and services among the people who are most able to pay for them. All of this is best accomplished without laws or government regulation. Remember—if left alone, the market will reach equilibrium. Smith's ideas became the foundation of many European economies and continue to provide the financial principles of countries around the globe today.

Go to Questions 1 through 3.

Market Structures

When Adam Smith published *The Wealth of Nations* in 1776, businesses were competitive because most factories were small. By the end of the nineteenth century, however, conditions had changed. Many small firms had combined to form large companies through acquisitions and mergers. This resulted in the rise of industries that weakened the power of competition and created markets that were dominated by a few, influential firms. Economists use the term ***industry*** to represent all of the producers of an identical or similar good or service. For example, the U.S. steel industry refers to all companies that manufacture steel in the United States. Today, economists group industries into four, major categories known as market structures. They include perfect competition, monopoly, oligopoly and monopolistic competition. An industry's market structure depends on the number of businesses within the industry and the ways that they compete in the market.

Go to Questions 4 and 5.

Perfect Competition

The simplest market structure is called **perfect, or pure, competition**. As you may have guessed when you saw the word *perfect*, it refers to a very small number of industries that come close to reflecting this model. Although perfect competition is more theoretical than realistic, it is used by economists to evaluate the other market structures. The conditions listed below must be present for a perfectly competitive market to exist:

- **Large numbers of buyers and sellers:** Perfect competition requires many buyers and sellers for a particular good or service. A large number of independent producers and consumers means that no single company or individual is powerful enough to sway the total market supply or the market price. It also makes it more difficult for groups of buyers or sellers to control prices by working together. The market itself determines the price without any influence from individual producers or consumers. Perfectly competitive markets operate efficiently. Because it keeps prices and production costs low, perfect competition benefits producers and consumers.

- **Identical Products:** There are no differences among the items sold by the various producers in a perfectly competitive market. This is certainly true of commodities, such as milk, fuel oil, notebook paper and sugar. A **commodity** is a product that is basically the same regardless of who makes it. For example, if a grocer is buying cauliflower to sell in his store, he or she has no interest in who grew it as long as every farm is willing to deliver it for the same price. This is based on the simple fact that one head of cauliflower is very much like another. The buyer chooses the cheapest supplier for cauliflower and does not pay extra for an identical product from one, particular farmer.

Milk: An Example of a Commodity

- **Well-informed buyers and sellers:** When a market is purely competitive, buyers and sellers are knowledgeable about an industry's goods and services. This encourages both sides of the market to search for the best deals possible. Information concerning prices, products and technological improvements is readily available with no lag time. For example, if a company is planning on implementing a new production technique to streamline its manufacturing process, the news is made public immediately to benefit both producers and consumers.

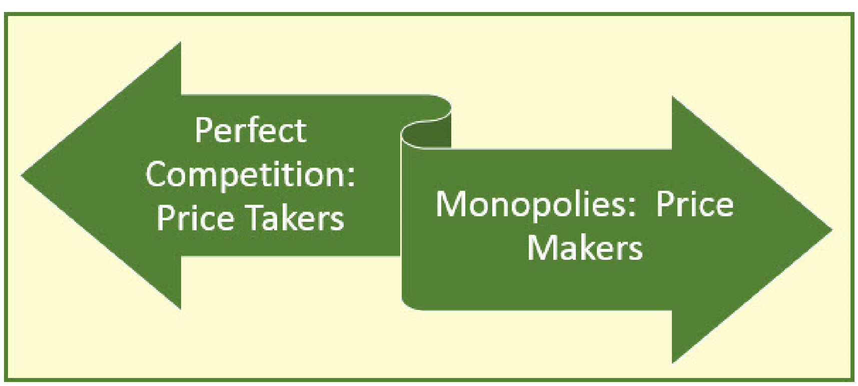
- **Free entry and exit from the market:** If one firm can keep other companies out of the market, it can sell its product at a higher price. For this reason, producers must be able to enter and exit a purely competitive market structure freely and easily. In other words, companies enter the market when they can make money and leave when they cannot. This helps to keep prices low because new firms take business away from older firms that do not keep their pricing competitive. It also makes it more difficult for a few large companies to dominate the market.

Just like everything else, perfect competition has advantages and disadvantages. In this situation, both buyers and sellers are what economists call **price takers**. They accept, or take, the market price. Since producers in this market structure cannot control prices, there is little opportunity to exploit the consumer. This benefits buyers because they receive a standard-quality good or service at a price determined by the market no matter where it is purchased. At the same time, the system offers sellers the advantage of spending little or no money on advertising. This is unnecessary since each firm's version of the product is identical. However, suppliers have little incentive to improve their products or to add new features. If they charge more than the market price, their customers are likely to shift their business to another company. There is no reason to charge less since firms can sell as much as they can produce at the market price.

