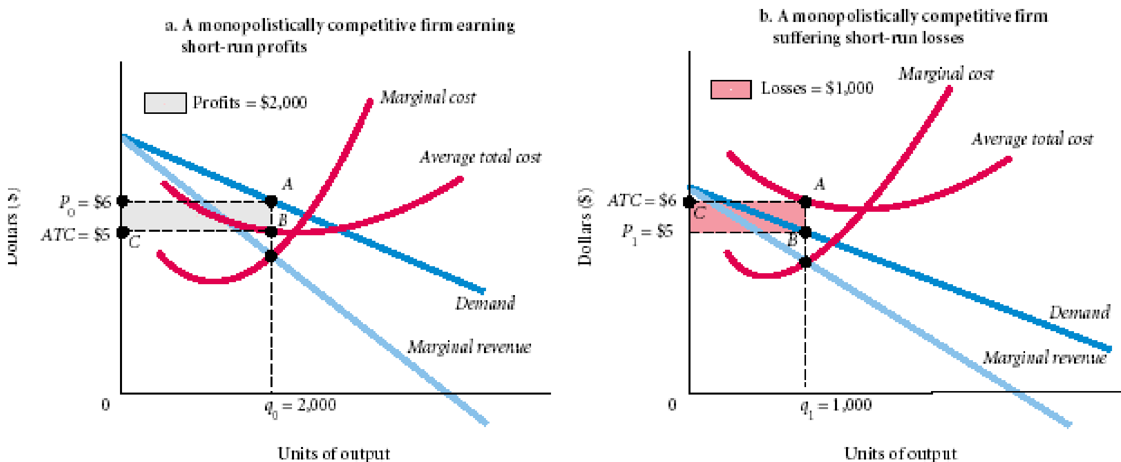
Monopolistic competition is a form of imperfect competition where many competing producers sell products that are differentiated from one another (that is, the products are substitutes, but, with differences such as branding, are not exactly alike). In monopolistic competition firms can behave like monopolies in the short-run, including using market power to generate profit. In the long-run, other firms enter the market and the benefits of differentiation decrease with competition; the market becomes more like perfect competition where firms cannot gain economic profit.

The Advantages of Monopolistic Competition

1. Pricing. The ability to set higher prices is a primary advantage of monopolistic competition. These companies can determine the item's price points, which tend to be much higher than perfectly competitive industries by virtue of their branding efforts. Monopolistic competition is one reason prescription drugs can be costly. Because companies are awarded patents for pharmaceutical innovations, they capitalize on this monopoly by charging high prices. These high prices are in part to recoup the expensive research and development costs, but they are also high because of the lack of competition from other drug companies. When the patent is lifted, companies must purchase extensive advertising. In this stage, the business must convince consumers their drug is somehow different despite the drug containing the same properties as its generic counterparts.
2. Product Quality and Development. An advantage of monopolistic competition is that it enhances a firm's ability to improve a product's quality through its brand.
3. Price Discrimination. Monopolies can engage in price discrimination, which is charging different prices to different consumer groups. Companies in a monopoly have the option of determining which customers receive discounts or premiums on goods and services, such as senior citizens or students receiving discounts.
4. Considerations. Though companies gain significant advantages from engaging in monopolistic competition, consumers experience no such benefits. Branding does not always signal the best value, as similar products perform similar functions as other goods at a fraction of the price. Additionally, price discrimination reduces consumer surplus. In the case of regressive price discrimination or, charging the poor at a higher percent than the wealthy, social welfare is reduced, as well.

Since the firm has a downward-sloping demand curve, it will also have a downward-sloping marginal revenue (MR) curve. A profit-maximizing firm produces where marginal cost (MC) equals marginal revenue (q0 in the graph below) and charges the price determined by demand (P0).



In panel (a) of the figure, the monopolistic competitor will make a profit. However, like a monopoly, a monopolistic competitor is not guaranteed to make a profit in the short run. The firm may make a loss in the short run; its profitability will depend on the demand. This is shown in panel (b).