The simplest market structure to study is known as perfect competition. In such a market, every firm produces the same product for about the same price. Because each firm produces a small part of the total supply, no one firm can control the price. In order to have perfect competition a market must meet four conditions. It must have many buyers and sellers participating. Sellers must offer identical products. Buyers and sellers must be well informed about the products. Sellers must be able to enter and leave the market easily.

Only a few industries come close to meeting these conditions. Two examples are the market for farm products and the stocks traded on a stock exchange.

Factors that make it difficult for new firms to enter a market are called barriers to entry. Common barriers to entry include start-up costs and technology. Start-up costs are the expenses an owner has to pay before opening a new business. For example, before starting a new sandwich shop you would have to rent a store, buy cooking equipment, and print menus. Other businesses require technical ability. Carpenters, pharmacists, or electricians need training before they can have the skills they need.

Perfectly competitive markets are efficient. The intense competition in these markets keeps both prices and production costs low. A firm that raised its prices higher than other firms, or experienced higher production costs, would not be able to compete.

**REVIEW QUESTIONS**

1. What are two common barriers to entry?

2. Chart Skills How much variety of goods is there in perfect competition?
A **monopoly** is a market dominated by a single seller. Instead of many buyers and sellers, as is the case with perfect competition, a monopoly has one seller and any number of buyers. Barriers to entry make monopolies possible. Monopolies can take advantage of their monopoly power and charge high prices. For this reason, the United States has outlawed monopolistic practices in most industries.

The government allows monopolies in certain industries. A **natural monopoly** is a market that runs most efficiently when one large firm provides all the output. In the local telephone industry, a monopoly developed because it was inefficient for more than one company to build an expensive wire network. In such cases, the government may give one company the right to dominate a geographic area. In return, that company will agree to let the government control its prices.

The government can also grant monopoly power by issuing patents or licenses. A **patent** gives a company exclusive rights to sell a new good or service for a specific time period. A **license** is a government-issued right to operate a business. Radio licenses give a station the right to broadcast at a certain frequency.

Unlike firms in perfectly competitive markets, monopolists have control over prices. However, the law of demand means that when the monopolist raises the price, it will sell fewer goods. So the monopolist sets a price that maximizes its profit. This usually means fewer goods, at a higher price, than would be sold in a more competitive market.

**Review Questions**

1. Name two ways in which government can grant a monopoly.
2. Chart Skills How much control does a monopolist have over pricing?
Perfect competition and monopoly are the two extremes in the range of market structures. Most markets fall into two other categories: monopolistic competition and oligopoly. Monopolistic competition is a market in which many companies sell products that are similar but not identical. For example, jeans can differ in brand, style, and color. Ice cream differs in taste and flavors. These markets are called monopolistic competition because each firm has a kind of monopoly over its own particular product. Monopolistic competition exists in industries where there are low barriers to entry.

Firms that are monopolistically competitive have slight control over their prices, because they offer products that are slightly different from any other company’s. They also use nonprice competition, or competition through ways other than lower prices, to compete. They may offer new colors, textures, or tastes in their products. They may also try to find the best location for their services.

Oligopoly is a market dominated by a few large firms. It can form when significant barriers to entry exist. Examples of oligopolies in the United States include air travel, cola, breakfast cereals and household appliances. Oligopolistic firms sometimes use illegal practices to set prices or to reduce competition. They may engage in price fixing, an agreement among firms to sell at the same or very similar prices. Price fixing is illegal in the United States and can lead to heavy penalties.

**GRAPHIC SUMMARY: Comparison of Market Structures**

<table>
<thead>
<tr>
<th></th>
<th>Perfect Competition</th>
<th>Monopolistic Competition</th>
<th>Oligopoly</th>
<th>Monopoly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of firms</td>
<td>Many</td>
<td>Many</td>
<td>Two to four dominate</td>
<td>One</td>
</tr>
<tr>
<td>Variety of goods</td>
<td>None</td>
<td>Some</td>
<td>Some</td>
<td>None</td>
</tr>
<tr>
<td>Control over prices</td>
<td>None</td>
<td>Little</td>
<td>Some</td>
<td>Complete</td>
</tr>
<tr>
<td>Barriers to entry and exit</td>
<td>None</td>
<td>Low</td>
<td>High</td>
<td>Complete</td>
</tr>
<tr>
<td>Examples</td>
<td>Wheat, shares of stock</td>
<td>Jeans, books</td>
<td>Cars, movie studios</td>
<td>Public water</td>
</tr>
</tbody>
</table>

The two most common market structures, monopolistic competition and oligopoly, fall between the two extremes of perfect competition and monopoly.

