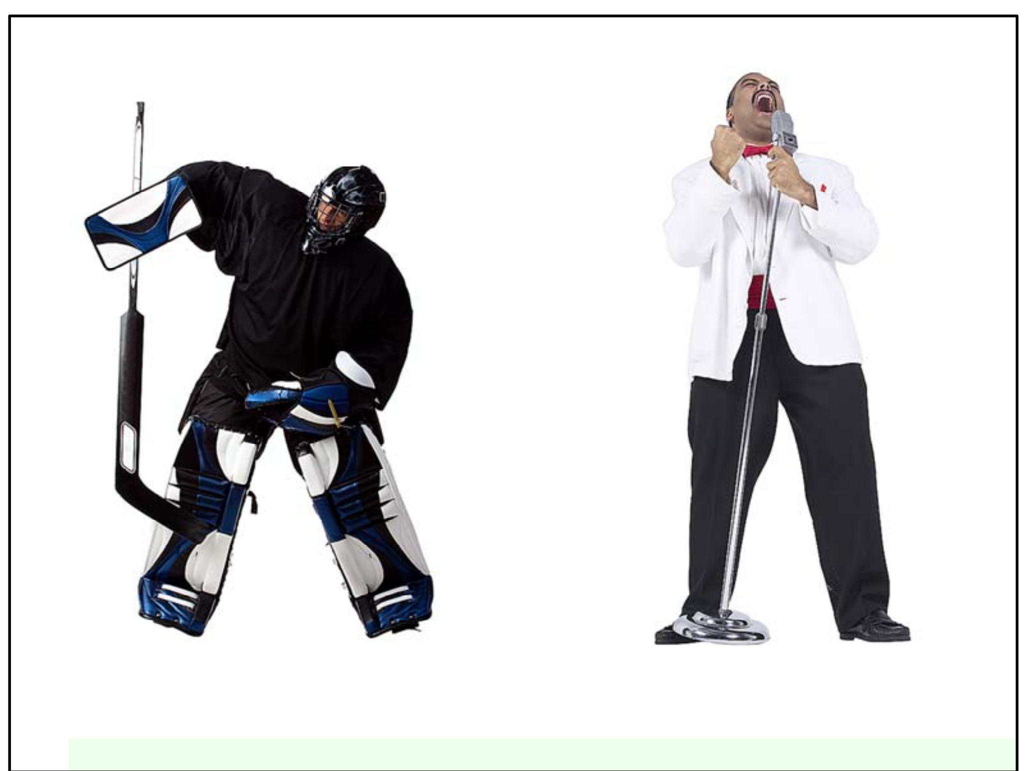
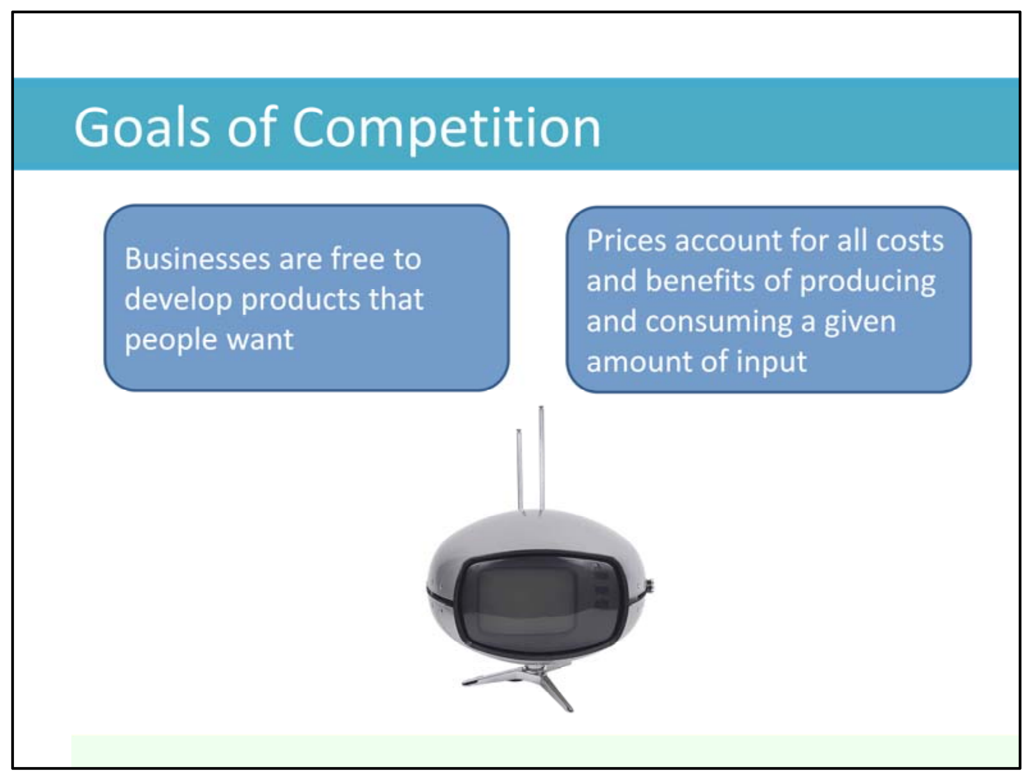