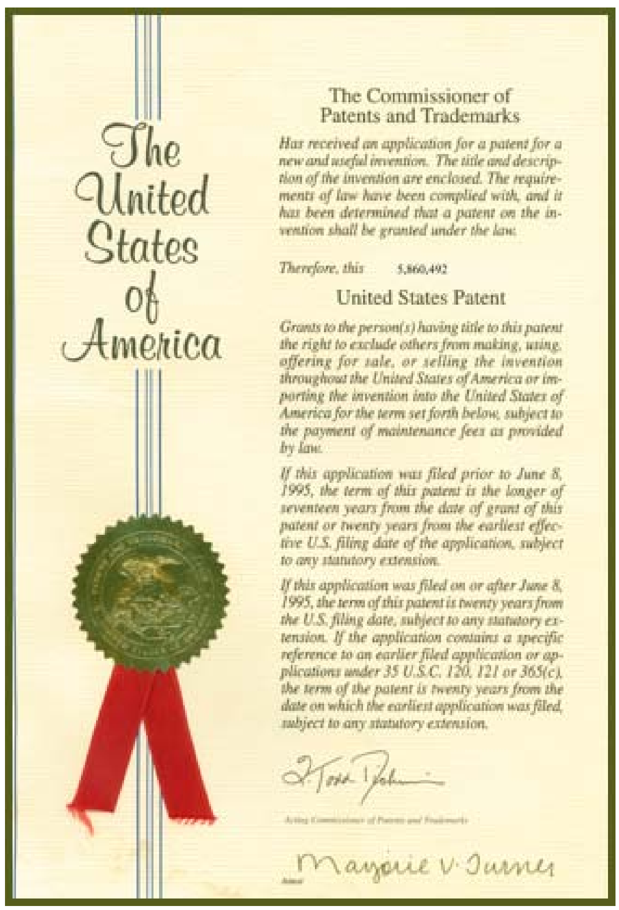
Go to Questions 6 through 10.

Monopoly

The remaining market structures are all examples of **imperfect competition**. When compared to perfect competition, a monopoly is at the opposite end of the market structure spectrum. A monopoly only has one seller for a particular good or service, but there may be any number of buyers. As with perfect competition, the U.S. economy offers few examples. This is because Americans have traditionally disapproved of monopolies and have encouraged Congress to pass anti-trust legislation opposing them. The development of new technology also places limitations on monopolies. For example, email now competes with the U.S. Postal Service, a federal agency that once was the sole supplier for mail delivery.



In a market structure controlled by a monopoly, there is one large firm supplying the product rather than thousands of smaller ones. This gives the monopolist market power. Since there are no other sellers, a single firm can raise prices without losing sales. Although higher prices normally pull more sellers into the market, this is only possible if producers can easily enter as they do in perfectly competitive markets. However, monopolies form because certain barriers make it difficult or impossible for new firms to come into the market. Start-up costs, the inability to obtain necessary natural resources and a lack of access to technology discourage entrepreneurs. Licenses, patents, copyrights and franchises also keep some companies out of the market. Without competition and ease of entry, the seller in a monopoly becomes a **price maker** rather than a price taker.



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Has received an application for a patent for a new and useful invention. The title and description of the invention are enclosed. The requirements of law have been complied with, and it has been determined that a patent on the invention shall be granted under the law.

Therefore, this 5,860,492

United States Patent

Grants to the person(s) having title to this patent the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States of America or importing the invention into the United States of America for the term set forth below, subject to the payment of maintenance fees as provided by law.

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Although most people have a negative view of them, some monopolies do serve a constructive purpose. This is true of **natural monopolies**. These are situations in which a good or a service produced by a single firm actually lowers costs and promotes efficiency. Public utilities fall into this category. What would happen if more than one company supplied water, natural gas or electricity to a small area? In the case of electricity, each company competing for customers would have to put up their own poles and lines. Each firm providing water would have to run its own network of pipes. Because that would be wasteful and expensive, utility companies often receive **franchises**, or exclusive rights to do business in a specified area without competition. Other beneficial monopolies can be found in locations where sellers of similar products are not present. This is known as a **geographic monopoly**. A single grocery store operating in a small town that is unable to support other similar businesses is one example.

Go to Questions 11 through 15.

Oligopoly

An **oligopoly** is a market structure in which a few large sellers dominant an industry. It is a little more competitive than a monopoly but much less competitive than perfect competition. Economists usually define an industry as an oligopoly if its four largest companies supply between 70% and 80% of the total product. Goods or services created by an oligopoly are often standardized products like gasoline, but they may also be differentiated. **Product differentiation** refers to the differences between two competing goods within the same industry. These variations may be real or, thanks to advertising, imaginary. Automobiles and smart phones are two examples. Both offer products that serve the same purpose but come in a wide variety of models, styles and brands. This category of market structures also includes the soft-drink industry dominated by Coke and Pepsi as well as the fast-food industry where McDonald’s, Wendy’s and Burger King maintain a large percentage of the market.