**REVIEW QUESTIONS**

1. What is the difference between monopolistic competition and oligopoly?

2. Chart Skills How many firms are typical of an oligopoly?
Monopoly and oligopoly can sometimes have negative effects on consumers and our whole economy. Markets dominated by only a few large firms tend to have higher prices and lower output than markets with many sellers. A firm with monopoly power can use predatory pricing. This is the practice of setting the market price below cost to drive competitors out of business. Another way firms try to reduce competition is by buying out their competitors.

Since the late 1800s, the United States has had antitrust laws to prevent companies from reducing competition. It is the job of the Federal Trade Commission and the Department of Justice's Antitrust Division to enforce these laws. The government also tries to prevent mergers that might reduce competition and lead to higher prices. A merger is when two or more companies join to form a single firm.

In the 1970s and 1980s, Congress passed laws leading to the deregulation of some industries. Deregulation is the lifting or reducing of government controls over a market. Markets experiencing deregulation included the airline, trucking, banking, railroad, natural gas and television broadcasting industries. When it is successful, deregulation increases competition and leads to lower prices for consumers. However, it may often cause hardship for employees of companies driven out of business by increased competition.

Antitrust laws strengthen government control over a market. Deregulation loosens government control. Yet both policies have the same purpose: to promote competition.

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1911</td>
<td>Supreme Court breaks up John D. Rockefeller's monopoly, Standard Oil.</td>
</tr>
<tr>
<td>1982</td>
<td>Facing government lawsuit, AT&amp;T agrees to end its monopoly over local phone service.</td>
</tr>
<tr>
<td>1999</td>
<td>Federal judge rules that Microsoft is a monopoly and begins taking steps to weaken the company.</td>
</tr>
</tbody>
</table>

In the twentieth century the federal government took several significant actions to increase competition in certain industries.

**Review Questions**

1. What is predatory pricing?
2. Chart Skills In what year did AT&T agree to break up its local phone service monopoly?
CHAPTER 7  Test

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

1. A market structure with many sellers and many buyers is
   A. an oligopoly.  
   B. monopolistic.  
   C. perfect competition.  
   D. nonprice competition.

2. An example of a barrier to entry is
   A. high start-up costs.  
   B. low start-up costs.  
   C. a market with imperfect competition.  
   D. government deregulation.

3. A market that is a monopoly has
   A. many buyers and sellers.  
   B. many firms selling slightly different products.  
   C. three or four firms dominating the market.  
   D. one seller and many buyers.

4. A natural monopoly is a market that runs most efficiently when it has
   A. few sellers and only one buyer.  
   B. many sellers and many buyers.  
   C. one large firm providing all output.  
   D. few government regulations.

5. Compared to a market with perfect competition, a monopoly has
   A. lower prices and fewer goods.  
   B. higher prices and fewer goods.  
   C. lower prices and more goods.  
   D. higher prices and more goods.

6. Offering products of different tastes and shapes is an example of
   A. perfect competition.  
   B. oligopolistic competition.  
   C. the law of demand.  
   D. nonprice competition.

7. A market that is an oligopoly has
   A. many buyers and sellers.  
   B. many firms selling slightly different products.  
   C. a few firms dominating the market.  
   D. one seller and many buyers.

8. Which of the following industries is not an example of an oligopoly?
   A. automobile repair  
   B. cola  
   C. air travel  
   D. breakfast cereals

9. One role of the federal government’s Justice Department is to
   A. encourage price fixing.  
   B. break up monopolies.  
   C. provide businesses with loans for start-up costs.  
   D. eliminate barriers to entry.

10. In many industries, deregulation has resulted in
    A. safer products.  
    B. antitrust laws.  
    C. lower prices for consumers.  
    D. increased government control.