Every kind of competition involves one or more parties trying to win by being better than the rest. It's the same for basketball teams, singers on American Idol, or businesses in a market economy. While athletes and singers may be competing for bragging rights or prize money, what are businesses competing for? Your hard-earned money.

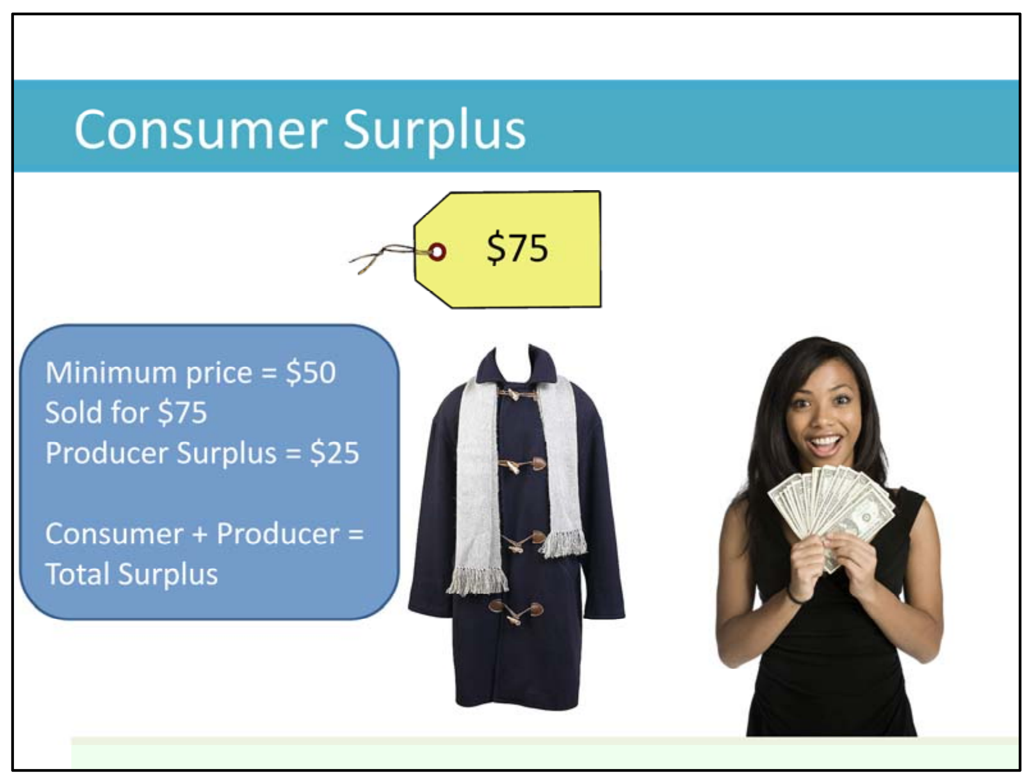
Competition among businesses has two great outcomes for consumers.

First, businesses produce at the lowest possible cost. Since businesses exist to make profits, they have to be able to sell their goods at a price that covers their costs plus some extra for profit. In a competitive market, other businesses are creating the same or similar products, so each business must be as cost efficient as possible: waste and inefficiency cost money and lower profits. The company that produces the best product for the lowest cost will sell the most products.

Second, competitive markets adjust production based on supply and demand, which ensures that goods are being produced at the lowest possible cost and are items that people want. They only make as many products as they can sell, which maximizes the returns on our limited supply of resources.



