1. Is monopolistic competition efficient?

*Answers may include:*

Monopolistic competition occurs when there are many firms producing differentiated products. The firms face a downward sloping demand curve and there is freedom of entry and exit in the long run.

In the long run the firms in monopolistic competition make normal profit. They are allocatively inefficient because the price paid is greater than the marginal cost of production. On this unit the extra benefit exceeds the extra cost and therefore to increase the welfare of society it should be produced and the firm should expand up to the point where the price equals the marginal cost.

The firms in monopolistic competition are also productively inefficient. This is because they are not selling at the output level where the cost per unit is minimized. To reach this output the firms would need to sell more and this would involve lowering the price on the next units and all the units before. The effect would be to reduce profits. Monopolistic competitive firms are therefore productively and allocatively inefficient.

2. What determines the price and output outcomes in an oligopoly?

*Answers may include:*

Oligopoly occurs when a few large firms dominate the market. In this situation each business will consider the potential actions of other firms. The price and output outcomes depend on the assumptions made about the behavior of each firm.

For example if we assume that firms collude then result will be the price and output outcomes of a monopoly. Each business would then be set a quota to sell at the given price. Alternatively in the kinked demand curve model it is assumed that if a firm increases its price it is not followed by competitors but if it cuts price it is followed. This means demand is price elastic for a price increase and price inelastic for a price decrease; this means there is little incentive to change price because revenue will fall and the result is that prices remain “sticky”.

The importance of the assumptions about other firms is shown in game theory which examines the outcomes based on your views of rivals. A maximin strategy, for example, assesses the worst possible outcomes of different strategies and then tries to maximize and find the best of these.

There are, therefore, many price and output outcomes depending on the assumptions made.

3. Is profit-maximizing behaviour likely?

*Answers may include:*

Profit maximizing price and output occurs at the output level where the marginal revenue equals the marginal cost. This maximizes the difference between total revenue and total
cost. This maximizes the financial rewards for investors and provides funds for investment. This may be an aim of managers and/or they may be pushed to achieve this position by investors. However in reality this position may not be reached:

- Difficulties gathering information may mean that managers do not actually know the exact point where MR=MC; they may be moving towards it but not be at the precise output required
- There may be many different interest groups within the business and managers may have to “satisfice” these different groups rather than maximise profits
- The rewards of the managers may be linked to sales or the size of the business meaning managers focus more on revenue or growth than profit
- Pressure for socially responsible behavior may mean managers move away from profit maximization because of their concern for the environmental or social issues