ECONOMIC BRIEF NO. 30

Benefits of Monopolistic Competition

This series of economic briefs explores fundamental concepts in economics and community and economic development.

Retail firms—grocery stores, gas stations, card shops, hair salons, flower shops, hardware stores—are the lifeblood of the local business community. They operate under a market structure that economists classify as "monopolistic competition." They function as competitive businesses with some of the advantages or drawbacks of monopolies. They have lots of competition, but they enjoy some advantage that lets them raise prices a little or be a bit slow on ordering spare parts without losing too many customers.

Monopolistic competition combines some of the best features of both competition and monopoly to provide the customer with variety and convenience.

Under a monopoly, a sole seller has lots of market power, and frustrated customers have no good alternatives. Under competition lots of similar, interchangeable small firms have very little market power because buyers have many good substitutes.

What makes a firm a hybrid between monopoly and competition?

A monopoly is created when it is virtually impossible for another firm to get into the industry; that is, the barriers to entry are high. The monopolist may have all the prime locations sewn up, control essential materials or patents, or have an exclusive government license. Or the nature of the product may require a firm to be very large in order to be cost-effective, so there is only room for one firm.

In monopolistic competition, the barriers to entry are low, so new firms can easily enter the industry if it looks profitable. That's why many smaller communities recently have been swamped with convenience stores and video rental places. So if a monopolistically competitive firm is making a profit, a competitor is almost certain to show up, undercut prices, offer longer hours or better service, steal some customers and wipe out the other firm's profits.

So where is the monopoly power?

The local monopolistically competitive firm or retailer has a few degrees of freedom. It can raise prices a little without making it worthwhile for new firms to move in or for customers to drive ten miles to shop. Monopoly power often derives from convenience—a small place that's close by and a quick stop for busy people. Sometimes a history of good service, customer loyalty, or friendship may keep people coming back even with a WalMart superstore just 15 miles away. But that WalMart also places some pretty strict limits on the market power of the local retailer. If the local firm's prices are raised too high or hours are too short, even the most loyal customer is likely to spend some dollars at WalMart.

Monopolistic competition illustrates both the costs and the benefits of firms with market power. The biggest cost of this market structure may be too many small, inefficient firms with high prices. The major benefit is the ability of customers to make choices based on variety and services as well as location and service. This structure also preserves downtowns or creates strip shopping centers that give a town gathering places and focal points.

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