Webnote 1596 Syllabus: Items 66 - 72

SYLLABUS REFERENCE: 1.5[1] THEORY OF THE FIRM
Economics Models : Monopolistic competition [2]

Assumptions of the Model:
1. thousands of small sized firms
2. product differentiation necessary as each monopolistic competitor is slightly different
3. no significant barriers to entry

The model suggests the following outcomes:

A. Inefficient – not at lowest point of AC
B. Higher prices + Lower output for the Industry than in PC
C. Resource Allocation is worse than PC as the firm is not producing at lowest point on AC

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Using a diagram(s), explain how the characteristics/assumptions of the models of perfect competition and monopolistic competition result in different demand curves for individual firms.

Note to diagrams: Look for the following points:
1. S/N exists where AR > AC
2. Max profit at MC = MR
3. Efficiency at lowest point of AC

Ar > Ac

M-istic

Fig a: momopolistic **short run** p and q equilibrium

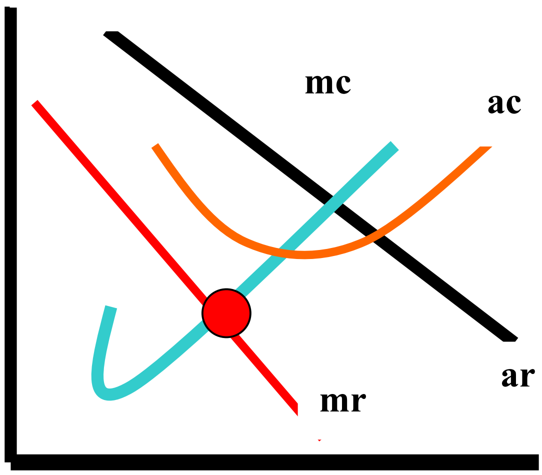
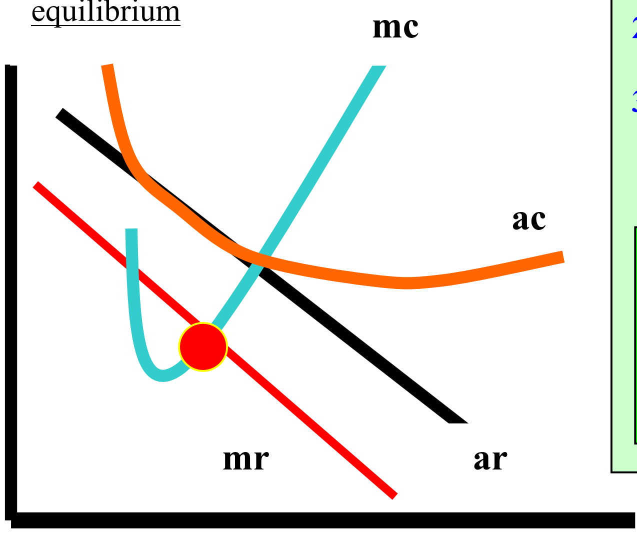


Fig b: momopolistic **long run** p and q equilibrium



Monopolistic : (+)

1. Economies of scale more likely than in PC ie larger firms
2. No S/N profits in the long run – see diag. B
3. Choice (consumer as stakeholder better off)
4. Quality

$mc \neq ac$
$mc \neq ar$

$mc = mr$
$ar = ac$

Monopolistic : (-)

1. May not enjoy cost advantages of large scale production
2. Poor allocation e.g. advertising is wasteful
3. Productively inefficient – not at lowest point of AC
4. Compared to PC price is higher and output lower
5. advertising wasteful

[1] 1 of 1
[2] Diagrams not required for SL