The Four Types of Market Structures

There are quite a few different market structures that can characterize an **economy**. There are four basic types of market structures: **perfect competition**, **monopolistic competition**, **oligopoly**, and **monopoly**. Each of them has their own set of characteristics and assumptions, which in turn affect the **decision making** of firms and the **profits** they can make.

It is important to note that not all of these market structures actually exist in reality, some of them are just **theoretical** constructs. Nevertheless, they are of critical importance, because they can illustrate relevant aspects of competing firms' decision making. Hence, they will help you to understand the **underlying** economic principles.

Perfect Competition

Perfect competition describes a **market structure**, where a large number of small firms compete against each other. In this scenario, a single firm does not have any **significant** market power. As a result, the industry as a whole produces the socially optimal level of output, because none of the firms have the ability to **influence** market prices.

The idea of perfect competition builds on a number of assumptions: (1) all firms maximize profits (2) there is free entry and exit to the market, (3) all firms sell completely **identical** (i.e. homogeneous) goods, (4) there are no consumer **preferences**. By looking at those assumptions it becomes quite obvious, that we will hardly ever find perfect competition in reality. This is an important aspect because it is the only market structure that can (theoretically) result in a socially optimal level of **output.**

Probably the best example of a market with almost perfect competition we can find in reality is the **stock market**.

Monopolistic Competition

Monopolistic competition also refers to a market structure, where a large number of small firms **compete** against each other. However, **unlike** in perfect competition, the firms in monopolistic competition sell similar, but slightly **differentiated** products. This gives them a certain degree of market power which allows them to **charge** higher prices within a certain range.

Monopolistic competition builds on the following **assumptions**: (1) all firms maximize profits (2) there is free entry and exit to the market, (3) firms sell differentiated products (4) consumers may prefer one product over the other. Now, those assumptions are a bit closer to reality than the ones we looked at in **perfect competition**. However, this market structure will no longer result in a socially optimal level of output, because the firms have more **power** and can influence market prices to a certain degree.

An example of monopolistic competition is the market for cereals. There is a huge number of different brands (e.g. Cap'n Crunch, Lucky Charms, Froot Loops, Apple Jacks). Most of them probably taste slightly different, but at the end of the day, they are all breakfast cereals.

Oligopoly

An oligopoly describes a market structure which is dominated by only a small number of firms. This results in a state of **limited competition**. The firms can either compete against each other or **collaborate**. By doing so they can use their **collective** market power to drive up prices and earn more profit.

The oligopolistic market structure builds on the following assumptions: (1) all firms maximize profits, (2) oligopolies can **set** prices, (3) there are **barriers** to entry and exit in the market, (4) products may be **homogenous** or differentiated, and (5) there is only a few firms that dominate the market. Unfortunately, it is not clearly defined what a «few» firms means exactly. As a rule of thumb, we say that an **oligopoly** typically consists of about 3-5 dominant firms.

To give an example of an oligopoly, let's look at the market for gaming consoles. This market is dominated by three powerful companies: Microsoft, Sony, and Nintendo. This leaves all of them with a significant amount of market power.

Monopoly

A monopoly refers to a market structure where a **single** firm controls the entire market. In this scenario, the firm has the highest level of market power, as consumers do not have any **alternatives**. As a result, monopolies often **reduce** output to increase prices and earn more profit.

The following assumptions are made when we talk about monopolies: (1) the **monopolist** maximizes profit, (2) it can set the price, (3) there are high barriers to entry and exit, (4) there is only one firm that dominates the **entire** market.

From the perspective of society, most monopolies are usually not desirable, because they result in lower outputs and higher prices compared to **competitive** markets. Therefore, they are often regulated by the **government**.

An example of a **real-life** monopoly could be Monsanto. About 80% of all corn harvested in the US is **trademarked** by this company. That gives Monsanto an extremely high level of market power.