Southwest Airlines: One of the four carriers that dominate the U.S. airline industry

The largest firms in an oligopoly tend to act as a team. Each of these companies knows that the others have the power to affect price and to influence the choices made by consumers. Therefore, whenever one company raises its prices, the others soon follow. Because the companies within the oligopoly act together when changing prices, firms tend to compete in areas other than price. They do this through advertising campaigns and by adding new features to their products. Although changes in price can be implemented quickly, advertising gimmicks and product upgrades take more time to counteract and put opposing firms at a disadvantage.

Within an oligopoly, the major firms act as price makers and seldom protest the price hikes of their rivals. When they choose not to support a higher price, however, the company that initiated the increase usually backs down to avoid losing customers. Companies in oligopolies seldom lower prices. When they do, oligopolists may become caught up in **price wars** in which firms slash prices to draw more buyers. These brief but intense clashes benefit consumers in the short-term. Overall, however, oligopolies result in higher prices for buyers. As with monopolies, patents, copyrights and licenses create barriers that make it difficult for new firms to enter the market.

The tendency of large firms within an oligopoly to work together sometimes leads to illegal activities, such as collusion. **Collusion** is a formal agreement made by firms to set prices and production levels. Such arrangements often lead to **price-**

fixing, an action which commits companies to charge the same or similar price for a product. These prices are almost always higher than those determined through competition. Just as a monopoly does, this puts the consumer at a disadvantage. The largest firms in the oligopoly may also decide to divide the market among themselves, an action that guarantees each of them a specific share and profit. Because collusion and price-fixing interferes with free trade, the U.S. Congress has passed legislation to forbid these practices. Nonetheless, some businesses still risk engaging in these illegal activities for the sake of higher profits.

	Number of firms	**Control over price**	**Variety of products**	**Entry into the market**	**Examples**
Perfect Competition	Many	None	None	Easy	Perfect: None Near: Farm Produce
Monopoly	One	Complete	None	Nearly impossible	Perfect: None Near::Electricity
Oligopoly	Few	Some	Some	Difficult	Cars Cell phone providers
Monopolistic Competition	Many	Little	Some	Easy	Jeans Bakeries Hotels

Go to Questions 16 through 19.

Monopolistic Competition

In several ways, **monopolistic competition** resembles perfect competition. Both market structures consist of large numbers of sellers. This limits the ability of an individual producer or a small group of them to control price or supply of an industry. The presence of many sellers also prevents some companies from working together to shut others out of the marketplace. As a result, firms can enter or exit the market with relative ease. There is, however, one major difference between perfect competition and monopolistic competition. One criteria for perfect competition is the sale of identical products. Monopolistic competitors, on the other hand, try to convince consumers to pay for goods and services that are similar but slightly different from those offered by other sellers. As an economist would say, monopolistic competition relies on differentiated products rather than identical ones.

Folded Jeans Waiting for Buyers in a Monopolistic Market

Monopolistic competitors focus on making sure that the buying public is aware of the unique aspects of their product. They use coupons, giveaways and advertising in their promotional campaigns. Think about the choices that you have when buying a pair of jeans. All jeans are a type of pants made from a version of denim, but stores stock a wide variety of this piece of clothing at an equally wide variety of prices. What makes us pay $49.99 as opposed to $17.99 for something that is made from similar material and serves the same purpose? Advertising convinces consumers that a particular brand, store or restaurant is better than another. Unlike firms that engage in perfect competition, companies operating in a monopolistic market structure are willing to spend large sums of money to create a certain image or status for their products.

Under monopolistic competition, similar products usually sell within a narrow price range. If a firm can convince the buying public that its brand is better, the company can charge a higher price. If a company cannot convince buyers that there are advantages to purchasing its brand, it cannot charge as much. Although the seller does have some leeway to raise and lower prices, this decision requires caution. If producers raise the price too much, consumers will lose interest. Since most differences that separate a similar good or service from another are minor, buyers will simply refuse to pay the extra cost and change brands.

Go to Questions 20 through 22.

What’s next?

Even though economists maintain that a free enterprise economy works best without government interference, the rise of large corporations in some markets has limited the number of sellers. It has also encouraged the formation of monopolies and oligopolies. To keep these market structures from controlling price and supply, the federal government has used its authority to block mergers and to prevent unfair competition. As you will see in the next unit, this has had both intended and unintended consequences. Before moving on, review the terms found in this Unit 7; then, complete Questions 23 through 32.

Go to Questions 23 through 32.