Monopolistic Competitors and Entry

If one monopolistic competitor earns positive economic profits, other firms will be tempted to enter the market. A gas station with a great location must worry that other gas stations might open across the street or down the road—and perhaps the new gas stations will sell coffee or have a carwash or some other attraction to lure customers. A successful restaurant with a unique barbecue sauce must be concerned that other restaurants will try to copy the sauce or offer their own unique recipes. A laundry detergent with a great reputation for quality must be concerned that other competitors may seek to build their own reputations.

The entry of other firms into the same general market (like gas, restaurants, or detergent) shifts the demand curve faced by a monopolistically competitive firm. As more firms enter the market, the quantity demanded at a given price for any particular firm will decline, and the firm’s perceived demand curve will shift to the left. As a firm’s perceived demand curve shifts to the left, its marginal revenue curve will shift to the left, too. The shift in marginal revenue will change the profit-maximizing quantity that the firm chooses to produce, since marginal revenue will then equal marginal cost at a lower quantity.

Figure 10.4 (a) shows a situation in which a monopolistic competitor was earning a profit with its original perceived demand curve (D0). The intersection of the marginal revenue curve (MR0) and marginal cost curve (MC) occurs at point S, corresponding to quantity Q0, which is associated on the demand curve at point T with price P0. The combination of price P0 and quantity Q0 lies above the average cost curve, which shows that the firm is earning positive economic profits.

Unlike a monopoly, with its high barriers to entry, a monopolistically competitive firm with positive economic profits will attract competition. When another competitor enters the market, the original firm’s perceived demand curve shifts to the left, from D0 to D1, and the associated marginal revenue curve shifts from MR0 to MR1 (as shown in figure 10.4a). The new profit-maximizing output is Q1, because the intersection of the MR1 and MC now occurs at point U. Moving vertically up from that quantity on the new demand curve, the optimal price is at P1.
As long as the firm is earning positive economic profits, new competitors will continue to enter the market, reducing the original firm’s demand and marginal revenue curves. The long-run equilibrium is shown in the figure at point V, where the firm’s perceived demand curve touches the average cost curve. When price is equal to average cost, economic profits are zero. Thus, although a monopolistically competitive firm may earn positive economic profits in the short term, the process of new entry will drive down economic profits to zero in the long run. Remember that zero economic profit is not equivalent to zero accounting profit. A zero economic profit means the firm’s accounting profit is equal to what its resources could earn in their next best use. Figure 10.4 (b) shows the reverse situation, where a monopolistically competitive firm is originally losing money. The adjustment to long-run equilibrium is analogous to the previous example. The economic losses lead to firms exiting, which will result in increased demand for this particular firm, and consequently lower losses. Firms exit up to the point where there are no more losses in this market, for example when the demand curve touches the average cost curve, as in point Z.

Monopolistic competitors can make an economic profit or loss in the short run, but in the long run, entry and exit will drive these firms toward a zero economic profit outcome. However, the zero economic profit outcome in monopolistic competition looks different from the zero economic profit outcome in perfect competition in several ways relating both to efficiency and to variety in the market.

**Self Check: Short Run and Long Run Equilibrium**

Answer the question(s) below to see how well you understand the topics covered in the previous section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

You’ll have more success on the Self Check if you’ve completed the Reading in this section.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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