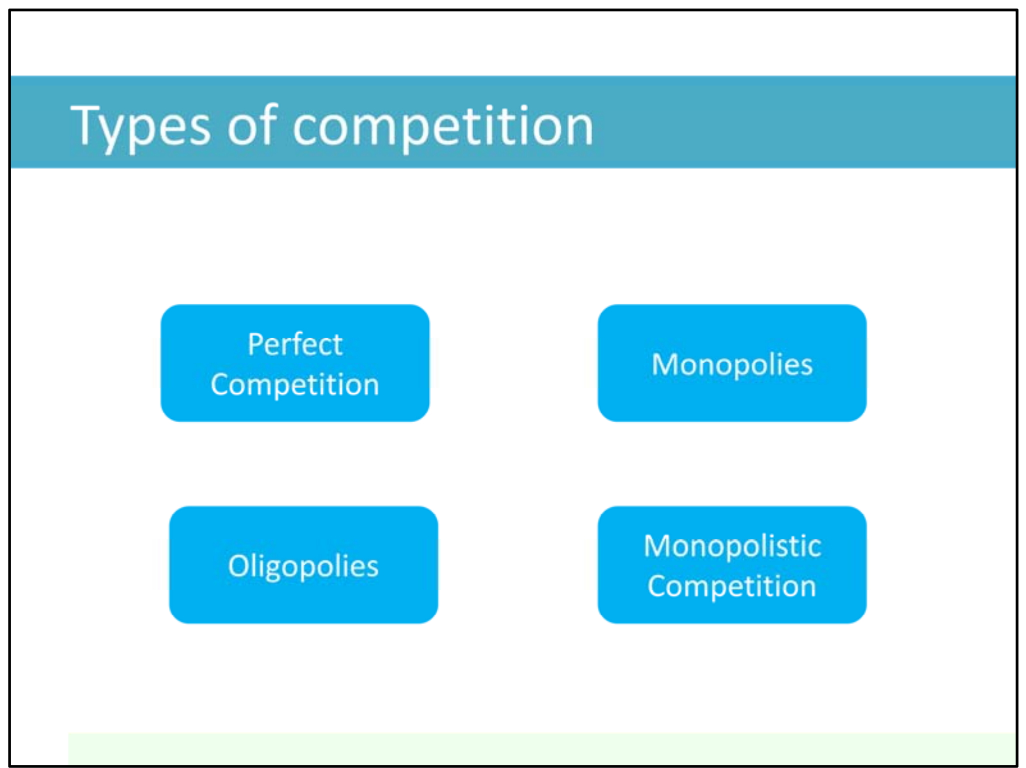
Competitive markets have two broad goals: to guarantee that businesses are free to develop products that people want, and that the prices for these goods take into account all costs and all benefits of producing and consuming a given amount of input. Businesses in a competitive market operate under the price-taking assumption because, basically, they have to accept the price that people are willing to pay. In a competitive market, no one seller is big enough to set the price for a good. This doesn't mean you can just walk into a store and tell them the price you want to pay. It means the price for an item reflects what most people will pay. If one store or manufacturer has a higher price, consumers will go to the competition. By shopping around, you are choosing the best price because you want to keep as much money in your pocket as possible.



What happens when you find an item for less than you were willing to pay? Let's say you need a new coat, and you have one hundred dollars saved to buy one. There's a big sale at Macy's and you find exactly the coat you want for seventy-five dollars. The extra twenty-five dollars that you were ready to spend, but didn't have to, is called the consumer surplus.

How does the producer measure surplus? Suppose the company that made your coat had a minimum price of fifty dollars in order to cover all costs and make a profit. When you bought the coat for seventy-five dollars, the difference between their lowest acceptable price and the price for which they actually sold the product is twenty-five dollars, which is the producer surplus.

You add together the consumer and producer surplus to come up with the total surplus. Because both you and the coat manufacturer had a surplus of twenty-five dollars, the total surplus that society receives from producing at the socially-optimal level of output is fifty dollars. Competition allocates this surplus between consumers and businesses so that both benefit.



Up until now, we've been talking about competition within the marketplace as if there were only one type, when if fact there are four basic types we'll discuss in this lesson:
- perfect competition
- monopolies
- oligopolies
- monopolistic

On your way home from school, you stop by the store to buy some milk. Milk is milk: you pick up a gallon and get moving.
Did you know you could get into the milk business if you had a dairy cow in your backyard? There are over sixty-five thousand dairy farmers in this country ranging from huge producers to very small farmers. Milk producers are a good example of perfect competition, which is a concept that economists use as the model for competitive markets.

