

Quadrant II - Notes

Paper Code: ECC102

Module Name: Social cost, excess capacity, economic efficiency and resource allocation under monopolistic competition

Module No: 18

In monopolistic competition there are large numbers of sellers and they sell differentiated products. If a firm working under monopolistic competition wants to increase the sales of its products it has to lower its price. On the other hand, it can increase its price if it is ready to lose some of its customers. The demand curve of the firm in monopolistic competition is downward sloping. The average revenue curve is also the demand curve of the firm. The Marginal revenue curve slopes downward and is below the average revenue curve.

The short run equilibrium of the firm in monopolistic competition is at the point where marginal revenue is equal to marginal cost. In the long run, equilibrium of the firm is at the point where the long run average cost is tangent to the AR curve. The price is above AC because the firm is producing at the falling part of the LAC and not at the minimum point of LAC.

The distance between the tangency of LAC to AR and the minimum point of LAC measures the excess capacity. The firm is not producing at the minimum point of LAC because if it does so, it will get lower price for its commodity. The amount by which the actual long run output of the firm under monopolistic competition falls short of the socially ideal output is a measure of excess capacity which means unutilised capacity.

If the firm had produced at the point where MLC is equal to AR the consumers would have paid a lower price than the existing equilibrium price. But since firm is not producing at this point there is loss of social welfare because the society is paying more for the commodity.

Since under monopolistic competition the firm produces output which is less than socially optimum there is economic inefficiency i.e they do not produce the level of output at which the LAC is minimum.