Perfectly competitive markets have three characteristics:

- All producers sell identical products. Milk is milk. When it comes out of the cow, it's just like the milk from the cow down the street or across the country.

- Because there are very few barriers for producers to start making the product, there are lots of producers, and no one can influence prices. As we just said, there are thousands of dairy farmers, so none of them can affect prices on their own. It's easy to get into the dairy business, you just need a cow or two, some land and some hands to do the milking. A local milk processor will gladly buy your milk – even in small quantities. There are no strict controls over who owns cows, and you don't need any expensive technology or training.

- Buyers have perfect information, meaning that they can easily access information about prices and products. In this case, the buyer is the local milk processor that buys the milk from producers. The processor knows what prices other processors are paying for milk, and they know the product since it's all identical.

Why is perfect competition good for consumers and producers?

It's very efficient. Producers don’t make more than they can sell, or they'll lose money. Consumers don’t pay more for a product than it is worth. If the price starts to rise, more producers will enter the market thereby lowering the price.

The outcome is that each firm produces the goods that consumers want in the largest quantity for the lowest possible cost.

Perfect competition is the standard for measuring all other markets. For economists it is the best market. It is “perfect”.

What happens when there is only one business in an industry? We call this a monopoly. Are monopolies good or bad? It depends on the industry and the company's ability to set prices.

When a company has a monopoly and can raise prices or reduce supply to get more money out of consumers, this is an example of a bad monopoly. These kinds of companies are often costly, and inefficient. Why should a company care if it wastes materials or spends lots of money to produce goods? It can just raise prices because there is nowhere else for you to buy that product, or flood the market with low priced goods to keep competitors out of the market. Monopolies charge more, produce less, and produce at higher costs than competitive businesses. Keep in mind though, that companies with a monopoly aren't guaranteed a profit. They have to produce something that people want!

Beneficial Monopolies

Patents give inventors exclusive rights to sell and market their inventions for twenty years.

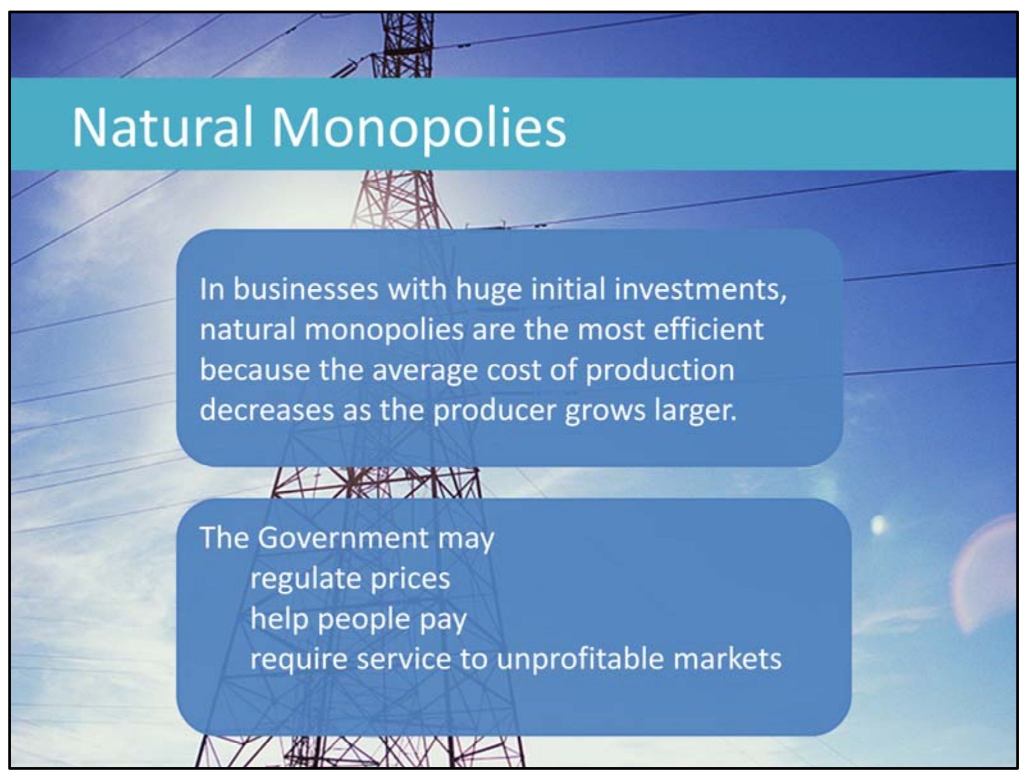
Results in faster innovation, rapid economic growth, higher standards of living. Society benefits greatly from patent monopolies

Monopolies aren't all bad though. Remember when we talked about patents? Patents give inventors exclusive rights to sell and market their inventions for twenty years without having to worry about someone else stealing their ideas and flooding the market with copies, which would reduce the price.

After twenty years, their inventions become public property, so basically they have a monopoly for twenty years. Patent monopolies ensure that inventors are rewarded for time, energy, and money they spent to develop their ideas. Countries all over the world have patent monopolies for their inventors. The result is faster innovation, much more rapid economic growth, and much faster increases in standards of living. Society benefits greatly from patent monopolies.

Government-supported monopolies for utilities are also common.

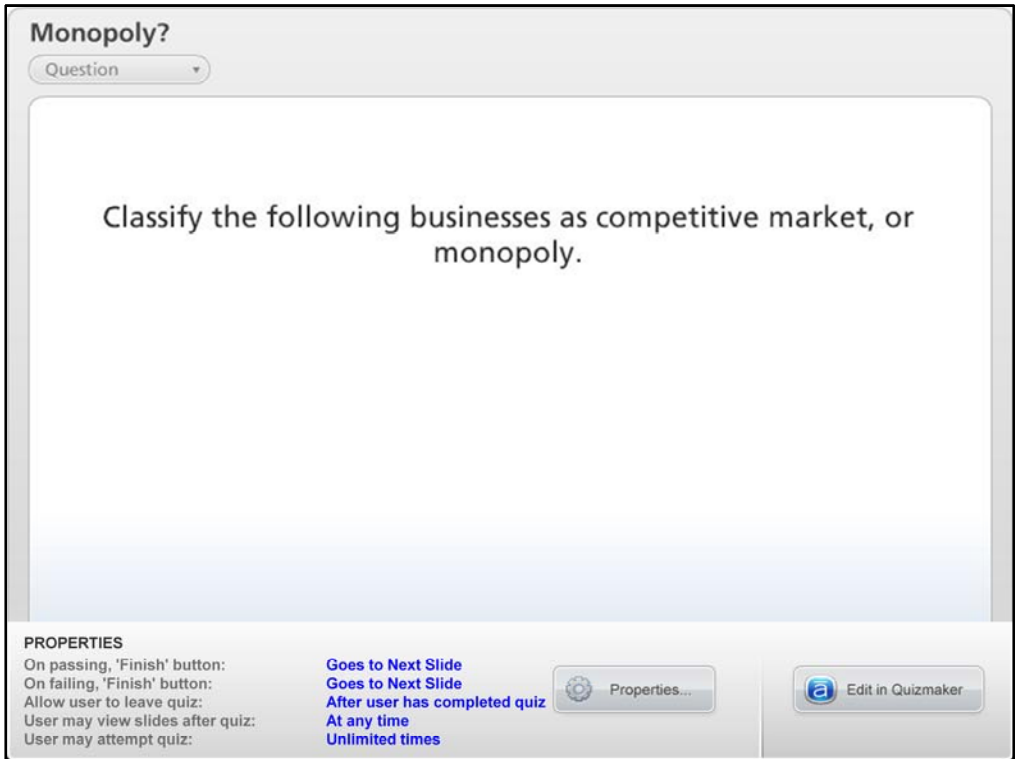
Think of natural gas. How many companies provide this service in your neighborhood? Since there's only one set of gas pipes to people's houses, there can only be one provider: Virginia Natural Gas. Having more than one provider would require more pipes, which would be wasteful. In order to ensure that they don't overcharge for the gas, the state set up a commission to set rates for gas prices.



Natural monopolies occur when the biggest company in an industry, has a huge cost advantage over their competitors. Think of the electric company. It costs so much to build a power plant and install the electricity lines that the company who builds these first can deliver the electricity much cheaper. No competitors bother to enter the market because they are sure to fail.

In businesses with huge initial investments, natural monopolies are the most efficient because the average cost of production decreases as the producer grows larger. As the electric company produces more power and services more customers, the cost to produce power gets cheaper on average.

In order to keep natural monopolies from over charging, as in government-sponsored monopolies, the government regulates the prices for their products, or may force these businesses to break into smaller units if they get too large. The government may also help people pay for these services if they can't afford them. For example, people may get help paying their heating bill, so they don't have to choose between eating and staying warm. The government may also require these businesses to serve unprofitable markets. For example, providing phone service to people in rural areas can be expensive, so phone companies collect extra fees from their customers in order to make phone service cheaper for less populated areas.


Monopoly?
Question
Classify the following businesses as competitive market, or monopoly.
PROPERTIES
On passing, 'Finish' button:
Goes to Next Slide
On failing, 'Finish' button:
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Allow user to leave quiz:
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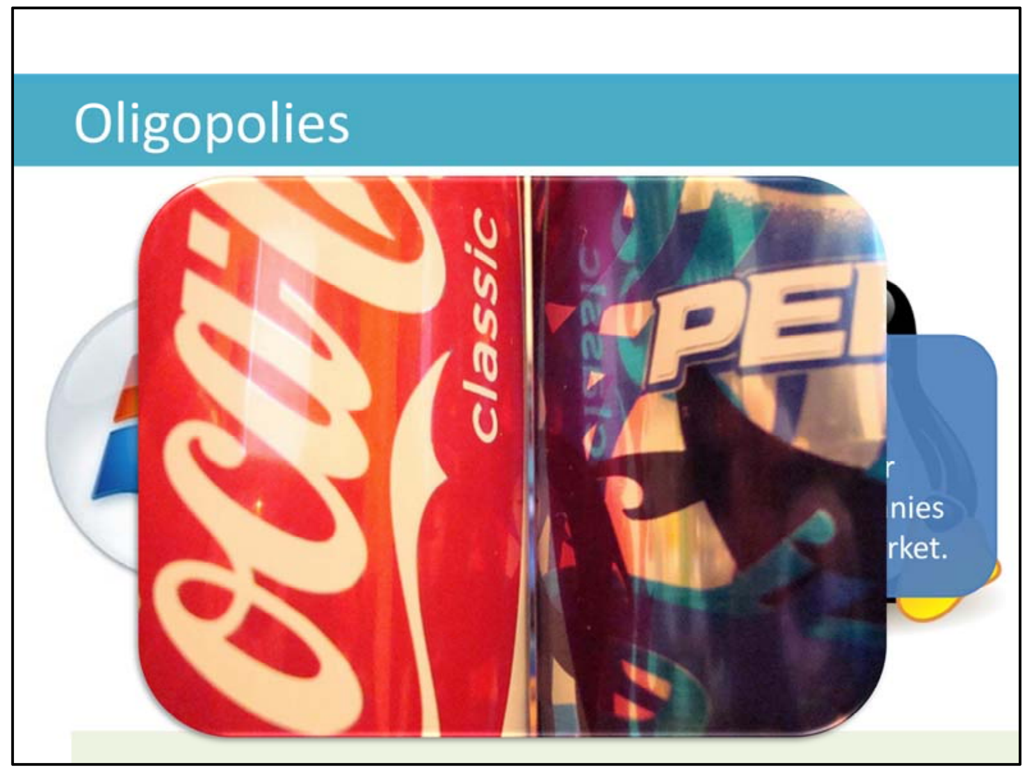
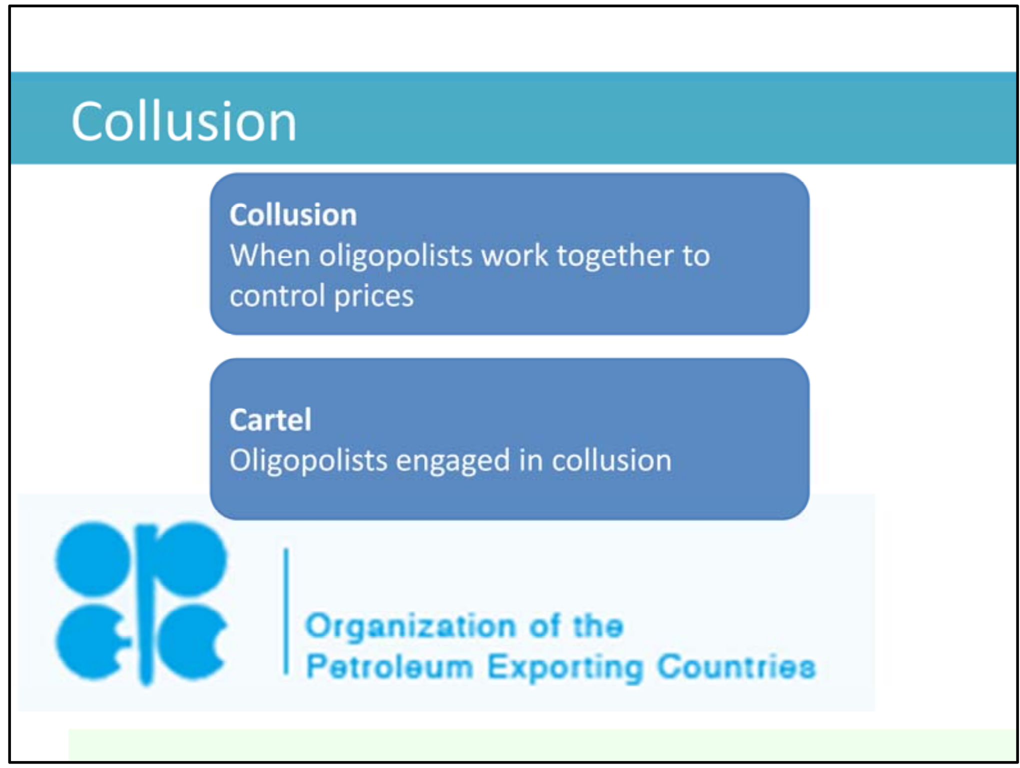


If you were going to buy a new computer, what operating system would you choose? Microsoft Windows®? Apple OS? The market for operating systems is basically controlled by two companies. You could install Linux on your computer for free, but that will limit your ability to run all kinds of software. When two or three companies control a market, this is called an oligopoly and the companies are oligopolists. Some other examples are cable TV providers, oil companies, soft drinks, and video game consoles.

Oligopolies are interesting because they are usually either fiercely competitive with one another or they unite to behave like a monopoly to dominate the market. Remember, in competitive markets, there are lots of companies producing similar goods, so one or two can't control prices. Oligopolies can have a powerful effect on prices because each one produces enough of the total output to be able to affect the market price.

Look at Coke and Pepsi, which pretty much own the cola market. Suppose Pepsi decides to increase their supply and flood the market. Pepsi would have to drop their prices to sell the extra cola. Coke would either have to lower its price, or people might just buy Pepsi because it's cheaper; therefore, the cost of Coke would drop, too. Pepsi and Coke can affect each other's sales by flooding the market, dropping their prices, or cutting back on production to cause a shortage.



While Pepsi and Coke are fierce competitors, sometimes oligopolies try to work together to raise prices. This is called collusion. Obviously, collusion is bad for consumers because they have to pay higher prices for the same goods, while competition drives the prices down.

Fortunately, collusion doesn't happen very often. It requires a lot of coordination among the firms. They have to agree on how much each company gets to produce, and also on how to share the profits. Even though it may seem like cell phone companies or cable TV providers collude to set prices, their prices are about the same because of competition, not collusion.

When oligopolies collude, they are called a cartel. The most famous cartel is OPEC, or the Organization of Petroleum Exporting Countries. OPEC sets oil export levels for each member country to ensure that the price of oil stays high. Although collusion is illegal in the U.S., the U.S. doesn't belong to OPEC, nor do its laws apply to this organization.

The government faces difficult decisions with oligopolies: should they leave them alone, regulate them or break them up to promote competition. Since oligopolies can be highly competitive, usually there has to be strong proof of collusion for the government to break up the company. The government will look at the circumstances and decide what is best to promote the general welfare of the public.

Summary

- Competition produces goods that people want at the lowest price.
- Companies have to consider what people want, and what they'll pay, or else the company will go out of business.
- For monopolies, the government sets prices
- When oligopolists dominate a market, the government may intervene

As we've just seen, competition is good for us as consumers because we get the things we want to buy at the lowest price. When companies compete for our business, they have to consider what people will want, and how much they're willing to pay, or else the company will go out of business. In instances where there are monopolies, the government often has a role in setting the prices for these products to keep these businesses from overcharging. Finally, when there are only a couple of businesses that dominate a market, the government may have to intervene if these businesses aren't setting prices competitively.

Competition is the underlying framework for market economies and crucial to keeping them strong.